EXECUTIVE COMPENSATION: CASES AND MATERIALS

2018 SUPPLEMENT

Andrew W. Stumpff

EDITORS' NOTE

This Supplement covers major developments through February 28, 2018, many resulting from the enactment, in late 2017, of the Tax Cuts and Jobs Act (P.L. No. 115-97).

CHAPTER 1

EXECUTIVE COMPENSATION: THE BIG PICTURE

Page 10: After the chart at the top of the page, insert:

According to the Economic Policy Institute, the ratio of CEO to typical-worker pay was 286 in 2015, and 271 in 2016. Lawrence Mishel and Jessica Schieder, "CEO Pay Remains High Relative to the Pay of Typical Workers and High-Wage Earners," (Economic Policy Institute Report July 20, 2017), http://www.epi.org/publication/ceo-pay-remains-high-relative-to-the-pay-of-typical-workers-and-high-wage-earners/ (Table 1).

Page 10: After the last paragraph of Section 4, insert:

Some research suggests "globalization" might be partly responsible for burgeoning executive pay. Wolfgang Keller and William W. Olney, "Globalization and Executive Compensation," NBER Working Paper 23384 (National Bureau of Economic Research 2017), http://www.nber.org/papers/w23384.pdf.

CHAPTER 3

BACKGROUND REGULATORY PRINCIPLES

Page 101: after the first full paragraph, insert:

On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act (P.L. No. 115-97), which made a number of major changes to the federal tax code. Among these was a reduction, from 35% to 21%, in the marginal tax rate applicable to corporations. Further, in order to avoid having that change skew the organizational playing field in favor of traditional corporations and against other forms of organization such as partnerships, limited liability companies and Subchapter S-Corporations ("pass-through" entities, as described below), the Act also provided a new 20% deduction of business income from noncorporate organizations. (New Section 199A of the Code.) These modifications do not change the general principles discussed below, but they alter the stakes involved. For example, the economic significance of a tax deduction decreases with Act's decrease in the marginal rate of taxation of corporate net income.

Several additional changes specifically aimed at executive compensation were also included in the Act, and are discussed at relevant points below (in Chapters 10 and 11, for example).

CHAPTER 6

EQUITY-BASED COMPENSATION: STRUCTURE, TAXATION AND REGULATION

Page 213: after the chart, add:

The Tax Cuts and Jobs Act of 2017 (P.L. No. 115-97) added a new subsection to IRC Section 83, 83(i), which permits employees of a private company who receive vested stock, including by exercise of an option, to defer income recognition until the company becomes public (but not more five years after the otherwise taxable date under Section 83). This helps ameliorate the liquidity problem created for employees of private companies by taxation under Section 83's general principles, under which an employee-recipient usually owes tax immediately upon receipt of a vested share which, however, cannot in practice be sold by the employee. The new provision is nonetheless likely to be of limited practical effect, because its availability is conditioned on at least 80% of the company's employees receiving more than *de minimis* amounts of stock under the plan. Thus the provision is applicable only to (relatively uncommon, in the case of private companies) broad-based stock plans, such as "employee stock purchase plans" described in Section 4 below. The new 83(i) election is in any case unavailable to the sponsoring company's chief executive officer, chief financial officer, or any of its four highest-compensated employees. A coordinating change with section 83(i) was also made to Section 409A, removing an 83(i)-sanctioned deferral from the definition of "nonqualified deferred compensation."

CHAPTER 7

PERQUISITES AND OTHER FORMS OF COMPENSATION

Page 278: at the end of the carryover paragraph at the top of the page, insert:

The Tax Cuts and Jobs Act of 2017 (P.L. No. 115-97) eliminated, for years 2018 through 2015, the exclusion for (as well as an employee's entitlement to deduct from income) job-related moving expenses.

Page 280: at the end of the last paragraph under Section 1.a, add:

(The first of these three initiatives was significantly curtailed by the Tax Cuts and Jobs Act of 2017 (P.L. No. 115-97), which repealed the so-called "individual mandate" which had previously subjected to a tax penalty individuals who failed to obtain qualifying health insurance coverage for a taxable year.)

CHAPTER 9

STATE BUSINESS ORGANIZATION LAW

Page 383: add at the end of Section B.4:

An exception to this rule applies where the company's shareholders have approved the directors' compensation. In the case of an equity compensation arrangement such as a stock option plan, where a "pool" of awards is approved from which the directors retain discretion to make awards to themselves, this exception applies only if the plan places "meaningful limits" on such self-grants. *In re Investors Bancorp, Inc. Stockholder Litigation*, 2017 DEL. LEXIS 517 (Dec. 13, 2017).

CHAPTER 10

PUBLIC COMPANIES: REGULATION AND DISCLOSURE

Page 447-48: replace the third paragraph on page 447 through the first full paragraph on page 448 with the following:

For most of its existence Section 162(m) contained an exception for "performance-based" compensation, such as stock options and formula-based bonus plans – an exception that had the practical effect of significantly limiting the impact of the section as a whole. This performance-based exception was eliminated by the Tax Cuts and Jobs Act of 2017 (P.L. No. 115-97), and, accordingly, the deduction limit will henceforth apply to *all* compensation of a public company's named executives.

The Act also extended the statutory deduction limitation to, in addition to the employer's top five executives, any executive who has *ever* (since 2016) been a top-five executive of the employer. The Act thus makes designation as a "named executive," for purposes of this Code section, a permanent lifetime proposition.

CHAPTER 11

GOVERNMENT, NONPROFIT AND NON-U.S. EMPLOYERS

Page 508: insert the following before Section C.3:

c. EXCISE TAX ON COMPENSATION OVER $1 MILLION AND LARGE SEVERANCE PAYMENTS.

In an apparent effort to parallel the effect of Code Section 162(m) for taxable public companies, Congress imposed as part of the Tax Cuts and Jobs Act of 2017 (P.L. No. 115-97), in newly created Code Section 4960, a 21% excise tax on the compensation of any of the top-five highest-paid employees of a nonprofit employer or any employee who has since 2016 been among the highest-paid five. (Note that, in marked contrast to the effect of Section 162(m)'s disallowance of an employer's deduction, this new excise tax falls on executives themselves.)

Section 4960 also contains a new provision paralleling Section 280G (involving "excess parachute payments" for private company executives, discussed in Chapter 13), by which a 21% excise tax is levied on severance payments to top-five nonprofit executives, if the severance payment equals or exceeds three times the executive's average compensation for the preceding five years. (As with Section 280G, while the *trigger* for excise tax is three times average compensation, if triggered, the tax actually applies to all severance in excess of *one* times the prior five-year average.)

These changes are likely to have significant impact on the very highest-paid employees of nonprofit entities – which, again, include the likes of prominent football and basketball coaches, as well as top administrators and some physicians. One might expect, given the parallel history of Section 280G in the private sector, that highly compensated nonprofit employees of this ilk will begin to seek to negotiate tax "gross-up" features, as part of their compensation packages, to protect them from the burden of the new excise tax. See Chapter 13, Section 4, below, for a description and mathematical example of how gross-ups work.