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WRMarketplace

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TOPIC: Performance Anxiety? A Look at Recent §162(m) Tax Reform.

MARKET TREND: Executive compensation at public companies has long been a hot topic. Accordingly, certain provisions of the Tax Cuts and Jobs Act (the "Tax Act") attempts to ensure companies implement "reasonable" compensation practices for top executives.

SYNOPSIS: Effective January 1, 2018, the Tax Act amended the deduction limitations under Internal Revenue Code §162(m) for executive compensation. The specific changes include: (1) elimination of the "qualified performance-based" pay exception to the $1 million deduction limitation on compensation for "covered employees" and (2) expansion of the scope of §162(m) so that more companies and individuals are now subject to the limitation. These changes present several technical and/or practical challenges for companies subject to §162(m) as they await further IRS guidance on these issues.

TAKE AWAYS: So far, it does not appear that the changes made to §162(m) will result in a significant decrease in compensation to the senior management of covered companies. As these companies will continue to face competitive pressures regarding their ability to recruit and retain key employees, the prospect of a limited compensation deduction is unlikely to outweigh the need to attract talent with market-based compensation. Nonetheless, the pressure from proxy advisory firms, the market trends toward equating performance-based pay with increased shareholder value, and SEC reporting rules designed to give shareholders an advisory voice on compensation pay and practices are likely to mitigate the trend away from incentive- and performance-based pay.

The Tax Act, effective January 1, 2018, amended the tax provisions limiting the deductibility of executive compensation, ostensibly in an attempt to ensure "reasonable" compensation practices. When confronted with various market realities, however, these supposedly straightforward amendments will face certain "real-world" issues. This article notes a few such technical and/or practical concerns that have or likely will arise as taxpayers await further guidance.

THE WAY IT WAS: QUALIFIED PERFORMANCE-BASED EXCEPTION

Since the early nineties, public companies have lived under the risk that deductible compensation expenses related to "covered employees"[1] would be capped at $1 million annually under Internal Revenue Code §162(m) ("§162(m)"). A popular exception to this limitation was for "qualified performance-based" pay ("performance exception").[2] Under this exception, a compensation expense was excluded from the limitation if the compensation was incentive-based (such as annual cash bonuses, commissions, and certain equity awards like stock options and SARS) and met other applicable requirements. The result was a strong trend among public companies to favor incentive awards in their executive compensation packages.

THE WAY IT IS: TAX ACT CHANGES & IMPACT

Elimination of Exception. Significantly, the Tax Act eliminates the performance exception to the §162(m) compensation deduction limitation, raising a number of collateral issues.

- **Impact:** Now, under the new rules, it is not relevant whether the compensation to covered employees is or is not performance-based — incentive pay (including gain realized on the exercise of certain compensatory stock options) is subject to the deduction limitation just like fixed or guaranteed pay.

Expansion of Limitations. The Tax Act also expands the scope of §162(m) so that more companies and more individuals are subject to the compensation deduction limitation.

More Companies Covered. Before, the limitation applied to corporations issuing any class of common equity securities required to be registered under Section 12 of the Securities Exchange Act of 1934 (the "Exchange Act"). Now, in addition to such public companies, the limitation applies to entities that are required to file SEC reports under Section 15(d) of the Exchange Act.

- **Impact:** Companies with publicly traded debt (such as certain private equity portfolio companies) and foreign companies that trade on U.S. exchanges through American depositary receipts, or ADRs, likely find themselves now subject to the rule.

More Employees Covered. Before the Act, the individuals covered by the rule were a narrower group comprised of the CEO and the three most highly compensated officers other than the CEO or CFO, determined annually as of the last day of the taxable year for the company – the CFO was excluded from the definition, in part due to guidance harmonizing the tax rules to disclosure requirements under the Exchange Act. Now, the Act's definition of covered employee expressly includes an applicable company's CFO (in addition to the CEO) and requires that any individual who meets the covered employee requirements at any time on or after January 1, 2017 be treated as a covered employee of the company thereafter.

- **Impact:** The Tax Act's changes essentially amount to a sort-of "covered employee taint," which will continue to apply to an individual even if, in subsequent years, he or she ceases to be the CEO, CFO, or among the highest compensated officers of the company or, indeed, ceases to be employed by the company at all. Moreover, it is clear that this taint is intended to survive the covered employee's death. The definition of remuneration was correspondingly amended to clarify that it includes remuneration includible in the income of a person other than the covered employee (or paid to another person, such as a beneficiary), if attributable to the covered employee. Accordingly, severance pay, post-termination and deferred compensation arrangements, and certain death benefits may be subject to the compensation deduction limitation under the Act.

Limited Transitional Relief. With respect to the elimination of the performance exception, the Tax Act includes limited transition relief, noting that the amendment does not apply to remuneration payable pursuant to a written binding contract that was in effect on November 2, 2017, provided that such contract is not materially modified after such date.

While the transition relief is welcome, practitioners are left with a variety of questions and dilemmas related to interpreting how this grandfathering rule will apply. For example, many existing incentive awards and plans designed to meet the former performance exception to §162(m) include the right for the administrator of such plan or performance award to apply negative discretion in adjusting the amounts paid to holders (i.e., the right to pay less than the amount otherwise due under the plan). The existence or exercise of negative discretion does not seem inconsistent with the grandfathering provisions, since such discretion was permissible under the old rules. Yet, some commentators point to the Conference Report accompanying the Act, in which a material assumption for transition relief with respect to a hypothetical deferred compensation plan is that "amounts payable under the plan are not subject to discretion."

- **Impact – Material Modifications:** The grandfathered protections offered by this transitional relief may be more fragile than companies anticipate due to the material modification restrictions:

  - Companies with existing compensation plans, agreements, or arrangements that qualify for the transition relief will need to proceed cautiously when considering modifications to these plans, even if the changes are for reasons unrelated to the amended §162(m), such as to address recent amendments by the Department of Labor to procedural requirements of ERISA plans providing disability benefits (see WRMarketplace No. 18-09) or to otherwise comply with regulatory or administrative updates. Modifications may inadvertently lose grandfathered protection for such plans by contravening the prohibition against material modifications.

  - Similar concerns about inadvertently losing grandfathered status due to modifications arise with respect to employment agreements or other arrangements that are subject to renewal provisions (automatic or otherwise).

  - Other routine practices of a company, such as executing a separation agreement with departing employees or negotiating change in control or similar agreements in an M&A context, may create an issue even if such agreements do not enlarge, enhance, or modify the payments to the individual, if such agreement is treated as a modification of the existing agreement or a new agreement altogether.

- **Impact** – Ongoing Compliance Issues: As a result of the transition relief, certain compliance requirements applicable to the performance exception will continue to apply, even though the exception has been eliminated. For example, the performance exception required shareholder disclosure and approval of the material terms of the underlying arrangements, and, in cases where the company's compensation committee had discretion to make certain changes to the arrangements (e.g., to change the applicable targets), required reapproval by shareholders at least every five years.[3] Imagine a case where a grandfathered agreement provides an employee with a right to future awards under the plan. The plan would need to be maintained in compliance with the rules of the performance exception for so long as existing, grandfathered rights to awards under such plans are applicable. In fact, there are already examples of companies who have sought shareholder reapproval in proxy statements filed after the Tax Act became law, in some cases expressly noting that such re-approval is being sought to obtain favorable tax treatment to the extent permitted under §162(m), and this ongoing compliance obligation may explain such actions.[4]

FURTHER GUIDANCE EXPECTED

The Internal Revenue Service has indicated that new regulations are forthcoming, and ideally this guidance will be helpful in addressing the ambiguities and issues highlighted above. In the meantime, some guidance may be gleaned by reference to the transition rules applicable to the enactment of §162(m) in 1993,[5] although this guidance may not be apt to technical concerns regarding whether features of existing 162(m) plans structured to meet the performance pay exception now disqualify such plans from grandfathering and similar concerns.

TAKE AWAYS

So far, it does not appear that the changes made to §162(m) will result in a significant decrease in compensation to the senior management of covered companies. As these companies will continue to face competitive pressures regarding their ability to recruit and retain key employees, the prospect of a limited compensation deduction is unlikely to outweigh the need to attract talent with market-based compensation. Nonetheless, the pressure from proxy advisory firms, the market trends toward equating performance-based pay with increased shareholder value, and SEC reporting rules designed to give shareholders an advisory voice on compensation pay and practices are likely to mitigate the trend away from incentive- and performance-based pay.

NOTES

DISCLAIMER

1 Treasury Regulation §1.162-27(c)(2).
2 Treasury Regulation §1.162-27(e).
3 Treasury Regulation §1.162-27(e)(4).
4 See, e.g., the 2018 proxy statement filed by the Walt Disney Company.
5 Treasury Regulation §1.162-27(h).