CLEARY GOTTLIEB

ALERT MEMORANDUM

Tax Cuts and Jobs Act Includes Significant Executive Compensation Changes, But Employers Should Proceed Incrementally in Revising Compensation Plans[1]

If you have any questions concerning this memorandum, please reach out to your regular firm contacts in the Executive Compensation and ERISA group.

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The recently proposed Tax Cuts and Jobs Act (the "Act") includes executive compensation tax reforms that, if enacted, would have significant implications for the way in which companies structure their compensation programs.

The Act was introduced in the U.S. House of Representatives on November 2, 2017, and may undergo significant revisions as part of the legislative process in the House, and the U.S. Senate is expected to propose tax reform legislation shortly that may not be identical to the House's bill, even though an identical bill could facilitate enactment without the need for a joint committee to reconcile differences.

At this time, there is substantial uncertainty as to whether the Act will be enacted in its current form, and we believe it would be premature for companies to redesign their contemplated plans for 2018 bonus awards and long-term incentive compensation awards at this stage of the process, even for awards expected to be made in early 2018. Nonetheless, we acknowledge that the compensation planning process is lengthy and involves many different parties, which can make it very difficult for companies to make extensive last-minute changes to proposed incentive arrangements. In light of this tension, as a preliminary matter, companies may be well-served to review the impact the Act, if adopted in its current form, would have on their overall plan design. For example, companies may wish to take note of performance awards that do not require continued service through the end of the performance period (such as awards that continue to vest based on company performance following a senior executive's retirement), while companies that traditionally issue options might also wish to assess the impact of switching from options to full value awards.

Companies should continue to monitor the state of the legislation and, as we approach year-end, consider whether any changes would be advisable based on the state of the legislation at that time.

[1] This memorandum has been revised to reflect an amendment offered by Chairman Brady to the proposed Tax Cuts and Jobs Act (the "Brady Amendment").

A summary of certain of the Act's proposed executive compensation-related tax reforms, together with notable exceptions, is provided below.

Nonqualified Deferred Compensation

Under current law, employees and other service providers are permitted to defer compensation, subject to Section 409A of the Internal Revenue Code (the "Code").

— ***Taxation upon Vesting.*** The Act proposes to repeal Section 409A (as well as Section 457A, which was more restrictive than Section 409A and specifically targeted hedge funds and other off-shore entities) of the Code and add a new Section 409B, under which compensation would become taxable when it is no longer subject to a requirement that the individual continue to provide services. Notably, this would also apply to stock options and stock appreciation rights, such that these awards would generally be taxed upon vesting rather than exercise, which would materially affect the economics of those awards. The Act includes an exception for compensation that is payable no later than two and one-half months after the end of the year in which the compensation vests.

— ***Application.*** As drafted, the Act's nonqualified deferred compensation provisions apply to services performed in 2018 and beyond. Existing nonqualified deferred compensation amounts would benefit from a limited grandfather, but would be required to be included in income before 2026 (or the date the amount is no longer subject to a service condition, if later). The Act also directs the Secretary of the Treasury to issue regulations to carry out the purposes of the Act, including regulations disregarding a substantial risk of forfeiture where necessary to avoid noncompliance.

— ***Exception for Private Company Options and Restricted Stock Units.*** While not included in the Act as originally proposed, the Brady Amendment would allow private company employees who receive stock in connection with the exercise of an option or the settlement of a restricted stock unit award to elect to defer tax for up to five years post-vesting, subject to certain eligibility requirements. Private companies would be required to notify employees of the deferral opportunity on or prior to the vesting date, and would be subject to penalties in the event that such notice is not provided (in an amount of $100 for each failure, subject to a cap of $50,000 per year). The proposal would apply to stock attributable to options exercised or restricted stock units settled beginning in 2018.

Limit on Excessive Compensation

In its current form, Section 162(m) of the Code generally disallows a publicly-traded company's federal income tax deductions for compensation in excess of $1 million per year paid to the company's Chief Executive Officer ("CEO") and three other most highly compensated executive officers other than the Chief Financial Officer ("CFO"), subject to two important exceptions for commissions and performance-based compensation.

The Act proposes several amendments to Section 162(m), effective as of tax years beginning in 2018.

— ***Commissions and Qualified Performance-Based Compensation.*** The Act proposes repealing the commission and qualified performance-based compensation exceptions, including for stock options. This means the primary exceptions to the rule would be eliminated and performance-based compensation would cease to be deductible above the $1 million limit. It also appears that with the rule becoming effective in 2018 there would be no grandfather or transition relief for outstanding performance awards.

— ***Definition of Covered Employees.*** The Act proposes expanding the definition of covered employees to include the CFO. This change would return the scope of covered employees to the definition that was in existence prior to the Item 402 amendments to Regulation S-K. Additionally, once an executive qualifies as a covered employee, the deduction limitation applies for so long as the company pays the executive (or his or her beneficiaries) compensation, including after termination of employment. The latter change could significantly expand the number of impacted individuals which, under current law, is generally limited to four or five individuals in a given tax year.

— ***Definition of Publicly Held Corporation.*** The Act also proposes to expand the companies subject to its reach to include issuers of securities required to file reports under Section 15(d) of the Exchange Act (e.g., companies with registered debt securities).

20% Excise Tax on Tax-Exempt Organizations

In general, tax-exempt organizations are not currently subject to limits on compensation paid to employees. Under the Act as proposed, a tax-exempt organization would be subject to a 20% excise tax on compensation in excess of $1 million paid in any year to any of its five highest paid current or former employees, and on certain payments made upon termination of employment, starting in 2018.

Limits on 401(k) Contributions

Prior to the Act's introduction, there was speculation as to whether the Act would further limit the ability of employees to contribute to 401(k) plans. As drafted, the Act does not propose any changes to the current limit on pre-tax contributions to 401(k) plans.

Carried Interest

While the Act as originally introduced did not propose any changes to the taxation of carried interest, the Brady Amendment includes a carried interest provision, which is described in further detail in our alert memorandum titled *Tax Cuts & Jobs Act: Considerations for Funds*, published November 8, 2017.

If you have any questions or would like to discuss this further, please do not hesitate to contact your regular contacts in the Executive Compensation and ERISA group.

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