

November 4, 2017

PROPOSED “TAX CUTS AND JOBS ACT” OVERHAULS TAXATION OF EXECUTIVE COMPENSATION

On November 2, 2017, the House Ways and Means Committee released the “Tax Cuts and Jobs Act” (H.R. 1). The bill designates several executive compensation items for amendment or repeal. If enacted as proposed, H.R. 1 would result in sweeping changes in the design and taxation of executive compensation including:

- Elimination of non-qualified deferred compensation arrangements
- Elimination of non-qualified stock options as a long-term incentive vehicle
- Elimination of deduction for performance-based compensation under I.R.C. §162(m)

Key Proposed Changes under H.R. 1

Section	Provision	Action	H.R. 1 Treatment
I.R.C. §409B	Non-Qualified Deferred Compensation	New	<ul style="list-style-type: none"> • All deferred compensation amounts will be taxed when there is no longer a substantial risk of forfeiture (i.e., taxed at vesting) • Only service-based vesting is recognized as a substantial risk of forfeiture • Any performance-based vesting condition would be disregarded • Effective with respect to amounts attributable to services performed after December 31, 2017
	Taxation of stock options and stock appreciation rights (SARs)	New	<ul style="list-style-type: none"> • Stock options and SARs are expressly designated as “non-qualified deferred compensation” under §409B • Taxable at vesting, whether or not exercised
I.R.C. §409A	Non-Qualified Deferred Compensation	Repeal	<ul style="list-style-type: none"> • Eliminates ability to defer income taxation until settlement / delivery of award • Existing deferrals attributable to services performed before January 1, 2018 must be

Section	Provision	Action	H.R. 1 Treatment
			included in income before 2026 (or, if later, the year it vests)
I.R.C. §162(m)	Qualified Performance-based Compensation	Repeal in part; Amend in part	<ul style="list-style-type: none"> Eliminates exception for “qualified performance-based compensation” from \$1 million deductibility limit Accordingly, any amount in excess of \$1 million that is paid in a taxable year to a covered employee will no longer be deductible CFO expressly added as a “covered employee” Any individual who is a “covered employee” after December 31, 2016 will remain a covered employee in future years, regardless of whether such individual is actually a proxy officer in a subsequent taxable year Expands \$1 million deductibility limit to issuers subject to Section 15(d) under the Exchange Act, e.g., companies who file an annual report on Form 10-K but are not otherwise required to file a proxy statement, such as public debt issuers Effective for tax years beginning after December 31, 2017
I.R.C. §4960	Tax on excess tax-exempt organization executive compensation	New	<ul style="list-style-type: none"> Tax-exempt organizations are subject to a 20% excise tax on compensation over \$1 million paid to any of their current or former five highest-paid employees Effective for tax years beginning after December 31, 2017

Some Preliminary Issues Under H.R. 1

- **§409B:** If performance-based conditions are disregarded, how will a performance stock unit (PSU) award be valued on the applicable vesting date (e.g., retirement eligible date) if performance is not measurable at such time and the value of earned compensation cannot yet be determined?
- **§409B:** H.R. 1 does not appear to alter the normal rules under I.R.C. §83 with respect to restricted stock. Will there be a reversion to use of restricted stock for performance-based awards?
- **§409B:** Because severance will be taxed upfront (i.e., at termination of employment), §409B will likely put pressure on employers to pay severance in a lump-sum, even if preferable for business reasons to pay severance over an extended period of time (e.g., to bolster enforceability of restrictive covenants).
- **Stock Options:** What is the income inclusion amount at the vesting date for stock options and SARs? Intrinsic value or fair value? Will it depend on whether the award is in-the-money or underwater on the

vesting date? It should be noted that proposed regulations under §409A took the view that the includible amount was the option's intrinsic value.

- **Stock Options:** Except for amending the disability definition, H.R. 1 does not appear to alter the rules relating to qualified incentive stock options (ISOs) under I.R.C. §422. In conjunction with the elimination of the Alternative Minimum Tax, will there be a renewed interest in ISOs as an equity vehicle to enable employees to control the timing of taxation with respect to at least a portion of their equity awards? The tradeoff will be employer's loss of the corresponding tax deduction but the financial inefficiency that exists under current law will be narrowed or eliminated by reduction in the corporate income tax rate.
- **§162(m):** It is unclear whether "qualified performance-based awards" granted prior to 2018 but vesting after 2018 are grandfathered (i.e., eligible for deduction). If there is no grandfathering, outstanding §162 qualified performance-based awards (including stock options and SARs) held by covered employees (as redefined under H.R. 1) will become subject to the \$1 million deductibility limit.
- **§162(m):** Will the transition period for newly public companies be retained in some form?
- **§162(m):** Public debt issuers will be subject to the \$1 million deductibility cap for the first time.
- **Effective Date and Transition Issues:** The proposed bill generally becomes effective starting 2018, but there are circumstances where the new rules would apply based on 2017 compensation (e.g., under the expanded definition of §162(m) "covered employees", 2017 named executive officers are automatically subject to the \$1 million deductibility limit in 2018 and beyond). Additionally, clarification will be needed on certain transition issues. For example, does the §409B grandfather clause mean that awards granted before January 1, 2018 are subject to immediate taxation to some extent if they were granted as consideration for services performed, in part, after 2017 (i.e., will we have to bifurcate the treatment of prior grants)? If an option is granted on January 1, 2017 and vests on December 31, 2018, is half the value included in income now because half the value is attributable to services performed in 2018?

Next Steps

We realize that many fiscal year-end companies are currently in the process of granting long-term incentive awards and/or finalizing the design of their upcoming annual bonus plans. Because it is unclear whether the H.R. 1 provisions, if enacted, will have retroactive effect (see transition issues discussion above), it is important that the Compensation Committee be advised about the impact of the new tax bill on equity awards/bonus plans before the grant is made/plan is finalized. The Compensation Committee may still rationally conclude that it should go forward on a business-as-usual basis, but it should not take this step until it considers the possible implications of H.R. 1.

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