November 10, 2017

EXEQUITY

Independent Board and Management Advisors

Client Alert

GOP Tax Proposal Eviscerates Current Executive Compensation Designs and Practices—Perhaps?

On November 2, 2017, the House Ways and Means Committee released the GOP's Tax Proposal,[1] also known as the Tax Cuts and Jobs Act and the potential harbinger of death for many current executive compensation programs. The Tax Proposal has already been amended by the Chairman of the House of Representatives' Ways and Means Committee, and is likely to undergo further changes as it winds its way through Congress. Also, the Senate released a summary of its plan late on November 9 and reconciliation between the House and Senate bills will need to occur. President Trump wants this signed into law by Christmas, so there is a lot to be done in a very short period of time. Thus, there could be many changes between now and then, including the possibility of no bill.

This Client Alert details the "worst-case scenario" key provisions that impact executive compensation directly and also discusses the immediate issues companies need to think through so they at least have some chance to take action before December 31, 2017 if they want to try and address some of the potential issues that this Tax Proposal would raise if it makes it into law in before the end of the year.

The GOP is trying to get this Tax Proposal signed into law using the Congressional "budget reconciliation" process, which permits a simple majority with the Vice President as the tie breaker. This requires keeping the changes wrought by the Act as revenue-neutral as possible over the next decade. As such, it appears that the marching orders of the drafters were to capture as much revenue into that 10-year period as possible, and the fact that some of these proposals do not appear to have any interest groups that would rally against them (such as the changes to executive compensation) may make it less likely that such revenue-raising provisions will be dropped from the final form of the bill.

> ***Note**: As of the writing of this Alert, we understand there is a Chairman's amendment that eliminated the provisions dealing with nonqualified deferred compensation (NQDC) from the Tax Proposal. It is unclear how the House and Senate bills will reconcile these issues. In order to assist companies with advance planning, this Client Alert assumes enactment based on a "worst-case scenario" of the originally proposed House rules and Senate summary. This is reflective of how fluid this situation is, so buckle up and stay tuned, as no one can predict where things will land.*

[1] The text of the Tax Proposal, the Tax Cuts and Jobs Act, H.R. 1, can be found at: https://www.congress.gov/115/bills/hr1/BILLS-115hr1ih.pdf.

Summary of Tax Proposal's Executive Compensation Provisions

The Tax Proposal's provisions that impact executive compensation at publicly held companies are:

- **NQDC** (defined to include stock options, stock appreciation rights (SARs), and other similar rights[2]) will be included in the gross income of the recipient when there is no substantial risk of forfeiture of the rights of the recipient to such compensation. This applies to amounts which are attributable to services performed after December 31, 2017.
  - The Tax Proposal defines a substantial risk of forfeiture very narrowly, which could lead to taxation in situations that would not be taxed today (e.g., when a stock option or SAR vests). The potential for forfeiture due to a company's bankruptcy or insolvency is not a sufficient risk of forfeiture; neither is attaching a non-compete covenant to the compensation; nor is a performance goal alone sufficient. What will constitute a **substantial risk of forfeiture** is a requirement for the **future performance of substantial services**.
  - The Tax Proposal replaces Code Sections 409A and 457 with new Code Section 409B, with the requirements outlined above for NQDC.
  - The Tax Proposal will continue to provide for a short-term deferral exemption if amounts are paid out within 2½ half months after fiscal year-end in which the compensation became no longer subject to a substantial risk of forfeiture.
  - The Tax Proposal also addresses NQDC that is vested as of December 31, 2017, indicating that such amounts will get taxed no later than 2025 (creating issues for retirement planning with respect to currently deferred values under SERPs and other NQDC arrangements).
  - Finally, property subject to Code Section 83, such as restricted stock, is ***not*** treated as NQDC under the Tax Proposal, and therefore would continue to be taxed as is currently the case.

  Exequity Comment: *This proposed change alone presents a significant paradigm shift for executive compensation and compensation in general. Ultimately, it could even cause companies to abandon the notion of providing retirement benefits above those offered by qualified plans and let employees fend for themselves in this regard by paying them compensation on a more current basis. The issues raised by this proposed change are significant, and while it may be tempting to wait until the final language for such provision is known before considering the potential impact and possible action steps, doing so may jeopardize companies' ability to take advantage of potential planning opportunities for compensation during 2017.*

  Importantly, future performance conditions and uncertainties will not, by themselves, delay taxation beyond the lapse of service conditions. Accordingly, performance-based awards could become taxable at a time when the prospect of receiving any payment at all would be uncertain. Similarly, taxation before the performance conditions have had a chance to play out would make determination of the amount of tax challenging, and taxation would, in many cases, occur before value under the award is available to the employee.

---

[2] But, as is noted in the Joint Committee on Taxation's Description of H.R. 1, the "Tax Cuts and Jobs Act" (released November 6, 2017 and available at: https://www.jct.gov/publications.html?func=startdown&id=5031), this is ***not*** intended to include incentive stock options (ISOs) or qualified Section 423 Employee Stock Purchase Plans.

Nonqualified Employee Stock Purchase Plans (ESPPs) would be subject to new Code Section 409B and should be analyzed to determine potential impacts and best remedial actions (note that qualified ESPPs would be exempt). Exequity believes that while ISOs are excluded from new Code Section 409B, companies may not significantly utilize ISOs, given their technical requirements and limitations.

- **Section 162(m)** will also be substantially revised by the Tax Proposal, as follows:
  - The performance-based exemption to the Code Section 162(m) limit on deductibility of compensation (typically $1 million) is ***eliminated***, subjecting all pay above $1 million to a covered executive to potential nondeductibility, effective for taxable years beginning after December 31, 2017.
  - Code Section 162(m) is explicitly extended to cover the Chief Financial Officer/Principal Financial Officer.
  - An individual who qualifies for any tax year beginning after December 31, 2016 as a covered employee will **forever after** be treated as a covered employee, even post-termination of employment, meaning that many forms of post-employment pay (e.g., severance and vesting/exercise of long-term incentive awards after termination) would be potentially nondeductible.
  - Code Section 162(m) would apply to any company that files SEC reports, including those that merely issue debt securities to the public, but do not have publicly traded stock.

Exequity Comment: *This provision represents another significant shift in compensation. If enacted, this provision would mean that there would no longer be a regulatory rationale for ensuring that a significant portion of executives' compensation is "performance-based" and, coupled with the proposed rules on NQDC, may move the mix of pay to one that relies more heavily on cash and restricted stock. Importantly, companies will no longer need to structure plans using shareholder-approved performance metrics, be constrained by individual limits on award sizes, or worry about the exercise of positive discretion. Of course, the unintended consequences of such a fundamental change in the tax structure are not known, but if experience with regulatory changes is any indicator, these tax law changes are likely to distort compensation and cause companies to modify their designs to ensure regulatory compliance and not necessarily comport with expectations of how compensation should be designed.*

It is also worth noting that this will further increase the tension between designing compensation programs to comply with tax code requirements versus current notions of good corporate governance espoused by shareholders and proxy advisors who believe a substantial portion of executive compensation should be performance-based. Since performance requirements alone for NQDC, stock options, and SARs are ignored for purposes of determining whether the award is subject to a substantial risk of forfeiture (and therefore not yet taxable), companies will need to ensure that any performance requirements are set concurrent with a service requirement.

Note*: While the November 9 proposed Chairman's amendment would eliminate the provisions dealing with NQDC from the Tax Proposal, there has not been a similar proposal to eliminate the provisions pertaining to the Section 162(m) rules. Additionally, the Senate bill summary introduced on November 9 includes NQDC and Section 162(m) provisions mirroring those in the House's original Tax Proposal.*

Triaging Compensation

In reaction to the Tax Proposal, companies should review their compensation—both outstanding and to be granted—and consider whether any changes are advisable to lessen the impact of the Tax Proposal changes. The chart below lays out the key issues most likely to be faced by the majority of public companies if the NQDC rules are enacted, but there will be specific facts and circumstances that could warrant other potential action that companies may need to consider as well.

Type of Compensation	Potential Issues/Concerns	Potential Action	Considerations
Near-Term (to be granted/made in next several months)	• **New grants of stock options or SARs in 2017**—Nonqualified stock options or SARs that vest on or after January 1, 2018 will be taxable upon vesting, regardless of the remaining period of the stock option/SAR for exercise. • **Equity grants in 2018 that are expected to include stock options**—Nonqualified stock options granted after December 31, 2017 would be subject to the Tax Proposal requirements and will be taxed when no longer subject to a substantial risk of forfeiture. • **Annual bonuses and long-term incentive cycles ending in 2017, payable in 2018**—Generally, companies cannot take a deduction for incentives to be paid unless certain requirements are met, including all events necessary for payment to the employee must be met. If a company requires employment through the incentive payment date to avoid forfeiture, those events would not be met until the incentive is paid. Thus, the company could not take a tax deduction until the year of payment. — Given the potential lowering of tax rates for companies, it may be advantageous to satisfy all requirements for the payment of 2017 annual bonuses as of the end of 2017, and not require continued employment through the date of	• **New grants of stock options or SARs in 2017**—Companies could grant options that are fully vested to garner the vested outstanding NQDC at December 31, 2017 treatment (see *Outstanding, Vested Stock Options/SARs or NQDC* below). — Alternatively, companies could delay their equity grant until a final tax law is available to determine a course of action. — Companies may also consider granting ISOs. • **Equity grants in 2018 that are expected to include stock options**—Companies could accelerate into 2017 the grant of the stock options to be made as part of the scheduled 2018 annual equity grant and grant such stock options fully vested to garner the vested outstanding NQDC at December 31, 2017 treatment (see *Outstanding, Vested Stock Options/SARs or NQDC* below). — Alternatively, companies could replace stock options with restricted stock for 2018 and later equity grants. • **Bonuses for 2017 payable in 2018**—Ensure that the "all events" test is satisfied so that the company can take the tax deduction in 2017 for bonuses to be paid in early 2018. • **Deferral elections**—Draft new deferral elections so that they will "self-destruct" if the Tax Proposal becomes law, i.e.,	• **New grants of stock options or SARs in 2017**—Granting fully vested stock options in 2017 will preserve current tax treatment of options. However, this approach will impact 2017 corporate earnings and may in turn impact the extent to which goals are achieved for the 2017 annual bonus and long-term performance cycles ending in 2017. — Weigh the impact of the loss of retention value of stock options/SARs that are granted with no vesting conditions. — Consider potential shareholder and proxy advisor reaction to such action. — Review impact of plan provisions that have minimum vesting period requirements. — Note, the Tax Proposal does not specify the way stock options or SARs would be valued for tax purposes, i.e., whether it will be based on the intrinsic value or the Black-Scholes value of such awards upon vesting. • **Equity grants in 2018 that are expected to include stock options**—Moving up the grant of the stock option portion of the 2018 annual equity grants into 2017 and granting them on a fully vested basis would need to be evaluated in the context of the issues discussed in the previous bullet compared to the

Type of Compensation	Potential Issues/Concerns	Potential Action	Considerations
	payment to ensure the tax deduction can be taken in 2017, which will have a larger tax benefit to the company than if it were to wait to take the deduction in 2018. Further, the elimination of the performance-based exception might reduce or eliminate the deduction for the incentives for named executive officers if employment in 2018 is required for payment. • **Deferral elections for service periods including time after December 31, 2017**—New elective deferrals related to service periods including dates after December 31, 2017 would be taxed when they are no longer subject to a substantial risk of forfeiture (so generally taxed when deferred). Thus, deferral of annual bonuses and long-term incentive cycles ending in 2017 would not be effective if employment in 2018 is required to earn the award.	provide for the deferral of compensation, but state if the tax laws require the individual to be immediately taxed upon such purported deferral, then the income will not be deferred and instead shall be paid directly to the individual who made such election in accordance with the Company's typical payment practices for such compensation. — Alternatively, the Tax Proposal indicates that the Treasury will be required to issue regulations within 120 days of its enactment, so companies could wait to address this after the regulations get published and simply use their existing deferral election form(s).	difficulty in coming up with a substitute equity award vehicle that will accomplish the company's goals in such a tight time frame (i.e., between now and the 2018 grant). • **Bonuses for 2017 payable in 2018—** There are definite pros and cons to structuring the bonus so that the company can take the deduction for it in 2017, but potential ramifications of changing the existing practice (if different) should also be considered. • **Deferral elections**—Consider how comfortable the company is drafting in such alternative provisions into the deferral elections compared to waiting for the relevant Treasury regulations if the Tax Proposal is enacted. Future deferrals are not viable if not subject to a substantial risk of forfeiture.
Outstanding, Unvested Stock Options/SARs or NQDC (excluding SERPs, discussed separately below) as of December 31, 2017	• Holders of stock options/SARs or NQDC will be taxed when the substantial risk of forfeiture lapses after December 31, 2017, i.e., when the stock options/SARs or NQDC vests. • **Attribution of service**—It is unclear how service provided prior to January 1, 2018 under the deferral election is credited towards a vesting event that occurs after December 31, 2017 for purposes of determining the taxable amount at vesting. • **Valuation of stock options/SARs upon vesting after December 31, 2017**—The Tax Proposal does not specify how stock options will be valued for purposes of determining the tax—it could be either	• **Accelerate the vesting** to remove the substantial risk of forfeiture for outstanding unvested stock options, SARs, and NQDC before December 31, 2017. ***Exequity Comment**: Consideration of accelerated vesting of stock options, particularly underwater options, is most urgent.*	• Determine whether the equity compensation plan permits the acceleration of vesting of stock options/SARs. • Consider potential shareholder and proxy advisor reaction to such action. • Weigh the impact of the loss of retention value of stock options/SARs that have vesting accelerated (for companies with graded vesting, this most likely will approximate one to two annual grants' worth of accelerated vesting). • Review impact of plan provisions that have minimum vesting period requirements. • Assess the accounting implications of accelerating vesting of stock options,

Type of Compensation	Potential Issues/Concerns	Potential Action	Considerations
	intrinsic value (the difference between the stock price on the vesting date and the exercise price) or a value derived from an option pricing model such as the Black-Scholes-Merton model.		SARs, and/or NQDC and their impact on 2017 incentives. • Consider proxy and other SEC disclosure ramifications if accelerate vesting. • Unlikely to require participant agreement so long as beneficial to participant, but need to evaluate any other changes made to the outstanding awards.
Outstanding, Vested Stock Options/SARs or NQDC as of December 31, 2017	• No issue other than the fact that the stock option/SAR recipient **will be taxed in 2025 if the stock option/SAR is not exercised before then**, regardless of whether the stock option still has time left in its term to be exercised. NQDC balances deferred beyond 2025 need to be paid by 2025, as they will be fully taxed at that time even if not distributed.	• **Communication with employees** about the potential for taxation without stock option/SAR exercise.	• Not critical to address in the near term. • Plan and agreement amendments may be needed.
Restricted Stock Units and Performance Share Units with Retirement Vesting Eligibility	• If awards include a **retirement eligibility provision** that would cause the award to vest upon becoming eligible for retirement, would cause taxation when such eligibility requirement is met after December 31, 2017. Note, for awards made prior to December 31, 2017 to individuals who are retirement-eligible as of that date, the award would be deemed vested under the new proposal as of December 31, 2017, and thus would be "exempt" and remain subject to current tax law. However, see note below on pro rata vesting. • So long as the awards are drafted so that they **vest and pay out** and do not contain the retirement eligibility issue detailed above, these awards should remain viable under the new tax rules, as the timing of taxation and payment will be concurrent. • If the Tax Proposal is enacted, then **pro rata vesting provisions for retirement**	• To address the **retirement eligibility issue**, a company could require the recipient of the award to give **notice of his/her intent to retire with sufficient time** so that it would necessitate the substantial performance of future services. Some have suggested that a **six-month notice period** may be sufficient, but there is no guidance yet from the IRS on what period will be acceptable. • Requiring a notice of intent to retire should also eliminate the additional problems with prorating vesting upon retirement. • Since tax will be due upon employment termination for performance awards, it may be necessary to determine the amount due at the time of termination, rather than at the end of the performance period.	• At this point, it is not clear that a six-month notice period will be sufficient to avoid immediate taxation upon attaining retirement eligibility status. Awards could be drafted to require notice equal to the longer of (i) six months, or (ii) a period designated as a safe harbor through IRS regulations, if any. • Determining the amount of payout of a performance award in the event of termination has historically been left until the end of the cycle. The new tax law will effectively require that determination to occur at employment termination in order to avoid a time gap between taxation at termination and the determination of performance at the end of the performance cycle. In order to avoid this taxation timing problem, choosing to settle the award at termination, with payout at target may become most common upon a retirement, death, or disability.

Type of Compensation	Potential Issues/Concerns	Potential Action	Considerations
	would present an interesting situation in that there would be taxation starting on the day that the individual satisfies the retirement requirements and then every day thereafter until the end of the normal vesting schedule (which, depending on the specific design, may be mitigated by the 2½ month short-term deferral rule). • Performance awards that provide a payment upon any type of termination will be taxed upon termination since there is no ongoing service condition. It is not clear how the amount of taxable income will be determined, since frequently the amount that will be paid is tied to actual performance through the entire performance period. Nevertheless, the proposed rule indicates that the timing of taxation will occur at termination.		
SERPs	• See above for issues regarding vested and unvested NQDC. • We would expect most SERPs, whether defined benefit or defined contribution, to be largely vested as of December 31, 2017. However, to the extent that these benefits are not vested as of December 31, 2017, they will be taxed at vesting, rather than at the scheduled future distribution date. • Given that these benefits are earned over the entire career, they are likely to be quite large, particularly defined benefit programs. Thus, if unvested SERP balances are outstanding, they are likely to be significant, thus creating a significant tax obligation at vesting.	• Same as above with respect to vested and unvested stock options/SARs and NQDC.	• If passed, the Tax Proposal likely ends SERPs as we know them today. • In the future, we would expect SERP programs to be replaced with either (i) current cash, leaving the executive entirely responsible for retirement savings other than the qualified plan, or (ii) potentially, career equity-type awards with very lengthy vesting periods.

Type of Compensation	Potential Issues/Concerns	Potential Action	Considerations
Severance	• **Severance paid out in installments**—If the individual receiving the severance payments no longer must provide substantial services upon termination, then the full amount of the severance payments would be taxable at that time. Note, an ongoing noncompete will not be considered substantial services, and thus will not delay taxation. • **Good Reason Severance**—If an individual has the right to severance for Good Reason, once the requirements of Good Reason are met, the severance would arguably be taxable, even if the executive does not terminate employment, since no service obligation exists at that time.	• **Severance paid out in installments**—If any executive is expected to be severed within the next several months, it may make sense to revise their severance payments to call for a **single lump-sum payment** if the payment of severance in installments would be taxed in full upon a date earlier then the installment payment date. • **Good Reason Severance**—If providing the company with an opportunity to cure the items giving rise to Good Reason would constitute a substantial risk of forfeiture under the Tax Proposal, such severance could be amended to provide for a 60-day cure period during which the executive would be required to continue providing service.	• Neither of these issues is critical to address in the near term, except for executives who may be terminated prior to the issuance of the Treasury regulations on unwinding existing NQDC amounts.
Annual Bonus (for 2018 and beyond)	• Annual bonus and long-term incentive awards must be paid out within 2½ months of the end of the year or else require continued employment through the date of payment to avoid potential taxation at the end of the performance period (2018).	• Amend the bonus plan and long-term performance plan to provide that awards must be paid out within 2½ months of the end of year or require continued employment through the actual date of payment.	• Making this change to require continued service if payment would be later than 2½ months after the end of the year would cause the company's tax deduction to be pushed into that following year.
Nonqualified ESPP	• Since not a qualified ESPP, subject to new NQDC rules under the Tax Proposal.	• Assess nonqualified ESPP design to determine if any changes are necessary to avoid a dry income issue, e.g., limit the look-back period.	• Same considerations as above in undertaking action.
Director Compensation	• Subject to the Tax Proposal in the same manner and with relatively the same issues as laid out above.	• Consider accelerating into 2017 the vesting of outstanding unvested awards. • Revisit vesting periods for directors on non-Section 83 property, e.g., RSUs, DSUs, and phantom stock, to see if directors should be granted immediately vested awards.	• Generally, the same considerations that apply to stock options, SARs, and NQDC granted to executives and employees will also apply to directors. • If the Tax Proposal passes, this may cause director awards to be immediately vested.

Exequity Comment: *If the Tax Proposal is enacted, companies can avoid the negative issues with NQDC for 2018 and later by structuring such compensation so that it pays out when the service vesting condition is satisfied. Accordingly, performance awards with performance goals likely will have the performance goals be required to be met within the stated service period to avoid issues as well. Of course, this may undercut the rationale for providing certain types of compensation, such as retention and retirement security.*

Conclusion

The Tax Proposal would cause significant changes to executive compensation plans and designs. Unfortunately, the timing of its introduction and its proposed effective date give companies very little time to assess and react to avoid potential negative consequences by acting in 2017 before the Tax Proposal would become effective for 2018.

If the final tax law looks at all like the original Tax Proposal, effective communications with employees will be critical. Employees will need to understand the significant changes in taxation they face, potential implications for their outstanding and future awards and NQDC, and what the company expects to do going forward.

Questions on how the Tax Proposal might impact your executive compensation design and practices? Exequity stands ready to discuss these issues with you and help assess potential ramifications and actions to address such issues before year-end.

If you have any questions about this ***Client Alert***, please contact **Ed Hauder**
((847) 996-3990 or Edward.Hauder@exqty.com) or any of the following:

Ben Burney	(847) 996-3970	Ben.Burney@exqty.com
Robbi Fox	(847) 948-8655	Robbi.Fox@exqty.com
Mark Gordon	(925) 478-8294	Mark.Gordon@exqty.com
Adam Hearn	(847) 996-3972	Adam.Hearn@exqty.com
Jeff Hyman	(203) 210-7046	Jeff.Hyman@exqty.com
Lynn Joy	(847) 996-3963	Lynn.Joy@exqty.com
Stacey Joy	(847) 996-3969	Stacey.Joy@exqty.com
Chad Mitchell	(949) 748-6169	Chad.Mitchell@exqty.com
Jeff Pullen	(847) 996-3967	Jeff.Pullen@exqty.com
Dianna Purcell	(718) 273-7444	Dianna.Purcell@exqty.com
Bob Reilley	(856) 206-9852	Bob.Reilley@exqty.com
Mike Sorensen	(847) 996-3996	Mike.Sorensen@exqty.com
Jim Woodrum	(847) 996-3971	Jim.Woodrum@exqty.com
Ross Zimmerman	(847) 996-3999	Ross.Zimmerman@exqty.com

Illinois Office (Headquarters) – 1870 West Winchester Road, Suite 141 ● Libertyville, IL 60048
California Offices – 650 Town Center Drive, Suite 830 ● Costa Mesa, CA 92626
– 2840 Comistas Drive ● Walnut Creek, CA 94598
Connecticut Office – 108 Pine Ridge Road ● Wilton, CT 06897
New Jersey Office – 309 Fellowship Road, Suite 200 ● Mt. Laurel, NJ 08054
www.exqty.com

You are receiving this ***Client Alert*** as a client or friend of Exequity LLP. This ***Client Alert*** provides general information and not legal advice or opinions on specific facts. If you did not receive this directly from us and you would like to be sure you will receive future ***Client Alert***s and our other publications, please click on the following link to add yourself to our subscription list: http://www.exqty.com/References/Subscribe.aspx. If you want to unsubscribe from our list, please click on “Manage Subscription” at the bottom of the e-mail sent to you.

PUB/CA/GOP Tax Proposal_20171110