Executive Compensation Again Targeted Under Proposed Tax Cuts and Jobs Act

As Congress attempts to *giveth* back to corporations via a sizable reduction in the applicable corporate tax rate (from 35 percent to 20 percent), it also attempts to offset and *taketh* away some of that loss in revenue by eliminating the tax favorable status afforded to select common elements of executive compensation programs. The proposed legislation includes provisions that focus on accelerating the recognition of taxable compensation to executives, as well as eliminating certain compensation-related corporate deductions. The bill would also impose a 20 percent excise tax on compensation paid in excess of $1 million to the five highest-paid current or former employees of tax-exempt organizations (see our other Alert for a more detailed discussion of the implications of the proposed bill on tax-exempt organizations).

Acceleration of Income

Nonqualified Deferred Compensation (Including Stock Options/SARs) Includible in Income Upon Vesting—As proposed under the bill, any compensation deferred under a *nonqualified deferred compensation plan* shall be includible in gross income when there is no longer any *substantial risk of forfeiture* (i.e., taxation occurs upon vesting, not on payment or settlement).

- *Substantial risk of forfeiture* exists only if deferred compensation is conditioned upon the future performance of substantial services, and not by reason of a covenant not to compete or the occurrence of a related condition other than future performance of services.
- *Nonqualified deferred compensation plans* generally includes any plan that provides for the deferral of compensation other than a tax-qualified employer plan, bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan.
- Stock options, SARs, and equity units are specifically identified as forms of nonqualified deferred compensation, and would be includible in income upon vesting (and not upon exercise or actual payout).
- Existing deferred compensation arrangements to be included in income by 2025 or, if later, the year it vests.

KFHG Comments: *If enacted, the underlying favorable tenets of delayed taxation and tax-deferred growth attributed to nonqualified deferred compensation plans will be eliminated. The vesting taxation trigger would likely hasten the already declining prevalence of new traditional SERPs or other nonqualified retirement plans. Delayed or periodic installment payments would be replaced with lump sum distributions to coordinate the timing of taxation with payout. Under the bill as proposed, most existing plans would eventually unwind by 2025.*

Triggering taxation upon vesting with respect to time-based restricted stock units (RSUs) would also eliminate the primary benefit associated with granting RSUs over granting actual shares of restricted stock. Performance-based equity design considerations will have to focus on aligning the vesting period with the actual performance period. On initial review, it appears that awards of stock options and SARs would experience a similar decrease in prevalence prospectively. However, other factors and possible design changes may be considered that defer the taxable vesting trigger, limit the amount of taxable income recognized upon vesting, or possibly recharacterize the gain on stock price appreciation from ordinary income to capital gain treatment; otherwise, stock options and SARs may be completely abandoned as a viable form of delivering equity compensation.

Potential plan design changes would include: (i) extending the vesting period, (ii) aligning the vesting period with the option term, (iii) revisiting premium-priced options, (iv) potential favorable capital gains tax treatment for any subsequent stock price appreciation following the taxable vesting date, and (v) granting stock options with immediate or shorter vesting periods (possibly combined with required holding periods).

Elimination of Deductions

Elimination of Performance-Based Exception under Internal Revenue Code (IRC) Section 162(m)—As proposed under the bill, the ability for public companies to deduct performance-based compensation in excess of the $1 million cap would no longer be permitted. No deduction would be allowed for compensation in excess of $1 million paid in one year to the principal executive officer (PEO), principal financial officer (PFO), or next three highest compensated officers ("covered employees") as disclosed in the proxy. Further, once identified as a covered employee for any preceding tax year that begins after December 31, 2016 the $1 million deductibility cap continues to apply indefinitely.

KFHG Comments: *If enacted, the loss of deductibility of performance-based compensation in excess of the $1 million cap would not likely result in significant compensation program changes. Most companies comply with the requirements of IRC section 162(m) and take advantage of the performance-based exception to preserve the deductibility of compensation as it is favorable to the company and its shareholders. However, tax efficiency alone, generally is not the driving design feature underlying executive compensation programs.*

Similarly, on the flip-side companies are also not likely to eliminate the performance-based design features within their pay programs in response to the proposed tax bill changes. A pay program that demonstrates an effective pay-for-performance alignment has become the central tenet underlying the design of any effective pay program, and moving away from emphasizing performance-based compensation is not likely to occur in-the-near future, if ever.

The proposed House legislation still has a long way to go, likely facing challenges and changes along the way as it moves through the full legislative process. We will provide additional information on substantive changes and developments as they arise.

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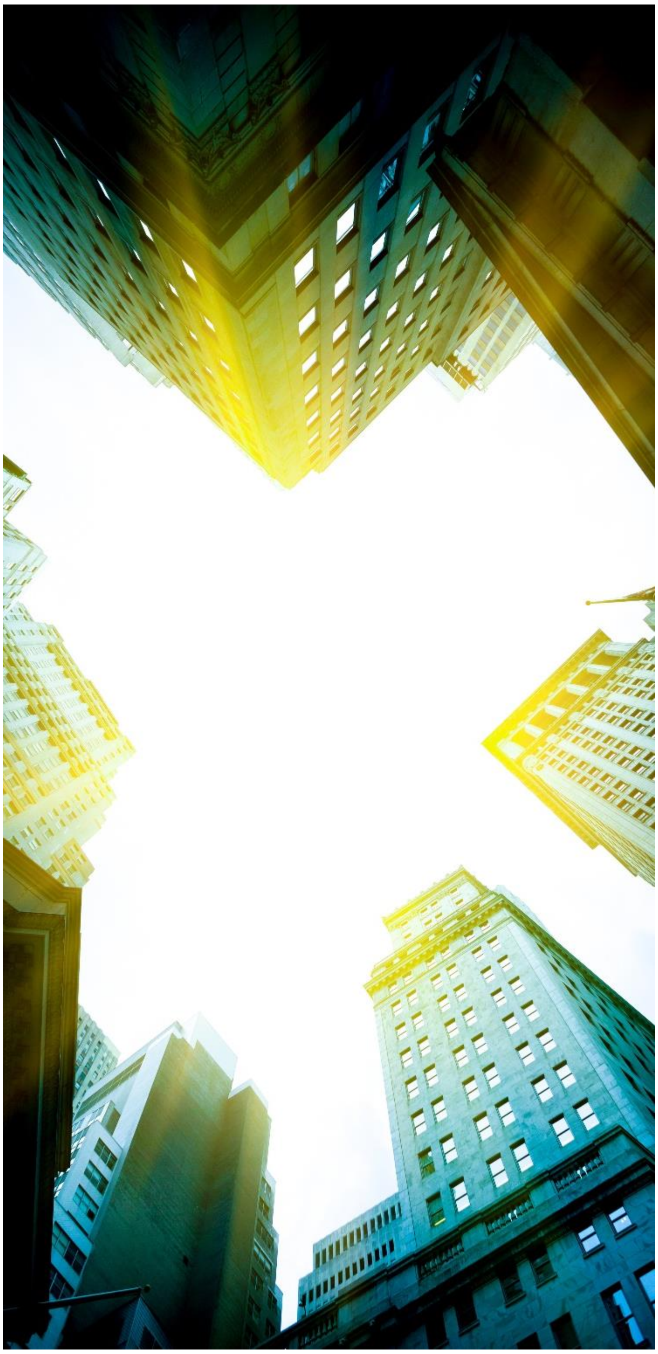

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