Impact of New Tax Law on Executive Compensation

Earlier this week, both the House of Representatives and the Senate approved the final version of the Tax Cuts and Jobs Act, H.R. 1 (the "Act"). The bill now goes to the President for his signature, which will result in its enactment into law. Among other things, the Act permanently reduces the corporate income tax from 35% to 21%, while also lowering the individual income tax rates and restructuring the existing deduction framework.

This Thoughtful Pay Alert summarizes our initial assessment of the provisions in the Act that will impact how companies compensate their executives and other employees.

Amendment of Section 162(m) – the $1 Million Deduction Limit on Executive Compensation

The Act makes several changes to Section 162(m) of the Internal Revenue Code (the "Code"), expanding both the companies and executives who are subject to the $1 million deduction limit. These changes go into effect for tax years beginning after December 31, 2017. While there is a "grandfather" provision for compensation paid pursuant to a written binding contract that was in effect on November 2, 2017, and is not subsequently modified, the precise scope of this provision is not entirely clear.

Elimination of "Performance-Based Compensation" Exclusion

Prior to the new law, Section 162(m) of the Code disallowed publicly-held corporations a federal income tax deduction for compensation in excess of $1 million paid to its so-called "covered employees" (that is, its chief executive officer and three other most highly-compensated executive officers, other than the chief financial officer) as of the last day of the company's taxable year, unless such compensation qualified as "performance-based compensation." The Act eliminates the exception to the deduction limit for performance-based compensation, including nonqualified stock options, as well as the exception for commission-based compensation. Consequently, beginning in 2018 amounts paid to any covered employee over the $1 million deduction limit will no longer be deductible, including any gain resulting from the exercise of stock options, receipt of performance-based equity awards or the payment of a performance-based cash bonus.

Three Things That Technology and Life Sciences Companies Should Know About the Act

1. **The Act eliminates the "performance-based compensation" exception from Section 162(m).**
   Starting in 2018, performance-based incentive compensation, whether short-term or long-term, granted to current or former named executive officers will be subject to the $1 million deduction limit of Section 162(m).

2. **The Act makes 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 will be able to elect to postpone taxation from such transaction for up to five years.

3. **The Act retains the alternative minimum tax for individuals.**
   Thus, the "spread" on the exercise of an incentive stock option will continue to be included in the calculation of the AMT, making them a less desirable equity vehicle than other types of equity awards for highly-compensated executives and key employees.

Inclusion of Chief Financial Officer as "Covered Employee"

The Act expressly treats a publicly-held corporation's chief financial officer as a "covered employee," adding this individual to the corporation's chief executive officer and next three most highly-compensated executive officers as the individuals subject to the $1 million deduction limit.

Expansion of "Covered Employee" Group

The Act provides that once an individual has been a covered employee (by virtue of being a publicly-held corporation's CEO, CFO or one of its next three most highly-compensated executive officers as of the end of the company's taxable year) he or she remains subject to the $1 million deduction limit in future years with respect to any subsequent payments from the corporation, notwithstanding that he or she is no longer a covered employee and (in the case of severance payments) may no longer be employed by the corporation. This provision applies where an executive has become a covered employee in any tax year beginning after December 31, 2016.

Expansion of Definition of "Publicly-Held Corporation"

The Act expands the definition of a "publicly-held corporation" to include corporations that are required to file reports under Section 15(d) of the Securities Exchange Act of 1934. This expansion means that corporations with publicly-traded debt that file reports pursuant to Section 15(d) will now be subject to Section 162(m). It also means that some corporations that are not publicly-traded, but which are subject to this statutory filing requirement, will be subject to the $1 million deduction limit.

Observations: The series of amendments to Section 162(m) upend the previously well-established practices for designing and administering incentive compensation plans and arrangements to achieve a company's business objectives while ensuring the deductibility of the compensation income arising from these plans and arrangements. In the weeks ahead, Boards of Directors and Compensation Committees will need to review their existing incentive compensation plans and evaluate the effectiveness of the current design of their performance-based awards in driving their financial and strategic goals. The elimination of the deduction may lead some companies to modify their incentive plans to provide greater flexibility in determining award payments and/or adjust their long-term incentive award mix.

In the near-term, as a result of the pending changes in corporate (35% to 21%) and top individual (39.6% to 37%) income tax rates that will go into effect in 2018, companies should consider the following:

- Whether their current outstanding performance-based incentive awards satisfy the transition ("grandfathering") provision described above.
- Whether it is desirable or feasible to accelerate incentive award payments that will otherwise be payable in 2018 into 2017 to ensure their deductibility. For purposes of Section 162(m), this may involve the Compensation Committee certifying the satisfaction of the performance goals and any other material terms of the plan or arrangement before year-end (if doing so is even possible). It may also involve evaluating the current terms of outstanding incentive awards and the applicable plans to determine if acceleration is permitted and appropriate (for example, in the case of an award that requires employment on the date of payment).
- Whether it is desirable or feasible to accelerate any compensation of the chief financial officer from 2018 into 2017 to the extent that his or her projected compensation for 2018 may exceed $1 million.
- Whether it is desirable or feasible to accelerate any compensation of the individual who was a "covered employee" in 2017, but will not be so in 2018 to the extent that his or her projected compensation for 2018 may exceed $1 million.
- How they may wish to modify their future executive compensation disclosure to address the impact (if any) of the amendments to Section 162(m) on their executive compensation program.

Companies that are considering any such actions, including in response to the amendments of Section 162(m), should consult their legal, tax and other advisors to ensure that they have complied will all applicable technical and other requirements.

Amendment of Section 83 – Tax Deferral of Private Company Equity Awards

The Act adds a provision to Section 83 of the Code that will enable certain employees of privately-held companies who exercise a stock option or vest in a restricted stock unit ("RSU") award to postpone taxation from such transaction for up to five years. Specifically, new Section 83(i) provides that stock options and RSU awards for so-called "qualified stock" that are granted to a "qualified employee" by an "eligible corporation" are eligible for tax deferral if the employee elects to defer taxation by making a formal election within 30 days of the first exercise of the option or vesting date of the RSU award.

However, several prescriptive rules limit the scope – and utility – of this provision:

- The stock option or RSU award for qualified stock must be granted by a company that doesn't have any stock that is readily tradable on an established securities market and has a written plan under which, during the year of grant, at least 80% of its U.S. employees were granted stock options or RSU awards with the same rights and privileges.

- The employee receiving the stock option or RSU award cannot be an "excluded employee," which is defined as:
  - a 1% owner of the company at any time during the year of grant or during the preceding 10 calendar years;
  - the current or former CEO or CFO of the company;
  - a family member of the CEO or CFO; and
  - one of the four highest compensated officers of the company (as determined under the SEC's executive compensation disclosure rules) for the year of grant or any of the preceding 10 taxable years.

If a "qualified employee" exercises a stock option or vests in a RSU award for qualified stock, he or she may make an election to postpone taxation until the earliest of (i) the date five years after the exercise or vesting event, as applicable; (ii) the first date the stock becomes transferable; (iii) the date he or she becomes an "excluded employee"; (iv) the first date the company's stock is readily tradeable on an established securities market; or (v) the date he or she revokes the election.

Observations: Effectively, this provision codifies the "Empowering Employees through Stock Ownership Act" (which was separately introduced in the House of Representatives earlier this year). See our Thoughtful Pay Alert, Congress Considers Legislation to Postpone Taxation of Private Company Equity Awards (September 19, 2016). While the provision may offer some liquidity relief to privately-held technology and life sciences companies that have postponed their IPO and may encourage broader use of RSU awards instead of stock options by such companies, its compliance complexities (particularly the requirement that 80% of the U.S. workforce be granted awards each year and the prohibition of granting awards for qualified stock to 1% shareholders and other senior executives) may discourage some companies from using it. The provision will require clarifying regulations from the Internal Revenue Service before its full utility can be evaluated.

Alternative Minimum Tax – Individual Tax Retained

While the initial version of the bill in the House of Representatives would have repealed the alternative minimum tax ("AMT") in its entirety, the Act retains the AMT for individuals. The only modifications to the provision for individual taxpayers involve increasing the exemption amount and the phase-out threshold (albeit on a temporary basis).

Observations: Initial predictions that we might see a resurgence in the use of incentive stock options ("ISOs") as a result of the repeal of the AMT (since the elimination of the provision would permit recipients to postpone taxation upon exercise until the ultimate disposition of the option shares without the attendant adverse AMT implications (the difference between the option exercise price and the fair market value of the shares acquired on exercise is considered income for purposes of the AMT)) proved unfounded. With the retention of the individual AMT, ISOs will continue to be less attractive for executives and other highly compensated employees impacted by the tax.

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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