Performance-Based Equity Awards: *Popular Before Tax Reform—What About After?*

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The Tax Cuts and Jobs Act ("Tax Reform" or "Act") contains the most significant changes to the US Tax Code in more than thirty years. The biggest change for executive compensation is that public companies will not be able to deduct performance-based compensation. Before the reform, public companies could deduct up to $1 million in compensation paid in a year to the CEO and next three highest paid executives (excluding the CFO), but performance-based compensation derived from awards, such as stock options, performance share units and cash bonus plans, were not counted towards this deduction limit and were therefore fully deductible.

Under the Act, starting in 2018, the exception for performance-based compensation and commissions is repealed, meaning that all compensation, even if it is performance-based, will be subject to the $1 million limit on deductible compensation. Also, starting in 2018, the group of covered executives will include the CFO along with the CEO, and the top three executives after the CEO and CFO, and will include individuals who may hold these positions at any time during the year. If an individual is a covered executive for 2017 or any later tax year, the individual is considered a covered executive for all future tax years (including after death). The number of companies that have to report will increase as the pre-Tax Reform 162(m) only applies to those companies that have to file a proxy statement. The new provision also applies to those companies that have publicly traded debt (but do not file a proxy statement).

The Act contains an important grandfather provision. Written binding contracts in effect on November 2, 2017, including plans where the right to participate in the plan is part of a written contract with an executive, are grandfathered. However, to preserve the deduction for existing grandfathered performance-based arrangements, those arrangements cannot be materially modified on or after that date. This provision will be subject to interpretation and may include a variety of agreements.

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Figure 1. Summary of Changes Related to Performance-Based Pay Exception

	OLD (2017 and Earlier)	NEW (Beginning January 1, 2018)
Performance-based pay exception	Performance-based pay greater than $1 million is deductible	Exception is eliminated. All amounts of compensation paid is subject to the $1 million cap
Covered companies	Companies required to file proxy statements (DEF 14A filings)	Also applies to those companies that have publicly traded debt (but do not file a proxy statement)
Covered employees	CEO and next 3 highest-paid employees (other than CFO) serving on the last day of year	Adds CFO and anyone who served as CEO or CFO during year. Once a covered employee, always a covered employee (even after death).
Grandfather Provision	N/A	Applies to "written binding" contracts in effect on and not materially modified after 11/2/2017

While compensation committees (who as an aside, became less relevant under Tax Reform in a variety of ways) deliberate over what this means to their programs, a few overall considerations are as follows:

- Incentive Stock Options ("ISOs") will become more popular as they are not deductible anyway (the tax effect is less as the corporate tax rate goes down to 21% from 35%). This will allow recipients to get capital gains tax treatment if they hold onto the stock for at least one year. In addition, the Tax Act reduces the effect of the Alternative Minimum Tax ("AMT") on individual tax payers, which was another impediment to using ISOs before 2018.

- The use of non-qualified stock options will continue to decline as restricted stock is treated the same by both the IRS and proxy advisory firms like Institutional Shareholder Services ("ISS") and Glass Lewis for top executives. Of course, high growth companies will continue to use stock options.

- Stock option programs may be redesigned to adapt to the new age of compensation. For example, the terms of stock options may be extended with limits on the amount of stock options that can be exercised (similar to ISOs), which will allow for more the stock option proceeds to become tax deductible.

- Compensation portfolios will be rebalanced to emphasize fixed pay (salary and time vested restricted stock or units) as no compensation will be deductible over $1 million. Since the inception of Internal Revenue Code ("IRC") Section 162(m) in 1994, the portion of incentive-based pay has skyrocketed from around 75 percent of total compensation to over 90 percent of total compensation. This distortion of incentive leverage has fueled the increase in executive pay and is also partly to blame for wage disparity between the executive group and the average worker.

- Supplemental Executive Retirement Plans ("SERPs") and other non-qualified deferral programs with their associated trust and funding techniques will make a comeback. Since any amounts paid to the top Named Executive Officers ("NEOs") will not be deductible over $1 million, amounts may be deferred as a supplemental post-employment payment (although this payment will be capped at $1 million, even in death, as well in order to receive the full deductibility).

- CEO pay growth will finally slow down as compensation committees will be more careful in paying CEOs large non-deductible amounts, particularly for middle-market companies where the loss of deduction is more meaningful to earnings. The advent of the CEO Pay Ratio, which applies to the 2018 proxy season, will assist in this braking of CEO pay growth.
- The structure of the role of executive officers will change causing fewer executives to be reported in the proxy statement and thus boost tax deductibility.

TAX REFORM CHANGES—FOCUS ON PERFORMANCE-BASED PAY EXCEPTION

For U.S. publicly traded companies, there has been a notable decrease in the use of stock options over the past decade. In turn, there has been a sharp rise in the use of equity awards that focus on the achievement of specific performance objectives rather than simple increase in stock price ("performance-based awards").

Equity compensation plays an essential role in the executive pay packages of public companies. "Plain vanilla" stock options were the gold standard of executive compensation for many years, but the mandatory expensing of stock options beginning in 2006 eliminated the compelling cost advantage of these awards over other types of equity awards Moreover, ISS never gave stock options their rightful due as being performance based which also accelerated the decline of stock options. However, a beacon of light for stock options was the tax rules that qualified stock options as performance based under IRC Section 162(m) and were acceptable under IRC Section 409A.

In addition to the change in account rules that eliminated the cost advantage of stock options, the significant increase in performance-based awards from 2006 to 2017 can be attributed to the following:

- *Deductibility under IRC Section 162(m)*—Before Tax Reform was signed into law by President Trump on December 22, 2017, publicly traded companies were able to deduct annual performance-based compensation (e.g. stock options, performance shares) in excess of $1 million for CEO and next three highest-paid employees (other than CFO) serving on the last day of year. In other words, performance-based compensation was excluded from the $1 million limit imposed by IRC Section 162(m) on publicly-traded company tax deductions for most compensation payments made by the company to its "covered employees" in a particular fiscal year.
- *The onset of Say-on-Pay and the corresponding voting recommendations of proxy advisory firms like Institutional Shareholder Services ("ISS") and Glass Lewis.* Starting in 2011 with Say on Pay, scrutiny from proxy advisory firms and their favorability towards performance-based compensation led many companies to redesign their equity plans to include performance-based awards. In formulating a voting recommendation for a public company, ISS will evaluate the proportion of the CEO's most recent fiscal year equity awards that are conditioned on achievement of a disclosed performance goal or goals. ISS does

not consider time-vested stock options and SARs performance-based awards. However, ISS will treat options and SARs as performance-based awards if either vesting or value received is conditioned upon the attainment of a specified performance goal or goals or the exercise price is at a substantial and meaningful premium over the grant date share price. If at least 50% of the CEO's equity awards are performance-based, ISS will assign the maximum points for this factor.

WHAT'S NEXT FOR PERFORMANCE-BASED AWARDS?

How will the repeal of the performance-based exception affect trends in equity awards after a decade of steady stock option decline as performance-based awards have become increasingly prevalent?

Despite the removal of the performance-based deduction exemption under IRC Code 162(m), we expect that public companies will continue to rely on performance-based awards as a component of their executive equity programs. In fact, the use of performance-based awards may continue to increase as stock options decline into the abyss. Three main reasons for this prediction are as follows:

1) The design and implementation of performance-based compensation arrangements will be possible without regard to the technical requirements of Section 162(m), and therefore much easier to create and manage;

2) Many states have corporate income tax laws that reflect an older version of the Internal Revenue Code, including the pre-Tax Reform version of Section 162(m); and

3) Shareholders and proxy advisory firms will continue to demand that executives' compensation pay for performance and be aligned with investor interests

We discuss these three items in more detail below:

1. *Performance-Based Equity Plans are much Easier to Design without Conforming to Stringent Section 162(m) Requirements*

   Before the tax reform, publicly-traded employers spent a lot of time ensuring that a significant portion of the compensation paid to their covered employees qualified as Code Section 162(m) performance-based compensation in order to maximize compensation-related tax deductions. Compensation committees went through elaborate gymnastics to draft incentive designs that were 162(m)-compliant, often sacrificing the design they really wanted for one that was tax deductible. Going forward, this maneuvering will no longer be necessary.

   The elimination of the performance-based exception means that companies will have more flexibility in the design of their incentive compensation arrangements because they will not be bound by the requirements of Section 162(m) (e.g., pre-established performance objectives approved by shareholders).

   Specifically, companies will have flexibility as follows:

   (a) to use any performance metrics that the compensation committee deems appropriate, including subjective performance metrics, and will not be limited to shareholder-approved performance metrics (however, SEC-reporting companies will need to ensure that such changes are aligned with the proxy advisory firms' pay-for-performance models);

(b) to increase or decrease the amount of incentive compensation (before the Act, a compensation committee had only negative discretion to reduce the amount of incentive compensation);

(c) to adjust incentive compensation payouts to take into account extraordinary events affecting the company's financials;

(d) to consider the type of equity compensation granted because stock options and stock appreciation rights will no longer be favored under Section 162(m); and

(e) to grant equity and cash incentive compensation without being subject to the annual individual limits in equity and cash incentive plans. In order to take advantage of this increased flexibility, companies will need to amend their incentive compensation plans, which may require shareholder approval. Such changes may also require SEC-reporting companies to revise their public disclosure.

2. *State Tax Considerations*

There is also the question of state corporate tax considerations. While the performance-based compensation exception to the $1 million compensation limit under Internal Revenue Code Section 162(m) for "covered employees" is a thing of the past (absent grandfathered contracts) for federal income tax purposes, Section 162(m) may continue to be a consideration for certain state tax venues. For administrative ease, almost all states conform many elements of their state tax codes to the federal tax code.

States conform their corporate tax to the federal tax provisions on either a "static" or a "fluid" basis, with approximately half choosing each approach. Static means conforming to the Internal Revenue Code as of a specific date agreed upon by the state, which varies widely. Fluid means adopting changes as they occur. Some large states, such as California and Florida, have static tax rules. Others, such as New York, have fluid tax rules. However, some fluid tax rule states are considering converting to static and preserving the performance exception under 162(m).

Overall, this means that many states have corporate income tax laws that reflect an older version of the Internal Revenue Code, including the older version of Section 162(m), so that, while complying with the performance-based exemption provision of Section 162(m) no longer has a federal tax benefit, it may have a state income tax benefit, at least under state tax law.

States that are vying to keep or attract business may consider keeping the performance exception. A typical corporate tax rate for a large state with high concentration of corporate presence is about 9% of taxable income, which is about 43% of the now reduced federal rate of 21%. Thus, if a state maintains the performance exception, it could translate into millions of tax benefits to the corporation and could substantially offset the loss of the federal tax deduction.

3. *The Unchanged Position of Proxy Advisory Firms (and Investors)*

ISS will continue to analyze equity plans and awards under the ISS Equity Plan Scorecard and annual review, and will continue to qualitatively evaluate plan amendments as they have for some time. This includes preferential treatment for performance-based awards.

Section 162(m) helped define in- and out-of-bounds for executive compensation programs, providing some transparency and investor control. Some investors fear that the removal of certain 162(m) features may serve to blur those lines, encouraging companies to be less transparent, objective, and performance-based towards executive compensation—potentially rolling back significant advances in executive compensation practices gained since the beginning of Say on Pay.

Many investors will be watching companies carefully over the next few years to see how compensation programs evolve in light of the Tax Reform. Investors will continue to expect that executive pay programs emphasize performance-based incentives. The purpose of these awards is both to retain and motivate management to drive performance that aligns with long-term corporate strategy, creating value for shareholders. While the tax deduction for performance pay afforded under 162(m) provided an added benefit, it was rarely a primary reason behind investors' expectation for performance-based programs, or a driving factor in ISS' analysis of pay for performance.

AN OVERVIEW OF EQUITY AWARD VEHICLES

Gallagher's annual study of short- and long-term incentive design criteria among the top US companies by market capitalization showed that in 2008, an average of 40% of the total long-term incentive ("LTI") value was provided in the form of stock options/SARs, 41% in performance-based awards, and 19% in time-based restricted stock/units. By 2015, the average of Top 200 performance-based awards had increased to 59% of the total LTI value with a corresponding decrease in stock options/SARs to 23% (with time-based restricted stock/units remaining relatively flat at 18%).

Figure 2 details some of the most common forms of equity-based compensation vehicles and the related tax, legal, and accounting issues.

Figure 2. Overview of Equity Award Vehicles

LTI Vehicle	Company Accounting/ Taxes[1]	Key Employee Tax Issue	Employee Capital Gains Tax Potential	Admin/ Other Costs	Disclosure of Company Information	Key Advantages	Key Disadvantages
NQSOs	Fixed Expense: grant date fair value[2]	Ordinary income at exercise	Post-exercise	Low	No	Upside potential; control taxable event	Underwater potential; highly dilutive
ISOs	Fixed Expense: otherwise not deductible, grant date fair value[2]	Capital gains at sale[2]	Post-exercise after one year hold; includes intrinsic value of option	High	No	Capital gains; upside potential; control taxable event	No company tax deduction (below NEOs); limit of $100,000 per year; underwater potential
Stock-Settled SARs	Fixed Expense: grant date fair value[2]	Ordinary income at exercise	Post-exercise	Low	No	Limits dilution, upside potential; control taxable event	Underwater potential; can be dilutive
Cash-Settled SARs	Variable Expense[2,4]: adjusted until paid	Ordinary income at exercise	None	High	No	No dilution, upside potential; control taxable event; receive cash	Underwater potential; cash flow
Restricted Stock	Fixed Expense: grant date face value[5]	Ordinary income when vested	Upon optional 83(b) election (income tax at grant)	Low	No	Retention; optional 83(b) election	Pay tax when vested
Restricted Stock Units (paid in stock)	Fixed Expense: grant date face value[5]	Ordinary income when delivered	Post-Vest	Low	No	Retention; easy to defer	Flexibility subject to 409A rules
Restricted Stock Units (paid in cash)	Variable Expense[4,5]: adjusted until paid	Ordinary income when delivered	Post-Vest	Low	No	Retention; easy to defer	Flexibility subject to 409A rules; cash flow
Performance Shares/Units (Financial-Based)	Fixed Expense: stock price fixed, shares adjusted[6]	Ordinary income when vested	Post-Vest	High	Company profit and/or sales	Add'l shares/units and higher stock price; expense reversible	Setting performance measures
Performance Shares/Units (Market-Based)	Fixed Expense: grant date fair value[7]	Ordinary income when vested	None	Medium	No	Add'l shares/units and higher stock price	Setting performance measures; expense not reversible
Performance Share Units (paid in cash) -- Financial or Market Based	Variable Expense[4]: adjusted until paid	Ordinary income when vested	None	High	Company profit and/or sales (Perf Based)	Add'l share units; receive cash	Setting performance measures; cash flow
Fixed Cash Long Term Incentive Plan	Variable Expense[4]: adjusted until paid	Ordinary income tax at exercise	None	Medium	Company profit and/or sales	Additional cash; receive cash; expense reversible	Setting performance measures; cash flow

[1] Any amount paid over $1 million in one fiscal year will not be deductible to the employer under the Tax Reform.
[2] Fair Value based on an option-pricing model, such as Black-Scholes.
[3] If requisite one-year holding and two-year post grant periods are met; otherwise same as NQSOs.
[4] Mark-to-market accounting until award is paid.
[5] Face Value equals stock price on grant date.
[6] Stock price fixed on grant date; shares are variable until measurement period is complete.
[7] Fair Value based on a Lattice model and Monte Carlo simulation

Stock Options

While the importance of stock options will most likely decline, incentive stock options ("ISOs") will become more popular as they are not deductible anyway, which will allow recipients to get capital gains tax treatment if they hold onto the stock for at least one year.

A stock option permits the holder to purchase stock at a predetermined price for a specified period of time. Options can be tax-advantaged ISOs or no statutory stock options, also commonly called nonqualified stock options (NQSOs). Options that do not comply with the requirements for an ISO or that specifically indicate that they are not intended to be ISOs are treated as NQSOs.

In order to be considered an ISO, an option must meet all of the following requirements, which are specified in Section 422 of the Internal Revenue Code (IRC) and applicable regulations:

- Only a corporation (including an S corporation, a foreign corporation, or a limited liability company treated as a corporation for tax purposes) may grant ISOs.
- Only persons who are employees of the corporation granting the option (or employees of a related parent or subsidiary corporation) are eligible to receive ISOs; consultants

and nonemployee directors cannot receive ISOs.

- An ISO must be granted pursuant to a plan that has been approved by the company's shareholders within 12 months before or after the plan is adopted by the board. Certain plan amendments are also required for shareholder approval.
- An ISO must be granted within 10 years of the date the plan was adopted by the board or the date the plan was approved by the shareholders, which is earlier.
- The plan under which ISOs are granted must designate a maximum aggregate number of shares that may be issued under the plan in the form of ISOs.
- The plan under which ISOs are granted must designate the employees or class or classes of employees eligible to receive options under the plan.
- The exercise price of an ISO may not be less than the fair market value (FMV) of the company's stock as of the date of the grant of the option (or 110% of the FMV in the case of an optionee who possesses more than 10% of the combined voting power of all classes of stock of the employer corporation or any related parent or subsidiary corporation).
- An ISO, by its terms, may not be exercisable more than 10 years from the date of grant (or 5 years in the case on an optionee who is a 10% shareholder) or more than three months after termination of employment (other than for disability, in which case the option may remain exercisable for one year after termination of employment, or for death, in which case the option may remain exercisable for its full original term).
- An ISO may not be transferable except in the event of the optionee's death, and is exercisable only by the optionee as long as he or she is living.

For any one person, the maximum FMV of stock subject to ISOs that become exercisable for the first time in any calendar year may not exceed $100,000, which value is measured as of the date of grant. Any portion of the option in excess of this limit will be treated as an NQSO.

Example: An employee is granted an option for 50,000 shares of stock with an exercise price of $10 per share. The option vests on a pro-rata basis over 5 years. Thus, each year $100,000 of stock options vest (10,000 stock options times $10 per share (the exercise price at time of grant)), which is the limit of the ISO rule.

The tax treatment of an option hinges on whether it is an ISO or an NQSO.

- <u>ISO</u>. The holder of an ISO is not taxed when the option is exercised (although the excess of the FMV of the stock on the exercise date over the exercise price—commonly referred to as the *option spread*—is included for purposes of calculating the optionee's alternative minimum tax (AMT) for the year of exercise). It is important to note that while the AMT provision was not eliminated under the Tax Act, the effect was substantially reduced in that a large amount of deductions were eliminated and the income levels where AMT would apply have been substantially increased.

The holder of an ISO is taxed when the acquired stock is eventually sold. In short, ISOs provide a tax advantage to optionees that NQSOs do not provide—automatic deferral of tax on the gain resulting from the exercise of the option. Moreover, if stock acquired through the exercise of an ISO is held for a specified period of time—the longer of two years from the date the option is granted or one year after the option is exercised—then any gain on the sale of stock will be taxed as long-term capital gain.

If the stock is not held for the required holding period, the difference between the exercise price and the lesser of (1) the FMV of the stock on the date of exercise, and (2) the sales price, will be taxed as ordinary income. Any additional gain will be taxed as long-term or short-term capital gain depending on how long the stock was held prior to sale. The employer is not entitled to a tax deduction upon exercise of an ISO or upon the subsequent sale of the stock if the required holding period is met. If the optionee does not hold the stock for the required holding period is met. If the optionee does not hold the stock for the required holding period, however, the employer will be entitled to a tax deduction equal to the amount of orginary income recognized by the optionee.

Example: An employee is granted an option for 3,000 shares of stock with an exercise price of $10 per share. The option vests in full in year 3. The employee exercises the option in year 4, when the FMV of the stock is $15 per share, and sells the stock in year 6 at a price of $20 per share. If the option is an ISO, the employee does not incur any tax upon exercise in year 4 (excluding, for this example, any impact of AMT which has been substantially eliminated by the Tax Act). Because the ISO holding period was met, the employee's full gain of $30,000 upon the sale ($60,000 sales price, less the exercise price of $30,000) is taxed as a long-term capital gain, and the company does not receive any deduction.

- NQSO. The holder of an NQSO recognizes taxable income at the time the option is exercised, in an amount equal to the excess of the FMV of the stock on the exercise date over the exercise price. This amount is taxed as ordinary income. Any further appreciation in the value of the stock will be taxed when the stock is sold and will be either long-term capital gain or short-term capital gain depending on how long the stock was held prior to sale. The company is entitled to a tax deduction equal to the amount of ordinary income recognized by the optionee on the exercise price of the NQSO. Unlike ISOs, the exercise price of an NQSO can be less than the FMV on the grant date. However, an NQSO that is "discounted" is not exempt from IRC Section 409A, as discussed in the following:

  Example: Assume the same facts as before, but the option is an NQSO. In that case, the employee would recognize taxable income of $15,000 upon exercise in year 4, and the company would receive a corresponding deduction. Upon sale of the stock in year 6, the employee would recognize a long-term capital gain of $15,000.

The primary advantage of stock options to the recipient is the risk-free right to appreciation in stock price and the ability to time the recognition of income. However, because it is an appreciation award, stock options can go underwater if the value of the stock drops below the exercise price. This can have a significant impact on the employee's perception of the value of stock options. The significant accounting advantage that stock options once enjoyed over other equity-based awards was eliminated under ASC 718.

As expected, there has been a gradual decline in the use of plain vanilla time-vesting options over the past several years. In the absence of the highly favorable accounting for such options, there is less compulsion to use them over other equity-based awards. While many options are still granted with solely time-based vesting requirements, compensation committees are now freer to use performance-vesting requirements, which would have resulted in variable accounting under ABP 25 and therefore were rarely used in the past.

Stock Appreciation Rights

A stock appreciation right (SAR) entitles the grantee to a payment (either in cash or stock) equal to the appreciation in value of the underlying stock over a specified time. For example, if the base price of a SAR is equal to the FMV of the company's stock on the grant date, the grantee will be entitled to a payment upon exercise of the SAR equal to the excess, if any, of the FMV of the stock at the exercise date over the base price, multiplied by the number of SARs being exercised. If the award is settled in cash, it is generally referred to as a cash-settled SAR; if the award is settled in share of stock, it is generally referred to as a stock-settled SAR.

The FMV of the consideration paid to the grantee upon exercise of a SAR (whether settled in cash or stock) constitutes ordinary income to the grantee. The company is entitled to a tax deduction equal to the amount of ordinary income recognized by the grantee at the time of exercise.

From the grantee's perspective, the principal advantage of a SAR is that the grantee may receive the benefit of appreciation in stock value without having to actually purchase stock. In addition, the fact that the grantee (typically) does not have to pay an exercise price to exercise a SAR eliminates the sometimes troublesome aspects of option exercises.

The principal disadvantage of SARs historically has been the requirement of variable accounting under APB 25 and, for cash-settled SARs, the requirement for liability accounting under ACC 718. In addition, similar to stock options, SARs can go underwater if the market value of the stock drops below the base price of the SAR.

Restricted Stock

Restricted stock is stock that is awarded to the grantee, usually without cost or for a nominal price. During the restricted period, the shares are not transferable and are subject to substantial risk of forfeiture based on the vesting conditions. For example, restricted stock typically is forfeited if the grantee terminates employment prior to a specific vesting date or the company fails to achieve a specified performance condition. The restricted stock may vest ratably over a period of time (graduated vesting) or become fully vested after a stated time period (cliff vesting).

Alternatively, an award of restricted stock could have performance-related vesting triggers, in addition to or in lieu of a time-based vesting date. Restricted stock is an example of a full-value award, as opposed to an appreciation-type award such as options and SARs. This means that restricted stock has value even if the stock price falls after the date of grant.

From the grantees perspective, the principal advantage of receiving restricted stock is that he or she is treated as an owner of the stock from the date of grant (usually including the right to vote the stock and receive dividends), and the grantee typically does not pay anything for the stock award. In addition, an 83(b) election gives the grantee the ability to accelerate taxation on the shares within 30 days following the date of grant to avoid a potentially higher tax as the shares vest. Also, as a full-value award, restricted stock does not go underwater if the stock price falls—it always provides some value to the grantee. From the company's standpoint, the company is able to give an immediate benefit to the grantee and, by imposing performance or service restrictions on the shares, can use the shares to encourage the grantee to meet performance objectives or remain in service with the company.

The principal disadvantage is that the company must withhold income taxes at the time the tax liability arises (i.e., when the restrictions lapse or a Section 83(b) election is made). Although the grantee is the owner of the stock, he or she might not have the cash to pay the withholding tax. Therefore, it is common for a company to withhold shares from the award in an amount sufficient to cover the tax liability, but this results in a cash-flow cost to the company, because it must remit cash to the IRS and cannot resell the shares absent registration or an applicable transaction exemption.

Restricted Stock Units or Deferred Stock Units

Restricted stock units (RSUs) represent the right to receive stock in the future, subject to the satisfaction of vesting requirements. Deferred stock units (DSUs) represent the right to receive stock at the end of a designated deferral period. It is also possible to combine the two, such that stock is not delivered at vesting, but is deferred to the grantee's termination of employment or some other date. In both cases, until the stock is delivered, the grantee does not own actual shares of stock and therefore does not have voting rights or the right to receive dividends. Because of this, such awards may be coupled with dividend equivalent rights such that phantom dividends are paid in cash or reinvested in additional stock units credited to the grantee's account.

The grantee's principal advantage in receiving stock units is that he or she is able to defer taxation until the shares are delivered or are constructively received. The principal disadvantage is that the grantee does not have voting rights in the interim and may not receive dividends (unless the award includes a dividend equivalents feature). From the company's standpoint, an award of stock units uses fewer shares than an option to deliver equivalent value, and performance or service restrictions on the stock units can help to drive performance and retention. If awards are deferred to termination of employment, they often avoid IRC Section 162(m) deduction limits. However, stock units are not categorically exempt from IRC Section 409A and must be designed either to meet the short-term deferral exemption or to comply with the strict distribution requirements of Section 409A.

Performance-Based Awards

Performance-baed awards are not really a separate type of award. Any of the equity awards described earlier (options, SARs, restricted stock, or stock units) may be referred to as performance awards if they have vesting criteria other than continued service. Cash awards that are based on performance are also performance awards. Under the executive compensation disclosure rules, all performance awards, whether cash or stock-based, are considered to be incentive awards. The compensation committee typically sets the performance goals and other terms or conditions of performance awards. As such, these awards can be used to directly correlate executive pay to strategically focused performance.

Before the tax reform, publicly traded companies were are able to designate an incentive award as a qualified performance-based award in order to make the award fully deductible without regard to the $1 million deduction limit imposed by IRC Section 162(m). Under IRC Section 162(m), in order for any other type of award to be a qualified performance-based award, a committee consisting entirely of outside directors must establish objectively determinable performance goals for the award based on one or more of the performance criteria that have been approved by the company's shareholders (typically such performance criteria are set out in the incentive plan). For example, the list of potential criteria might include some or all of the financial or nonfinancial metrics, and the permissible performance targets might be expressed in terms of companywide objectives or in terms of objectives that relate to the performance of a business unit, division, affiliate, department, region, or function within the company or an affiliate.

In order to obtain the exemption from IRC Section 162(m) limits, a compensation committee needed to establish the performance goals within the first 90 days (or the first 25%, if shorter) of the period for which such performance goals relate, and the committee may not increase any award or, except in certain circumstances, waive the achievement of any specified goal. Any payment of an award granted with performance goals must be conditioned on the written certification of the committee in each case that the performance goals and any other material conditions were satisfied. If the performance targets are not specifically set out in the plan, but are left to the discretion of the committee based on one or more shareholder approved performance criteria, the plan's performance criteria must be reapproved by the shareholders every five years to maintain the availability of the performance-based exemption.

Performance awards can provide an incentive for employees to accomplish a variety of targeted company and individual goals and objectives. In this sense, they can be tailored to encourage a longer-term focus than time-vesting awards, which are increasingly criticized as encouraging a short-term focus based solely on stock price. The principal disadvantage to the company is the challenge of designing meaningful and understandable performance objectives for the awards.

CONCLUSION

Most companies will still want to maintain performance-based compensation programs in order to appropriately incentivize executives and respond to the demands of pay-for-performance by proxy advisory firms and shareholders. We expect performance-based equity awards to remain prominent in public company equity plans.

While incentive plan design varies by company, there are a number of plan features recognized by investors and proxy advisory firms as best practices. The pre-Tax Reform version of 162(m) was used as a guideline for the design of these plans and helped define best practices. However, with the substantial alteration of 162(m), a review of pay practices in light of these changes may be helpful.

These changes will take about five years to take effect, but will begin in 2018 as companies begin the process. The full effect of these changes will not be apparent until about three years from now as companies determine what is right for them and then review what others have done in 2019 when the proxies are published. With a few iterations of this process, the answer will be apparent.