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Senate Passes Tax Reform Bill

In the early hours of December 2, the Senate passed its own tax reform bill. While passage of the bill seemed improbable as recently as last Thursday, Senate Republicans were able to overcome objections within their own caucus with last minute tinkering to their tax proposal. Up next is the reconciliation process during which House and Senate Republicans will iron out differences between their respective tax reform bills.

At this point, passage and enactment of a reconciled tax reform bill appears to be highly likely prior to year-end.

Under the Senate bill, changes to the Internal Revenue Code ("Code") would be effective for tax years beginning after 2017, except the change in the corporate income tax rate would first become effective in 2019. Under the House tax proposal, this change would first become effective in 2018 (i.e., a year earlier).

Provisions Relating to Executive Compensation

The Senate bill maintains the revisions to Code Section 162(m) that were included in the proposed version of the bill. This includes: (i) the elimination of the exception to the $1 million deduction cap for performance-based compensation, thereby making non-deductible all annual pay to a "covered employee"[1] in excess of $1 million; and (ii) the expansion of the definition of covered employee to include the chief financial officer. In addition, the Senate bill provides that once an individual qualifies as a covered employee, the $1 million deduction cap would apply to that person for so long as the individual is paid compensation. These revisions to Code Section 162(m) mirror the changes set forth in the House tax reform bill.

The Senate (but not the House) bill also includes comprehensive and complex transition rules for the revisions to Code Section 162(m). We believe that the Senate's transition rules will survive the reconciliation process.

Differences Between Senate and House Tax Reform Bills

Although broadly similar, the Senate and House tax reform bills contain significant differences that must be reconciled, with the reconciled bill subject to a Senate and House vote. Passage of a reconciled bill prior to the start of Christmas appears to be a good bet. Key differences between the Senate and House bills include the effective date of corporate tax rate reduction (as noted above), the number of individual income tax brackets, individual tax rates and the tax treatment of pass-through entities. However, none of the differences are likely to prevent the passage of a reconciled tax reform bill.

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[1] Under current law, covered employee refers to a public corporation's principal executive officer and the three-highest paid proxy-disclosed executive officers (other than the principal executive officer and principal financial officer).

Key Differences Between Senate and House Bill on Corporate Income Tax		
Provision	**House Bill**	**Senate Bill**
Corporate tax rate	20% (effective 2018)	20% (effective 2019)
Alternative minimum tax	Repeals	Preserves at 20%
Capital investments	Allows immediate deduction of the cost of "qualified property" through 2022	Allows immediate deduction of the cost of "qualified property" through 2022, with 5-year phase out thereafter
Interest deduction	Caps net interest deduction at 30% of *earnings before interest, taxes, depreciation and amortization*	Caps net interest deduction at 30% of *earnings before interest and taxes*
Net operating loss (NOL)	Allows deduction for NOL up to 90% of a business's taxable income; generally eliminates NOL carryback	Allows deduction for NOL carryover up to 80% of a business's taxable income; generally eliminates NOL carryback
Local lobbying expense	Disallows deduction for lobbying expenses relating to legislation before local governmental bodies	Preserves deduction for local lobbying expense

Key Differences Between Senate and House Bill on Individual Income Tax		
Provision	**House Bill**	**Senate Bill**
Tax brackets and top income tax rate	Reduces number of tax brackets from 7 to 4, with a top rate of 39.6% on taxable income in excess of $1 million for joint filers	Preserves 7 tax brackets, with a top rate of 38.5% on taxable income in excess of $1 million for joint filers
Duration of tax rate reduction	No sunset	Expires after 2025
Alternative minimum tax	Repeals	Preserves with larger exemption
Estate and gift tax	Increases exemption to $10 million; repeals estate and gift tax after 2023	Increases exemption to $10 million, with no future repeal
Tax rate on pass-through entity net business income	25% flat tax rate on "business income"	23% deduction for "business income" (expires after 2025)
Affordable Care Act individual mandate	Preserves	Repeals
Dependent care assistance (DCA)	Repeals exclusion from income of employer-reimbursed DCA expenses	Preserves exclusion from income of employer-reimbursed DCA expense
Mortgage interest	Limits interest deduction to first $500,000 of indebtedness, and only on primary residence; eliminates interest deduction on home equity loans	Preserves current law which allows interest deduction on first $1 million of indebtedness; eliminates interest deduction on home equity loans
Medical expenses	Repeals	Preserves and temporarily lowers the threshold percentage of AGI to be eligible for deduction from 10% to 7.5%

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The ***Client Update*** is prepared by Meridian Compensation Partners' Technical Team led by Donald Kalfen. Questions regarding this Client Update or executive compensation technical issues may be directed to Donald Kalfen at 847-235-3605 or dkalfen@meridiancp.com.