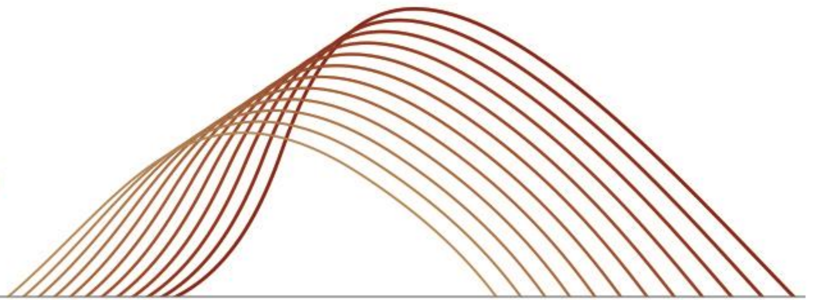
PAUL HASTINGS

STAY CURRENT



January 2018

Follow @Paul_Hastings

Unhappy New Year—New Tax Law Adversely Affects Certain Executive and Equity Compensation Arrangements

By Eric Keller & Steve Harris

On December 22, 2017 President Trump signed into law tax reform legislation containing the following three provisions that impact executive compensation and equity-based compensation:

1. expansion of the $1 million deduction limit for compensation paid to current and former executives of publicly traded corporations and elimination of certain exemptions;

2. imposition of a new excise tax on remuneration above $1 million paid to current and former highly paid employees of tax-exempt organizations; and

3. creation of "qualified equity grants" to allow employees of non-publicly traded companies to elect to defer income taxation of stock received from stock options or restricted stock units for up to five years from exercise of such options or vesting of such restricted stock units.

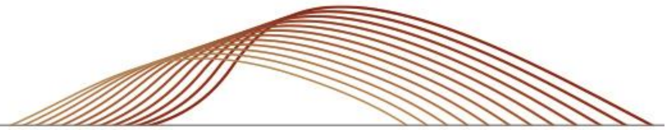
Expansion of Code Section 162(m)'s $1 Million Deduction Limitation; Repeal of Exemptions for Performance-Based Compensation and Commissions

The Act amends Section 162(m) of the Internal Revenue Code of 1986, as amended ("Code"), which limits annual deductions to $1 million for compensation paid to named executive officers of publicly traded companies, effective for taxable years beginning after December 31, 2017, to:

- eliminate the exemption for performance-based compensation and commission compensation;

- align the definition of "covered employee" with SEC reporting obligations to include the principal executive officer, principle financial officer and the three highest compensated officers other than the principal executive officer and principal financial officer (as well as those individuals who would fall within this definition for Section 15(d) required filers, as described below);

- expand the definition of "covered employee" to include, in perpetuity, any individual who was a covered employee for any year after 2016; the disallowed tax deduction is not avoided if the payments are made after termination of employment or to a party other than the former



covered employee (e.g., to a beneficiary after the former covered employee's death), apparently also including taxable disability payments from the employer; and

- expand the definition of "applicable employer" to include issuers of American Depository Receipts and other foreign issuers who are required to file reports under Section 15(d) of the Securities and Exchange Act of 1934, as amended (but not voluntary filers).

These new rules do not apply to compensation provided by a written binding contract which was in effect on November 2, 2017 and is not subsequently materially modified. The exact contours of this "grandfathering" exception are unclear, but we anticipate that the Treasury Department will provide guidance in the relatively near term, likely in the form of a Notice.

The elimination of the performance-based compensation exemption means that the $1 million deduction cap can no longer be avoided by granting stock options or other compensation that qualified as performance-based compensation. However, awards outstanding as of November 2, 2017 that qualified as performance-based compensation may remain exempt if they are not subsequently materially modified.

Because the disallowed tax deduction continues to apply even after the individual is no longer a covered employee, the $1 million annual cap will apply to post-termination payments such as severance and non-qualified deferred compensation benefits.

Paul Hastings Practice Pointers

Some of the options for employers to consider include:

- Whether continued inclusion of the typical "162(m) automatic deferral" provision in non-qualified deferred compensation plans is sensible. Some executives have 10s of millions of dollars in benefits under such plans and deferral for a decade or more may not be palatable. Such provisions can be eliminated with respect to future credits without causing Section 409A problems, but employers may want to wait to adopt such an amendment until the grandfathering rules are clearer, as some arrangements might be subject to grandfathering, even as to future deferrals, although unlikely.

- Whether to adopt a rule that executives cannot exercise options if doing so would put them over the $1 million cap on deductions.

- Whether to adopt similar rules with respect to restricted stock units and other forms of equity awards.

- Whether the decrease in the corporate tax rate from 35% to 21% is sufficient to not care about losing a deduction.

- The consequences of having a board member serve as an interim executive officer (hopefully, compensation earned as a board member will be exempt from the new non-deductibility rule, even if the individual serves temporarily as a Named Executive Officer).

Excise Tax on Tax-Exempt Organization Executive Compensation in Excess of $1 Million

The Act imposes a 21-percent excise tax on "remuneration" (defined as wages under Code Section 3401(a)) in excess of $1 million paid to a "covered employee" of certain tax-exempt organizations, including organizations exempt from tax under Code Section 501(a), effective for taxable years beginning after December 31, 2017. Covered employees are one of the five highest compensated employees of the tax-exempt organization or an individual who was in such group in any year after 2016. The tax is payable by the employer and there are special rules for compensation paid by related organizations. Remuneration is considered paid for purposes of this provision when payment of the amounts is no longer conditioned on the future performance of services by any individual.

The excise tax also applies to "parachute payments" made to current or former covered employees on account of their separation from employment if the aggregate value of the payments equals or exceeds 3 times such individual's "base amount." The legislative history states that the base amount is the individual's average taxable compensation for the five years immediately before the year of severance from employment. The excise tax applies to the excess over the base amount; not the excess over the three times base amount. Amounts subject to this excise tax are excluded from the amounts subject to the above excise tax on compensation over $1 million.

Tax Deferral Allowed for New "Qualified Equity Grants"

The Act adds new Code Section 83(i), which allows eligible employees of an eligible corporation to elect to defer federal income (but not FICA or FUTA) tax on receipt of such corporation's stock in connection with the exercise of stock options or settlement of restricted stock units until the earliest of: (1) the date such stock becomes transferrable; (2) the date the employee becomes an ineligible employee; (3) the date the stock becomes readily tradable on an established securities market; (4) five years after the rights of the employee in such stock are not subject to a substantial risk of forfeiture; and (5) the date on which the employee revokes the election in a manner permitted by the IRS. Both ESPP stock and ISO stock are eligible for Section 83(i) elections; however, if an election is made, the stock is subject to tax under Section 83(i) rather than Code Section 422 or 423.

An employee is an eligible employee unless he or she: (1) is or was in the preceding 10 years a 1-percent owner of the corporation as defined under Code Section 416(i); (2) is or has been at any time the chief executive or chief financial officer of such corporation or any individual acting in such capacity; or (3) a family member of any individual described in clause (2); or (4) one of the four highest-compensated officers of the corporation for the current or any preceding ten years.

A corporation is eligible if its stock is not readily tradable on an established securities exchange and such corporation has a written plan under which not less than 80-percent of all the non-part-time employees (30+ hours per week) of such corporation employed in the U.S. or any U.S. territory are granted stock options or restricted stock units with the same rights and privileges *in the year of the Section 83(i) election*. Employees do not have to receive stock options or restricted stock units with the same amount of shares, but they must be more than a de minimis amount. In addition, stock option rights are treated as different rights than restricted stock units for purposes of the 80% determination. In addition, a corporation is not eligible if it repurchased too much non-Section 83(i) stock in the year before the year in which the employee's rights are transferrable or no longer subject to a substantial risk of forfeiture.

The employer is required to provide eligible employees with notice of their right to defer income inclusion at a reasonable period of time before the option or restricted stock unit otherwise would cause inclusion in their income absent the election under Code Section 83(i) or to pay a $100 per violation tax of up to $50,000 per year. Employees must make the election no later than 30 days after the employee's rights in the stock are transferrable or not subject to a substantial risk of forfeiture (but, note above that the statute facially states that the deferral will cease when the stock is transferrable; presumably, that is a drafting glitch that should have stated five years after the stock is transferrable).

At the end of the deferral period, the employer is required to withhold income taxes at the highest rate (37% for 2018). The amount subject to withholding is the amount that would have been included in the employee's income but for the deferral election. Consequently, the amount subject to income inclusion and withholding at the end of the deferral period is not reduced if the value of the stock is lower at the end of the deferral period.

Paul Hastings Practice Pointer

It appears that the employer is required to provide the notice, even if it does not want employees to make the deferral. Employers should consider whether to include a provision in the grant or plan documents obtaining the employee's agreement not to make such an election, which should provide the employer the ability to avoid deferral of its deduction and avoid what might be an obligation to determine whether the equity program falls within Section 83(i)'s contours.

Because of the 80% requirement, it appears unlikely that most private employers, other than, perhaps very small employers, will try to design their equity programs to comply with Section 83(i).

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Los Angeles

Stephen H. Harris
1.213.683.6217
stephenharris@paulhastings.com

Palo Alto

Dan Stellenberg
1.650.320.1833
danstellenberg@paulhastings.com

Washington, D.C.

Eric R. Keller
1.202.551.1770
erickeller@paulhastings.com

J. Mark Poerio
1.202.551.1780
markpoerio@paulhastings.com

Paul Hastings LLP

Stay Current is published solely for the interests of friends and clients of Paul Hastings LLP and should in no way be relied upon or construed as legal advice. The views expressed in this publication reflect those of the authors and not necessarily the views of Paul Hastings. For specific information on recent developments or particular factual situations, the opinion of legal counsel should be sought. These materials may be considered ATTORNEY ADVERTISING in some jurisdictions. Paul Hastings is a limited liability partnership. Copyright © 2017 Paul Hastings LLP.