

November 7, 2017

## Introduction to the Tax Cuts and Jobs Act

On November 2, 2017, House Ways and Means Committee Chairman Kevin Brady (R-TX) released a comprehensive tax reform bill titled the “Tax Cuts and Jobs Act,” on November 3, 2017 Chairman Brady proposed an Amendment in the Nature of a Substitute to the bill and on November 6, 2017 Chairman Brady proposed an Amendment to the Amendment in Nature of a Substitute to the bill (together, the “Act”). The Ways and Means Committee (the “Committee”) will consider the Act this week, and the Senate Finance Committee expects to release its version of a tax reform bill shortly after the Committee finishes its markup of the Act. The Republican legislators’ stated goal is to reach an agreement on a single tax reform bill before the end of 2017. Given the compressed timeline to consider changes to the Act, the extensive nature of the changes under consideration and the larger political context, it is hard to predict with any certainty which proposals in the Act, if any, may ultimately become law.

In its current form, the Act would make a number of significant changes to the U.S. federal income taxation of both individual taxpayers and businesses, including:

- reducing the number of individual income tax brackets and repealing the alternative minimum tax (the “AMT”),
- increasing the standard deduction and limiting or eliminating various itemized deductions such as the state and local income tax deduction,
- doubling the federal estate, gift and generation skipping transfer (“GST”) tax exemptions and ultimately repealing the federal estate and GST taxes,
- immediately and permanently reducing the corporate income tax rate to 20% and repealing the corporate AMT,
- creating a 25% income tax rate for income attributable to certain types of businesses operated in pass-through form,
- changing the rules for carried interest by increasing the required holding period for long-term capital gains to three years in respect of certain partnership interests transferred in connection with the performance of services by taxpayers in connection with certain trades or businesses,
- imposing limits on the deductibility of business interest and eliminating deductions for certain other business expenses,

- changing to a partial territorial system of international taxation while introducing new provisions designed to combat base erosion,
- subjecting certain additional tax-exempt investors to tax on their unrelated business taxable income (“UBTI”), and
- modifying the taxation of executive and nonqualified deferred compensation.

We summarize certain key provisions of the Act below. Unless otherwise noted, the changes discussed below would be effective for taxable years beginning after 2017.

### **Tax Reform for Individuals**

The Act would introduce significant changes to the individual income tax regime.

#### ***Tax Rates***

Under the Act, the existing marginal individual income tax brackets would be consolidated into four brackets: 12%, 25%, 35% and 39.6%, with the income threshold for the 39.6% bracket raised to \$1 million from \$470,000 in the case of married taxpayers filing jointly for 2018 and the tax brackets would be indexed for inflation. The benefit of the 12% bracket would be phased out for certain high-income taxpayers. The preferential rates applicable to qualified dividends and capital gains would remain unchanged, and the 3.8% net investment tax (commonly referred to as the “Obamacare Tax”) would continue to apply.

#### ***Deductions and Exemptions***

The Act would make numerous modifications to the deductions and exemptions available to individual taxpayers. The Act would essentially double the standard deduction, while eliminating the personal exemptions. The Act would also repeal the overall limitation on itemized deductions (commonly known as the Pease limitation), and would increase the limit on the deduction for charitable contributions to 60% of a taxpayer’s adjusted gross income.

While those modifications could prove beneficial to certain taxpayers, numerous other changes in the Act would reduce or eliminate the availability of certain itemized deductions. Importantly, the Act would generally repeal the itemized deduction available to individuals for state and local income and sales taxes, but would continue to permit deductions for state and local income or sales taxes paid or accrued in carrying on a trade or business or producing income. The Act would also cap the deduction available for real property taxes at \$10,000. In addition, the Act would restrict the mortgage interest deduction by eliminating the ability to deduct interest on mortgages in excess of \$500,000 (down from \$1 million) on

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primary residences for mortgages incurred after November 2, 2017 (with limited grandfathering for certain binding contracts and refinancing transactions) and all mortgages incurred with respect to non-primary residences and home equity loans. Finally, among other things, the Act would eliminate the deduction for medical expenses, casualty losses and alimony payments.

### ***Alternative Minimum Tax***

The Act would eliminate the individual AMT, and beginning in 2019, taxpayers would be permitted to utilize any remaining AMT credits generated in earlier tax years to offset income tax liability. Beginning in 2022, taxpayers would be permitted to claim a refund for any remaining AMT credits. As a result of the proposed elimination of various itemized deductions, it is unclear whether and to what extent the AMT repeal would actually be beneficial to taxpayers that are subject to the AMT under current law.

### ***Estate and Gift Taxes***

Under the Act, beginning on January 1, 2018, the exemptions for federal estate, gift and GST taxes would double: each exemption would equal \$10 million, subject to an inflation adjustment that now applies. Under current law, the inflation adjusted figure for 2018 is \$5.6 million. Accordingly, under the Act, the new exemption figure would be \$11.2 million.

Except for the expanded exemptions, the federal estate, gift and GST tax rules would remain the same during the next six years. As of January 1, 2024, the federal estate and GST taxes would be repealed. The federal gift tax would remain, but the tax rate (beginning in 2024) would decline from 40% to 35%.

Despite the repeal of the federal estate tax beginning in 2024, assets held at death would continue to receive a new basis equal to fair market value as of date of death.

### **Partnerships and Other Pass-Through Entities**

#### ***25% Pass-Through Rate***

The Act would provide for a preferential 25% tax rate for “qualified business income” earned through certain pass-through entities such as partnerships, limited liability companies, S corporations and sole proprietorships. Certain types of income already specifically subject to either preferential rates (*e.g.*, long-term capital gains and qualified dividend income) or ordinary rates (*e.g.*, short-term capital gains and other dividends) would be excluded from the determination of “business income” for purposes of these rules. The Act also would apply a maximum 25% rate on certain dividends from a real estate investment trust.

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Under a default rule, “qualified business income” would include 100% of a taxpayer’s income from “passive business activities,” and, subject to certain exceptions (including an exclusion for professional service businesses, *e.g.*, law, accounting, trading and financial services firms among other businesses where the principal asset of such trade or business is the reputation or skill of one or more of its employees), 30% of “active business income.” Active and passive income would be determined under existing rules regarding “material participation” under Section 469 of the Internal Revenue Code of 1986, as amended (the “Code,” unless otherwise noted below, all Section references are to the Code), and the relevant Treasury Regulations, which look to, among other factors, the number of hours the taxpayer spends each year participating in the activities of the business.

As an alternative to the default rule, taxpayers with active business income would be permitted to use a “facts and circumstances” approach to have a greater percentage of their otherwise active income taxed at the preferential rate by looking to the amount of capital invested in the business. Such an approach would measure a taxpayer’s “capital percentage” based on a deemed rate of return (the federal short-term rate plus 7%) multiplied by the capital investments of the business, which generally would be measured by looking to the amount of depreciable property or real property used in such taxpayer’s trade or business. This election could be appealing to taxpayers, particularly those in non-professional service businesses, who have made large capital investments in their businesses. A similar election would also be available to taxpayers in professional service businesses who are otherwise not eligible for the preferential 25% tax rate, if the “capital percentage” described above is at least 10% with respect to the business for a taxable year. Once made, this election would be binding for a five-year period.

We expect that the changes summarized above would reduce the tax rate for investors who invest capital, directly or indirectly through pooled investment vehicles, in pass-through entities that generate operating income, including certain MLPs, while professional service providers in these vehicles (including fund managers) would continue to be taxed at ordinary rates on the same income.

We expect to see many planning strategies emerge in these areas. The range in rates applicable to U.S. taxable investors could also create complexities in the negotiation of tax distribution baskets in operating agreements and credit agreements, as lenders and preferred investors could negotiate for lower tax rates in making such distributions. In addition, the new rules may encourage private equity firms to structure more deals in pass-through form, partnerships may seek preferred equity financing in lieu of subordinated debt and domestic taxable investors might consider investing in investment funds that conduct active lending businesses.

In addition, the Act would eliminate the “limited partner” exception from self-employment tax, which many taxpayers, including asset managers, have claimed for limited partner interests they hold in businesses in which they materially participate.

***Carried Interest***

The Act would limit, but not eliminate, the current treatment of carried interest. This would be accomplished by increasing the required holding period for long-term capital gain treatment in this context to three years for income earned in respect of certain partnership interests transferred in connection with the performance of certain services by a taxpayer in any “applicable trade or business.” An “applicable trade or business” generally is raising or returning capital and either investing in or developing certain specified assets, including securities, commodities, options, derivatives or real estate for rent or investment. Amounts denied long-term capital gain treatment pursuant to this provision would be treated as short-term capital gain. The proposal contains relief for certain capital interests. These proposed changes take a different drafting approach than prior proposals in this area and appear to be aimed at carried interests held by professional money managers and not at partnership profits interest awards to management of manufacturing and non-investment services businesses.

**Corporate Tax Reform**

The Act would create a lower headline corporate tax rate of 20% for all corporations other than personal service corporations (which would be taxed at a 25% rate), repeal the corporate AMT, provide for temporary immediate expensing of certain qualified tangible property and impose limitations on certain deductions, notably including interest and net operating losses (“NOLs”).

***Immediate Expensing***

Under the Act, most taxpayers would be able, fully and immediately, to expense 100% of the cost of qualified property, which would include certain tangible personal property, acquired by the taxpayer and placed in service after September 27, 2017 and before January 1, 2023 (with an additional year for certain qualified property with a longer production period). Taxpayers would be able to expense “used” property acquired during the relevant period, subject to exclusions for property acquired in certain related party transactions. Consistent with current accelerated depreciation rules, intangible property and real property would not be eligible for immediate expensing.

***Interest Deductions***

The Act would replace existing Section 163(j), which generally applies to certain interest payments by corporations to certain related parties, with a broader limitation on interest deductibility that would apply to leveraged taxpayers more generally regardless of when the taxpayer incurred the debt, entity classification of the taxpayer or whether the lender is a related party. Under the Act, business interest expense could always be used to offset business interest income (defined as interest expense or income, as applicable, that is allocable to a trade or business). Otherwise, any net business interest expense would be disallowed to the extent the expense exceeds 30% of the business’ “adjusted taxable income,”

which would be a taxpayer's taxable income excluding business interest income or expense, any income or expense that was not allocable to a trade or business, deductions attributable to NOL carryforwards, or deductions for depreciation, amortization or depletion. Any disallowed interest expense could generally be carried forward for five years.

U.S. corporations that are part of an "international financial reporting group" would be subject to an additional limitation on the deductibility of interest. An international financial reporting group is a group of entities that includes at least one foreign corporation engaged in a trade or business in the United States or at least one domestic corporation and one foreign corporation, prepares consolidated financial statements, and has annual global gross receipts of more than \$100 million. The deductible net interest expense of the U.S. corporation would be limited to the extent the U.S. corporation's share of the group's global net interest expense exceeds 110% of the U.S. corporation's share of the group's global EBITDA. Interest expense disallowed as a result of this provision generally would be carried forward for up to five tax years. We expect that this limitation may affect multinational corporations that frequently borrow in the United States to fund operations throughout the globe, and would also limit many existing earnings stripping arrangements that may have been put in place in connection with inversion transactions.

Given the significant expansion of the restriction on interest deductibility and lack of an exception for existing arrangements or any transition rules, if enacted, taxpayers will need to move quickly to review their existing leverage profiles to determine the impact of these rules on their overall tax profile. These rules can also be expected to have an impact on capital structures for both private equity and strategic buyer acquisitions.

### ***Changes to NOLs***

Under the Act, NOL carryforwards would only be available to offset 90% of the taxpayer's income in any taxable year. This is similar to the NOL rules under the current AMT. Taxpayers could carry forward unused NOLs generated in taxable years after December 31, 2017 indefinitely (increased from 20 years), but, except for limited exceptions for certain disaster losses, taxpayers would no longer be able to carryback such NOLs to prior taxable years. NOLs that are carried forward from post-2017 periods would be increased by an interest factor equal to the short-term federal rate plus 4%, designed to preserve the value of the NOL against inflation.

### ***Other Changes***

The Act would also make other changes that would impact businesses generally, both in corporate and pass-through form, including limiting like-kind exchanges to those involving real property only and taxing businesses on contributions to capital in excess of the value of the interest in such entity issued to the contributor, for example, contributions by state and local governments (effective after the date the Act is enacted). The summary provided by the Joint Committee on Taxation that accompanies the Act clarifies

that this provision is intended to remove the federal subsidy for contributions to businesses by state and local governments, and therefore, we do not think it is intended to apply more generally to historically tax-deferred transactions under Section 351 or Section 721.

In addition, the Act would eliminate a wide range of credits, including the “orphan drugs” credit, employer-provided child care credit and the rehabilitation credit for old and/or historic buildings. Certain energy credits would also be eliminated, while others would be modified. The Act would reduce the circumstances under which a taxpayer can deduct entertainment expenses. Finally, the Act proposes significant changes to the taxation of insurance companies, which Chairman Brady subsequently indicated may be modified to address initial taxpayer concerns with such proposals.

### **International Tax Considerations**

The Act proposes sweeping modifications to existing international tax provisions, which would move the U.S. tax system closer to a territorial system and would fundamentally change the way multinational corporations are taxed.

#### ***Partial Participation Exemption/Territorial – System***

Under existing law, U.S. corporations generally are taxed on their worldwide income with foreign income earned by a foreign subsidiary of a U.S. corporation generally not subject to U.S. tax until the income is distributed to the U.S. parent corporation. To prevent U.S. corporate shareholders from avoiding U.S. tax on the distribution of earnings from a foreign subsidiary, a foreign subsidiary’s undistributed earnings that are invested in U.S. property (*e.g.*, physical assets in the United States, loans to related U.S. parties or guarantees of their debt) are deemed distributed and subject to current U.S. tax. A foreign tax credit generally is available to reduce U.S. tax owed on foreign income either actually or deemed repatriated, but the U.S. parent corporation often owes residual U.S. tax. This current system of taxation has led to multinational corporations retaining trillions of dollars of cash and other assets at foreign subsidiaries to avoid paying current U.S. tax on the foreign income.

The Act seeks to encourage the repatriation of foreign earnings to the U.S. on a go-forward basis by establishing a partial participation exemption system. Under the proposed system, 100% of the foreign-source portion of dividends paid by a foreign corporation to a 10% or more U.S. corporate shareholder would generally be exempt from U.S. taxation. No foreign tax credit or deduction would be allowed for any foreign taxes paid or accrued with respect to any exempt dividend. The exemption would not apply to dividends received from a passive foreign investment company (a “PFIC”) that is not a controlled foreign corporation (a “CFC”). In addition, current law would remain applicable to other taxpayers (*e.g.*, individuals and less than 10% corporate shareholders).

Importantly, unlike most European nations that utilize a participation system, the U.S. system would not exempt capital gains generated by disposing of qualified foreign subsidiaries.

Because a U.S. parent would no longer avoid U.S. tax under the proposed participation exemption system by reinvesting a foreign subsidiary's earnings in U.S. property rather than distributing those earnings to its U.S. corporate shareholder, the rule imposing current U.S. tax with respect to untaxed earnings of foreign subsidiaries invested in U.S. property would be repealed for U.S. corporate taxpayers. These rules would remain relevant for non-corporate U.S. shareholders.

### ***Deemed Repatriation of Deferred Earnings***

To move the U.S. to a partial participation exemption system, under the Act, all U.S. shareholders owning at least 10% of a CFC and all U.S. shareholders owning at least 10% of any foreign corporation that has at least one corporate U.S. shareholder (regardless of whether the foreign corporation is a CFC) would be deemed to receive a distribution of their pro rata share of the corporation's post-1986 historical untaxed earnings and profits, determined as of November 2, 2017, or December 31, 2017, whichever is higher, for the last taxable year of the foreign corporation beginning prior to 2018.

As the House Republicans previewed, the Act sets forth two tax rates on the deemed repatriated foreign earnings: the portion of the earnings that does not exceed the foreign corporation's cash and cash equivalents would be subject to a 12% rate while the remaining portion would be taxed at a 5% rate.<sup>1</sup> While the proposed rates are higher than expected, they are significantly lower than the current 35% corporate rate. Foreign tax credits may be partially available to offset the tax, and the U.S. shareholder may elect to pay the tax liability over a period of up to eight years, in equal annual installments of 12.5% of the total tax liability due. The current proposal does not seem to impose an interest charge on the deferred liability.

### ***Minimum Current Tax on High Return Income***

Under the Act, a U.S. taxpayer who is a U.S. shareholder of a CFC would be subject to current tax on 50% of the U.S. shareholder's pro rata amount of a CFC's income referred to as "foreign high return amounts," which is the excess of the CFC's income over a benchmark return on investment in tangible assets only (computed using a rate equal to the short-term federal rate, plus 7%). Foreign high returns would not include income effectively connected with a U.S. trade or business, subpart F income, insurance and financing income that meets the requirements for the active finance exemption from subpart F income under current law, income from the disposition of commodities produced or extracted by the taxpayer, or

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<sup>1</sup> The Act proposes complex computational rules for taxpayers to determine what qualifies as "cash" for this purpose, and generally calculates the average of a U.S. shareholder's pro rata share of the cash position over three dates (November 2, 2017 and the end of each of the taxpayer's two preceding taxable years).

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certain related-party payments. The summary provided by the Joint Committee on Taxation that accompanies the Act indicates that the inclusion is intended to subject U.S. shareholders to a current tax on intangible property held in offshore corporations.

A U.S. shareholder that includes income under this provision would receive a foreign tax credit which would be limited to 80% of the foreign taxes paid by the CFC on this income. This would effectively create a minimum U.S. tax on this income of 10%, which can be fully eliminated through foreign tax credits only if non-U.S. tax is at least 12.5%. This foreign tax credit would be in a separate basket and, as a result, could only be used to offset the U.S. shareholder's income inclusion for foreign high return amounts. Importantly, the tax would be computed by pooling the taxpayer's share of income from all CFCs, rather than on a CFC by CFC basis.

### ***Other Base Erosion Rules***

In addition to other base erosion measures discussed above (notably the interest deduction limitations and the minimum tax on high return income), the Act would also impose a 20% excise tax on payments other than interest made by a U.S. corporation that is part of an international financial reporting group to a related foreign corporation to the extent such payments are deductible, includible in costs of goods sold, or includible in the basis of a depreciable or amortizable asset, unless the related foreign corporation elects to treat the payments as income effectively connected with the conduct of a U.S. trade or business or, in certain circumstances, the payment is at cost. Under the Act, if the related foreign corporation elects to treat such payments as income effectively connected with the conduct of a U.S. trade or business, a deemed foreign tax credit is available based on the lesser of 50% of the international financial reporting group's effective foreign tax rate and 20%. Branch profits tax may also apply to such payments. Unlike most other provisions in the Act, the excise tax would apply for tax years beginning after 2018 rather than 2017, which would give taxpayers a year to restructure arrangements that may be subject to this tax.

### ***Changes to CFC and PFIC Rules***

Except as discussed above, the Act generally would leave the CFC rules in place, but with important changes, such as expanding the number of foreign corporations that may be treated as CFCs and increasing the income inclusions required for partial year CFCs. The Act would eliminate the limitation on attribution from U.S. persons to non-U.S. persons, which is often relied on by private funds in structuring offshore investments to avoid CFC status. The Act would also require U.S. shareholders of a CFC to include subpart F income even if the CFC had been a CFC for less than 30 consecutive days during the taxable year.

Separately, the Act would amend the insurance business exception to the PFIC classification to be a more objective test based in part on calculations of the entity's insurance liabilities, rather than the business activities of the entity.

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### **Tax-Exempt Organization Considerations**

While not introducing broad changes to the taxation of tax-exempt organizations, one key provision in the Act proposes a significant change for state and local pension plans that are exempt from tax under Section 115(1) (in addition to Section 501(a)) (commonly referred to as “super tax-exempt investors”). This may be particularly relevant to sponsors of private investment funds, such as private equity funds and hedge funds, which count these “super tax-exempt investors” as significant investors.

Under existing law, tax-exempt organizations, such as charities, private foundations and other non-profit organizations are exempt from U.S. federal income tax on their income unless such income is UBTI. Historically, “super tax-exempt investors” have taken the position that they are not subject to tax on their UBTI. As a result, these “super tax-exempt investors” have (i) invested in private investment funds without the use of “blocker” entities typically utilized by other tax-exempt organizations to avoid incurring UBTI and (ii) made debt-financed investments and investments in pass-through operating businesses without paying U.S. federal income tax. The Act would clarify that all tax-exempt organizations, including “super tax-exempt investors” are subject to tax on their UBTI for taxable years beginning after 2017. This change, which may be challenged by “super tax-exempt investors” on constitutional grounds, may prompt “super tax-exempt investors” to reconsider how they hold current investments in private investment funds and how they make such investments in the future, as they may choose to invest through “blocker” entities (or offshore feeder funds) going forward (or even request that sponsors restructure existing investments). It is possible that this change may also lead this subset of investors to reallocate their capital to asset classes other than private investment funds that generate significant amounts of UBTI.

The Act would also allow tax-exempt organizations operated for a religious purpose to participate and intervene in political campaigns on behalf of, or in opposition to, candidates for public office (which the “Johnson Amendment” currently prohibits for all tax-exempt organizations), so long as such speech is in the ordinary course of the organization’s business and its expenses are de minimis.

### **Significant Executive Compensation-Related Amendments**

#### ***Nonqualified Deferred Compensation Eliminated; Stock Option Taxation Revolutionized; New Deferral Opportunity for Certain Broad-Based Private Company Equity Grants***

The Act would repeal and replace the three main Code sections governing executive nonqualified deferred compensation with an even harsher new rule. Slated for repeal: Section 409A (for compensation deferrals after 2017), which prescribes timing rules for deferral elections and payment dates; Section 457A, which applies to tax-indifferent plan sponsors like offshore hedge funds, and causes the deferred amounts to be taxed when no longer subject to a service-based substantial risk of forfeiture; and Section 457(f), which limits the ability to defer compensation at tax-exempt organizations including at

foundations and charities. The Committee noted that the proposed repeals are intended to simplify an extremely complex area of law that benefits only highly compensated employees.

Proposed new Section 409B would effectively eliminate deferred compensation outside of tax-qualified retirement plans in most cases. Any amount deferred under a nonqualified deferred compensation plan (now including all stock options and other equity-based incentive awards except transfers of property like restricted shares and partnership profits interests) would be taxed when no longer subject to a service-based risk of forfeiture. With respect to options and stock appreciation rights, there is no guidance on income inclusion after vesting, although conceivably additional income recognition might occur each year after vesting until exercise. Existing awards attributable to pre-2018 services would be grandfathered until 2025 (or, if later, until vesting). Qualifying risks of forfeiture would relate only to the future performance of substantial services, and thus would exclude a covenant not to compete or the occurrence of any other condition related to the compensation's purpose, like performance-vesting conditions. Significantly, there is no guidance on how to impose taxes on a service-vesting date if the compensation is not yet then performance-vested.

The new rule would retain a short-term deferral concept that permits deferred payments until 2 ½ months following the end of the company's taxable year in which they service-vest, but it is unclear whether any other exception under Section 409A would be retained, for example, the limited exception for severance payments up to a certain threshold paid within two years following a separation from service without cause. Without such an exception, all severance benefits payable beyond the short-term deferral period would be taxed at the employee's separation from service under Section 409B, even if the payments are made in installments over time and without regard to compliance with noncompetition or other covenants.

Importantly, performance vesting would continue to be available for transfers of property like restricted stock or partnership profits interests; and so, for many employers, those arrangements might become the primary incentive equity delivery vehicle were the Act to pass in its present form. Additionally, incentive (tax-qualified) stock options would remain available and may regain popularity (especially in light of the proposed repeal of the AMT), despite the dollar limitation on scheduled annual vesting (\$100,000 per year of grant-date value).

Existing deferrals attributable to services performed prior to January 1, 2018 would remain subject to Section 409A, and if not included in income before 2026, such amounts would be taxed in the later of the last tax year (presumably of the company's) beginning before 2026 or the tax year in which the amounts service-vest. However, the Act might be applied so as to treat only a portion of an existing award as attributable to pre-2018 service (and so enjoying grandfathered Section 409B treatment at least through 2025), with the balance being subject to the new Section 409B rules starting in 2018; this could prove more than somewhat awkward, for example, in the case of outstanding stock options. The Act calls for Treasury guidance shortly after enactment providing for a period during which such deferrals may be

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amended to conform to these payment dates without violating Section 409A, and such amendments would not be considered a material modification of the deferral, which would otherwise require compliance with Section 409A.

Interestingly, this anti-deferred compensation Act offers a deferral opportunity not available under current law: to defer tax on stock compensation for up to five years, in the case of certain broad-based plans in private companies. Options and restricted stock units (RSUs) granted under qualifying plans would be free from the harsh early recognition rules of new Section 409B described above.

***Proxy Officer Compensation over \$1 Million would be Nondeductible, even if Performance-Based and Shareholder-Approved***

Deductions for compensation in excess of \$1 million payable to a public company's CEO or three other most highly compensated officers (other than the CFO), as identified in the company's annual proxy statement, are currently only permitted under Section 162(m) with respect to certain performance-based compensation. The Act would eliminate this exception for performance-based compensation, broaden the covered employees to include any person who served as the CEO or CFO at any time during the taxable year and expand the companies subject to this provision to include those required to file reports under section 15(d) of the Securities Exchange Act of 1934 (e.g., certain debt issuers and issuers with a recent registration statement). Further, once covered by Section 162(m) after 2016, the individual's compensation from the company in future taxable years, including severance benefits, would remain subject to this deduction limitation.

***Exempt Organization Compensation: New Excise Tax on Top Five Executives' Compensation Over \$1 Million***

The Act would introduce a new Section 4960, which the Committee states would be the Section 162(m) analogue for tax-exempt organizations. Any compensation in excess of \$1 million payable to any one of the five highest compensated employees of the organization for the applicable taxable year or any future taxable year would be subject to a 20% excise tax, payable by the organization. The excise tax would also apply to any "excess parachute payments." However, unlike the golden parachutes under Section 280G, these would cover large severance payments irrespective of a change in control transaction.

We will continue to monitor developments in this area and report as matters progress.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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