

Client Update

How the Tax Reform's Changes to Section 162(m) Executive Compensation Rules Impact You

The Tax Cuts and Jobs Act brought sweeping changes to Section 162(m) of the Internal Revenue Code, which for decades had prohibited public companies from deducting nonperformance-based compensation to covered employees in excess of \$1 million. The revised rule expands the Section 162(m) deduction limitation to deny deductions to **more companies for more compensation** payable to a **larger group of covered employees**. These changes will necessitate reviewing proxy disclosures related to Section 162(m) and considering whether provisions and practices related to complying with the previously applicable Section 162(m) rules should continue to be followed. As companies **both public and private** prepare for their compensation decisions in 2018, here are key things you need to know about the new changes to the executive compensation deduction limitation under Section 162(m). Of course, this is not an exclusive list, and companies' circumstances differ.

MORE COMPANIES ARE NOW SUBJECT TO THE DEDUCTION LIMITATION

- As a result of the expansion of Section 162(m) coverage to companies that are required to file reports under Section 15(d) of the Securities Exchange Act and all issuers of securities registered under Section 12 of the Securities Exchange Act, many companies will be surprised to learn that they are ensnared by the “new” Section 162(m), including ***foreign private issuers who have executive officers based in the United States and privately held companies that issue public debt***.
- Many companies (including private foreign issuers) newly covered under Section 162(m) who are not required to provide compensation disclosure under the SEC's compensation disclosure rules will now be required to calculate compensation under those rules to identify which of their executives are now subject to the deduction limitations.
- Importantly, the changes to Section 162(m) leave in place the limited transition rule for preexisting compensation arrangements of companies that are engaged in an initial public offering. Thus, such companies have some time to address transition to the deduction limitation.

- Note, however, that there is no parallel transition rule available for issuers of public debt.

MORE EXECUTIVES ARE NOW SUBJECT TO THE DEDUCTION LIMITATION

- The Chief Financial Officer (the “CFO”) is once again covered by the rule, along with the Chief Executive Officer (the “CEO”) and the three other most highly paid named executive officers. Previously, the CFO position had fallen out of the 162(m) web due to a quirk in the law.
- Anyone who serves as a CEO or CFO at any time during the year is covered. Previously, only the CEO serving in such position at the end of the year was automatically covered. Now, being CEO or CFO on any day during the taxable year subjects such executive’s compensation, including severance, to the \$1 million deduction limit.
- In addition, if an executive is considered a “covered employee” for 2017 or any subsequent year, the executive is treated as a “covered employee” for all future years (including post-employment). This will require companies to track all of the non-grandfathered compensation (including supplemental pension, non-qualified deferred compensation and severance) paid in the future to such executives to ensure no deduction is taken by the company if it exceeds the annual \$1 million limit.
- These changes restrict the ability to avoid the Section 162(m) deduction limitation by deferring the payment of compensation until after the executive’s employment terminates (unless the deferred compensation arrangement is grandfathered or designed to benefit from paying over multiple years).
- But all is not necessarily lost. It may be possible for companies to spread the payment of what would otherwise be nondeductible excess compensation over a longer period of time, such that the resulting smaller payments would be deductible under Section 162(m). For example, a company could modify the non-grandfathered benefit provided pursuant to an existing supplemental executive retirement plan (a “SERP”) from a lump sum payment in excess of a million dollars to an annuity with annual payments of less than a million dollars. As another example, a company could extend the post-termination period over which options may be exercised. Of course, companies contemplating such deferrals need to ensure that they comply with the deferred compensation rules of Section 409A.

THE EXCEPTION FOR PERFORMANCE-BASED COMPENSATION NO LONGER APPLIES

- Other than certain grandfathered arrangements and a short “stub period” for companies whose tax year is not a calendar year (discussed below), the frequently used “performance-based compensation” exception to the Section 162(m) deduction limitation has been eliminated.
- Going forward, annual bonuses and long-term cash and equity awards (including stock options) that previously could have escaped the Section 162(m) deduction limitation will

not be deductible if they exceed the \$1 million threshold (taken together with other compensation payable in the year of payment), whether or not they are based on performance.

- While this is bad news for companies that have relied on the performance-based exemption for executive compensation, the benefits of the lower corporate tax rate are likely to far exceed the lost deduction value (which is also less valuable at the lower corporate income tax rate). Moreover, companies will no longer have to undertake rigorous formal procedures that were necessary to take advantage of the performance-based exception (such as obtaining shareholder approval every five years where a company desired to choose from multiple performance criteria, establishing relatively inflexible performance formulas and generally limiting the company's discretion).
- Although we have already seen companies move away from performance-based compensation and expect to see more base salaries that exceed \$1 million in light of the rule change, we believe that most companies will continue to use performance as a key determinant of compensation as a matter of good business practice and shareholder interest.

CERTAIN PREEXISTING COMPENSATION AGREEMENTS ARE GRANDFATHERED

- Written binding contracts that were in effect on November 2, 2017 will continue to be subject to the "old" Section 162(m), unless the contract is materially modified.
- Under this provision, for example, compensation paid pursuant to a written binding contract would not be subject to the deduction limitation if it (i) is paid to someone who would not have been considered a "covered employee" under the old rules (e.g., a CFO, an executive who is not employed at the end of the calendar year in which the payment is made or an executive who would not have been a covered employee in a subsequent payment year), (ii) meets the performance-based compensation exception or (iii) is paid by a Section 15(d) filer or a foreign private issuer.
- Depending on the particular terms of such arrangements, the grandfathering provision can apply to many forms of outstanding performance-based equity awards and long-term cash awards as well as other nondiscretionary compensation arrangements that were in place as of November 2, 2017, including non-qualified pension plans, deferred compensation and post-employment obligations.
- **A few areas of caution:**
 - It is not yet clear how this grandfathering rule will apply to commonly used "162(m)" plans that permit a compensation committee to reduce the amounts payable upon the attainment of performance goals (i.e., using "negative discretion").
 - Companies will need to tread cautiously with such grandfathered arrangements to avoid making changes that constitute material amendments that inadvertently cause the arrangements to lose grandfathered status. Private companies and foreign private

issuers who were not previously covered by Section 162(m) should be particularly mindful of this.

- Also, grandfathered arrangements that rely on the performance-based exception must continue to comply with the formal procedures previously applicable to performance-based compensation. For example, if an executive had a contractual right as of November 2, 2017 to receive a performance-based award in the future, the performance criteria applicable to such award may need to be reapproved by shareholders if, when the award is granted, five years have passed since the last shareholder approval.

NON-CALENDAR YEAR COMPANIES STILL HAVE TIME TO TAKE ADVANTAGE OF THE OLD SECTION 162(M)

- The revisions to Section 162(m) will not apply to companies with tax years that are not based on the calendar year until their next tax year that begins after December 31, 2017.
- Therefore, non-calendar year companies may benefit from accelerating the deduction for bonuses under “162(m)” plans into their current tax year to utilize the performance-based compensation exception before it lapses (and to take advantage of the benefit of the deduction while the higher corporate tax rate still applies to them). Related actions may include determining the bonus pool amount for their current tax year before the end of the current tax year or eliminating service requirements that extend beyond their current tax year.

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Please do not hesitate to contact us with any questions.

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