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Client Alert

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US Tax Reform: Compensation Update #1
House Ways and Means Committee Revisions & Senate Mark of Tax Cuts and Jobs Act

As part of the push to enact US tax reform by year-end, on November 9th the House Ways and Means Committee approved a revised version of its initial bill that we discussed in our November 3rd alerts. In its most dramatic compensation-related change, the final House bill eliminated the proposal to tax nonqualified deferred compensation (including equity compensation) at vesting, thereby preserving current tax rules including section 409A. The final House bill also retained a provision allowing for the deferral of tax on options and restricted stock units ("**RSUs**") granted by private companies.

However, later that same day, the Senate Chairman released a conceptual mark-up (the "**Senate Mark**"), which *included* the House's original proposal to overhaul the tax treatment of nonqualified deferred compensation, by imposing tax at vesting. The Senate Mark also introduced a five percent Federal income tax withholding obligation on compensation paid to independent contractors and included other differences to the final House bill impacting (1) compensation-related deductions, (2) employer-provided fringe benefits, (3) retirement plans, (4) capital gains tax rules for disposal of partnership interests, and (5) certain employer credits. Notably, the House bill and Senate Mark are aligned on changes to section 162(m), including the proposed elimination of the performance-based compensation exception to the $1 million limit on the deductibility of covered employee compensation.

Below we provide a snapshot of the current status of tax reform in each of these key areas. However, this week, as the House moves to vote on its final bill and the Senate Finance Committee meets to review the Senate Mark, the only certain thing is that further change is imminent.

Current House/Senate Conflict on Elimination of Deferred Compensation

As outlined above, the Senate Mark contains the same deferred compensation provision as was in the original House bill, except that under the Senate Mark grandfathered deferred compensation (i.e., vested prior to 2018) is not required to be taken into income until 2026 (rather than 2025 as in the House bill).

As a reminder, this deferred compensation provision would make deferred compensation, including voluntary salary and bonus deferral arrangements, SERPs, severance, non-qualified stock options, SARs, and certain RSUs, taxable at vesting, rather than distribution or settlement. The House ultimately amended its bill to remove the deferred compensation provision, and the hope is that the Senate will do the same (notwithstanding that a Senate summary cites the Joint Committee on Taxation's projection that this proposed change will raise $13.4 billion in revenues over 10 years).

ISOs and ESPP Excluded from Nonqualified Deferred Compensation

The Senate Mark further clarifies that incentive stock options and employee stock purchase plans qualified

under Section 423 are not considered nonqualified deferred compensation, provided that there is no disqualifying disposition of the shares acquired. Therefore, even if the final law were to tax nonqualified deferred compensation at vesting, it appears that this would not apply to ISOs or ESPP options unless the applicable statutory holding periods were not met or if options were granted under a non-423 component of an ESPP.

House Bill Provides New Tax Deferral for Private Company Equity

Not only did the House amend its bill to remove the provision taxing deferred compensation at vesting, it added favorable provisions for stock options and RSUs granted by private companies (companies whose stock is not publicly traded on an established securities market). These provisions are not in the Senate Mark, but their addition to the House bill suggests there may be pressure to include them in the next version of the Senate Mark.

The proposal would allow eligible private company employees to make an election to defer payment of income tax to the *earliest* of (1) the stock becoming transferable (including to the company), (2) the stock of the company becoming publicly traded on an established securities market, such as upon an IPO; (3) five years after the vesting date; (4) the employee losing his or her status as an eligible employee; and (5) the employee revoking the deferral election. The amount of income that would be required to be recognized under the deferral election would be based on the value of the stock at the time the employee's rights in such stock first became transferable or not subject to substantial risk of forfeiture, without regard to whether such value decreases during the deferral period.

All full-time employees are eligible to make an election under the proposed deferred tax rules, excluding an employee who: (1) is or was a 1% owner of the company at any time in the 10 preceding calendar years, (2) is or has been the company's CEO or CFO; (3) is related to the CEO, CFO or former CEO or CFO; (4) has been one of the company's four highest paid officers in any of the 10 preceding taxable years.

Among other requirements, to qualify for the deferred taxation, the equity awards must be offered on terms that provide the same rights and privileges (other than with respect to the number of underlying shares) to at least 80% of employees providing services in the US and the company must not have repurchased any of its outstanding stock in the preceding year, unless at least 25% of the dollar amount of the repurchased stock was stock issued to employees electing to defer taxation under the proposed deferred tax rules.

House Bill Proposes Changes to Capital Gains Taxation of Partnership Interests

The final House bill added a provision on the taxation of carried interests, which was not included in the Senate Mark. Carried interests or profits interests are non-capital interests in a partnership that are issued to service providers as compensation for services. The IRS has issued guidance treating such interests as not taxable at issuance, largely on the basis that Court cases have held that they are difficult to value and tax at grant. Such interests are instead taxable at capital gain rates when sold.

The House amended its bill to clarify that such interests will be subject to capital gains rates at sale only if they are held for three years (rather than the one year applicable to other capital assets). As mentioned, the Senate Mark does not reflect a similar provision on carried interests.

House/Senate Variation on Disallowance of Compensation Related Deductions - Except 162(m)

As with the House bill, certain compensation-related deduction disallowances are included in the Senate Mark, including with respect to section 162(m). However, the Senate Mark takes a somewhat different approach to the disallowance of entertainment deductions under Section 274.

- **Section 274 Expanded.** The Senate Mark makes changes to section 274's deduction disallowance for entertainment and meals, but does so in a way very different than the House bill. Instead of taking the House bill approach of specifying that certain expenses (such as athletic facilities, and

other amenities of a personal nature) are non-deductible under section 274, the Senate Mark removes the exception to Section 274 for entertainment that is directly related to the active conduct of a trade or business.

Thus, generally, under the Senate Mark, entertainment expenses are non-deductible regardless of how closely related they are to operation of the taxpayer's trade or business. However, the Senate Mark also targets expenses of providing qualified transportation fringe benefits (parking and mass transit) and any form of commuting benefit (other than for the safety of the employees) for deduction disallowance.

Additionally, while currently, meal expenses are exempt from the 50 percent deduction disallowance if they constitute de minimis fringe benefits (as is the case with certain employer-subsidized company cafeteria meals, as well as free meals provided to employees for the convenience of the employer under certain circumstances), the Senate Mark would make those meal expenses subject to 50 percent deduction disallowance.

- **Section 162(m) Also Expanded.** The Senate Mark contains amendments to section 162(m) that are identical to those in the House bill. In other words, the CEO, CFO, and top three most highly paid executives in a year are treated as covered employees subject to section 162(m) deduction disallowance in that year and all future years. Further, under the Senate Mark there is no longer an exception from section 162(m) for performance-based and commission compensation.

Elimination of Certain Employer-Provided Fringe Benefits

The Senate's Mark would do away with the exclusion for qualified bicycle commuting reimbursements and qualified moving expenses reimbursements (for all but military personnel). By contrast, the House bill also would repeal the exclusion for other benefits, such as employee achievement awards, educational assistance, dependent care assistance, and adoption assistance. (The House bill originally repealed the tax credit for adoption assistance, but was amended to preserve the tax credit for adoption assistance, but not the exclusion for employer provided adoption assistance.) In addition, the House bill, rather than do away with the exclusion for bicycle commuting reimbursements, made the costs of such programs non-deductible.

Senate Mark Includes New Worker Classification Safe Harbor

The Senate Mark contains a safe harbor provision which, if met, means a service provider will not be treated as an employee for employment tax and other purposes under the Code.

In order to meet the safe harbor, the worker must (1) incur and be reimbursed for deductible trade or business expenses, (2) agree to perform the service for a particular time period (but not based on hours of work performed), a specific task, or to achieve a specific result, and (3) have one of several other listed indicia of independence and business ownership, such as significant investment in the business of performing the services, or not being exclusive to one particular service recipient.

The worker must have a principal place of business other than the service recipient's business, must primarily use his own equipment to provide the services, or must pay rent for use of the service recipient's premises. A salesman taking advantage of this safe harbor must be compensated primarily through commissions. Finally, the parties are required to have a written contract acknowledging that the worker will not be treated as an employee and will be responsible for his or her own taxes, and that the service recipient will report and withhold consistent with the safe harbor provision.

Compensation up to $20,000 paid under such a contract would be subject to Federal income tax withholding at a five percent rate. If the IRS reclassifies a worker that the parties treated as meeting the safe harbor, that reclassification can be prospective only. This worker classification safe harbor provision would be effective for services performed after December 31, 2017 and amounts paid after that date, with an

exception for amounts paid in the period 180 days before the proposal's enactment.

Health and Retirement Rules – High-Earner Limit on 401(k) Plan "Catch-Up" Contributions

Under current law, employee elective deferrals to a 401(k) plan are capped at the limit provided under section 402(g) ($18,000 for 2017) which is periodically adjusted by the IRS. However, individuals age 50 or older are permitted to make additional "catch-up" contributions to the plan, up to certain limits which are generally adjusted annually ($6,000 for 2017). The Senate Mark would do away with catch-up contributions for any employee who received wages of $500,000 or more in the prior year. It is worth noting that Senator Hatch has already introduced an amendment that would keep the catch-up contribution available to all and raise the limit to $9,000, but it would require that all catch-up contributions be in the form of Roth after-tax contributions.

Repeal of Credits

Unlike the House bill, the Senate Mark does not do away with the employer provided child care credit under section 45F or the work opportunity credit under section 51 and it places no additional conditions on the availability of the credit under section 45B for FICA taxes on tips.

Please contact your Compensation attorney with any questions related to the proposed tax legislation.

For more information on the broader implications of the proposed tax legislation on your company, please see the ***Tax News and Developments*** **alert**, *Senate Finance Committee Releases "Chairman's Mark" of Tax Reform Legislation; Mark Up Begins*, issued by Baker McKenzie's tax practice (November 13, 2017).

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