Latham & Watkins Tax Practice and Benefits, Compensation & Employment Practice

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Update: Executive Compensation Ramifications of Proposed Tax Cuts and Jobs Act

Proposed tax reform legislation includes several provisions that will affect the treatment of executive compensation.

Key Points:

- The current House and Senate bills remove the previously proposed Section 409B[1] and therefore nonqualified deferred compensation and equity compensation will generally remain subject to taxation under currently applicable rules under Section 409A and Section 83.
- Otherwise, the current House and Senate bills are similar to the initial House bill, including with respect to its meaningful changes to the Section 162(m) US$1 million executive compensation deduction rules and tax-exempt executive compensation rules.

On December 2, 2017, the US Senate (the Senate) passed its version of the Tax Cuts and Jobs Act (the Senate Bill). With respect to the executive compensation provisions, the Senate Bill generally aligns with the corresponding bill passed by the US House of Representatives (the House) on November 16, 2017 (the House Bill). However, both the Senate Bill and the House Bill differ significantly from the earlier iteration of the House Bill proposed on November 6, 2017 (the Proposed House Bill). For more information on the Proposed House Bill, see Latham's analysis in this November 8, 2017 *Client Alert* (the Prior Alert).

The Prior Alert outlines the proposed Section 409B, which generally would have taxed nonqualified deferred compensation and other incentive compensation (including stock options) upon vesting rather than payment. Neither the Senate Bill nor the House Bill contains proposed Section 409B, however, and thus they effectively preserve the current legal treatment of nonqualified deferred compensation, leaving Sections 409A, 457A, and 457(f) intact.

The House Bill and the Senate Bill retain the newly proposed Section 83(i) contained in the Proposed House Bill, which provides for the deferral of taxation on certain qualified equity grants for up to five years after vesting, but further clarify that restricted stock units are not eligible for elections under Section 83(i). As noted in the Prior Alert, Section 83(i) will likely not be used widely because of its narrow scope.

The House Bill and the Senate Bill preserve the following changes — contained in the Proposed House Bill — to limitations on deductible compensation paid to certain public company executive officers under Section 162(m):

- Repealing exceptions to Section 162(m) for performance-based compensation and commission-based compensation, thereby rendering all compensation paid to a covered employee that is greater than US$1 million per year non-deductible.

- Expanding the scope of covered employees to include the principal financial officer (who is not currently covered), and to provide for continued application for all years in which a covered employee receives any compensation from the company.

- Expanding the scope of corporations for which Section 162(m) would be applicable to include corporations with publicly traded debt. The scope may extend to foreign private issuers as well.

Departing from the House Bill, the Senate Bill provides that the changes to Section 162(m) will not apply to compensation under a written binding contract in effect on November 2, 2017 that is not materially modified after such date.

The House Bill and the Senate Bill, like the Proposed House Bill, also preserve the implementation of an employer excise tax on tax-exempt organizations that provide certain highly-compensated employees with:

- Compensation in excess of US$1 million per year, or

- "Excess parachute payments" — *i.e.*, payments in excess of an employee's average compensation over the prior five calendar years (base amount), triggered if payments to the employee are contingent upon the employee's separation from employment and have an aggregate present value in excess of three times the employee's base amount. This is similar to the Section 280G tax penalties with respect to excess parachute payments paid to employees of for-profit corporations.

The House Bill and the Senate Bill preserve the changes to the taxation of carried interests contained in the Proposed House Bill. The changes provide that certain carried interests issued in exchange for investment services — specifically, raising capital and investing in, disposing of, or developing stock or securities or real estate assets — will not qualify for long-term capital gains treatment unless such interests are held for at least three years. The House Bill and the Senate Bill generally do not, however, affect the beneficial tax treatment associated with profits interests issued in exchange for other types of services.

Unless the House votes to approve the Senate Bill in its entirety, a Conference Committee of House and Senate members will meet to reconcile differences between the House and Senate Bills. The House and Senate then will vote on the Conference Report that emerges from this Committee. In the Senate, only a simple majority vote is required for passage due to application of special budget reconciliation rules. Provided the Conference Report passes both the House and the Senate, it will proceed to the President for his signature. Latham will continue to monitor the bills' progress and issue updates on any developments.

This *Client Alert* addresses the aspects of proposed tax reform that impact executive compensation. For a broader discussion of other specific provisions in the House and Senate bills see Latham's *Client Alert* Congressional Tax Reform Proposals: Businesses Will Need to Rethink Key Decisions, and visit Latham's US Tax Reform Resource Center for subsequent developments.

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Endnote

1 All references to "Section" refer to sections of the Internal Revenue Code of 1986, as amended.