House Tax Reform Proposal Creates Uncertainty for Year-End Compensation Planning: What You Can Do Now to Best Prepare Your Company

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The proposed **tax reform bill**, known as the Tax Cuts and Jobs Act, in its current form would significantly upend **compensation** practices, not only for senior executives, but also for broad-based employees and board members, making tried and tested compensation tools – including most forms of employee stock options and deferred compensation programs – tax-inefficient for U.S. taxpayers. Specifically, the impact of the bill on companies that are based or have employees in the United States includes the following:

- Eliminates the ability of individuals to defer taxation of compensation, including under supplemental executive retirement plans (SERPs), elective deferral programs and multi-year severance payouts;
- Significantly limits the ability to grant stock options and stock appreciation rights as they have conventionally been granted; and
- Eliminates the performance-based and commission exceptions from the Section 162(m) limitation on the tax deductibility of executive compensation and expands the scope of covered employees.

House Republicans first released the text of the bill on November 2, 2017. Since then, the House Ways and Means Committee has already approved an **amendment** to the bill, which was introduced by Chairman Kevin Brady (which provides **limited relief** for stock options and RSUs granted by private companies whose stock is illiquid). We anticipate that the bill will continue to evolve as it works its way through the legislative process.

That said, in recognition that this is the season when many companies review their remuneration practices for the upcoming year, and that any changes can require a meaningful lead time, this memorandum highlights the bill's compensation-related provisions and identifies a few ways in which companies can best prepare for possible changes to the tax treatment of compensation – whatever might ultimately come to pass:

- Don't panic or rush into any decision – the bill is a moving target;
- Educate yourself and be prepared:
    - Inventory your company's compensatory plans and agreements;
    - Consider whether to seek shareholder approval to amend your company's equity compensation plan to add greater flexibility, so as to be best positioned to make grants that are most tax-efficient, even if the plan has sufficient shares;
    - Consider whether to add a "savings" clause to compensatory plans and agreements;
- Revisit year-end tax planning and consider whether it would be possible to take a compensation tax deduction in 2017, rather than in 2018, when the corporate tax rate would, under the bill, be reduced;
- Model the value of the lost tax deduction if the performance-based compensation and commission exceptions to Section 162(m) are eliminated and covered employees are expanded to include the chief financial officer;

- Closely monitor developments in this area; and
- Find out about any advocacy efforts and consider whether it would be beneficial to join.

In addition, the bill would include a number of changes to the tax treatment of employee benefit programs, including the repeal of exclusions, deductions and credits for certain employee benefits and changes to rules for qualified retirement plans. As with the compensation provisions in the bill, these provisions would also be effective for tax years beginning after 2017. These are not addressed in this memorandum, but further discussion can be found **here**.

Highlights of the Bill's Compensation-Related Provisions

At a high level, the bill, as proposed, provides for the following:

- *No deferred compensation, including equity compensation that is treated as deferred compensation*: Nonqualified deferred compensation would no longer be eligible for deferred taxation beyond the satisfaction of service-based vesting conditions.
    - This would mean that SERPs, voluntary salary and/or bonus deferral arrangements, director fee deferral arrangements, vested deferred compensation credits and other forms of deferred compensation would be taxed in full when vested, regardless of when the compensation is paid.
    - Performance conditions would not count as a valid basis for vesting, so compensation would be taxed when applicable service vesting conditions are met, even if the compensation is subject to further performance conditions. This would be particularly relevant for long-term incentive programs, including certain performance stock units (PSUs).
    - Nonqualified stock options (NQSOs) (with the exception of those granted by private companies in specified circumstances), restricted stock units (RSUs) and PSUs would not be exempt. Notably, NQSOs would be taxable in full when they vest (i.e., before exercise). A description of the bill released by the Joint Committee on Taxation (JCT) indicates that there would be an exception for incentive stock options (ISOs) and qualified employee stock purchase plans (ESPPs).
    - The JCT description indicates there would be no exception for severance payments. This would mean that severance could be taxed at the time of termination of employment, even if the severance were paid over a longer-term severance period.
- *No tax deductibility of compensation over $1 million paid to certain executive officers*: The Section 162(m) exceptions for qualifying performance-based compensation (including stock options and stock appreciation rights) and commissions for compensation paid to a public company's chief executive officer and certain other executives would be eliminated, meaning that all compensation over $1 million that is paid to them would not be tax-deductible. Additionally, the company's chief financial officer would automatically be covered, and any individual who is a covered employee on or any time after January 1, 2017 would remain covered so long as he or she receives remuneration from the company.

With this in mind, the following are a few tips for companies to best prepare for possible changes to the tax treatment of compensation.

Tip 1: Don't Panic or Rush – the Bill Is a Moving Target

Although the proposed changes, which would impact not only executives, but also employees, contractors and directors, are significant, the bill has only just been proposed. On its way to becoming law, the bill remains subject to further amendment and approval by the House Ways and Means

Committee, then approval by the full House (by a majority vote). In the meantime, Republicans on the Senate Finance Committee have already announced their intent to unveil their own version of the tax reform bill (currently slated for later this week). Assuming that the House and Senate pass different versions of the bill, there will be a reconciliation process and the reconciled version would need to be approved by both chambers (by a simple majority vote), before going to the President for his signature.

This is all to say that, while House Republicans have publicly expressed their hope to present this bill to the President by year-end, and notwithstanding that the proposed version on the table would begin to apply in 2018, our current view is that it is premature for a company to make significant reactive changes to its compensation program without considering the form in which the final bill, if at all, is enacted.

On the other hand, time spent considering the impact of the proposal will likely not go wasted, since it is possible that, even if the changes are not enacted as part of overall tax reform, some or all of the changes to compensation could be re-proposed in future legislation as revenue-raising tools.

Tip 2: Educate Yourself and Be Prepared

***Inventory Your Company's Compensatory Plans and Agreements*.** We recommend that companies begin to prepare for possible changes, first by inventorying existing and proposed compensatory plans and agreements to better understand points of vulnerability should current tax law change. This is a non-exhaustive list of items to consider:

- Does your company sponsor any vested deferred compensation plans and, if so, when are distributions slated to occur? Does the deferred compensation plan have an earnings or interest crediting factor?
- Does your company sponsor any deferred compensation plans under which employees, executives and directors would be invited to submit voluntary deferral elections for their salary, bonuses or fees, or would otherwise be offered open enrollment? Does your company provide matching or profit-sharing contributions and, if so, are they vested upon contribution?
- Does your company typically grant stock options or stock appreciation rights? If your company grants stock options, are they NQSOs or ISOs?
    - As a side note, ISOs may become more attractive under the tax reform bill, since it would also eliminate the alternative minimum tax (AMT), which has often undercut the utility of ISOs, since ISO exercises are included in income for ATM purposes under current tax law.
    - Note, however, that the tax code provides a limitation on how many ISOs can be granted to any one individual – no more than $100,000 worth of shares (calculated as the exercise price multiplied by number of shares) can become exercisable during any calendar year.
- Do your company's equity compensation plans have any limitations on full-value awards (i.e., restricted stock, RSU and PSU awards) or minimum vesting requirements for equity awards generally? Do they permit the grant of ISOs? (see "Possible Shareholder Approval of Equity Compensation Plans" below)
- If your company grants RSUs, PSUs or phantom stock arrangements, what are the vesting conditions? Is vesting based solely on time, or are there also performance conditions? If based on performance, do those conditions require continued service? Do awards contain "good leaver" or "retirement eligibility" provisions (i.e., are they eligible for continued or accelerated vesting on an involuntary termination or qualifying retirement)?

- Do any plans or agreements have "good reason" or similar provisions? If so, how easily triggerable is "good reason"?
- Do any plans or agreements provide for a single-trigger payout upon a change in control? If so, do they require continued employment through the change in control?
- Do your company's severance plans and agreements pay out over time (and, if so, how long)?
- If the employment of an employee or executive is terminated without cause, what is the impact on his or her annual bonus for the year of termination, as well as other outstanding incentive and equity awards?
- Does your company sponsor a nonqualified ESPP?
- Has your company made any retention awards? If so, what are their payout terms?
- If your company has acquired employees through a merger or other acquisition, do those employees participate in any earn-out or similar transaction-related arrangements? If so, what are the payout terms and are they conditioned on continued employment?
- Does your company impose stock ownership guidelines on executives or directors, with which it would become difficult to comply if the company's compensation programs had to change?
- Is your company subject (or might your company become subject) to compensation-related regulations, such as CRD IV and Section 956 of the Dodd-Frank Act for financial institutions, which mandate, or could mandate, deferrals of incentive compensation?
- Are there aspects of your company's compensation program that would be difficult to change, given the express perspectives of institutional shareholders and other stakeholders?

Once your company's compensatory plans and agreements are inventoried, consider keeping a list of plans and agreements that fall into different categories, noting their amendment procedures. This will make it easier to track whether or not they will actually be affected by any proposed change to the tax law.

Possible Shareholder Approval of Equity Compensation Plans. A number of public companies have equity compensation plans that contain limitations on the number of full-value awards that can be granted or minimum vesting requirements for equity awards generally (which were generally implemented in order to gain favorable recommendations from institutional investors or proxy advisory firms, such as ISS).

If your company tends to grant stock options or stock appreciation rights, the use of which may become unattractive as a result of changes in the tax law, it may be helpful to consider whether to seek shareholder approval to amend or remove those limitations on full-value awards and minimum vesting requirements, even if the plan has sufficient shares and your company would not otherwise seek shareholder approval with respect to the plan. Note that such changes may be difficult (but not impossible) to implement as a practical matter, given how ISS models the cost of equity compensation plans when it determines whether to recommend voting for or against an equity compensation plan proposal.

In addition, if your company's equity compensation plan does not already include a provision for the grant of ISOs, you may want to consider seeking shareholder approval to add such a provision to the plan.

***Possible "Savings" Clause*.** Companies may wish to consider whether to add a "savings" clause to their compensatory plans and agreements, particularly new agreements that are being currently negotiated, which would permit them to make changes if there is a material change to the intended tax treatment and economic benefit of the payments provided under those arrangements. If so, we recommend taking care to ensure that no such clause implies that the company would somehow be required to incur additional cost or pay an additional amount to the employee, or be obligated to commit to any particular action or timing.

This may also be a good time to review whether your company's arrangements include disclaimer language about the tax treatment of the payments and benefits provided by the plan or agreement not being warranted or guaranteed.

Tip 3: Revisit Year-End Tax Planning – Possible Compensation Tax Deduction in 2017, Rather than in 2018

Many employers take a tax deduction for bonuses in the year that they are paid, rather than the year for which the bonuses are earned. However, under the accrual method of accounting, as set forth in Treas. Reg. § 1.461-(a)(2), a liability is generally incurred and taken into account in the taxable year in which:

- All events have occurred that establish the fact of the liability;
- The amount of the liability can be determined with reasonable accuracy; and
- The economic performance has occurred with respect to the liability.

For many companies, bonuses that are in respect of one year, but paid in the next year, remain subject to continued employment, compensation committee approval, employer discretion and other factors, and thus would not meet the requirements of the "all events" prong of the test. However, if a company is able to satisfy that prong, as well as the two additional prongs of the test, it would be entitled to take its deduction in the year for which the bonuses are earned.

Given the possible reduction in the federal corporate tax rate (under the bill, from 35% to as low as 20%, effective for tax years beginning after December 31, 2017), companies may be able to achieve meaningful savings if they are able to take the deduction in 2017, rather than in 2018.

Tip 4: Model the Value of Lost Tax Deduction, if Section 162(m) Is Amended

Companies could experience a significant loss in tax-deduction value if Section 162(m) is amended (i) to eliminate the current exceptions for qualifying performance-based compensation (including stock options and stock appreciation rights) and commissions for compensation paid to a public company's chief executive officer and certain other executives and (ii) to expand the covered employee definition to automatically include the chief financial officer. Given this, we recommend that companies begin to model the impact of the lost tax deduction, which may run through a company's financial statements.

Tip 5: Closely Monitor Developments

As indicated at the outset, we anticipate that the tax reform bill will go through multiple iterations before it is ultimately enacted (if it is enacted at all). We recommend close monitoring of developments. Early harbingers of change may include amendments to the bill introduced by members of the House Ways and Means Committee, as well as whatever is put forward by the Senate Finance Committee.

To subscribe to Davis Polk's tax reform and transition blog, which is devoted to coverage of and perspectives on the evolving tax policies of the current administration and the 115th Congress (including those that affect compensation and employee benefits), please go **here**.

Tip 6: Consider Possible Advocacy Efforts

Tax reform, like any other major legislative initiative, will be subject to significant lobbying. There may be advocacy efforts, such as those organized by trade organizations, that will be important to your company. This may be an area where close coordination with your company's governmental affairs professionals may be helpful. In this regard, consider the following potential impacts of the proposed tax reform bill:

- For employees who have relied on their employers' retirement programs that would be treated as deferred compensation, the proposed tax treatment of these programs may require companies to take actions that would be inconsistent with their and their employees' retirement planning goals. This may be a particular hardship for older employees.
- While the bill would permit the acceleration of certain deferred compensation payments, companies may not be in a position to accelerate those payments, given the potential burden on cash flow.
- The restrictions on stock options and other forms of equity compensation are at odds with many company policies, and the stated preferences of institutional shareholders, that encourage stock ownership.
- Similarly, director fee deferral arrangements are a popular and convenient way for directors to increase their stock ownership in the companies on whose boards they sit, and the inability of companies to sponsor such programs will likely make it more difficult for directors to have "skin in the game."
- The constraints on performance-based compensation may discourage its use, which will disappoint many institutional shareholders, who typically view performance conditions as an integral way to link pay and performance.
- Longer-term severance payout periods are typically considered good corporate governance, particularly when they add "teeth" to the practical enforceability of post-employment restrictive covenants. If the JCT description of the bill is correct, the bill would have the effect of shortening these payout periods.
- The acceleration of individual income tax recognition could result in decreased tax revenues in a rising market, which is presumably one of the goals of tax reform.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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