Proposed Tax Legislation Would Affect Executive Compensation

In recent weeks, both the House of Representatives and the Senate have taken up tax reform bills that include potential changes to the current federal tax laws governing executive and equity compensation. Last Thursday, November 9th, the House Ways and Means Committee approved its reform bill (H.R. 1, the "Tax Cuts and Jobs Act") which now has been approved by the full House. Also on November 9th, the Senate Finance Committee released its version of the legislation (which is in the form of a conceptual narrative, rather than actual bill text), which is currently being debated and revised by the committee.

While there are many unanswered questions about the pay-related provisions at this time and the bills will likely continue to change significantly in the coming weeks, this Thoughtful Pay Alert summarizes our initial assessment of the provisions in the bills as of November 16th that could have an impact on the way companies compensate their executives and other employees

Key Executive Compensation-Related Provisions of the Tax Cuts and Jobs Act

Elimination of "Performance-Based Compensation" Exclusion from Section 162(m)

Currently, Section 162(m) of the Internal Revenue Code disallows public companies a federal income tax deduction for remuneration in excess of $1 million paid to its so-called "covered employees"

Four Things That Technology and Life Sciences Companies Should Know About the Tax Cuts and Jobs Act

1. **Bill would eliminate exception from Section 162(m) deduction limit for "performance-based compensation."** Performance-based incentive compensation, whether short-term or long-term, granted to current or former named executive officers would no longer be eligible for exclusion from the $1 million deduction limit of Section 162(m).
2. **Bill would make certain equity awards granted by privately-held companies eligible for tax deferral.** Employees of privately-held companies who exercise a stock option or vest in a restricted stock unit award that meets certain conditions would be able to elect to postpone taxation from such transaction for up to five years.
3. **Bill would repeal the alternative minimum tax.** The alternative minimum tax, which captures the "spread" on the exercise of an incentive stock option, would be repealed, possibly reinvigorating the potential use of ISOs.
4. **Proposed changes to nonqualified deferred compensation rules stricken from bill.** At one time, both the House and Senate versions of the bill included a provision that would have dramatically changed the tax treatment of nonqualified deferred compensation, including subjecting stock options to taxation at the time of vesting rather than exercise. ***This provision has now been stricken from both the House and Senate versions of the bill.***

(that is, the chief executive officer and three other most highly-compensated executives, other than the chief financial officer) in any taxable year, unless such remuneration qualifies as "performance-based compensation." Both the House and Senate versions of the bill would eliminate the exception to the deduction limit for performance-based compensation, including nonqualified stock options. Consequently, in operation no amounts paid to any covered employee over the $1 million limit would be deductible, including specifically gain resulting from the exercise of stock options, receipt of performance-based equity awards, or the payment of a performance-based cash bonus.

In addition, once an executive became subject to the deduction limit, he or she would continue to be subject to the limit on all compensation payments from the company in future years even if he or she is no longer a covered employee (and, in the case of severance payments, even, presumably, if he or she is no longer employed by the company). Finally, the provision would provide that the CFO of a public company is to be considered a covered employee.

Observations: While the elimination of the exception for performance-based compensation would simplify both plan design and administration, its reception by Boards of Directors and shareholders would be, at best, problematic. The amendment may cause companies that seek to ensure the deductibility of their executive compensation to rethink the use of performance-based equity awards as part of their long-term incentive compensation programs. On the other hand, a significant reduction in the corporate tax rate may cause some companies to reevaluate the importance of deductibility when compared to the plan design restrictions imposed by Section 162(m). Overall, Boards of Directors that rely on performance-based awards to align pay with performance and to drive shareholder value creation may ultimately decide that the loss of the tax deduction is an acceptable tradeoff.

Finally, we note that the Senate version of the bill indicates that the chamber is considering whether to extend the coverage of Section 162(m) to include certain additional corporations that are not publicly-traded, such as very large privately-held companies. The application of the deduction limitation to such companies may present unique issues based on their relative income tax positions.

Tax Deferral of Private Company Equity Awards

Both the House and Senate versions of the bill contain a provision that, among other things, would enable certain employees of privately-held companies who exercise a stock option or vest in a restricted stock unit award to elect to postpone taxation from such transaction for up to five years. To qualify for this tax deferral, the equity award would have to be granted under a written plan under which not less than 80% of all employees were granted stock options or RSU awards in the same calendar year.

Observations: Both the House and Senate versions of the bill have essentially incorporated the "Empowering Employees through Stock Ownership Act" (which was separately introduced in the House of Representatives as H.R 3084 back in June) into the legislation. While H.R. 3084 would have allowed employees of privately-companies to overcome the lack of liquidity for their companies' shares by deferring for up to seven years the taxes that arise on the exercise of certain employee stock options and the vesting of restricted stock unit awards, as proposed the bills shorten the deferral period to five years.

Treatment of Nonqualified Deferred Compensation

At one time, both the House and the Senate versions of the bill contained a provision that would have made major changes in the taxation of nonqualified deferred compensation ("NQDC"). As proposed:

- most stock options would have been treated as NQDC subject to taxation at the time of vesting rather than exercise;
- many performance-based equity awards would have not been eligible for deferral of taxation until settlement unless also subject to service-based vesting requirement constituting a "substantial risk of forfeiture"; and
- severance arrangements would have been subject to taxation at termination of employment.

This provision has now been stricken from both the House and Senate versions of the bill.

Repeal of Alternative Minimum Tax

Both the House and Senate versions of the bill would repeal the alternative minimum tax. If this proposal is ultimately signed into law, incentive stock options may experience a resurgence as they would permit recipients to postpone taxation upon exercise until the ultimate disposition of the option shares without the previously adverse AMT implications (the difference between the option exercise price and the fair market value of the shares acquired on exercise is considered a "preference item" for purposes of the AMT).

Final Thoughts

While the policy rationale for the changes to Section 162(m) is unclear, overall it appears that Congress is motivated by both a desire to simplify the income tax code – a long-standing goal of many legislators – as well as a desire to address a problem for employees of privately-held companies who face taxation for their equity awards without concurrent liquidity for the acquired shares. Like any proposed legislation, however, the bills first must be approved by their respective chambers. Then any differences in the competing versions of the bill must be worked out by a joint House/Senate conference committee, with the final bill ultimately approved by both the House and Senate. Thereafter, it must be signed into law by the President. Given the vagaries of the legislative process, particularly in 2017, as well as the numerous constituencies which have a stake in tax policy and reform, it is virtually assured that there will be further changes to the bills' content. Thus, its final form and its ultimate fate are uncertain.

Nonetheless, given its potential impact on current executive compensation program design, we recommend that companies and their Boards of Directors monitor the bills' progress and begin to understand how the bills could affect their current and future executive and equity compensation programs. If Congress is successful in achieving its goal of completing tax reform by the end of the year, calendar year companies won't have much time to design and approve their 2018 compensation decisions.

Need Assistance?

Compensia has extensive experience in helping technology and life sciences companies understand the impact of tax laws and other legislation on the design and operation of their executive and equity compensation programs. If you have any questions on the subjects addressed in this Thoughtful Pay Alert or would like assistance, please contact your Compensia engagement manager.■

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