Sweeping Tax Reform Bill Passed by Congress

Congress has passed the most far reaching tax reform bill in over 30 years, the Tax Cuts and Jobs Act ("Tax Act"). The Tax Act will affect nearly all taxpayers (business and individuals). Corporations will be subject to a significantly reduced income tax rate of 21% and generally will be taxed solely on U.S. based income (with some exceptions). Individuals will see the elimination of many itemized deductions but higher standard deductions and slightly lower marginal tax rates.

Generally, the changes made to the Internal Revenue Code ("Code") under the Tax Act are effective for taxable years beginning after December 31, 2017. The changes to the corporate income tax provisions are permanent. However, most changes to individual income tax provisions (including changes in income tax rates) are temporary and will sunset at the end of 2025.

Highlights of the Tax Act

- Named executive officer annual pay in excess of $1 million is non-deductible, without exception.
- Top corporate income tax rate falls from 35% to 21%.
- Accumulated foreign earnings deemed repatriated and subject to preferred tax rates.
- Generally, future foreign earnings are exempt from U.S. corporate income tax.
- Pass-through entities allowed to deduct 20% of business income.
- Alternative minimum tax applicable to businesses is repealed but will remain applicable to individuals, subject to certain modifications.
- Number of individual income tax brackets will remain at seven.
- Top individual tax rate falls from 39.6% to 37%, which applies to taxable income over $600,000 for joint filers.
- Standard deduction increases from $12,700 to $24,000 for joint filers.
- Repeal of health care reform individual mandate.
- Estate tax exemption doubles from $5 million to $10 million (indexed for inflation occurring after 2011).

This Client Update first summarizes the Tax Act's provisions relating to executive compensation and then compares current law and the key provisions of the Tax Act.

Provision Relating to Executive Compensation – Modification to Code Section 162(m)

The Tax Act affects only one provision of the Code that directly relates to executive compensation, Code Section 162(m) (which solely applies to "publicly held corporations"). The Tax Act makes the following modifications to Code Section 162(m):

- Eliminates the performance-based exception to the $1 million deduction cap,
- Expands the definition of a covered employee to include a publicly held corporation's CFO, and
- Provides that once an individual qualifies as a covered employee of a corporation, the $1 million deduction cap would apply to that person so long as the corporation pays remuneration to such person (or to any of that person's beneficiaries).

Under current law, publicly held corporation refers to (i) any corporation issuing any class of common equity securities required to be registered under section 12 of the Securities Exchange Act of 1934 and (ii) any foreign corporation issuing American Depository Receipts (ADRs) subject to this registration requirement. The modification to Code Section 162(m) expands the definition of publicly held corporation to include (i) any foreign corporations issuing ADRs regardless of whether the ADRs are subject to registration and (ii) any privately held corporation required to register equity securities or debt securities.

The modifications to Code Section 162(m) will become effective for taxable years beginning after December 31, 2017 ("Effective Date").

Transition Rule

The Tax Act also incorporates the transition rule included in the Senate tax reform bill. Under the transition rule, the modifications to Code Section 162(m) will ***not*** apply to compensation paid to a covered employee if the following conditions are met:

- Compensation is paid under a written binding contract which was in effect on November 2, 2017, and
- Such contract was not materially modified on or after that date.

The deductibility of compensation grandfathered under the transition rule would be determined under the current provisions of Code Section 162(m).

The written binding contract requirement may prove problematic for many common incentive plan designs. As suggested in the conference committee summary to the Tax Act, the binding contract requirement might not be met in cases where (i) amounts payable under an incentive plan are subject to company discretion or (ii) the company has the right to amend materially the plan or terminate the plan (except on a prospective basis before any services are performed with respect to the applicable period for which such compensation is paid). A company's right to unilaterally adjust awards or amend/terminate an incentive plan suggests that the plan or awards thereunder are not subject to a binding contract but are illusory in nature.

Compliance with the written binding contract requirement will depend upon a plan's or award's specific terms and conditions. For example, an annual incentive plan typically allows for the compensation committee to make discretionary adjustments to otherwise earned awards. In such a case, the annual incentive plan might not be considered a written binding contract. Conversely, performance-based equity awards are typically subject to anti-cutback provisions, which prohibit the diminution of benefits under such awards without participant consent. In this case, the performance-based equity awards would appear to meet the written binding contract requirement.

We anticipate that future treasury regulations will provide clarity on the written binding contract requirement.

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Comparison of Select Corporate Income Tax Provisions under Current Law and the Tax Act

Provision	Current Law	Tax Act
Income Tax Rates and Earnings Subject to U.S. Corporate Income Tax		
Corporate tax rate	Graduated tax rates with top tax rate of 35%	Flat 21% tax rate (effective for taxable years beginning after December 31, 2017)
Income subject to tax	Worldwide income	Territorial system (i.e., only U.S.-based income subject to U.S. corporate income)
Foreign earnings	Foreign earnings subject to U.S. corporate income tax	Generally, foreign earnings are exempt from U.S. corporate income tax subject to anti-abuse provisions and related anti-abuse tax
Alternative minimum tax	20% tax rate applied to an alternative definition of taxable income	Repeals
Special Treatment of Foreign Earnings Accumulated Prior to Effective Date		
Held in liquid assets	N/A	Deems repatriated; subject to a 15.5% tax rate
Held in illiquid assets	N/A	Deems repatriated; subject to a 8.0% tax rate
Changes in Corporate Tax Deductions		
Limit on deduction for compensation paid to named executive officers (Code Section 162(m))	Allows deduction for “performance-based compensation” paid to a “covered employee” in excess of $1 million during tax year CFO not treated as a covered employee	Disallows deduction for annual compensation paid to a covered employee in excess of $1 million, without exception Covered employee expanded to include CFO Covered employee maintains such status as long as employee (or beneficiary) is receiving compensation
Accelerated depreciation for certain “qualified property”	A first-year additional depreciation deduction allowed equal to 50% of qualified property acquired and placed in service before January 1, 2018, with three-year phase-out thereafter	Allows immediate deduction of the cost of “qualified property” acquired and placed in service after September 27, 2017 and before January 1, 2023, with five-year phase-out thereafter
Cap on deduction for net interest expense	Generally, net interest expense is fully deductible	Limits deduction for net interest expense at 30% of EBITDA for four years and 30% of EBIT thereafter, with indefinite carryforward of disallowed deduction
Net operating loss (NOL)	Generally, a NOL may be carried back two years and carried forward 20 years to offset taxable income in such years	Eliminates NOL carrybacks Allows for indefinite NOL carryforwards, limited to 80% of taxable income
Local lobbying expense	Generally, lobbying expenses relating to legislation before local governmental bodies are fully deductible	Disallows deduction for local lobbying expenses
Entertainment expense	Generally, 50% of business-related entertainment expenses are deductible	Disallows deduction for entertainment and related expense

Comparison of Select Individual Income Tax Provisions under Current Law and the Tax Act

Provision	Current Law (2017 Tax Year)	Tax Act
Tax Rates on Income, Estates and Pass-Through Entities		
Tax brackets and top tax rate	7 tax brackets, with top rate of 39.6% on taxable income in excess of $470,700 for joint filers (see below comparative tax tables)	Preserves 7 tax brackets, with a top rate of 37% on taxable income in excess of $600,000 for joint filers*
Alternative minimum tax (AMT)	Parallel tax system that determines minimum tax amount on AMT income (i.e., taxable income subject to certain required adjustments) $84,500 of income is exempt from AMT for joint filers, subject to phase-out starting once AMT income exceeds $160,900 for joint filers	Preserves AMT but increases amount of income exempt from AMT to $109,400 for joint filers, with phase-out starting once AMT income exceeds $1 million for joint filers*
Estate and gift tax	Exempts $5 million from estate and gift tax, indexed for inflation occurring after 2011	Exempts $10 million from estate and gift tax, indexed for inflation occurring after 2011*
Pass-through entities' tax rate	N/A	Allows 20% deduction for pass-through income, subject to certain limitations and phase-outs
Treatment of Deductions, Exemptions and Exclusions from Income (Prior to Itemized Deductions)		
Standard deduction	Married couples filing jointly: $12,700 Single filers: $6,350	Married couples filing jointly: $24,000* Single filers: $12,000* (indexed to inflation starting in 2019)
Personal exemption	$4,050 per dependent, subject to phase-out	Repeals
Employer reimbursed moving expenses	Qualified moving expenses are excluded from gross income	Repeals exclusion from income of employer-reimbursed moving expenses*
Moving expenses in connection with new job (unreimbursed)	Qualified unreimbursed moving expenses are excluded from gross income	Repeals deduction from income for unreimbursed moving expenses*
Treatment of Itemized Deductions		
Partial phase-out of itemized deduction on high earners	Itemized deductions are partially phased-out for high earners	Suspends phase-out of itemized deduction for high earners*
Charitable contributions	Allows deduction for charitable contributions, subject to certain limitations	Preserves deduction for charitable contribution deduction, subject to certain modifications
Medical expenses	Allows deduction for unreimbursed medical expenses that exceed 10% of adjusted gross income (AGI)	Preserves deduction for unreimbursed medical expenses (with deduction threshold decreased from 10.0% to 7.5% of AGI for 2017 and 2018)
Mortgage interest	Allows interest deduction on first $1 million of mortgage debt (for both primary and secondary homes)	Preserves current law for mortgage debt incurred prior to December 15, 2017 For mortgage debt incurred after December 14, 2017, limits deduction to interest on first $750,000 of mortgage debt (for both primary and secondary homes)*
Home equity interest	Allows deduction for interest on first $100,000 of home equity loans	Suspends interest deduction on home equity loans*

Provision	Current Law (2017 Tax Year)	Tax Act
Property tax	Allows deduction for property taxes without limitation	Allows deduction for up to $10,000 for joint filers for the aggregate of (i) State and local property tax and (ii) State and local income taxes*
State and local tax	Allows deduction for state and local taxes without limitation	
Property casualty and theft losses	Allows deduction for property and casualty losses that exceed 10% of adjusted gross income	Suspends deduction for property casualty and theft losses*
Misc. itemized deductions subject to 2% floor	Allows deduction for miscellaneous itemized deduction to the extent they exceed, in the aggregate, 2% of AGI	Suspends deduction for miscellaneous itemized deductions subject to 2% floor*

*Denotes that item will sunset at the end of 2025.

Tax Brackets for Ordinary Income (Single Filer)

Income Taxed	Current Rate (2017 Tax Year)	Tax Act	New Rate
$0-$9,325	10%	$0-$9,525	10%
$9,326-$37,950	15%	$9,526-$38,700	12%
$37,951-$91,900	25%	$38,701-$82,500	22%
$91,901-$191,650	28%	$82,501-$157,500	24%
$191,651-$416,700	33%	$157,501-$200,000	32%
$416,701-$418,400	35%	$200,001-$500,000	35%
$418,401+	39.6%	$500,001+	37%

Tax Brackets for Ordinary Income (Married Filing Jointly)

Income Taxed	Current Rate (2017 Tax Year)	Tax Act	New Rate
$0-$18,650	10%	$0-$19,050	10%
$18,651-$75,900	15%	$19,051-$77,400	12%
$75,901-$153,100	25%	$77,401-$165,000	22%
$153,101-$233,350	28%	$165,001-$315,000	24%
$233,351-$416,700	33%	$315,001-$400,000	32%
$416,701-$470,700	35%	$400,001-$600,000	35%
$470,701+	39.6%	$600,001+	37%

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