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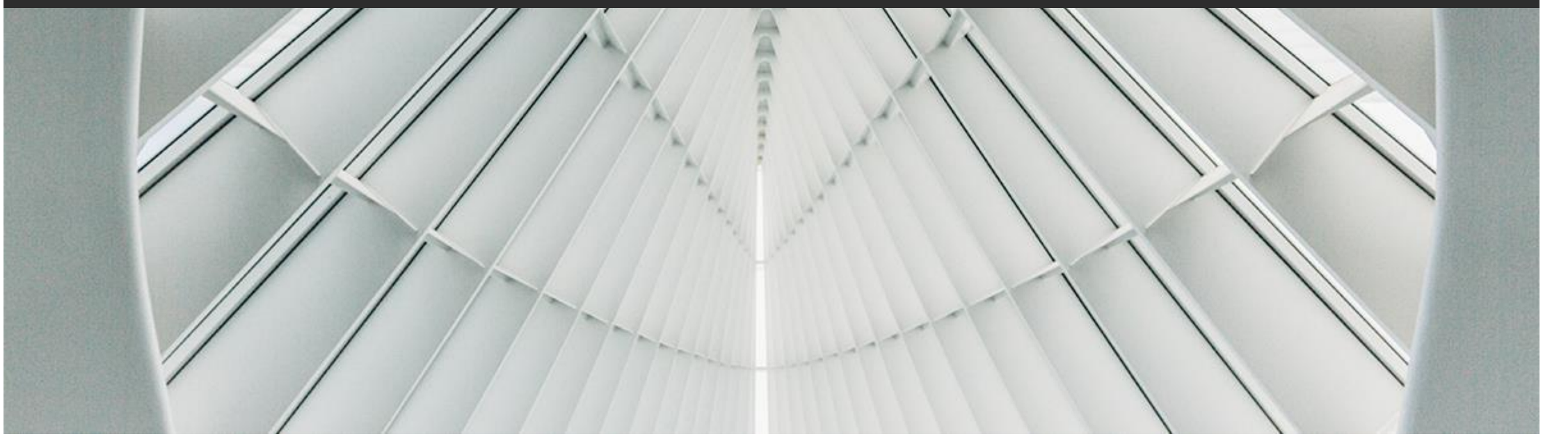

November 2017

Impact of Proposed Tax Reform Legislation on Executive, Equity and Deferred Compensation

On Nov. 16, 2017, the House of Representatives approved H.R. 1, the Tax Cuts and Jobs Act (the "House Bill") and the Senate Finance Committee approved a bill of that same name (the "Senate Bill"). The House Bill and the Senate Bill are referred to collectively in this Alert as the "Bills."

The House Bill and the Senate Bill contain provisions that would: (1) eliminate the exceptions for "performance-based compensation" and commissions to the $1,000,000 deduction limitation paid by a publicly traded company to "covered employees" and broaden the definition of "covered employees" to include not only the corporation's CEO and three next most highly compensated officers who are included under current law, but also the CFO and anyone who was a covered employee in any year after 2016; (2) subject tax-exempt organizations to a 20 percent excise tax on compensation in excess of $1,000,000, and on "excess parachute payments," paid to any of their five highest paid employees; and (3) permit employees (other than the CEO, CFO, 1 percent owners, and any of the four highest paid officers) of private companies to defer income otherwise required to be recognized as a result of the exercise of a stock option or settlement of a restricted stock unit (RSU) for up to five years after the underlying shares are no longer subject to a "substantial risk of forfeiture."

The original Chairman's Marks in both the House and the Senate also contained provisions that would have drastically changed the taxation of deferred compensation – broadly defined to include stock options, stock appreciation rights, and severance pay – by taxing that compensation as soon as the employee's rights to it were no longer subject to a substantial risk of forfeiture. Those provisions were removed by amendment shortly after the Chairman's Marks were released, and it therefore seems unlikely that they will be included in any tax legislation enacted this year.

What follows is a summary of each of the foregoing proposed changes. We note, of course, that the Senate Bill needs to be submitted for approval by the full Senate (where it will be subject to floor amendments), and the many significant differences between the House and Senate Bills then will need to be resolved by a Conference Committee. Thus, much remains to be done and passage of this tax legislation is by no means a certainty.

Section 162(m) Deduction Limit

Section 162(m) generally imposes a $1 million limitation on the amount of compensation that a publicly-held corporation can deduct in any taxable year on account of compensation paid to its CEO or any of the three other most highly compensated employees (other than the CFO). The House Bill and the Senate Chairman's Mark contain provisions that would significantly broaden the scope of the deduction limit.

Under the proposed changes, the exceptions to the Section 162(m) cap on deductible compensation paid by a public company to a covered employee that have applied to "performance-based compensation" and commissions generally no longer would apply for compensation paid in taxable years after 2017.

The term "covered employee" would be revised to include the company's CFO. Also, unlike under current law, an individual who was a "covered employee" at any time during any taxable year after 2016 would be treated as a covered employee in all subsequent years in which he or she receives compensation. Thus, compensation paid to a covered employee would be subject to the $1,000,000 cap on deductible compensation even if paid after the covered employee's termination of employment or death.

The House Bill would apply to all compensation for which the corporation seeks to claim a deduction in taxable years beginning after Dec. 31, 2017, with no grandfathering of compensation earned prior to that date.

The Senate Bill, on the other hand, contains a transition rule pursuant to which the proposed changes would not apply to any remuneration under a written binding contract that was in effect on Nov. 2, 2017, and that was not modified after that date in any material respect. Thus, it would appear that under the Senate Bill, the new deduction limitation would not apply to a stock option or stock appreciation right, or other performance-based deferred compensation, payable pursuant to an agreement that was legally binding on Nov. 2, 2017, and that was exercised or paid after 2017, if that compensation would have qualified as "performance-based compensation" under current law or the executive was not a covered employee on the last day of the year under the current law definition.

20 Percent Excise Tax on Compensation in Excess of $1 Million Paid by Tax-Exempt Organizations

Both Bills would subject tax-exempt organizations to a 20 percent excise tax on total compensation paid to any "covered employee" that is in excess of $1,000,000 for any taxable year. Both Bills also would impose a 20 percent excise tax on any "excess parachute payment," defined to include payments to a "covered employee" that are contingent upon a separation from service that exceed three times the covered employee's "base amount." For this purpose, the "base amount" would be defined in a manner similar to the rules under Section 280G of the Code, which generally should be equal to the average annual W-2 compensation paid to the covered employee in the five years preceding the separation from service. For this purpose, a "covered employee" would include the organization's five highest paid employees for the taxable year. Also, once deemed to be a covered employee, an executive would continue to be so treated for as long as the organization pays that person compensation. For purposes of this provision, compensation would include all taxable remuneration paid to the employee for services, including cash and the cash value of all taxable benefits, except for payments to tax-qualified retirement plans. This provision would be effective for taxable years beginning after 2017.

Up to Five-Year Deferral for Stock Awards under Broad-Based Plans of Private Companies

Both Bills contain a provision that would permit "qualified employees" of private corporations to elect to defer the recognition of income with respect to "qualified stock" received in connection with the exercise of a stock option or settlement of a restricted stock unit (RSU) granted in connection with the performance of services. The deferral would be for five years after the rights of the employee in the stock are no longer subject to a substantial risk of forfeiture (or are transferable, including to the employer, free of that risk) but would end if and when the employer's shares become publicly traded, the employee becomes an "excluded employee" or the employee revokes the deferral election.

For this purpose, a "qualified employee" does not include any individual (referred to in the Bills as an "excluded employee") who was a 1 percent owner in any of the prior ten years, is or ever was the corporation's CEO or CFO (or persons related to those officers), or who in the prior ten years was one of the four highest-compensated officers of the corporation. The deferral election would need to be made no later than 30 days after the employee's rights to the stock are no longer subject to a substantial risk of forfeiture (or are transferable, including to the employer, free of that risk).

The stock of a corporation would not be treated as "qualified stock" unless no stock of the corporation was readily tradable on an established securities market and, in the year in which the deferral election is made, the corporation had a written plan under which not less than 80 percent of all of its full-time U.S. employees were granted stock options or RSUs with the "same rights and privileges" to receive qualified stock (determined in a manner similar to the rules under Section 423 of the Code applicable to employee stock purchase plans). A plan would not fail to provide the same rights and privileges solely because the number of shares available to all employees is not the same, so long as the number of shares available to each employee is more than a "de minimis amount."

A deferral election could not be made in any year if the corporation purchased any of its outstanding stock in the calendar year preceding the year in which the stock subject to the deferral election vests, unless not less than 25 percent of the repurchased stock is stock that had been deferred, and the employees whose deferred stock was repurchased were selected on a reasonable basis.

If an employee makes a deferral election, the amount of income to be recognized at the end of the deferral period will be based on the value of the stock at the time the stock was first not subject to a substantial risk of forfeiture (or could be transferred, including to the employer, free of that risk), even if the value of the stock declined during the deferral period. The employer's tax deduction would be delayed until its taxable year in which or with which ends the taxable year of the employee in which the employee is required to recognize the income.

This provision generally would be effective with respect to stock attributable to options exercised and RSU's settled after Dec. 31, 2017 (and thus would be applicable to equity awards granted prior to 2018 that are exercised or settled after 2017). Further under a special transition rule, stock acquired pursuant to stock rights granted prior to 2018 may be treated as "qualified stock" even if those stock rights do not have the same rights and privileges (but only if not less than 80 percent of all full-time U.S. employees were granted stock options or RSUs).

Deferred Compensation

The original version of the Chairman's Marks in both the House and Senate contained provisions that would have dramatically changed the rules pertaining to deferred compensation as we know them today. Both would have made all compensation taxable when the employee's rights to the compensation ceased to be subject to a "substantial risk of forfeiture" (*i.e.*, when the employee vested in his or her rights to the compensation). As a result, under the proposed legislation, the tax benefit of deferring compensation beyond the date it vests would no longer exist.

Both Marks also would have defined "deferred compensation" broadly to include stock options and stock appreciation rights and severance pay, and would have narrowly defined a substantial risk of forfeiture to only include a forfeiture condition based upon the performance of services. Thus, requirements such as the satisfaction of performance criteria and satisfaction of noncompetition and other restrictive covenants would not have constituted substantial risks of forfeiture.

Both Chairman's Marks were amended, however, to delete these deferred compensation proposals, and it thus now seems unlikely that these changes will be enacted as part of this year's tax legislation. This is something, however, that should continue to be monitored.

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