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Client Alert Commentary

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The Impact of Pending Tax Reform on Executive Compensation: The Need for Deductive Reasoning

Proposed US tax reform may impact the deductibility of executive compensation programs and companies should evaluate any potential tax planning opportunities in 2017 and the impact of the proposed changes going forward.

The US House of Representatives and the Senate continue to work to reconcile the two versions of the Tax Cuts and Jobs Act (the Bill) previously passed in each chamber. However, both versions make significant changes to a public company's ability to deduct compensation paid to certain of its executive officers and other changes that will impact future executive compensation.

The major changes are:

- Repealing the exceptions for "performance-based compensation" under Section 162(m)[1], thereby rendering all compensation paid to a "covered employee" that is greater than US$1 million per year non-deductible.
- Expanding the scope of "covered employees" to include the principal financial officer. This expansion also provides for continued application of Section 162(m)'s deduction limitations to any compensation paid to an individual who is a covered employee at any time on or after January 1, 2017 (even after termination of employment).
- Expanding the scope of corporations to which Section 162(m) would apply to include those with publicly traded debt, and potentially also to foreign private issuers.

Under both versions of the Bill, these changes will be effective for tax years beginning on or after January 1, 2018. Companies that could be affected by these changes (essentially, all companies with publicly traded securities or debt in the US) should analyze the impact of the proposed changes on their executive compensation program prior to year-end, and consider whether they should take any proactive measures.

Additionally, the Bill would change tax rates and could eliminate deductions for state and local income taxes. This will affect executive compensation taxation in years to come and will require continuing consideration after 2017.

Year-End Planning Considerations

Public companies may want to evaluate whether to accelerate certain executive compensation payments into 2017 to take advantage of current tax rules, including the certainty of deductibility under Section 162(m) this year. In doing so, companies should keep the following points in mind.

- ***Company Deductions.*** Due to the proposed reduction in the corporate tax rate under both versions of the Bill, deductions taken in 2017 could be more valuable to companies than those taken in 2018. Companies may want to consider securing compensation deductions in 2017, if possible. For example, companies that normally would not be able to deduct 2017 bonuses (such as those that require employment on the date of payment in 2018) may have an opportunity to secure a deduction in 2017 for that compensation by accelerating payment of cash bonuses into 2017. Alternatively, companies could establish a minimum bonus liability under bonus plans by year-end to secure 2017 deductions. Similarly, companies could consider accelerating the vesting and/or payment of equity awards that otherwise would have been vested and/or paid in 2018 into 2017. Companies would need to ensure actions would not run afoul of the Section 162(m) performance-based compensation requirements, such as the need to certify actual performance through the performance period prior to payment, or constitute impermissible accelerations under Section 409A. Various technical requirements under tax and accounting rules also apply to ensure the acceleration of the timing of the deduction will be honored.

- ***"New" Covered Employees For 2018.*** As noted above, under both versions of the Bill, a public company's principal financial officer will be a "covered employee" subject to Section 162(m)'s deduction limitations for future tax years. Because a company's principal financial officer is not considered a "covered employee" under the current rules, companies should consider accelerating compensation payable to their principal financial officers in 2018 into 2017. This would ensure a deduction for such payments to the extent the officer's 2018 compensation is expected to exceed US$1 million. Likewise, if a company employs an individual who currently would be a covered employee for 2017 but for the fact he or she ceased to be a covered employee prior to the last day of the 2017 taxable year (due to termination of employment or change in position, for example), that individual will continue to be a covered employee going forward under the Bill. If such a terminated executive is expected to receive compensation in excess of US$1 million during 2018, accelerating those payments into 2017 could have a tax benefit for the company.

- ***Executive Deductions*.** Under both versions of the Bill, individuals will no longer be able to deduct state and local income taxes on their federal income tax returns. Consequently, executives (particularly those residing in states with high state income tax rates, such as California and New York) may be interested in accelerating the taxation of certain compensation into 2017 to ensure they can deduct the state and local income taxes on such payments. There are a number of technical tax and accounting requirements to ensure the acceleration of the timing of the deduction will be honored. For example, employers may need to actually issue checks for early bonus payments or deliver shares for acceleration of equity awards prior to the end of the day on December 31, 2017, ensuring the deduction can be taken in 2017 (approval of these payments may not be sufficient).

- ***Transition Relief*.** The Senate version of the Bill contains transition relief for certain Section 162(m) performance-based compensation arrangements pursuant to "written binding contracts" in effect as of November 2, 2017, so long as such arrangements are not "modified in any material respect." Whether the transition relief will be included in any final Bill is unclear, however, companies will want to tread carefully to ensure that their actions will not adversely affect any "grandfathering" of existing Section 162(m) performance-based compensation arrangements.

- ***Reviewing Plan Documents and Proxy Disclosures.*** As always, companies should carefully review their plan documents and proxy disclosures. Companies should pay particular attention to those made in connection with obtaining shareholder approval for the plans, to confirm that any contemplated changes in payment timing or processes have been duly authorized and are consistent with the terms of the plans and disclosures.

Moving Forward Under New Rules

Even if the Bill is enacted and the Section 162(m) changes survive in substantially the forms the House and Senate have passed to date, US public companies will undoubtedly continue to rely on performance-based compensation as a component of their executive compensation programs, due to the need to ensure proper incentives for executives and that shareholders and proxy advisory firms will continue to demand that executives' compensation pay for performance and be aligned with investor interests. That said, compensation (including performance-based compensation) in excess of US$1 million that is paid to a covered employee will be non-deductible. As a result, the design and implementation of performance-based compensation arrangements will be possible without regard to the highly technical and prescriptive requirements of Section 162(m).

Even if the Bill is enacted, it likely will take months before the ultimate impact of the final Bill on Section 162(m) is known. The Department of Treasury will issue regulations on the final Bill, but the timing is unknown. However, even in the absence of final guidance, the proposed changes to Section 162(m) will impact US public companies in some of the following ways, each of which will require careful consideration:

- ***Reevaluate and Reconsider Performance-Based Compensation Designs*.**
  - Performance-based compensation programs will be able to use any performance metrics the compensation committee deems appropriate, and will not be limited to the shareholder-approved performance goals.
  - The compensation committee can retain negative or positive discretion on any final payouts (currently, only negative discretion is allowed).
  - Adjustments to performance goals will not need to be objective and specified in advance — the compensation committee will have the ability to adjust performance goals as it deems appropriate, to match a company's actual business results and unexpected circumstances.
  - Stock options and stock appreciation rights no longer will receive preferential treatment under Section 162(m) as performance-based compensation and other award types may become even more popular, as they will no longer be disadvantaged from a deductibility perspective.
  - Companies may want to consider modeling different vesting and payment timing to enhance the deductibility of equity (and other incentive) compensation, such as longer vesting periods to spread out the income realized from equity awards over a greater number of calendar years.
- ***Reevaluate Severance and Equity Acceleration Provisions*.** Currently under Section 162(m), compensation fails to qualify as performance-based compensation if such compensation is payable without regard to whether the underlying performance goals are attained in the event of a termination without cause, a resignation for good reason, or retirement. For example, under the current rules, a severance arrangement providing for payment of a covered employee's target bonus for the year of termination without regard to actual performance would render any annual bonus payable to such employee as ineligible for the Section 162(m) performance-based compensation exception,

regardless of whether the termination provision was triggered. Under both versions of the Bill, companies can revisit these provisions.

- ***Consider Equity and Cash Bonus Plan Amendments.*** Equity plans typically contain extensive provisions designed to ensure that equity awards can qualify as performance-based compensation for Section 162(m) purposes. These include individual limits on the number of shares and/or amount of cash that companies may pay to individuals during a specified time period. If the performance-based compensation exception is eliminated, equity plans could be amended to remove these provisions. Whether shareholder approval of any such amendments is required will largely depend on the equity plan's amendment language and applicable national stock exchange rules on equity plans. How the proxy advisory firms will view proxy proposals to amend plans to remove Section 162(m) provisions remains unclear. The stock exchanges may also weigh in on whether such amendments will require shareholder approval. Companies may also need to update equity plan prospectuses if they include tax disclosure regarding Section 162(m). Companies maintaining cash bonus plans with Section 162(m) provisions may also want to revisit or discontinue those plans in favor of more flexible arrangements.

- ***Consider Covered Employee Group Expansion*****.** Companies will want to ensure they understand who their covered employees will be for 2018 and beyond, so that their compensation committees can make informed executive compensation decisions. Additionally, companies may want to consider ensuring their executive officer list is as narrow as possible, while still complying with securities law requirements (as the determination of the covered employee list will be based on the executive officer list).

- ***Review Compensation Committee Membership*****.** Although the national stock exchanges and securities laws still impose requirements on compensation committee member qualifications, compensation committee members would no longer need to qualify as "outside directors" for purposes of Section 162(m). Under the transition relief, it may be necessary to ensure compensation committee members satisfy the Section 162(m) requirements until any grandfathered awards are certified and paid. Companies that have used subcommittees of the compensation committee to approve performance-based compensation (because a member of the compensation committee was not an "outside director") will be able to disband such subcommittees once they are no longer needed under any transition relief.

- ***Reevaluate Compensation Committee Charters*****.** Companies may need to amend compensation committee charters to remove references to Section 162(m).

- ***Consider Section 162(m) Transition Periods.*** How the Bill will affect existing transition periods under Section 162(m) (such as after an initial public offering or a spin-off) is unclear at present. Companies that are in such a transition period will want to monitor the rules and confirm with their legal, tax, and accounting advisors how the final rules will affect their executive compensation deductions.

The Bottom Line

Companies should consult with their legal, tax, and accounting advisors to determine whether any year-end actions are possible or advisable to maximize deductions for executive compensation and to mitigate tax costs to executives, given, the proposed changes to Section 162(m), the proposed reduction in the corporate tax rate for future tax years, changes in individual tax rates and deductions under the Bill, and the need to navigate requirements under Section 409A and securities laws.

Companies must also consider the effect of any actions on existing Section 162(m) performance-based compensation arrangements under the proposed transition rules. However, in many cases, the reduced corporate tax rate may somewhat offset any lost deduction in 2018 due to Section 162(m) changes. Companies should account for this in evaluating the relative costs (including administrative time and effort) and benefits of any 2017 year-end machinations to accelerate company deductions. Ultimately, the value of accelerating the deduction for executive compensation will depend on a company's particular tax situation.

If the Bill is enacted and Section 162(m)'s scope is expanded as proposed, US public companies will also want to review their existing executive compensation program, plans, and arrangements and consider whether any adjustments are desirable or, potentially, required in order to accommodate the new realities and to maximize their alignment with company and shareholder interests.

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[1] All references to "Section" refer to sections of the Internal Revenue Code of 1986, as amended.