LATHAM&WATKINS

Client Alert Commentary

Latham & Watkins Tax Practice and Benefits, Compensation & Employment Practice

November 8, 2017 | Number 2240

Executive Compensation Ramifications of Proposed Tax Cuts and Jobs Act

In its current form, the proposed legislation would drastically change the tax treatment of executive compensation in several areas.

The Tax Cuts and Jobs Act, as proposed by the Ways and Means Committee of the US House of Representatives, and amendments proposed by its Chairman Congressman Kevin Brady (together, the Proposed Act), would implement sweeping reforms to the provisions of the Internal Revenue Code (the Code) governing executive and director compensation, fundamentally altering the:

- Taxation of nonqualified deferred compensation
- Taxation of long-term incentives and most forms of equity compensation
- Deductibility by public companies of executive compensation of more than US$1 million per year
- Compensation practices for highly compensated employees of tax-exempt organizations

If adopted, these changes would have a significant impact on the executive compensation practices that most companies utilize today, requiring companies to rethink and restructure their incentive and other compensation practices.

This *Client Alert* addresses the aspects of the Proposed Act that impact executive compensation. Latham & Watkins will be publishing additional materials analyzing the Proposed Act more broadly and other specific provisions in it, as well as any subsequent developments.

Deferred Compensation, Long-term Incentives and Equity Compensation

Current Law

Under current law, nonqualified deferred compensation is defined broadly as compensation that is earned or vests in one year, but may be payable in a future year. Nonqualified deferred compensation plans and arrangements include traditional executive deferred compensation plans and supplemental executive retirement plans (SERPs), as well as many equity arrangements (including certain restricted stock units), bonus plans, severance, and other employment arrangements. Stock options and stock appreciation rights (SARs) that are granted at fair market value and meet certain other requirements are currently not considered nonqualified deferred compensation, despite the fact that options and SARs may vest in one year, but not be exercised until a future year. Compensation that must be paid within two and one-half months following the year in which it vests also is not treated as deferred compensation. Under current law, nonqualified deferred compensation is generally taxed when it is paid as long as it meets certain requirements set forth in Section 409A of the Code (Section 409A). If compensation does not meet the requirements of Section 409A (or the conditions of an available exception), then the compensation is taxed immediately upon vesting (*i.e.*, when no longer subject to a substantial risk of forfeiture), rather than when paid, and is further subject to an additional 20% penalty tax. Additional interest penalties and state taxes may also apply to a non-compliant arrangement.

Proposed Changes

Under the Proposed Act, any nonqualified deferred compensation earned for services performed after 2017 would be taxed at vesting, rather than when the compensation is actually paid. The company would continue to be entitled to the corresponding deduction for the compensation only upon its payment.

In addition, compensation will be considered to be subject to a substantial risk of forfeiture (and thus unvested) *only* if the service provider's right to receive the compensation is conditioned upon the future performance of substantial services. Under current law, payments conditioned upon the achievement of performance goals — including the attainment of liquidity events — are generally considered to be subject to a substantial risk of forfeiture (unvested) as a result of such conditions. This new limitation on available vesting conditions would mean, for example, that long-term cash and equity incentives that would otherwise vest based on performance conditions and be taxed after termination of employment will instead be deemed vested (and thus includible as taxable income) sooner (and in all cases no later than termination of employment).

Another significant change is that stock options and stock appreciation rights will now generally be considered nonqualified deferred compensation, even if granted at fair market value, and will be taxed upon vesting, rather than upon exercise, unless the discussion below regarding "Qualified Equity Grants" applies. Under the Proposed Act, incentive stock options, however, will not be subject to these new rules and will continue to be taxed at capital gains rates if employees meet certain holding requirements. The taxation of restricted stock is unaffected by the Proposed Act (assuming the stock is not restricted stock received upon exercise of a stock option or settlement of a restricted stock unit, which is treated as described under Qualified Equity Grants below — unless a Section 83(b) election is made to cause such stock to be taxed upon receipt).

While the new rules would initially apply only to compensation for services performed after 2017, existing deferrals for services performed before 2018 would become subject to the new rules in 2026 (and therefore subject to taxation in the later of the last taxable year before 2026 and the time of service vesting). The Proposed Act directs the Treasury Department and the IRS to issue guidance to allow companies to make changes to the currently scheduled time of payment of deferred compensation in order to comply with the new rules, without violating the current restrictions on accelerating payments contained in Section 409A. The new rules would be codified in a new Section 409B of the Code. The existing Section 409A and Section 457A of the Code, which applies to nonqualified deferred compensation of certain foreign entities, would be repealed.

Considerations

In its current form, the Proposed Act makes many existing compensation formats unattractive and would likely require companies to restructure their executive compensation practices:

- **Equity awards:** All nonqualified stock options, equity appreciation rights and equity-based incentive awards (other than restricted stock) granted after 2017, or currently outstanding but not vested as of December 31, 2017, will be included in income of the service provider upon service vesting (regardless of whether these awards are exercised and regardless of whether they remain subject to any performance condition), unless the Qualified Equity Grant discussion below applies. Companies may instead rely more heavily on the grant of incentive stock options and/or restructure their awards so that the awards pay out only upon service vesting, such as by requiring continued employment until a liquidity event. In the latter case, companies would then need to be especially mindful of equity awards that vest upon retirement, because for tax purposes the vesting would occur upon the individual reaching the age/years of service for retirement eligibility, even if the individual does not actually retire at that time.

- **Profits interests:** The Proposed Act does not change the beneficial tax treatment of profits interests (which generally result in taxation at capital gains rates) other than those granted to individuals engaged in the business of capital investment and related activities (as described in further detail below). This benefit, along with several others for pass-through entities under the Proposed Act, will likely result in a shift from private companies using a corporate form and stock-based equity awards to using a partnership form and profits interests to incentivize executives instead.

- **Severance compensation:** The practice of paying severance compensation in installments over a one- or two-year period following termination of employment would likely cease, as under the Proposed Act, severance would be taxable in its entirety upon termination of employment, except to the extent it is paid no later than two and one-half months after the end of the year of termination. Instead, companies would likely pay severance in a lump sum upon termination or shortly thereafter, making it more difficult to enforce noncompetition and other post-employment restrictive covenants.

- **"Walk rights":** The practice of providing executives with "walk rights" (*i.e.*, rights to resign following an event or specified period and still collect severance) would likely cease. Walk rights became less popular after the enactment of Section 409A because of more rigorous compliance requirements of Section 409A. Walk rights would likely be eliminated entirely if the Proposed Act becomes law, since these rights would be treated as vested and subject to taxation on the full severance amount as soon as the walk rights become exercisable, even if the executive opts not to terminate employment at that time.

- **Traditional Nonqualified Retirement plans:** Due to the taxation at vesting, traditional nonqualified retirement plans, including excess benefit plans (which supplement 401(k) contributions — both employee and employer match — and other tax qualified retirement plans) as well as SERPs, would become obsolete, since the amounts deferred into these plans are usually vested immediately or upon the same schedule as the tax qualified plan.

- **Annual bonus programs:** Annual bonus programs would need to pay out no later than March 15th of the year following the performance year or else require continued employment through the applicable payment date, if allowable under state law, to avoid potential taxation at the end of the performance year (prior to payment). In addition, long-term cash incentive plans that permit vesting of all or a portion of the award following good leaver terminations (based in part on post-termination performance of the company) would need to make payouts at or shortly after termination of employment instead of waiting until the performance period ends, as these awards would be deemed vested at termination for purposes of the Proposed Act.

New Treatment for Qualified Equity Grants

Current Law

As described above, under current law, stock options that are granted at fair market value and meet certain other requirements are currently not taxed until they are exercised, and restricted stock units (RSUs) that are exempt from or comply with Section 409A are not taxed until they are settled.

Proposed Changes

The Proposed Act generally requires stock options and RSUs to be taxed upon vesting. However, the Proposed Act would add a new Section 83(i) to the Code to provide limited relief from the normal application of the rules for employees of private companies who receive stock options or RSUs. Such employees would be able to defer taxation for up to five years after vesting.

In order to qualify, an employee would need to make an election within 30 days following vesting. If the election is made with respect to incentive stock options or an option granted under an employee stock purchase plan, then the existing rules relating to these statutory stock options and the related stock would not apply.

Notably, this exception to the Proposed Act would not apply to a present or former CEO or CFO, any 1% owners at any time during the 10 preceding calendar years or the four most highly compensated officers during any of the 10 preceding calendar years. Furthermore, the provisions would require that the corporation grant stock options or RSUs with the same rights and privileges to at least 80% of its US employees in the same year as the grant of the options or RSUs in question. As a result, only broad-based grants on similar terms would qualify for the exception. However, the number of shares made available to all employees would not need to be equal in amount (as long as the number of shares available to each employee is more than a de minimis amount). The exception is not available for companies that have securities readily tradeable on an established exchange or for option or RSU grants made to directors or contractors.

Considerations

Although the Qualified Equity Grant proposal does provide some relief from the Proposed Act's new mandate requiring taxation upon service vesting for stock options and RSUs, the application of the proposal may not prove useful given the narrow scope and complexities.

Public Company and Public Debt Issuer Limitations on Deductible Compensation

Current Law

In general, Section 162(m) of the Code (Section 162(m)) limits to US$1 million the yearly deduction that a corporation with publicly traded equity may claim with respect to annual compensation paid to a "covered employee." For corporations that are not categorized as smaller reporting companies or emerging growth companies, a covered employee includes only the corporation's principal executive officer(s) during such year and the three other executive officers with the highest total compensation during such year other than the principal financial officer. There are broad exceptions from the Section 162(m) limit for commission-based compensation and qualified performance-based compensation Qualified performance-based compensation is compensation that is conditioned on the achievement of preestablished objective performance goals and that meets certain other requirements set forth in the Code and the regulations, and also includes typical stock options and stock appreciation rights. Companies that issue public debt but that do not have publicly traded equity are not subject to Section 162(m) deduction limitations.

Proposed Changes

The Proposed Act removes the exceptions for commission-based compensation and performance-based compensation, making all compensation greater than US$1 million per year non-deductible for taxable years beginning after December 31, 2017. The compensation affected (subject to the US$1 million threshold) would generally include any portion of a covered employee's outstanding performance-based awards granted on or prior to December 31, 2017 that becomes payable in 2018 or later.

In addition, the Proposed Act modifies the scope of the covered employees subject to the deduction limitations. In addition to the principal executive officer(s) and the three other executive officers with the highest total compensation for such fiscal year, the principal financial officer will also be included to align with SEC disclosure rules. Further, if an executive officer qualifies as a covered employee of a corporation in one fiscal year, he or she will automatically be considered a covered employee of such corporation in all subsequent fiscal years in which he or she receives compensation from such corporation.

Finally, the Proposed Act expands the breadth of Section 162(m) to apply to corporations with publicly traded debt.

Considerations

If the Section 162(m) provisions of the Proposed Act were to be enacted in their current form:

- Repeal of the performance-based compensation exception to the Section 162(m) limit on deductibility would likely lead companies to award more compensation that is not based on the achievement of objective performance goals. Salaries may increase and other compensation may be tied solely to continued service and/or to more subjective performance goals.

- If a corporation has a large number of executive officers with heavy volatility in total annual compensation provided to those executive officers, the Proposed Act's requirement that executive officers who are covered employees remain covered employees for so long as they receive compensation from the corporation could eventually result in far more than five individuals qualifying as covered employees in a fiscal year. This could lead to a significant increase in lost compensation deductions. To mitigate this result, corporations may seek to limit the number of individuals who are designated as executive officers and/or may seek to provide relatively consistent compensation to executive officers, so that the pool of covered employees does not change over time.

- Corporations with publicly traded debt that do not have publicly traded equity would need to consider their executive compensation programs in light of Section 162(m) for the first time.

Carried Interests

Current Law

Partnership profits interests are generally subject to capital gains tax rates (with a top marginal rate currently equal to 23.8%) rather than the typically higher ordinary income tax rates (with a top marginal rate currently equal to 39.6%). Profits interests held for one year or less result in short-term capital gains tax treatment (effectively ordinary income tax treatment) and profits interests held for more than one year result in long-term capital gains tax treatment.

Proposed Changes

The Proposed Act seeks to provide that profits interests granted to individuals engaged in the business of capital investment and related activities and held for three years or less would be subject to short-term capital gain treatment.

Considerations

Companies engaged in the business of capital investment and related activities that grant profits interests to individual service providers should consider that disposition of such interests within three years of grant will generally result in short-term capital gain treatment for the recipients. Such companies may want to take steps to maximize the likelihood that such interests will remain outstanding for three years prior to a sale of the interest so that individual service providers will benefit from long-term capital gains tax treatment. Such companies may also want to consider simpler forms of incentives with respect to which long-term capital gains benefits are not likely to be realized.

Excise Tax on Tax-Exempt Organization Employee Compensation

Current Law

There is currently no bright-line rule or limitation on providing excessive compensation to employees of a tax-exempt organization other than that the compensation provided to such employees must be fair and reasonable.

Proposed Changes

The Proposed Act seeks to impose a limitation on compensation practices at tax-exempt organizations that is similar to Section 162(m) for public companies. Although not identical to Section 162(m), a tax-exempt organization that provides compensatory payments in a fiscal year in excess of US$1 million (subject to certain exclusions) to a covered employee of the tax-exempt organization would be liable for an additional 20% tax on such payments (*i.e.*, imposed on the employer) beginning in any fiscal year following December 31, 2016. For purposes of this provision, a covered employee would include the five most highly compensated employees of the organization in any given fiscal year. As in the case of the Section 162(m) revisions, any such employee will automatically be considered a covered employee in all subsequent fiscal years in which he or she receives compensation from the organization. Additionally, the Proposed Act imposes a 20% tax on severance payments to covered employees similar to the “golden parachute” tax under Sections 280G and 4999 of the Code.

Considerations

Tax-exempt organizations may seek to immediately curb individual annual compensation to amounts below US$1 million and restructure severance arrangements to avoid potentially triggering a 20% excise tax liability. This limitation will significantly impact non-profits and state universities that compete for talent with for-profit entities.

Conclusion

The Proposed Act is currently in the initial stages of the legislative process and may change significantly, or it may not be enacted at all. While making changes to existing arrangements based on the Proposed Act would be premature, companies should begin to think about the ramifications for their compensation arrangements and consider what changes would be necessary or desirable if the Proposed Act were enacted. In addition, companies that are currently amending any of their existing compensation arrangements or entering into any new arrangements in the ordinary course should consider including appropriate reservations of rights to permit flexibility to make unilateral revisions to address any future tax law changes.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Matthew R. Conway
matthew.conway@lw.com
+1.202.637.1086
Washington, D.C.

Lori D. Goodman
lori.goodman@lw.com
+1.212.906.4533
New York

Laurence Seymour
larry.seymour@lw.com
+1.213.891.8780
Los Angeles

Maj Vaseghi
maj.vaseghi@lw.com
+1.650.470.4852
Silicon Valley

Rifka M. Singer
rifka.singer@lw.com
+1.212.906.4528
New York

Max Raskin
max.raskin@lw.com
+1.212.906.1781
New York

James I. Robinson
james.robinson@lw.com
+1.650.470.4983
Silicon Valley

Jordan S. Salzman
jordan.salzman@lw.com
+1.212.906.4625
New York

You Might Also Be Interested In

US Tax Reform Resource Center

We've Got Washington Covered

2018 Proxy Season: Strategically Preparing for the Upcoming Season

Public Company Summer/Fall To-Do List: 5 Steps Toward CEO Pay Ratio Disclosure

Designing and Administering Executive and Director Compensation in Today's Uncertain Environment

---