New Tax Reform Bill – Major Changes to Executive Compensation Lead Impact on Benefits and Compensation Practices

Published: November 8, 2017

The "Tax Cuts and Jobs Act" (the "Tax Bill"), introduced by House Republicans on November 2, 2017, contains many provisions that, if enacted, would result in significant changes in the way employers hire, compensate and provide benefits to employees, especially executives. Additional proposals would (i) reduce tax rates on most individuals, (ii) increase tax rates on the highest earners, (iii) reduce corporate tax rates, and (iv) reduce or eliminate many commonly used deductions, exemptions and credits. Some key domestic tax provisions of the bill are summarized in the following sections ***(you may click on any of the listed sections to go directly to that section)***.

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<tr><th>Tax Feature</th><th>Terms of Tax Provision</th></tr>
<tr><td colspan="2">I. Individual Tax Provisions</td></tr>
<tr><td>Individual Tax Rates and Brackets</td><td>Seven brackets (10%, 15%, 25%, 28%, 33%, 35% and 39.6%) would be consolidated into four brackets, as indicated below:
<table><tr><th>Rates</th><th>Single</th><th>Married, Filing Jointly</th></tr><tr><td>12%</td><td>Less than $45K</td><td>Less than $90K</td></tr><tr><td>25%</td><td>$45K</td><td>$90K</td></tr><tr><td>35%</td><td>$200K</td><td>$260K</td></tr><tr><td>39.6%</td><td>$500K</td><td>$1M</td></tr></table>In addition, the lowest bracket would be phased out for individuals with taxable income over $1M and joint filers with taxable income over $1.2M. This means that these single filers will pay a "bubble tax" of 45.6% on the first $207,000 over $1M, and joint filers will pay a "bubble tax" of 45.6% on the first $414,000 over $1.2M.</td></tr>
<tr><td>Standard Deduction and Personal Exemptions</td><td>The personal exemption would be eliminated, and the standard deduction would be significantly increased.
This change would result in fewer taxpayers itemizing their deductions.</td></tr>
<tr><td>Alternative Minimum Tax</td><td>The alternative minimum tax would be repealed.</td></tr>
<tr><td>Expanded Child Tax Credit and New Family Tax Credit</td><td>To replace personal exemptions for children, the proposed legislation would increase the child credit from $1,000 to $1,600, allow a non-refundable credit of $300 for non-child dependents, and introduce a family credit of $300. The current phase-out limitations based on income would also increase.</td></tr>
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<tr><th>Tax Feature</th><th>Terms of Tax Provision</th></tr>
<tr><td>Elimination of Certain Other Nonrefundable Credits</td><td>Credits for age 65, disability retirement, adoption expenses, mortgage credit certificates and plug-in electric drive motor vehicles would be eliminated.</td></tr>
<tr><td>Changes to Deductions</td><td>
The cap on itemized deductions would be eliminated.
The mortgage interest deduction would be limited to a maximum loan amount of $500,000 on principal residences only (i.e., not on second homes), and no deduction would be allowed for home equity loans.
Changes to charitable contribution deductions would include:
Increase in the limit on cash contributions from 50% to 60% of the taxpayer's contribution base;
No deductions for the right to purchase tickets for college athletic events;
Adjust the amount deductible per mile for charitable work by an inflation factor; and
Require substantiation for all contributions over $250.
No deductions would be allowed for the following:
Tax preparation expenses;
Medical expenses;
Alimony;
State and local income or sales taxes (state and local property taxes would still be deductible up to $10,000 per year);
Personal casualty losses;
Moving expenses;
Archer Medical Savings Accounts, but these accounts could be rolled over to Health Savings Accounts;
Business expenses for being an employee; and
Interest on education loans and qualified tuition and related expenses.
</td></tr>
<tr><td>Requirement of Social Security Numbers</td><td>Work-eligible Social Security Numbers would be required to claim refundable credits.</td></tr>
<tr><td>Consolidation of Education Savings</td><td>Contributions to Coverdell education savings accounts after 2017 would be prohibited, but individuals could make tax-free rollovers to 529 plans.

Additionally, elementary and high-school expenses up to $10,000 would be qualified under 529, and apprenticeship programs would be covered.

Unborn children could be beneficiaries under 529 plans.

Hope Scholarship Credit and Lifetime Learning Credit would be repealed, but the American Opportunity Tax Credit (AOTC), which helps defray such higher-education costs as tuition, fees and course materials, would continue and be available for the fifth year of post-secondary education.</td></tr>
<tr><td>Student Loan Indebtedness</td><td>Income from student debt discharge because of death or disability would be excluded from taxable income.</td></tr>
<tr><td>Sale of Principal Residence</td><td>An individual must own and use his/her home as primary residence for 5 out of the last 8 years to exclude gain from the sale, which is longer than the current requirement of owning and using a primary residence for only 2 out of the last 5 years. Additionally, the amount excluded from income is phased out dollar for dollar for every dollar by which the taxpayer's adjusted gross income exceeds $500,000 ($250,000 for single filers).</td></tr>
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Estate and Gift Taxes	The level at which estate tax applies would increase from $5 million to $10 million (indexed), and the estate and generation-skipping taxes would be eliminated after 2023. The gift tax would be reduced to a top rate of 35% after 2023, but would retain the basic exclusion amount of $10 million and annual exclusion of $14,000 (also indexed).
II. Corporate Tax Provisions	
Reduced Corporate Tax Rate	The corporate tax rate would be reduced from 35% to 20%. The tax rate for net income from pass-through entities such as partnerships and LLCs would be as low as 25%. The tax rate for personal service corporations would be a flat 25%.
Elimination of Deductions	There would be no deductions for any of the following: • Lobbying expenses for legislation before local governmental bodies; • Entertainment, amusement, recreation activities, facilities, or membership dues, except for qualifying business meals; • Transportation fringe benefits; and • Benefits for onsite fitness facilities or other personal amenities not related to a trade or business, except to the extent those expenses are treated as taxable income to employees.
Tax-Exempt Entities and UBTI	Tax-exempt entities would be taxed on the value of (i) transportation fringe benefits, and (ii) on-premises facilities by treating funds used to pay for these benefits as unrelated business taxable income.
Work Opportunity Tax Credit	Under current law, employers may claim a Work Opportunity Tax Credit for first-year wages for certain employees. Under the Tax Bill, this credit would be eliminated.
Employer-Provided Child Care Credit	Under current law, employers may claim credits for qualified expenses for employee child care and child care resource and referral services. Under the Tax Bill, this credit would be eliminated.

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III. Executive Compensation	
Elimination of Nonqualified Deferred Compensation Plans for For-Profit Companies	Under current law, key management and highly compensated employees of for-profit companies may elect to defer their compensation, and employers may make tax-deferred contributions and provide benefits on behalf of these "top-hat employees". • Employees are not taxed on these contributions or on investment earnings attributable to them until the amounts are paid, even if the employees vest in these amounts at an earlier date. • Employers do not receive a deduction on these contributions or investments until they are paid. • Social Security and Medicare taxes are generally payable upon vesting. Under the Tax Bill, amounts considered deferred compensation that are earned after 2017 (and investment earnings attributable to those amounts) would be taxable upon vesting, even if those amounts are not paid to the employees at that time. This means that: • There would be no tax-deferred contributions by top-hat employees under these plans; and • Employer contributions and benefits would be taxable upon vesting. Temporary Grandfathering Provisions. Tax-deferred accounts and benefits attributable to compensation earned before January 1, 2018, would be grandfathered and would retain their tax-deferred status until the later of December 31, 2025, or the date those accounts and benefits become vested. • The Treasury Department would be required to issue regulations allowing payment of these grandfathered amounts to be accelerated without violating Section 409A. *While Section 409A, which was enacted in 2004, had a monumental impact on deferred compensation, this proposed change would effectively eliminate the entire nonqualified plan industry as we know it, resulting in the elimination of entire businesses (e.g., recordkeepers, actuaries and insurance focused on corporate-owned life insurance) and displacement of employees in these businesses.* *Employers that have used nonqualified deferred compensation plans to attract and retain highly compensated employees who might otherwise be unable to accrue benefits under 401(k) plans or other tax-qualified retirement plans due to contribution limitations and nondiscrimination requirements would need to consider alternatives to achieve their goals, including:* • *Redesigning their 401(k) plan structures to include, for example, safe-harbor and automatic enrollment features, which probably would increase employer costs;* • *After-tax benefit programs possibly with gross-ups; and/or* • *Increasing current compensation.* *Since the Tax Bill provisions track rules currently in place for nonqualified deferred compensation plans sponsored by tax-exempt employers, new nonqualified deferred compensation plans for for-profit companies could be designed similarly to the Section 457(f) plans of tax-exempt entities. However, these new plans may be impractical for large groups of employees and do not easily align with retirement planning.*

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Accelerated Taxation of Certain Equity Compensation Arrangements	The acceleration of taxation upon vesting that would apply to nonqualified deferred compensation plans would also apply to restricted stock units (RSUs), performance share units (PSUs), stock options and stock appreciation rights (SARs). This means that no tax deferral beyond the vesting date under these equity arrangements would be permissible. Except as described below for non-public corporations, stock options and stock appreciation rights, which are not currently treated as deferred compensation if granted at fair market value, would become taxable when they vest and become exercisable, effectively eliminating the "option" feature. Restricted stock awards are already taxable upon vesting. Employees of corporations that are not publicly traded could defer income from options and restricted stock units for up to 5 years. *With the possible exception of incentive stock options, there would appear to be no reason for employers to grant stock options or stock appreciation rights. RSUs and PSUs have become popular forms of equity compensation. While they would still be useful arrangements, the tax-deferral qualities would be limited.*
Restrictions on Short-Term Deferrals	Under current law, amounts are not considered deferred compensation if paid within 2½ months after the later of the last day of the calendar year in which the amounts vest or the last day of the employer's tax year in which the amounts vest. Amounts are considered "unvested" if they would be forfeited if the employee terminates employment or if the compensation is subject to the satisfaction of company performance or similar business objectives. Under the Tax Bill, the 2½-month short-term deferral period would be based only on the employer's fiscal year. In addition, an amount would be considered unvested only if it is conditioned on the future performance of substantial services by the employee. Other vesting conditions such as company performance would be ignored. *The narrowing of the short-term deferral exception would have a significant impact on a variety of compensation arrangements, including many annual bonus plans, long-term incentive plans and equity-based compensation such as RSUs and performance shares.*

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Hard $1M Cap on Deductible Executive Compensation for Public Companies	Under current law, a public corporation may deduct compensation expenses as ordinary and necessary business expenses, subject to the Section 162(m) maximum limit of $1 million on non-performance-based compensation for the CEO and 3 highest paid executive officers (other than the CFO). Performance-based compensation is not subject to the $1 million cap, and the CFO is not subject to the deduction cap. Under the Tax Bill, the $1M maximum deductible compensation limit would apply to all compensation paid to the CEO, the CFO and the 3 highest paid executive officers, whether or not the compensation is performance-based. Once an employee qualifies as a "covered employee" in one year, the deduction limitation would continue to apply in all future years and would apply to compensation paid after termination of employment and payments made to the covered employee's beneficiaries. *The lost deductions for public companies would increase the cost of compensating their senior executives, although that impact would be mitigated by lower corporate tax rates. For reasons unrelated to deductibility, corporations are likely to continue to make performance-based compensation a significant component of executive pay, but compensation committees will no longer be constrained by the rigid requirements of the current rules for performance-based compensation under Section 162(m).*
IV. Special Provisions for Tax-Exempt Entities	
Section 457(b) Plans Eliminated	Under current law, highly compensated employees of tax-exempt organizations may make before-tax contributions of up to $18,000 ($24,000 if the employee is 50 or older) to a 457(b) plan. Under the Tax Bill, employees of tax-exempt organizations would no longer be able to make before-tax contributions to 457(b) plans. This change would not affect 403(b) and 401(k) plans.
Tax on Executive Compensation exceeding $1M for Tax-Exempt Entities	Under current law, no specific restrictions exist on compensation in excess of $1 million paid by tax-exempt entities for executive compensation. Under the Tax Bill, a 20% tax would apply to compensation exceeding $1 million paid by a tax-exempt entity to any of its 5 highest paid employees. The tax is imposed on the tax-exempt entity, not the employee. Once an employee qualifies as a "covered employee" in one year, the excise tax would apply in all future years and would apply to compensation paid after termination of employment and payments made to the covered employee's beneficiaries. *This excise tax would impact the cost structure of affected tax-exempt entities and could require additional disclosures to donors.*

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Tax on Excess Severance Payments to Executives	Under current law, there are no specific restrictions on severance benefits payable to executives of tax-exempt entities. Under the Tax Bill, a 20% tax would apply to any "excess parachute payment" paid by a tax-exempt entity to any of its 5 highest paid employees. A parachute payment is a payment contingent on the employee's separation from employment. The tax applies to parachute payments that exceed 3 times the employee's average taxable wages over the preceding 5 years. *This tax resembles the tax imposed on employees of taxable corporations under Section 280G on excess parachute payments that are conditioned upon a change in control of the corporation, and the Tax Bill incorporates concepts from Section 280G. However, the tax is not related to a change in control and is imposed on the tax-exempt entity, not the employee.*
V. Qualified Retirement Plans	
Reduced Age for In-Service Withdrawals from Pension Plan	Under current law, while most defined contribution plans can permit in-service distributions at age 59½, defined benefit plans may not permit in-service distributions prior to age 62. Under the Tax Bill, defined benefit plans could allow in-service distributions beginning at age 59½.
Simplification of Hardship Withdrawal Rules	Under current law, unless special action is taken, employees who receive hardship withdrawals may be required to wait 6 months after the distribution to recommence contributions. Hardship withdrawals may not be made from (i) investment earnings on employee elective deferrals, or (ii) qualified nonelective contribution accounts. Also, employees must first take any available loan before being eligible to receive a hardship distribution. Under the Tax Bill, employees who receive a hardship withdrawal could continue making contributions to the plan without a 6-month suspension. Hardship distributions could also include (i) earnings on elective deferrals, and (ii) qualified nonelective contributions. The requirement to take any available loan before taking a hardship distribution would be eliminated. *These rule changes would ease the ability of employees to take hardship withdrawals and would reduce some of the complexity in administering hardship withdrawals.* *Employers would need to work with recordkeepers to update their systems and communications.* *While not required, employers could continue to impose some limits on hardship withdrawals to help protect employees' retirement savings.*
Rollover of Loan Offset Amounts	Under current law, if a participant defaults on a plan loan, that loan becomes immediately taxable to the participant. The participant may avoid taxation by making a contribution to an IRA or a qualified employer plan in an amount equal to the defaulted loan. This contribution is treated as a rollover of the loan offset amount, so it must be made within 60 days of the loan default. Under the Tax Bill, the contribution deadline would be extended to the latest date for the participant to file his or her tax return for the year of the loan default.

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Relief for Frozen Pension Plans	Under current law, employers who freeze their pension plans will often allow a grandfathered group to continue to accrue benefits. As this group naturally shrinks and becomes more highly paid over time, the coverage and nondiscrimination requirements that apply to the pension plan become harder and harder to satisfy. Under the Tax Bill, frozen pension plans would get automatic relief from some coverage and nondiscrimination requirements. In addition, for purposes of satisfying other nondiscrimination requirements, it would be easier to count replacement defined contribution plan benefits along with frozen defined benefit accruals.
Recharacterizing Roth Contributions and Conversions	Under current law, individuals who make IRA contributions may choose to recharacterize those contributions as either traditional contributions or Roth contributions. Similarly, an individual who elects to convert a traditional IRA into a Roth IRA may also recharacterize that conversion. Recharacterizations are generally permitted as late as October 15 of the year following the year of contribution or conversion, as applicable. Under the Tax Bill, recharacterization would no longer be allowed. IRA contributions would need to retain their original characterization, and Roth conversions could not be undone.
VI. Health, Welfare and Fringe Benefits	
No Changes to ACA (for now)	The Tax Bill, as introduced on November 2, does not make any changes to the ACA. However, the House is currently considering a separate repeal of the ACA's individual and employer mandates.
Dependent Care FSAs	Under current law, employees can use a Dependent Care Flexible Spending Account (FSA) to set aside on a tax-free basis up to $5,000 per year to help pay for childcare or dependent care expenses to enable the employee to work or look for work. Under the Tax Bill, contributions to a Dependent Care FSA would be taxable beginning in 2023. *As a taxable contribution, these arrangements would be effectively eliminated as they would have no value to employees.* *Both employees and employers would have an increase in Social Security and Medicare tax expenses, since Dependent Care FSA contributions currently are exempt from those taxes.* *The Tax Bill does not eliminate Health Care Flexible Spending Accounts.*
Adoption Assistance Programs	Under current law, employers can provide up to $13,570 in tax-free adoption assistance to employees for amounts paid (or deemed paid for special-needs adoptions) or expenses incurred for the adoption of a child. Under the Tax Bill, adoption assistance payments would be taxable to the recipient.
Qualified Moving Expense Reimbursement	Under current law, certain moving expenses provided by an employer are excluded from an employee's income. Under the Tax Bill, moving expenses received by an employee from an employer as payment or reimbursement would be taxable to the recipient.
Employee Achievement Awards	Under current law, qualified service awards are excludable from employees' taxable compensation up to certain amounts. Under the Tax Bill, these service awards would be fully taxable to the recipient.

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Tuition Reimbursement and Education Assistance	Under current law, amounts received from an employer under a qualified educational assistance program are excluded from taxable income up to $5,250 per year. Under the Tax Bill, these amounts would be fully taxable to the recipient.
Housing Allowances	Under current law, the value of housing and meals provided to an employee, spouse and/or dependents for the convenience of the employer are excluded if certain requirements are met. Under the Tax Bill, the exclusion for housing would be limited to $50,000, phased out for highly compensated employees, and limited to one residence.

The Future of the Tax Bill is Uncertain. The Tax Bill is scheduled for review and markup by the House Ways and Means Committee this week. Once recommended by the Committee, it must still be approved by the full House. This passage is by no means assured:

- Democrats have declared that none of them will vote for it;
- Republicans from states with high income taxes may not vote for it because the bill would eliminate the deduction for state income taxes; and
- The home builders, mortgage and insurance lobbies (among others) will be doing all they can to kill or change it.

If the Tax Bill passes the House, it still must go to the Senate, and the Senate is reportedly preparing its own version of the bill.

Most likely, the House and Senate bills will go to a Conference Committee to try to reach a compromise on the two versions. After that, the compromise must be submitted to, and approved by, both Houses of Congress, which again is by no means guaranteed. Passage in the current form may not happen at all.

What This Means for Employers. If the Tax Bill becomes law, employers will have new challenges in attracting, paying and retaining employees, especially senior executives:

- Employers would be challenged to find creative ways to offer attractive non-cash compensation on a tax-free basis.
- In particular, it would be difficult to compensate senior executives and help them save for retirement in a tax-efficient manner.
- The cost of compensating the most senior and highly-prized executives could increase dramatically.
- Equity compensation practices would have to be revisited.
- Additionally, although corporations would benefit from a lower overall tax rate, many employers will see cost increases due to the elimination of tax credits and deductions.

Next Steps. Although the future of the Tax Bill is uncertain, if the legislation overcomes all of the obstacles above, it likely will occur late in the year with little time to react. For that reason, it is prudent to begin discussions of alternative benefit arrangements with an eye towards those items currently included in the proposed legislation.

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