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House Bill Proposes Major Modifications to Employee Compensation and Benefits-Related Laws; Initial Amendments Provide Limited Relief

The Tax Cuts and Jobs Act proposed by the US House of Representatives on November 2 (House Bill) proposes major modifications to employee and partner compensation and benefits-related provisions of the Internal Revenue Code,[1] including repealing Sections 409A and 457A, modifying Section 162(m) to eliminate the ability of public companies to use the commissions and performance-based compensation exceptions, eliminating deductions for contributions to medical savings accounts, and repealing the exclusions from income for dependent care assistance programs and employee achievement awards. The House Bill also proposes to implement an excise tax regime on excessive compensation paid to certain employees of tax exempt organizations. On November 6, House Ways and Means Committee Chairman Kevin Brady released amendments (Brady Amendments) to certain provisions of the House Bill, some of which modify the benefits and compensation provisions in the House Bill (like the three-year holding period for carried interests). A Senate proposal is expected to be published shortly, and we will continue to analyze and report on the provisions of such a proposal in additional updates.

Highlights of the House Bill's and the Brady Amendments' compensation and benefit provisions are below:

- **Repeal of Sections 409A and 457A, and Replacement With a "Tax When Vested" Regime.**
  - In effect, the House Bill eliminates deferred compensation and would require the recognition of income tax upon vesting of compensatory awards and arrangements, other than property transfers (like stock and partnership interests) subject to Section 83 of the Code. The House Bill's timing rule would affect traditional deferred compensation awards, restricted stock units and performance-based restricted stock units, severance arrangements, phantom stock arrangements, and appreciation-type awards like stock options and stock appreciation rights. The House Bill, however, does not appear to change the tax treatment of interests in a partnership (including profits interests), restricted stock or other transferred property subject to tax under Section 83, but would appear to include incentive stock options within this new "tax when vested" regime.
  - ***Special Deferral Feature for Stock Options and RSUs.*** Notwithstanding the treatment as deferred compensation of stock options and restricted stock units (RSUs) proposed in the House Bill, the Brady Amendments would afford "qualified employees" limited deferral opportunities (i.e., up to five years) for stock options and restricted stock units so long as (1) their employer's stock has never been readily tradable on an established securities market and (2) such awards are made under a written plan to

[1] All section references herein are to the applicable sections of the US Internal Revenue Code of 1986, as amended.

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at least 80 percent of its employees. "Qualified employees" exclude the current or any former CEO, CFO or individuals who during the preceding 10 calendar years were either one of the top four highest compensated officers or a 1 percent owner. This relief could be beneficial to startup companies who regularly use equity-based awards as an element of compensation for most, if not all, employees.

- ***Partnership Interests.*** As a condition to long-term capital gains treatment, the Brady Amendments imposes a three-year holding period requirement for partnership interests in certain trades or businesses (e.g., hedge fund and private equity), which are granted in connection with the performance of services.
- ***Vesting.*** Under the House Bill, deferral of tax on compensation may only be accomplished if the compensation is subject to a *time-based* substantial risk of forfeiture (i.e., performance-based and restrictive covenant-based forfeiture provisions will not be considered good forfeiture conditions for the deferral of tax). The House Bill's focus on time-based vesting runs contrary to recent performance-based vesting trends that are supported by institutional advisory services and many employers, including private equity sponsors. While these trends are expected to continue, the timing of tax liabilities and deductions, with respect to performance-based vesting awards, would be remarkably different under the House Bill.
- ***Payment Timing.*** The House Bill also proposes certain modifications to what is commonly referred to as the "short-term deferral" exception under Section 409A. The House Bill provides that an amount will not be treated as nonqualified deferred compensation if it is paid no later than 2½ months after the end of the tax year of the service recipient (e.g., employer), during which the right to compensation is no longer subject to a substantial risk of forfeiture. This is a departure from the current rule under Section 409A that provides that a payment will be treated as being made within the short-term deferral period if paid within 2½ months following the end of the *later of* the service provider's (e.g., employee) or service recipient's (e.g., employer) tax year in which the amount was no longer subject to a substantial risk of forfeiture.
- ***Taxation of Previously Deferred Amounts.*** Compensation for services performed prior to January 1, 2018, will be required to be included in gross income by 2025 or, if later, the date that the compensation becomes vested, regardless of whether it has been paid to the service provider. Additional reporting requirements may apply to employers with respect to these amounts.
- ***Open Questions.*** The House Bill and Brady Amendments raise many questions including:
  - How and whether risks of forfeiture, and thus the timing of taxation, may be able to be extended (other than limited deferral opportunities for stock options and restricted stock units described above);
  - How appreciation-type awards and awards the value for which is undeterminable at vesting (e.g., transaction bonus compensation) would be calculated for tax liability and deduction purposes; and
  - How the income recognition rules would apply to severance arrangements payable over an extended period of time.
- ***Effect on Employers.*** The House Bill's treatment of compensation programs would cause companies to revisit long-standing compensation programs and philosophies, and to look to restricted stock or profits interest awards that are taxable under Section 83 and not subject to these restrictions.

- **Elimination of 162(m)'s Performance-Based Compensation and Commissions Exceptions.**
  - The House Bill eliminates the widely used exceptions to the $1 million compensation deduction limitation under Section 162(m) for "performance-based compensation" and commissions payable to covered employees of public companies, and expands the persons for which the deduction would be limited. Under the House Bill, the annual deduction for compensation paid to the CEO, CFO and top three other most highly compensated executives of a public company (which, under the House Bill, would also include certain issuers of public debt) would be capped in all instances at $1 million per individual.
  - Importantly, unlike under current law, the House Bill *includes* CFOs (i.e., primary financial officers) within the definition of "covered employees." Of similar import, the House Bill causes the designation of being a covered employee in 2017 or beyond to remain with those designated employees even if they no longer qualify as CEO, CFO or a top three highest compensated executive for the applicable tax year. This continued designation would have the effect of including more individuals in the group covered by the limitation, and could limit the deductibility for compensation paid after such employee is no longer CEO, CFO or in the highest compensated group, including as severance, deferred compensation and other post-termination payments.

- **Twenty Percent Excise Tax on Tax Exempt Employers for Excessive Executive Compensation.** The House Bill proposes a 20 percent excise tax on tax exempt employers for "excessive compensation" paid to the top five highest compensated employees of the organization for the taxable year (or for any preceding year after 2016). The excise tax would apply to remuneration (other than excess parachute payments) paid to a covered employee in excess of $1 million and to termination payments (e.g., parachute payments) above a safe harbor threshold (like the threshold established under the "golden parachute" rules under Section 280G). The House Bill could have a significant impact on the pay practices of tax exempt employers, and such employers will need to analyze their current programs and become familiar with this new regime, given the potential for significant excise taxes.
- **Elimination of Certain Benefit Plan and Employee Related Deductions.** The House Bill disallows deductions for contributions to an Archer Medical Savings Account, certain deductions for entertainment, amusement and recreation activities, and deductions for transportation fringe benefits, unless such fringes were included in the employee's income.
- **Elimination of Exclusion for Employee Achievement Awards and Dependent Care Assistance Programs.** The House Bill repeals the exclusion for employee achievement awards and dependent care assistance programs. The Brady Amendments would push the effective date for repeal of the exclusion for dependent care assistance programs until after December 31, 2022. The repeal of these exclusions would result in taxable income for any such benefits provided to employees.
- **Disallows Recharacterization of IRA Contributions as Roth IRA Contributions (and Vice Versa) and Roth Conversions.** Under the House Bill, individuals would no longer be permitted to recharacterize a contribution to a traditional IRA as a contribution to a Roth IRA, and vice versa. In addition, individuals would no longer be able to reverse/undo a conversion of a traditional IRA to a Roth IRA.
- **In-Service Distributions.** The House Bill would harmonize the in-service distribution rules for state and local government plans and defined benefit plans with the in-service distribution rules that now apply to defined contribution plans (such as 401(k) plans). Under the House Bill in-service distributions would be permitted for employees of all such plans at age 59½.
- **Hardship Distributions.** Under the House Bill, participants in defined contribution plans that are permitted to take "hardship distributions" from the plan (in the event of an immediate and heavy financial need) will no longer be required to cease making contributions to the plan for the six-month period following the distribution (as is currently mandated). In addition, the House Bill would permit hardship distributions from earnings on employee contributions as well as employer contributions. Hardship distributions under current law are restricted to employee contributions only.
- **Rollover of Loans.** The House Bill would extend the period of time following a termination of employment or plan termination in which a participant with an outstanding loan from a defined contribution plan may roll over the outstanding amount of such loan to an IRA in order to avoid a taxable distribution (and potential penalties) from 60 days following the event until the employee's tax filing due date for such year.
- **Nondiscrimination Testing.** The House Bill would modify the nondiscrimination testing requirements where an employer maintains both a defined contribution plan and a defined benefit plan, and thereafter takes action to freeze participation in the defined benefit plan.
- **Unrelated Business Income Tax of Certain Governmental Trusts.** The House Bill would "clarify" existing law to make it clear that retirement trusts, Voluntary Employees' Beneficiary Association (VEBAs) and other tax-exempt entities under Section 501(a) remain subject to the unrelated business income tax (UBIT) provisions of Sections 511–514 irrespective of whether the entity's income is also excluded from gross income under any other provision of the Code, including Section 115 (related to the exercise of an essential governmental function). This clarification would be effective for tax years starting after 2017.

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