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KIRKLAND **ALERT**

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2017 Tax Cuts and Jobs Act Would Affect Compensation Plans and Arrangements

On November 2, 2017, the House Ways and Means Committee unveiled the first draft of the Tax Cuts and Jobs Act (H.R. Bill 1) (as amended through November 6, 2017, the "House Proposal").

Although the House Proposal is likely to change, if enacted as currently proposed, the House Proposal would significantly affect and curtail the design of executive compensation arrangements, as described below.

If enacted as currently proposed, the Tax Cuts and Jobs Act would significantly affect and curtail the design of executive compensation arrangements.

Takeaways

- Non-qualified deferred compensation attributable to services performed after December 31, 2017, will be taxable when "time-vested," i.e., a subsequent "performance-vested" condition alone will not defer taxation. This requirement will all but eliminate deferral of vested compensation into retirement plans other than qualified 401(k) and pension arrangements. **Previously deferred amounts will be includable in income prior to the 2026 tax year** or, if later, the year in which the compensation is no longer subject to a time- or service-based vesting condition.
- Stock options, stock appreciation rights and restricted stock units will be included in income when "time-vested," even if not exercised or settled until a later taxable year, with only a limited exception for awards granted to non-executive employees of certain private corporations. By accelerating tax on an illiquid instrument, the economic incentive for granting these awards, which align employees' incentives with shareholders, will be significantly impaired.
- Beginning with compensation paid in the 2018 taxable year, compensation paid to certain senior executives of publicly traded corporations and privately held corporations whose debt is publicly traded in excess of $1 million per year will not be deductible by the corporation, even if it is performance-based. This change will subject more corporations to significant limitations on the ability to compensate senior employees and will diminish the economic incentives for granting performance-based compensation.

Changes to Non-Qualified Deferred Compensation

Under current tax law (Section 409A of the Internal Revenue Code), non-qualified deferred compensation (e.g., an excess 401(k) plan) is generally not taxable until it is paid out, which permits executives (and other employees) to defer receipt of com-

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pensation (and related income inclusion) into later taxable years even when the compensation is vested.

The House Proposal will add a new Section 409B that rewrites the tax rules related to non-qualified deferred compensation and, as a collateral effect, drastically alter the economic benefits of compensating employees with stock options and other equity-based awards, as described below. Specifically, Section 409B provides that an employee will be taxed on compensation earned for services rendered (including stock options) when there is no "substantial risk of forfeiture" with respect to the compensation, rather than when the compensation is distributed to the employee. As a result, Section 409B eliminates a valuable tax planning tool previously available to all employees. These changes will apply to compensation attributable to services performed after December 31, 2017. Compensation previously deferred under Section 409A will be includable in income prior to 2026 or, if later, the year in which it vests.

Key Changes

- **Compensation must be included in income when vested** or no longer subject to a substantial risk of forfeiture, regardless of when it is actually received by the employee. This will include, for example, vested restricted stock units with deferred delivery features (subject to limited exceptions, described below), and severance payments paid in installments.
- **Continued compliance with restricted covenants, or satisfaction of a future performance condition, will not constitute a substantial risk of forfeiture.** Compensation will only be considered subject to a substantial risk of forfeiture if receipt is conditioned upon the future performance of substantial services.
- **There will be a limited transition relief period during which payment of amounts deferred prior to December 31, 2017, may be accelerated.** However, the Proposed Bill does not include any indication of when that period may occur or whether it may include one or more taxable years.

<u>Changes to Taxation of Equity-Based Compensation</u>

The changes to Section 409B described above will have a dramatic effect on equity incentive awards such as stock options, stock appreciation rights, and restricted stock units with delayed delivery features, all of which will become taxable when "time-vested."

An amendment to the House Proposal added by Ways and Means Chairman Brady on November 6, 2017, includes a narrow exception to this new general rule. In limited circumstances, certain employees of privately held corporations may be eligible to elect to defer taxation of vested restricted stock units and exercised stock options for up to five years following the lapse of a substantial risk of forfeiture. This election will only be available to employees of a privately held corporation that grants

equity awards to at least 80% of its employees each year, and will not be available to the corporation's chief executive officer, chief financial officer or any of its four highest-compensated employees. This provision appears intended to benefit start-up companies, which rely heavily on stock options and restricted stock units to compensate a broad group of employees; however, it imposes significant compliance obligations on employees and employers and will impact every aspect of compensation design and succession planning. The narrow exception fails to protect employees of private companies with more traditional equity compensation structures or employees of publicly traded companies, and could result in immediate taxation for employees who are promoted to the senior ranks. These changes will apply to taxable years beginning after December 31, 2017.

In addition, the November 6, 2017, amendment proposes changes to the taxation of so-called "carried interest" in investment partnerships. The proposal is limited to entities in the business of raising or returning capital, and investing or disposing of securities, real estate, cash and derivatives. As a result, the November 6, 2017, amendment appears not to change the taxation of "profits interests" commonly granted to employees at portfolio companies owned by private equity funds.

Key Changes

- **Restricted stock units, stock options and stock appreciation rights will generally become taxable when "time" vested (even if not settled or not exercised).** As with deferred compensation generally, described above, satisfaction of a future performance condition will not constitute a substantial risk of forfeiture.
- In extremely limited circumstances, **rank-and-file employees of privately held companies with broad equity programs may be eligible to elect to defer taxation of vested equity awards for up to five years** following the vesting date, subject to earlier taxation if an initial public offering occurs.

Changes to Deductibility of Compensation

Corporations may generally deduct compensation paid to employees for personal services rendered. Section 162(m) currently limits the deductibility of compensation paid by a publicly traded corporation to certain "covered employees," consisting of its chief executive officer and the next four most highly-paid executives (regardless of title) other than the corporation's chief financial officer. As a result, under current law, compensation paid in excess of $1 million to a covered employee is generally not deductible by the corporation. However, Section 162(m) includes a broad exception for performance-based compensation, including stock options, cash performance bonuses, and equity-based awards subject to performance conditions that meet certain requirements.

The House Proposal will limit the deductibility of all compensation paid in excess of $1 million to covered employees, eliminate the exception for performance-based

compensation and commissions, and expand the corporations subject to this loss of deduction. The loss of deduction will apply to any compensation paid after December 31, 2017, and there will be no transition relief for performance-based compensation granted in prior years, such as long-term incentive compensation with multi-year performance periods granted prior to December 31, 2017. These changes will be effective for tax years beginning after December 31, 2017.

Key Changes

- **Eliminates exceptions** for performance-based compensation, stock options and commissions.
- **Expands the corporations subject to Section 162(m)** to include privately owned corporations whose debt is publicly traded.
- **Expands "covered employees" to include a corporation's principal financial officer** (generally aligning with the definition of "named executive officers" under Rule 402 of Regulation S-K applicable to companies that are not smaller reporting companies). Once an employee is a "covered employee" for one taxable year, any compensation paid to that employee will be subject to Section 162(m) limitations for all subsequent taxable years.

Changes to Compensation Paid by Tax-Exempt Organizations

The House Proposal will subject private foundations and other tax-exempt organizations to a 20% excise tax on compensation paid to senior executives in excess of $1 million. Covered employees will include the five most highly compensated employees of the organization and, like the proposed changes to Section 162(m), once an employee becomes a covered employee, any future compensation to the employee in excess of $1 million will continue to be subject to an excise tax for all subsequent taxable years.

Tax-exempt organizations will also be subject to a 20% excise tax on excess parachute payments (defined for these purposes as payments made in connection with a termination of employment and calculated in a manner similar to transaction-related excess parachute payments under the "golden parachute" tax rules).

These additional excise taxes will apply to any compensation or excess parachute payments paid after December 31, 2017.

If you have any questions about the matters addressed in this *Kirkland Alert*, please contact the following Kirkland authors or your regular Kirkland contact.

Scott D. Price
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
www.kirkland.com/sprice
+1 212 446 4851

Michael Krasnovsky
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
www.kirkland.com/mkrasnovsky
+1 212 446 5922

Jennifer Pepin
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
www.kirkland.com/jpepin
+1 212 446 4817

Tiffany B. Wong
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
www.kirkland.com/twong
+1 212 390 4565

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