

**ABA TAX SECTION
MID-YEAR MEETING**

**IMPACT OF TAX REFORM ON EXECUTIVE
COMPENSATION AND EMPLOYEE BENEFITS**

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Andrew Liazos, Esq.
McDermott Will & Emery LLP

McDermott
Will & Emery

Section 162(m) - \$1 Million Deduction Limit

Prior Law

- No deduction limit for performance-based compensation
- Compensation paid to CFO not subject to \$1 million limit
- Applies only to other current NEOs employed at fiscal year end
 - CEO and three other most highly compensated executive officers
- Only covers corporations with publicly traded equity securities

Section 162(m) - \$1 Million Deduction Limit Key Changes under Tax Cuts and Jobs Act

- Eliminates performance-based compensation exception
- CFOs are covered employees
- Includes current and former named executive officers
 - NEO in 2017 or later year cannot lose covered employee status
- Includes private companies with publicly traded debt and foreign private issuers with ADRs traded on U.S. market

Section 162(m) - \$1 Million Deduction Limit Transition Rule under Tax Cuts and Jobs Act

- Applies to “written binding contracts” in effect by 11/02/17
- Loss of relief if there’s a “material modification”
- Key terms not defined; limited guidance in conference report
 - Merely being in existence on 11/2/17 is not a written binding contract
 - A written binding contract may be formed directly or indirectly
 - Renewal date ends relief under written binding contract rule

Section 162(m) - \$1 Million Deduction Limit

Original Transition Rule

- Transition rule original included as part of § 162(m)
 - relief for certain pre 2/17/1993 arrangements
- Key terms the same as under new transition rule
- Reg. § 1.162-27(h) interpreted the original transition rule
 - “under applicable law, the corporation is obligated to pay the compensation if the employee performs service”

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Interpretation of Original Transition Rule

- CCA199926030

- Addresses bonus plans in place before 2/17/1993
- Payments tied to achieving written performance goals
- “Guideline” bonus earned for performance at budget
- Amount could be 80% to 120% of the total "guideline" bonus
- Plan termination allowed only as of January 1st of the following year
- No right to amend plan to adversely affect existing granted awards

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Interpretation of Original Transition Rule

- CCA199926030: bonuses are “written binding contracts”
 - Executives “relied” on the potential bonus compensation
 - Amendment could not impair rights under a granted award
 - Awards were in writing
 - Executives performed the necessary services for payment
 - Discretion exercised under plan was limited
 - Right to payment existed under state law (NY)

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“Negative Discretion” under Bonus Plans

- Cash awards often include discretionary payment reduction
 - Negative discretion not addressed in CCA199926030
- Current regulations suggest a state law contract analysis
 - Consider implied covenant of “good faith and fair dealing”
- Possible positions
 - If some amount must be paid, all payments under arrangement are pursuant to a written binding contract – compare to § 409A
 - Only required payments are part of a written binding contract
- Proceed with caution

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Material Modification

- Reg. § 1.162-27(h)(1)(iii) definition
 - contract is “amended to increase the amount of compensation payable to the employee”
- Modifications previously ruled not to be a material under § 162(m)
 - Transfer of options for estate planning purposes (PLR 9551024)
 - Changes to options for corporate transaction (PLR 9810024)
 - permitting beneficiary designations for stock options (PLR 9712002)
 - accelerating vesting of stock options (PLR 9649014)
- Potential application of 409A concepts?

Section 162(m) - \$1 Million Deduction Limit Nonqualified Deferred Compensation (NQDC)

- Change in determining covered employees is grandfathered
- Many NQDC payments are made after termination
 - SERP and DC account balance plans
- Need to account for benefit under transition rule
 - Amounts deferred after 11/02/17 under binding written elections
 - Post 11/02/17 earnings on deferred amounts
- What is a material modification in this context?
 - Accelerated vesting, re-deferral elections, changes in investments?
- Review agreements for deferrals to ensure deductibility

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Other Selected Compliance Issues

- Adjusting results under existing incentive awards
 - Effect of tax rate changes, GAAP revenue recognition rules
- Impact on IPO transition rule for existing equity plans
- Accelerated deductions for last FY under old rules
 - All events test
 - Deferred compensation under 404(a)
- Applying covered employee rule within a controlled group when more than one entity issues debt securities

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Potential Changes to Incentive Compensation Practices

- More flexibility to select grant date – 90 day requirement
 - Mid year grants for new hires and promotions
- No advantage to umbrella / “plan within a plan” approach
- Discretionary mid year adjustments can be made
 - But consider potential disclosure and accounting impact
- Easier to take into account individual performance

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Potential Changes to Incentive Compensation Practices

- Committee need not include “outside directors”
 - Former officers can be independent under listing standards
- Committee need not set performance goals for awards
 - But committee action will likely still be needed for grant approval
- No Committee certification requirement
 - But certification by outside directors needed under transition rule
 - Consider changes to compensation committee charter

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Potential Changes to Incentive Compensation Practices

- Removal of performance based compensation provisions
 - But consider prior proxy disclosures regarding plan approval
 - Plan provisions requiring plan approval every 5 years?
- Removal of cash bonuses from omnibus equity plans
- Add protection against loss of grandfathered status
- Consider necessity / prudence of stockholder approval
- Should a new plan be adopted

Other Considerations

- Impact of changes on say on pay voting?
- Change to voting guidelines by shareholder advisory services (ISS, Glass Lewis)?
 - No changes for upcoming proxy season – EPSC remains
- Fewer requests for stockholder approval of plans?
- Impact on IPO practice?
- Shift towards salary greater than \$1 million?
- Changes to compensation committee charters?

Supplemental Wage Withholding Changes for 2018

- Tax withholding practices can trigger variable accounting
 - Withholding at more than maximum statutory rate
- Supplemental wage withholding rate adjusts for tax rates
- New rates for 2018 (Notice 1036)
 - 37% for employees with more than \$1 million of wages during year
 - 22% in all other situations