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Examining the Impact of the 2016 US Elections on Executive Compensation

Will it soon be time to chart a new course in executive compensation?

As a result of the November 8, 2016 election, Republicans will control the Presidency, the Senate and the House of Representatives beginning on January 20, 2017. As a candidate, President-Elect Donald Trump proposed a tax plan and a rollback of federal regulations (including the Dodd-Frank Act), both of which could significantly affect US executive compensation practices. In addition, Republican members of Congress have introduced executive compensation-related legislation that could serve as the basis for laws the incoming Congress would consider, and the House Ways and Means Committee is reportedly in the process of drafting tax reform legislation to be released this winter.

There is no guarantee that any of Mr. Trump's specific campaign proposals or any current Republican-sponsored legislation will become law. Some changes to current laws and regulations require Congress to pass legislation that the President would need to sign into law. Other changes could be made via federal agency regulation, federal agency enforcement (or non-enforcement) priorities, or federal agency litigation strategy. And, in some cases, Mr. Trump's campaign statements were directional rather than specific and left exact policy details to be worked out with Congress in the future.

But with Republicans poised to control both the Presidency and Congress, we believe that it is reasonable to begin looking at Mr. Trump's and Congressional Republicans' current proposals and to begin assessing how incentive compensation, equity-based compensation, non-qualified deferred compensation and carried interest programs could evolve in coming years.[1] We will also address the possible effect of the Trump administration and the new Congress on the new Fair Labor Standards Act overtime regulations that are scheduled to become effective on December 1, 2016.

Securities and Exchange Commission (SEC) Regulation

As a candidate, Mr. Trump proposed a moratorium on new federal regulations that are not compelled by Congress or public safety. In addition, Mr. Trump criticized the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) during the campaign for, in his view, stifling economic growth and said that he would "absolutely" consider repealing it. Although we do not believe that a complete repeal (or even a substantial repeal) of the entire Dodd-Frank Act is likely, we do believe that certain Dodd-Frank Act provisions relating to executive compensation could be repealed or modified — particularly provisions that have not yet become effective.

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The Dodd-Frank Act

Should Mr. Trump and Congress make good on campaign promises to repeal the Dodd-Frank Act in its entirety, all of the executive compensation-related rules implementing it would be repealed, including the following rules that are not yet effective:

- The proposed rules regarding disclosure of pay for performance, implementing Section 953(a) of the Dodd-Frank Act[2]
- The proposed rules regarding clawbacks of incentive compensation, implementing Section 954 of the Dodd-Frank Act[3]
- The regulations proposed by various federal agencies to limit incentive compensation practices at financial institutions, implementing Section 956 of the Dodd-Frank Act[4]
- The final CEO pay ratio rules scheduled to become effective following 2017 requiring public companies to disclose the ratio of the compensation of the chief executive officer to that of the median of its employees, implementing Section 953(b) of the Dodd-Frank Act[5]
- The proposed rules regarding employee and director hedging, implementing Section 955 of the Dodd-Frank Act

In addition, if the Dodd-Frank Act were to be fully repealed, the currently effective say-on-pay, say-when-on-pay, and say-on-golden-parachute requirements would be repealed along with the Compensation Committee independence and Chairman/CEO structure proxy disclosure rules that the SEC promulgated under the Dodd-Frank Act. All of these rules are well-established at this point, so it would not be surprising to see these rules remain in place and to see some or all of the Dodd-Frank Act executive compensation rules that are not yet effective be repealed or modified. The CEO pay ratio rule, for example, has come under intense criticism in the past by Republican members of the SEC and Congress for imposing potentially heavy administrative burdens on companies while providing, in their view, little benefit for shareholders.

Taxation

Mr. Trump and Republicans in Congress have indicated that they intend to overhaul the tax code, and plan to decrease individual and corporate income tax rates. During the campaign, Mr. Trump proposed a tax plan that would reduce the current seven income tax brackets to three brackets: 12%, 25% and 33% (a reduction from the current maximum rate of 39.6%). In addition, the maximum corporate income tax rate would be reduced from 35% to 15%, the "carried interest loophole" would be eliminated and the alternative minimum tax would be repealed.[6] These changes could all be expected to influence the design and drafting of executive and management compensation programs.

Deferred Compensation

If Mr. Trump's tax proposal is adopted in the future, it would likely discourage the use of deferred compensation plans and arrangements because the lower the income tax rate in effect, the less incentive individuals have to defer taxes (and the more risk that rates will increase in the future). However, if an individual believes that US federal income tax rates are likely to be reduced in a Trump administration, he or she may wish to defer compensation otherwise payable in 2016 or 2017 into a future year when federal income tax rates are expected to be lower. Conversely, due to the uncertainty regarding potential changes to tax law, an individual who values certainty may wish to accelerate payments into this year or next year. Before either accelerating or deferring income, however, individuals should consult with

counsel regarding the effects of Section 409A of the Internal Revenue Code (Section 409A), which governs the taxation of deferred compensation and imposes strict limitations on changes in the time of payment of income and severe penalties for non-compliance.[7]

Although Mr. Trump's tax proposal did not provide specific detail on reforming the taxation of deferred compensation, it is conceivable that the current deferred compensation tax regime could be overhauled completely by Congress and Mr. Trump to eliminate or severely curtail the ability of individuals to defer compensation from the year earned into a future year. In 2014, former House Ways and Means Committee Chairman Dave Camp (R - MI) introduced a comprehensive tax reform bill that included several executive compensation proposals that could serve as a framework for Mr. Trump and the Republican Congress. The Camp bill included provisions revoking Section 409A (which generally allows deferral of taxation on vested compensation until the compensation is actually paid, so long as complicated rules are complied with, and exempts non-discount stock options and stock appreciation rights) and replacing it with a simpler provision (Section 409B), which would tax deferred compensation, including stock options and stock appreciation rights, when the compensation is no longer subject to a substantial risk of forfeiture (*i.e.*, when it vests).[8] If such a provision were to be adopted into law, companies would be required to analyze and revamp all their outstanding deferred compensation arrangements. Under both Section 409A and proposed Section 409B, deferred compensation includes not only traditional deferred compensation plans but also severance payments paid in installments under an employment agreement, so these employment agreements and other severance arrangements would need to be reviewed as well. The Camp bill contemplated only limited grandfathering.

On the other hand, other recently proposed legislation that the Trump administration could consider in connection with broader tax reform would serve to encourage certain deferrals of compensation. Currently, stock transferred to employees upon the exercise of nonqualified stock options or the settlement of restricted stock units (RSUs) is taxed upon the receipt of the underlying stock by the employee upon exercise or settlement (or the later vesting of the underlying shares, if the shares are subject to vesting requirements), and it is difficult to defer the receipt of the shares beyond exercise or settlement. The House passed the bipartisan Empowering Employees through Stock Ownership Bill (HR 5719) shortly before recessing in the fall of 2016. The bill would allow certain employees of private corporations that have broad-based equity plans to elect to defer income attributable to stock received upon exercise of a stock option or settlement of an RSU for up to seven years.[9]

Performance-Based Compensation

As mentioned above, Mr. Trump's tax plan would lower the corporate tax rate from 35% to 15% and eliminate the alternative minimum tax. If corporate tax rates are reduced, the value of corporate deductions would decrease and thus corporations may be less concerned about limitations on the deductibility of compensation. For example, Section 162(m) of the Internal Revenue Code denies a deduction to public companies for compensation paid to certain executive officers in excess of US$1 million per individual, with an exemption for performance-based compensation. If corporate tax rates are reduced to 15%, companies may be less concerned with structuring their compensation to avoid the deduction limitation under Section 162(m). Companies could instead, for example, structure compensation to be less tied to performance, and more fixed (*e.g.*, greater base salaries or guaranteed bonuses) or discretionary (*e.g.*, annual bonus amounts determined in the discretion of the Board of Directors or Compensation Committee, rather than based on pre-established, objective performance goals). Similarly, companies may be less inclined to grant nonqualified stock options (which are generally considered performance-based compensation for purposes of Section 162(m)) or performance shares and may instead grant time-vesting restricted stock or restricted stock unit awards.[10]

In addition, if corporate income tax rates are reduced, companies that utilize performance targets measured on an after-tax basis for annual performance-based bonuses, performance shares or other incentive compensation arrangements may wish to review the goal amounts and the adjustment language in the applicable plan documents to make sure that the goals may be equitably adjusted if appropriate to reflect the lower corporate income tax rates.

Carried Interest

Private equity and hedge fund partners often share in the profits of the partnership through a "carried interest." Under current law, partners are generally not taxed upon the receipt of these interests, and their allocable share of partnership income, including the character of such income, flows through to them. Thus, to the extent that the partnership's profits constitute long-term capital gains, partners who are individuals are taxed on their allocable share of such capital gains at a current maximum federal rate of 20% (rather than the 39.6% maximum ordinary income tax rate). To take advantage of this rule, many private equity and hedge funds compensate employees with carried interests, or profits interests.

Over the past few years, there have been various proposals to eliminate the carried interest "loophole." Both Democrats and Republicans — including Mr. Trump — have expressed an intention to tax carried interests like ordinary income.

Mr. Trump's campaign has not specified whether carried interest should be subject to individual or corporate income tax rates (or special small-business or partnership tax rates). If carried interest would be subject to ordinary income tax rates, this would eliminate the advantage of compensating employees with profits interests as opposed to corporate stock options, and companies may then wish to re-evaluate the forms of compensation they provide.[11]

Incentive Stock Options

Under current tax law, incentive stock options (ISOs) are theoretically more desirable to employees than nonqualified stock options because, if statutory requirements are met, they allow the gain on the underlying stock price between the grant date and the exercise date to be taxed at capital gains rates and they delay taxation until the date the shares are ultimately sold. In contrast, the gain between the grant date and the exercise date for nonqualified stock options is taxed at ordinary income rates on the exercise date. As a practical matter, however, the tax benefits of ISOs to employees are often not fully realized because ISOs are subject to the alternative minimum tax (AMT), which requires complicated separate tax calculations and often eliminates much or all of the ordinary income tax savings to the employee. In addition, the company does not receive a tax deduction with respect to ISOs that satisfy the statutory requirements (while companies generally receive deductions with respect to nonqualified options). If the AMT is eliminated, if capital gains rates remain lower than ordinary income rates, if corporate income tax rates are reduced (making the lost deduction less significant to companies), and if the tax advantage of carried interest is eliminated, there may be a renewed interest in utilizing ISOs to incentivize employees.[12]

FLSA Overtime Rules

New overtime regulations promulgated by the Department of Labor (DOL) under the Fair Labor Standards Act (FLSA) are scheduled to go into effect on December 1, 2016. Under the new rules, any employee who earns less than US$47,476 annually will be classified as "non-exempt" for purposes of the FLSA and will be entitled to overtime pay. Prior to the effectiveness of these new regulations, any employee who earned at least US$23,660 annually could generally be treated as an "exempt" employee for purposes of the FLSA, and the employer would be exempt from the overtime pay obligations. In Mr. Trump's only

comments during his election campaign regarding the new FLSA rules, he indicated that he would favor a small business exception. There is no record of Mr. Trump calling for the complete invalidation of the FLSA rules, although the elimination of these rules would be consistent with his stated views on regulations of this nature generally.

Such a rollback could be achieved in several ways. The most conventional path would be for the new DOL under the Trump administration to promulgate new proposed regulations that supersede these rules. This approach would require the DOL to comply with all the standard procedures by which the current rules were generated, including the publication of proposed rules, a notice and comment period, and the publication of final rules (addressing the comments received) at least 60 days before the new rules go into effect. This is a relatively lengthy process — for reference, the rules that are going into effect on December 1, 2016 are the final result of a process that began with a presidential memo issued in March 2014. The DOL could speed up the process by invoking Administrative Procedure Act exemptions that allow it to dispense with the notice and comment period and/or pre-publication requirements in limited circumstances. But invoking these exemptions could open the DOL up to litigation risk and it would need to demonstrate that there was particular urgency that justified short-circuiting the usual process in implementing new regulations.

Another approach would be to look to Congress to pass legislation invalidating the new overtime regulations. When these FLSA rules were released in May 2016, House Speaker Paul Ryan issued a statement that concluded, “We are committed to fighting this rule and the many others that would be an absolute disaster for our economy.” President Obama would have vetoed any such countervailing legislation, but a President Trump is likely to sign it into law. If repealing these regulations is a legislative priority for the new Congress, as it very well may be, this could be accomplished relatively quickly after January 20, 2017.

A third possibility would be for the Trump administration to attempt to invalidate the overtime rules by consent decree in one of the pending lawsuits challenging the rules. The new DOL could file a brief in the case agreeing with the challengers that the new rules are inconsistent with the statute or otherwise invalid under the Administrative Procedure Act, which would allow the court to strike down the rules without engaging in the procedures described above for the adoption of new superseding rules. Notably, a consolidated 21-state lawsuit challenging the DOL’s statutory authority to issue the final rules is currently pending in the Eastern District of Texas, pursuant to which the challengers are seeking an injunction against the implementation of the rules on December 1, and a hearing in the case has been set for November 16, 2016. While the Eastern District of Texas court could point to the election results as a reason to delay implementing the rules, the judge in the case is an Obama appointee and whether he will issue an injunction on the basis that the new administration should be setting the terms of the exemptions to the FLSA overtime rules remains unclear.

In the meantime, employers should assume that the new overtime regulations will go into effect beginning on December 1, 2016, and will remain in effect at least until January 20, 2017 (and, as noted above, will likely remain in effect for a longer period unless a court issues a consent decree and/or Congress takes immediate action). Accordingly, employers should ensure that they are in a position to classify and compensate their employees in compliance with these new FLSA rules. Because of the potential employee relations difficulties of walking back a raise once it has been provided, employers may wish to consider classifying affected employees (particularly employees who do not frequently work overtime) as non-exempt, rather than increasing their salaries.

Next Steps

At this point, the changes to be made by the incoming Congress and the Trump administration to federal tax laws, the Dodd-Frank Act, the FLSA regulations and other federal rules impacting executive compensation and employee matters are still coming into focus. As the contours of these changes become more clear, companies and individuals will wish to review their executive compensation programs and employee practices to ensure that they serve the employer's purpose of motivating, retaining and incentivizing employees in the most effective possible manner under the new rules. We expect to provide periodic updates as this process unfolds.

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Endnotes

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[1] This *Client Alert* does not address the potential repeal or modification of the Affordable Care Act, which we intend to address separately in the future.

[2] See previous discussion in Latham & Watkins *Corporate Governance Commentary*, "New SEC Rules on Pay versus Performance," May 5, 2015.

[3] See previous discussion in Latham & Watkins *Client Alert* Number 1862, "How to Navigate the SEC's Proposed Mandate on Clawbacks," August 4, 2015.

[4] See previous discussions in Latham & Watkins *Client Alert* Numbers 1177, "Federal Agencies Propose Rules on Dodd-Frank Incentive Compensation Requirements for Financial Institutions," April 20, 2011, and 1962, "Revised Rules on Dodd-Frank Incentive Compensation Requirements for Financial Institutions Proposed," May 4, 2016.

[5] See previous discussions in Latham & Watkins *Corporate Governance Alert*, "SEC Has Issued Proposed CEO Pay Ratio Disclosure Rules, September 2013; and Latham & Watkins *Client Alert* Numbers 1864, "SEC Adopts CEO Pay Ratio Disclosure Rules," August 12, 2015, and 2026, "New SEC Staff Guidance on CEO Pay Ratio Disclosure Rules – Determining the Median Employee," October 31, 2016.

[6] In addition, the 3.8% net investment income tax would be eliminated. The House Republicans would tax corporate income based on a consumption-based approach focused on business cash flow and would lower the corporate tax rate to a flat 20% and the maximum rate for income from pass-through businesses to 25%.

[7] See Latham & Watkins *Client Alert* Number 589, "Internal Revenue Service Issues Final Regulations under Section 409A of the Internal Revenue Code," April 12, 2007.

[8] Under the proposal, compensation would be considered to be subject to a substantial risk of forfeiture only if the individual's rights to such compensation are conditioned upon the future performance of substantial services. This approach is consistent with Section 457A of the Internal Revenue Code, but is unlike Section 409A of the Internal Revenue Code, which also recognizes performance conditions as imposing substantial risks of forfeiture. Under the proposed Section 409B, compensation would not be treated as deferred if the service provider receives payment of such compensation no later than six months after the end of the taxable year of the employer during which the compensation vests.

[9] The following employees are excluded from coverage by the bill: (i) any individual who is, or has been at any time, a 1% owner of the corporation, (ii) any individual who is, or has been at any time, the chief executive officer or chief financial officer of the corporation, (iii) any individual who is a family member of an individual described in (i) or (ii), or (iv) any individual who is, or has been for any prior taxable year, one of the four highest compensated officers of the corporation. An eligible corporation covered by the bill is a corporation in a calendar year if (1) no stock of the corporation is readily tradable on an established securities market during such year or any preceding year and (2) the corporation has a written plan under which, for the calendar year, not less than 80% of the corporation's employees receive stock options or RSUs with the same rights and privileges to receive qualified stock. If the employee makes a deferral election, the amount of income required to be included at the end of the deferral period will be based on the value of the stock at the time the employee's right to the stock is substantially vested, notwithstanding whether the value of the stock has declined over the deferral period. The employer's deduction for the income attributable to the stock would be correspondingly deferred.

[10] Dave Camp's bill proposes to eliminate the performance-based exception from Section 162(m) of the Internal Revenue Code entirely.

[11] If, however, carried interest becomes subject to a special partnership tax rate, such as the 15% maximum rate that Mr. Trump's campaign proposed at one point but which seems to have been abandoned, then carried interest awards for private equity or hedge fund managers may remain viable.

[12] The tax advantages of ISOs will not apply unless the shares are held by the employee until the later of (i) two years after the date of grant of the ISO and (ii) one year after exercise and other statutory requirements are met.