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Meridian Client Update

House Passes Tax Reform Bill

Yesterday, the U.S. House of Representatives passed its tax reform bill by a vote of 227 to 205.

The tax reform bill approved by the full House does not substantively differ from the bill previously approved by the House Ways and Means Committee, as described in our Client Updates dated November 7, 2017 and November 10, 2017. Therefore, in contrast to the Senate tax reform bill, the passed House bill does not include a transition rule to the proposed changes to Section 162(m) of the Internal Revenue Code ("Code"). However, we expect that a transition rule similar to the one included in the Senate bill (described below) would be included in any final bill before being voted upon by the two chambers.

Amendments to Senate Tax Proposal Affects Executive Compensation Provisions

Following the lead of House Republicans, on November 14, 2017, the Senate Finance Committee amended the Senate tax reform bill to eliminate the proposed change in the tax treatment of nonqualified deferred compensation plans, including stock options. These provisions are now omitted from both the House and Senate bills. Separately, the Finance Committee added a transition rule to the proposed changes to Section 162(m) of the Code.

Elimination of Proposed Change in Tax Treatment of Nonqualified Deferred Compensation

Both the *initial* House and Senate tax reform bills would have required nonqualified deferred compensation (NQDC) to be subject to tax when such compensation is no longer subject to a substantial risk of forfeiture (i.e., no longer subject to a service condition), rather than when paid or settled. Included in the definition of NQDC would have been certain equity awards, such as restricted stock units, performance stock units, performance units, nonqualified stock options and stock appreciation rights.

The Senate Finance Committee has stricken the provisions on NQDC from the Senate tax reform bill. Therefore, these provisions are now omitted from both the House and Senate bills. Current tax treatment of NQDC and the above-referenced equity incentive programs will seemingly remain unchanged.

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Transition Rule to the Proposed Changes to Code Section 162(m)

Both the House and Senate tax reform bills eliminate the performance-based exception to the $1 million deduction cap on compensation paid to "covered employees"[1] and extend the definition of covered employee to include a corporation's principal financial officer. Further, both tax proposals provide that once an individual qualifies as a covered employee, the $1 million deduction cap will apply so long as the corporation pays remuneration to such person or to any of that person's beneficiaries. The proposed changes in Code Section 162(m) would take effect for taxable years beginning after December 31, 2017 ("Effective Date").

Transition Rule Requirements

The amended Senate tax bill includes a transition rule to the proposed changes to Code Section 162(m). Under the transition rule, the changes would not apply to compensation paid to a covered employee if the following conditions are met:

- The compensation is paid under a written binding contract which was in effect on November 2, 2017,
- Such contract was not materially modified after that date, and
- The right of the covered employee to such compensation was no longer subject to a substantial risk of forfeiture (i.e., vested) prior to January 1, 2017.

Application of Transition Rule to Performance Awards and Nonqualified Stock Options

The transition rule would provide no relief for incentive compensation paid under a typical performance plan (e.g., payments under a performance share unit arrangement) after the Effective Date, since such payments rarely would have been vested prior to January 1, 2017. In contrast, the transition rule would appear to grandfather compensation paid after the Effective Date upon the exercise of a nonqualified stock option that vested prior to January 1, 2017, which would not be uncommon. Such compensation would not be subject to the $1 million deduction cap.

Application of Transition Rule to NQDC

The primary relief afforded by the transition rule would relate to compensation paid under a NQDC arrangement. Under current law, compensation paid under a NQDC arrangement to a former covered employee (e.g., an individual who loses covered employee status due to change in position or termination of employment) would not be subject to the $1 million deduction cap. However, under the proposed modification of Code Section 162(m), an individual who becomes a covered employee would never lose that status. Therefore, unlike under current law, NQDC paid to such an individual (or the individual's beneficiary) would always be subject to the $1 million deduction cap under the proposed modification.

The transition rule would grandfather compensation paid after the Effective Date to a covered employee, provided that such compensation was vested prior to January 1, 2017. Whether such compensation would be subject to the $1 million deduction cap would be determined under current law. For example, if under current law the recipient of compensation paid under a NQDC arrangement would not be treated as a covered employee, such compensation would not be subject to the $1 million deduction cap.

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[1] Currently, under Code Section 162(m), the term "covered employee" refers to a corporation's principal executive officer and three highest-paid proxy-disclosed officers other than the principal executive officer and principal financial officer.

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Examples of the Application of Transition Rule to Typical Plan Designs

Many typical plan designs would not fall under the transition rule because compensation paid under those plans would not have been vested by December 31, 2016. For example, the proposed transition relief generally would ***not*** cover compensation paid after the Effective Date to a covered employee under each of the below scenarios:

- 2017 calendar year annual incentive plan with incentive awards earned and paid after December 31, 2017.
- Three-year performance plan ending on December 31, 2017 (e.g., performance share plan, performance cash plan) with incentive awards earned and paid after December 31, 2017.
- Compensation recognized upon the post-December 31, 2017 exercise of a nonqualified stock option that vested after December 31, 2016.

Compensation paid under each of the foregoing scenarios would be subject to the proposed modifications to Code Section 162(m).

However, the transition rule would cover compensation paid under legacy NQDC arrangements and nonqualified stock option grants under the following circumstances (which are not intended to be exhaustive):

- The payment of a NQDC account balance that vested prior to January 1, 2017 to an indivdual who at the time of payment would not have been considered a covered employee under the current law[2]. Under this scenario, the payment of such compensation would not be subject to the $1 million deduction cap.
- Compensation paid under a stock option that vested prior to January 1, 2017 and is exercised after December 31, 2017 would remain subject to current law and, therefore, would not be subject to the $1 million deduction cap.

Meridian Comment. The action by the Senate Finance Committee to strike the provisions pertaining to NQDC from the Senate tax bill is a very welcome development, which eliminates a major difference between the Senate and House tax bills. Similarly, the transition rule on the proposed changes to Code Section 162(m) provides clarity on the treatment of NQDC and incentive compensation paid to a covered employee after the Effective Date.

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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.

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[2] E.g., An individual who was a corporation's principal executive officer at the time amounts were credited to the officer's NQDC account balance but was retired at the time of its payment.

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