

Client Update

Tax Reform: The Impact on Management Incentive Programs for PE Sponsors

We previously sent you our firm memo on the House tax bill in which we discuss the bill's deferred compensation provisions. While the House bill has since been amended to remove these provisions, they have been included in the Senate's newly released version of the tax bill.¹ It is too early to know where this will end. But if these provisions as described in the Senate summary are enacted, they are likely to have a substantial impact on compensation planning and the structure of PE firm portfolio company equity incentives. ***However, profits interests and restricted stock are largely unaffected by these new rules and our expectation is that, with appropriate modifications, stock options can continue to be used as a primary incentive tool for portfolio company management.***

EQUITY AND LONG-TERM CASH COMPENSATION TAXED ON SERVICE VESTING

Equity awards, including stock options and restricted stock units (RSUs), and long-term cash awards that are not contingent on continued service will be profoundly changed:

- Generally, stock options will be characterized as deferred compensation, and taxed when they are no longer subject to service-based vesting conditions.
- While the House bill contains a special rule for broad-based employee option programs, because CEOs, CFOs and other prescribed senior executives are excluded and the rule requires grants to 80% of the employee population, we do not expect it to be attractive to private equity portfolio companies.

Comment: While options might be less attractive than they were, we believe these changes (even if effective) will not spell the end of options, and we are considering ways that stock options may be restructured in the context of a portfolio company investment to provide beneficial incentive and retention value without disadvantageous tax treatment.

¹ Our memo on the Senate bill may be found at https://www.debevoise.com/~media/files/insights/publications/2017/11/20171113_The_Senate_Tax_Reform_Proposal.pdf.

- Restricted stock units (RSUs) and long-term cash awards will also be characterized as deferred compensation, and taxed when they are no longer subject to service-based vesting.

Comment: *RSUs and long-term cash awards will need to include a continued service requirement, regardless of whether the awards also have a performance-vesting condition, and (to avoid adverse tax consequences) must be settled by March 15 of the year following the earlier of the year in which the service conditions are satisfied or the year in which the employee's employment terminates.*

- Restricted stock (as opposed to restricted stock units) and partnership profits interests are largely unaffected by these proposed changes. The only significant change is a rule in the House Bill that, for investment entities, assets must be held for three years for profits interests to achieve long-term capital gain treatment for the recipient.

USE OF CASH MAY BE REQUIRED BEFORE EXIT

Companies that currently have deferred compensation arrangements may need to pay some or all of the compensation earlier than currently provided under the terms of the arrangement, and their ability to enter into new deferred compensation arrangements will be severely limited.

- Under a proposed transition rule, deferred compensation attributable to services performed prior to 2018 must be taken into income by **2027**.
- Deferred compensation that is attributable to services performed after 2017 is subject to the general rule that it is included in income when vested.

Comment: *This may result in an unexpected use of cash. Companies should consider how accelerated taxation of deferred compensation may impact their projections for use of cash.*

MORE LUMP-SUM SEVERANCE PAYMENTS

As a practical matter, most severance will need to be paid in a lump sum after termination of employment. Because employees will have immediate taxation on the full amount of any severance benefits payable, it will no longer be practicable to pay severance over a post-employment period, even if it is in exchange for non-compete.

We believe that there is a good chance that these rules, or something close to them, will be included in any tax reform, if it is enacted. Of course, we will keep you posted as we learn more.

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Please do not hesitate to contact us with any questions.

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