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Skadden

Executive Compensation and Benefits Alert

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Section 162(m) After the Tax Cuts and Jobs Act: What to Do Now

On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act (the Act), which includes significant changes to the executive compensation deduction rules in Section 162(m) of the Internal Revenue Code (Code) that could dramatically impact the way many companies design and administer executive compensation programs.

Overview of Changes Under Code Section 162(m)

The following changes under Code Section 162(m) became effective on January 1, 2018, for calendar year companies (or will become effective for tax years after December 31, 2017, for non-calendar year companies):

- Code Section 162(m) will limit the deduction that covered companies may take for annual compensation paid to any individual who served as the CEO or CFO at any time during the taxable year and the three other most highly compensated officers (other than the CEO and CFO) for the taxable year. This is a change from the scope of covered employees previously in effect under Code Section 162(m), which had excluded the CFO.
- Once an individual becomes a covered employee for any taxable year beginning after December 31, 2016, that individual will remain a covered employee for all future years, including after termination of employment or even death. This is a departure from the prior rules, under which a covered employee for any given taxable year was determined based on the individual's status and compensation at the end of that year and did not carry forward for future years.
- The exception under Code Section 162(m) for qualified performance-based compensation and commissions will be eliminated, so that all compensation paid to a covered employee in excess of $1 million would be nondeductible, including post-termination and post-death payments, severance, deferred compensation and payments from nonqualified plans. This is a major change for companies that have historically designed their compensation programs to meet the requirements of the performance-based exception.
- Companies subject to Code Section 162(m) will include corporations that have publicly traded equity and publicly traded debt, as well as foreign private issuers that meet the new definition of a publicly held corporation (even if not subject to the executive compensation disclosure rules of the Securities Exchange Act) and possibly other corporations that are not publicly traded, such as large private C or S corporations. Code Section 162(m) had previously applied to corporations with publicly traded equity only.

Code Section 162(m) Transition Rule

The Act includes a transition rule under which the changes to Code Section 162(m) will not apply to compensation payable pursuant to a written binding contract that was in effect on November 2, 2017, and is not materially modified after that date. The conference agreement under the Act sheds light on the potential scope of the transition rule by providing that amounts paid after there has been a material modification will become subject to Code Section 162(m) and that the transition rule will not be available for new contracts that are either entered into or renewed after November 2, 2017. A contract that is in effect as of November 2, 2017, and renewed after that date is treated as a new contract entered into on the date that the renewal takes effect.

The conference agreement includes an example of a contract that is grandfathered under the transition rule. Assume that a covered employee was hired by a company on October 2, 2017, pursuant to a written employment contract that provides for eligibility to participate in the company's executive deferred compensation plan. The terms of the plan provide that participation occurs after six months of employment, amounts payable under the plan are not subject to discretion, and the company does not have the right to materially amend the plan or terminate the plan, except on a prospective basis before any services are performed for the applicable period for which compensation is to be paid. In this case, payments under the plan would be grandfathered, even though the employee was not actually a participant in the plan on November 2, 2017.

The statutory language and the limited commentary in the conference agreement are likely to leave many companies with questions as to how the transition rule may apply to their contracts and specific circumstances. While stock options, stock appreciation rights, performance stock units and performance shares outstanding on November 2, 2017, would appear to qualify under the transition rule, it is unclear how the transition rule would apply to, for example, 2017 annual performance-based cash bonus awards (particularly in cases where the compensation committee retains discretion to reduce the amount of an award or not pay an award) or performance-based cash and equity awards granted under existing plans going forward. We are hopeful that future guidance will be issued clarifying the application of the transition rule. In the meantime, companies should consult with their advisers on questions about relying on this rule.

Planning for Changes Under Code Section 162(m)

Below are some planning considerations and action items for companies to review as they prepare for the new tax regime under Code Section 162(m).

Planning Considerations

- Companies will have more freedom to design executive compensation programs that address pay for performance without complying with the strict rules of the qualified performance-based compensation exception under Code Section 162(m). For example, companies will be able to design performance goals and adjustments without the need to have them be objectively determinable and pre-established, including having the flexibility to establish performance goals more than 90 days into the performance period. Similarly, companies may retain discretion to adjust payouts upward or downward based on actual performance. This likely means the end of Code Section 162(m) umbrella plans that many companies have established to address the current limitation under Code Section 162(m). Also, companies will no longer be limited by the current rule for qualified performance-based compensation that requires compensation, such as pro rata annual bonuses, to be paid only upon achievement of the performance goal in connection with a covered executive's termination of employment without cause, resignation, or good reason or retirement. Many companies have previously eliminated rights to receive such compensation at target levels in severance arrangements with executives, but companies may want to revisit those arrangements and consider whether to amend them by, for example, providing for a severance payout equal to a pro rata portion of the covered employee's target bonus for the year of termination rather than a pro rata bonus based on actual performance for the year of termination.
- Even though the tax deductibility of qualified performance-based compensation will no longer be available, 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. Proxy advisory firms have become increasingly interested in the rigor of performance goals in recent years, and there is good reason to expect that this trend will continue even as companies will have more flexibility to establish performance goals without

being limited to shareholder-approved goals under the current rules for qualified performance-based compensation under Code Section 162(m). Companies should continue to take into account the views of proxy advisory firms and shareholders when designing performance goals in future years.

- Companies may consider implementing longer vesting schedules for equity awards or extending the timing for cash payouts of awards or other compensation (such as severance or payments under a supplemental executive retirement plan or other nonqualified deferred compensation plan) by spreading the payments over multiple years in an attempt to fit within the annual $1 million threshold under Code Section 162(m). Companies should be aware that doing so may cause the compensation to become subject to the deferred compensation rules under Code Section 409A, particularly with respect to severance and other types of post-termination compensation.
- While companies will not be required to monitor the status of outside directors for purposes of the qualified performance-based compensation exception under Code Section 162(m), companies will still need to comply with the independence requirements for compensation committee members under the NYSE and NASDAQ listing standards, as applicable, and the rules under Section 16(b) of the Securities Exchange Act. In addition, proxy advisory firms and shareholders have views and expectations concerning director independence.

Action Items

- Companies should model the cost of compensating covered employees under Code Section 162(m) by taking into account the reduction in the federal income tax rate for corporations, the broader definition of covered employees, the elimination of the exceptions for qualified performance-based compensation and any contracts that may be covered by the transition rule. Companies also will need to monitor the number of covered employees (including current and former executive officers) and the extent to which their covered compensation may exceed $1 million.
- Companies should take an inventory of all performance-based compensation arrangements in effect on November 2, 2017, and consider which of those may be grandfathered under the Code Section 162(m) transition rule. Given the technical requirements of the transition rule and the current lack of clear guidance, companies should consult with their legal advisers before making any modifications to those grandfathered arrangements and discuss whether those modifications may jeopardize their grandfathered status.
- Companies should review the terms of their existing equity and cash incentive plans and programs to determine whether they provide for flexibility to grant performance awards that are not intended to qualify as performance-based compensation under Code Section 162(m) and if any changes should be made to the plan design. The Code Section 162(m) requirements for qualified performance-based compensation that are found in many cash and equity incentive plans may ultimately be eliminated and replaced with more appropriate performance award provisions that are tailored to achieving the company's financial and business objectives. At this time, it is unclear whether any elimination of Code Section 162(m) provisions in such plans will require shareholder approval under the stock exchange rules and how proxy advisory firms may view modifications to plans to remove references to existing performance-based requirements under Code Section 162(m). Companies also should expect to update their compensation committee charters and equity plan prospectuses to eventually eliminate references to these requirements.
- Companies intending to rely on the transition rule for awards that are intended to qualify as performance-based compensation under Code Section 162(m) will still need to comply with certain operational requirements under Code Section 162(m) as in effect prior to the changes under the Act in order to retain their grandfathered status, such as only making objectively determinable adjustments to performance goals that were previously established under the plan, retaining discretion to adjust payouts downward only to the extent permitted under the plan and certifying the achievement of the performance goals based on actual performance prior to payment. In addition, companies should consider whether the performance goals applicable to grandfathered, but not yet granted, awards may need to be submitted for shareholder approval (for example, where a company has committed to granting an award upon shareholder approval of a new equity plan).
- It may be the case that companies include disclosure of the impact of the elimination of the qualified performance-based compensation under Code Section 162(m) on their executive compensation programs in the compensation discussion and analysis section of their 2018 proxy statements. The proxy disclosure rules generally refer to disclosure of the impact of the accounting and tax treatments of the particular form of compensation and the extent to which such disclosure constitutes material information that is necessary to an understanding of the company's compensation policies and decisions regarding the named executive officers. Companies should discuss with

their legal counsel and other advisers the extent to which disclosure relating to the loss of deductibility under Code Section 162(m) should be included in their proxy statements, particularly in light of any changes that the company makes or intends to make to its executive compensation programs as a result of the new Code Section 162(m) provisions.

- If companies plan to take advantage of the additional flexibility in designing compensation programs for 2018 due to the elimination of the requirements for qualified performance-based compensation under Code Section 162(m), consideration should be given to how the new awards will be disclosed in the compensation tables of the 2019 proxy statement. For example, adopting a discretionary performance program in place of a Code Section 162(m) umbrella plan could have a significant impact on how amounts are disclosed in the Summary Compensation table (including the Bonus and Non-Equity Incentive Plan Compensation columns) and the Grants of Plan-Based Awards table (including the Threshold, Target and Maximum columns for estimated future payouts of awards).

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The changes under Code Section 162(m) relating to the scope of covered employees, the loss of deductibility of performance-based compensation and, for companies that may not have previously been subject to Code Section 162(m), the definition of a covered company, will require decisions impacting the design and administration of executive compensation programs in 2018 and beyond. Companies should reach out to their legal, compensation consulting and accounting advisers for their perspective in formulating a customized approach in 2018 to address the new tax rules under Code Section 162(m) while taking into account the design, goals and elements of the company's executive compensation program.

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