IMPACT OF TAX REFORM ON EXECUTIVE COMPENSATION AND EMPLOYEE BENEFITS

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Andrew Liazos, Esq.
McDermott Will & Emery LLP
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
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?
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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
Section 162(m) - $1 Million Deduction Limit
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