

Strafford

Presenting a live 90-minute webinar with interactive Q&A

Executive Compensation Limitations: New IRS Section 162(m) Guidance and Key Planning Tips

Covered Employees, Grandfathering Rules for Certain Arrangements,
Written Binding Contract Rules and More

TUESDAY, NOVEMBER 13, 2018

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Colleen Hart, Partner, **Proskauer Rose**, Los Angeles

Shawn E. Lampron, Partner, **Fenwick & West**, Mountain View, Calif.

Joseph M. Penko, Partner, **Skadden Arps Slate Meagher & Flom**, New York

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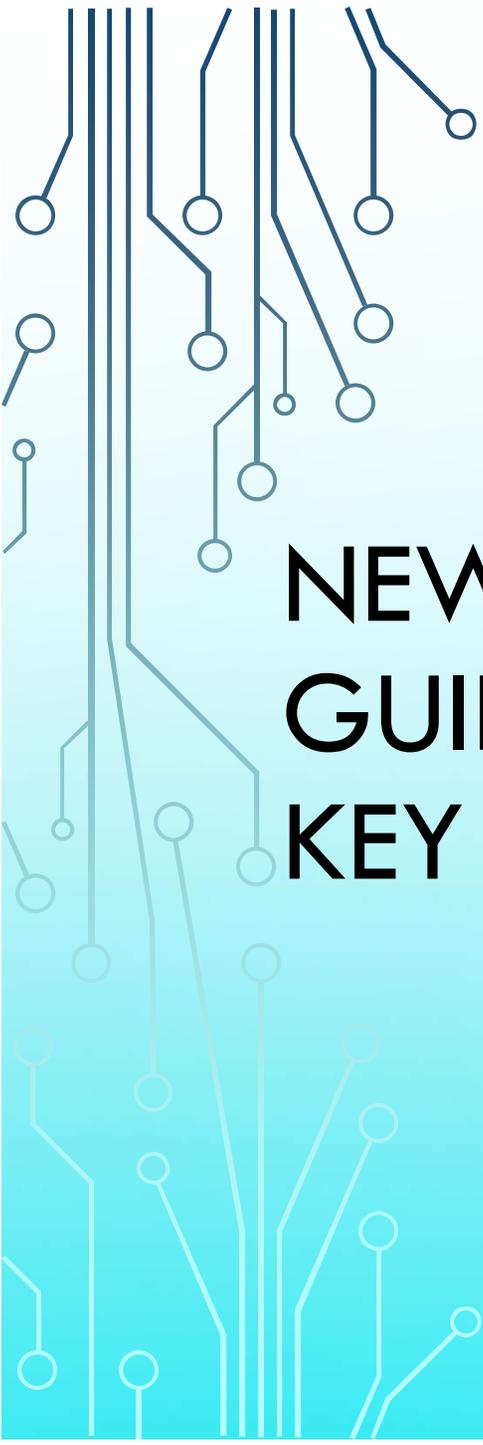
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NEW IRS SECTION 162(M) GUIDANCE AND KEY PLANNING TIPS

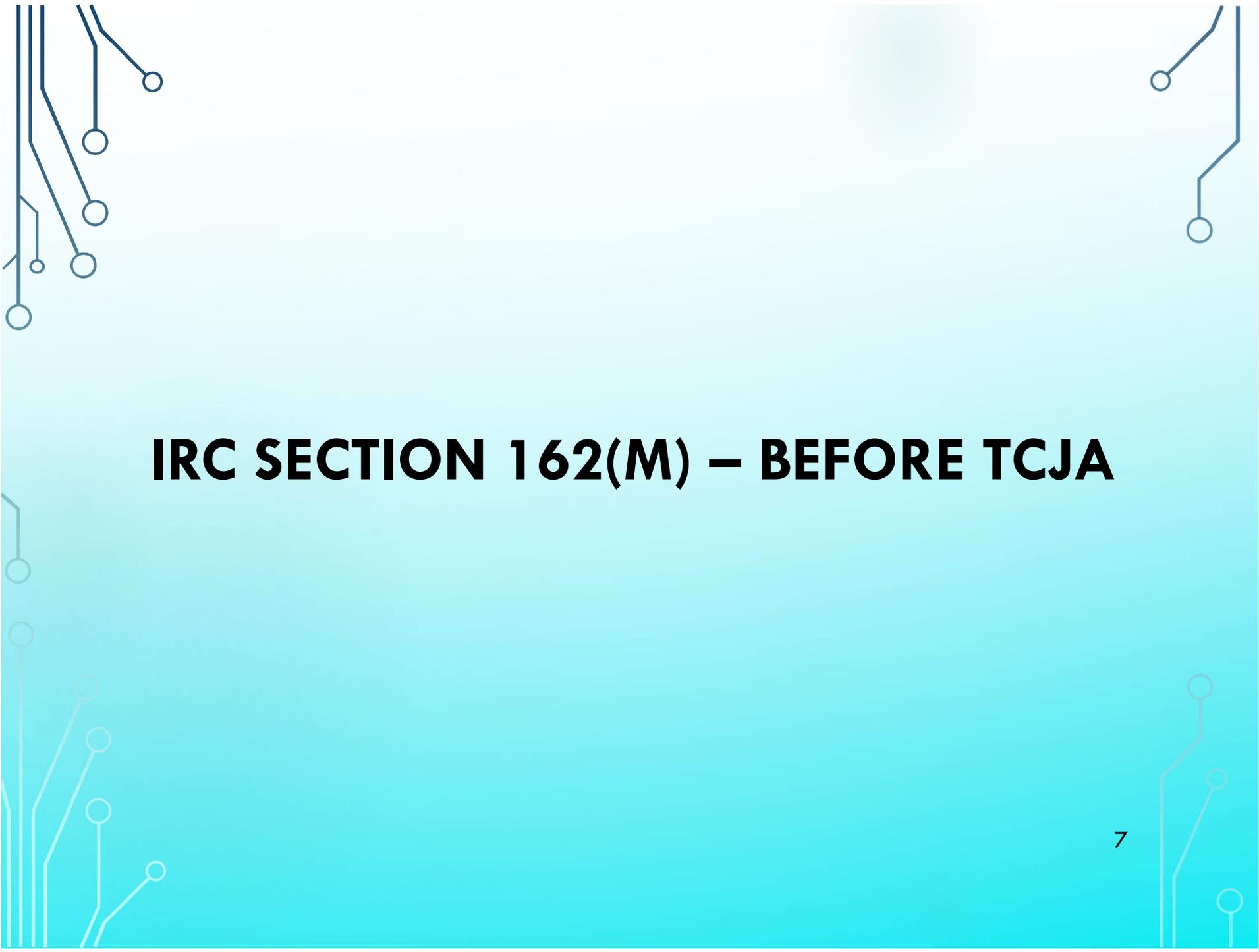
COLLEEN HART
SHAWN E. LAMPRON
JOE PENKO

November 13, 2018

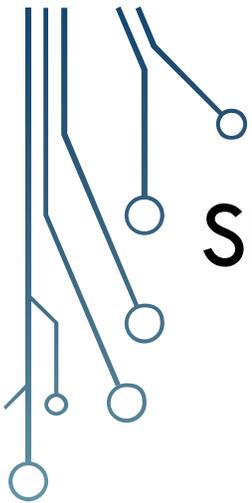


AGENDA

- IRC Section 162(m) – Before TCJA
- IRC Section 162(m) – After TCJA
- Key Planning Tips and Open Questions



IRC SECTION 162(M) – BEFORE TCJA



SECTION 162(M) – BEFORE TCJA

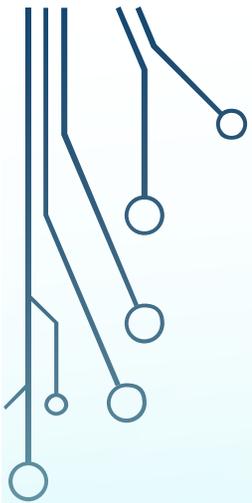
- Under §162(m), a publicly held corporation (including non-publicly held affiliates) is denied a deduction for compensation paid to “covered employees” in a single year to the extent the compensation exceeds \$1 million, unless the compensation qualifies as “performance-based”
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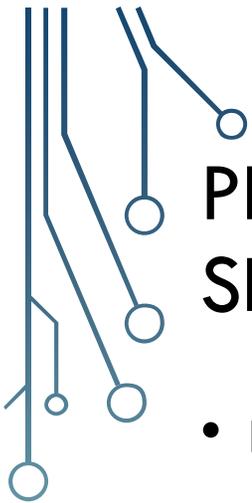
SECTION 162(M) BEFORE TCJA – COVERED EMPLOYEES



- Generally, covered CEO and the three other most highly compensated executive officers (other than the CFO) serving at the end of the taxable year for whom disclosure is required under Item 402 of Regulation S-K

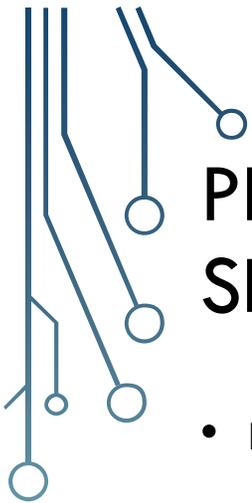


SECTION 162(M) BEFORE TCJA – PUBLICLY HELD CORPORATION



PERFORMANCE-BASED EXCEPTION UNDER SECTION 162(M)

- Performance-based compensation
 - The performance goal must be set by a committee consisting solely of 2 or more “outside directors”
 - The plan must be approved by shareholders (separate vote)
 - The compensation committee must certify in writing prior to the payment of compensation that the goals are satisfied
 - Pre-established performance goals
 - The performance goal must be pre-established (must occur prior to or during the first 25% of the performance period, but not more than 90 days into the performance period); goals must be substantially uncertain to be achieved
 - May be based on one or more business criteria that apply to the individual, business unit or corporation
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PERFORMANCE-BASED EXCEPTION UNDER SECTION 162(M) (CONT'D)

- Pre-established performance goals
 - Must be objective without any discretion to increase award (negative discretion is permitted)
 - To be objective, a third party having knowledge of the relevant facts could determine whether the goal is met; also, the arrangement must quantify the award through a formula or standard that would allow a third party to calculate the max amount that could be received
 - Adjustments
- Payments triggered on termination without cause / good reason that are not based on actual achievement of performance goals will taint the deduction (even if this type of termination does not occur)



WHO IS AN OUTSIDER DIRECTOR?



- Not a current employee of the publicly held corporation
- Not a former employee of the publicly held corporation who receives compensation for prior services (other than benefits under a qualified retirement plan) during the tax year
- Never served as an officer of the publicly held corporation
- Does not receive remuneration (including any payment in exchange for goods or services) from the publicly held corporation, either directly or indirectly, in any capacity other than as a director
- “Publicly held corporation” generally is 1504 consolidated/affiliated group of corporations - 80% vote and value



SECTION 162(M) – APPLICATION TO STOCK OPTIONS AND SARS

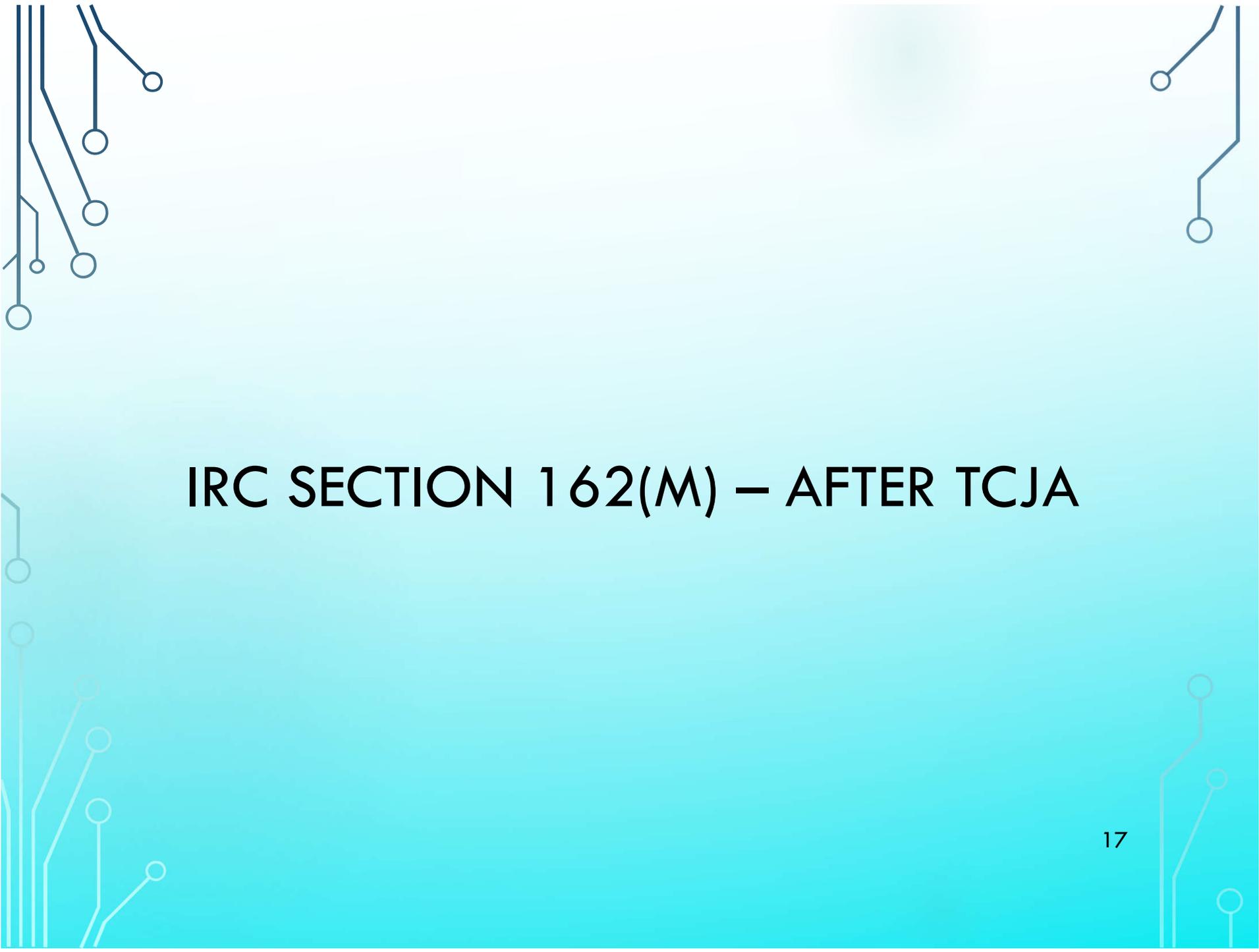


- Stock Options and SARS – to comply:
 - Grant must be made by Compensation Committee satisfying §162(m)
 - Plan must state maximum number of shares underlying an option that may be granted to an individual (the “individual share limit”)
 - Exercise price may not be less than FMV on grant date
 - Plan must be approved by shareholders
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SECTION 162(M) – APPLICATION TO RSUS

- Restricted Stock/RSUs
 - Grant must be made by Compensation Committee satisfying §162(m)
 - Need individual share limit
 - Vesting or grant must be based solely on attainment of performance goal/no discretion to increase
 - Certify goal
 - Plan must be approved by shareholders

The slide features a light blue background with a gradient. In the corners, there are decorative line-art patterns resembling circuit board traces and nodes. The top-left and bottom-left corners have dark blue patterns, while the top-right and bottom-right corners have light blue patterns. The central text is in a bold, black, sans-serif font.

IRC SECTION 162(M) – AFTER TCJA



IRC SECTION 162(M) – AFTER TCJA

- New Law: TCJA amends IRC §162(m) in several significant ways:
 - Expanded definition of covered employees;
 - Expanded definition of “publicly held corporations” subject to §162(m);
 - Eliminated exceptions to the §162(m) deduction limitations for performance-based compensation; and
 - Established transition rules for certain outstanding arrangements (i.e., grandfathering rules).
 - The changes to §162(m) became effective on January 1, 2018 for calendar year companies (and become effective for the first year beginning after December 31, 2017 for non-calendar year companies)
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EXPANDED DEFINITION OF COVERED EMPLOYEE

- TCJA Modifies definition of “covered employee”
 - Includes principal executive officer(s) and principal financial officer(s) at any time during the tax year
 - Includes three highest-paid officers (excluding the PEO and PFO) any time during the tax year
 - An individual who becomes a covered employee for any taxable year beginning after December 31, 2016 continues to be a covered employee in subsequent years, even if the individual is no longer an employee of the company or is deceased
 - Officers do not need to be serving with the publicly held corporation at the end of the taxable year in order to be covered employees
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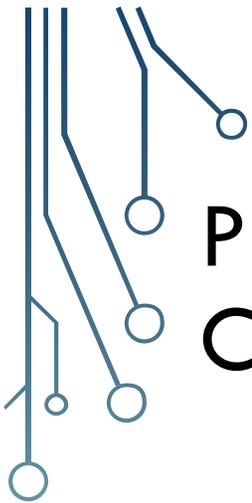
EXPANDED DEFINITION OF COVERED EMPLOYEE (CONTINUED)

- Executives may be covered employees even if their compensation is not required to be disclosed by the applicable publicly held corporation under Item 402 of Regulation S-K
 - Covered employees of smaller reporting companies and emerging growth companies are determined in the same manner as other publicly held corporations, regardless of whether the disclosure of their compensation is required under the SEC rules



EXPANDED DEFINITION OF PUBLICLY HELD CORPORATION

- Expands the scope of corporations subject to the limitation to generally include all companies that are required to file reports with the SEC, including those filing solely because of public debt
 - May include foreign issuers (registered under Exchange Act § 12)
 - Includes issuers of public debt (§ 15(d) reporters)
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PERFORMANCE BASED COMPENSATION



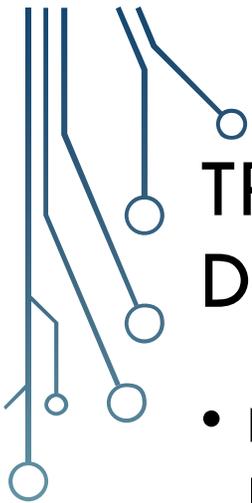
- TCJA eliminates the exemption for “performance-based” compensation
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TRANSITION RULES



- The changes made to §162(m) do not apply to payments made under a written binding contract that was in effect on November 2, 2017 and is not materially modified after that date
 - A contract is considered to be “binding” only if the company is legally obligated to pay compensation under the contract pursuant to applicable law (e.g., state contract law) if the employee performs the applicable services or meets the applicable vesting conditions
 - Compensation will also not be grandfathered if the grant of the compensation remained subject to a condition as of November 2, 2017, such as a grant that is subject to board approval.
 - Unless a contract is materially modified, its “grandfathered” status will generally continue until the contract expires by its terms or is able to be terminated by the employer (e.g., by giving notice of non-renewal)
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TRANSITION RULES – NEGATIVE DISCRETION



- Notice 2018-68 states that a company is not legally obligated to pay compensation for purposes of the transition rule to the extent that the amount of compensation may be reduced upon the company's exercise of negative discretion
 - Applies even if the negative discretion is not actually exercised
 - A portion of the amount may be grandfathered if negative discretion is capped
 - The key takeaway is that annual bonus payments, performance stock units and other performance-based incentives that are subject to negative discretion will generally not be covered by the transition rules
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TRANSITION RULES – FIRST TIME COVERED EMPLOYEES



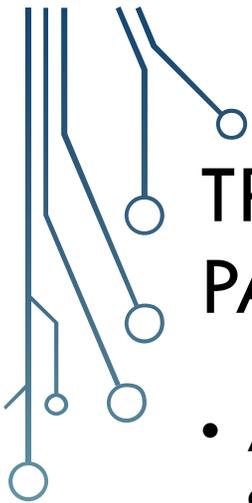
- If an individual becomes a covered employee solely by reason of the amendments to §162(m) made by the TCJA, any payments made to the individual under a written binding contract in effect on November 2, 2017 will not be subject to §162(m)
 - For example, if the CFO of a publicly traded company is entitled to payment of a specified salary under a written binding employment agreement in effect on November 2, 2017 and first becomes a covered employee on January 1, 2018 as a result of the amendments to §162(m), those salary payments will not be subject to §162(m)
 - We expect the grandfathering rule to have the greatest impact when the covered employee would not have been a covered employee for the taxable year under the pre-amended rules. In this case, all compensation under a grandfathered contract (even non-performance based) will remain deductible until the contract is materially modified
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TRANSITION RULES – MATERIAL MODIFICATIONS



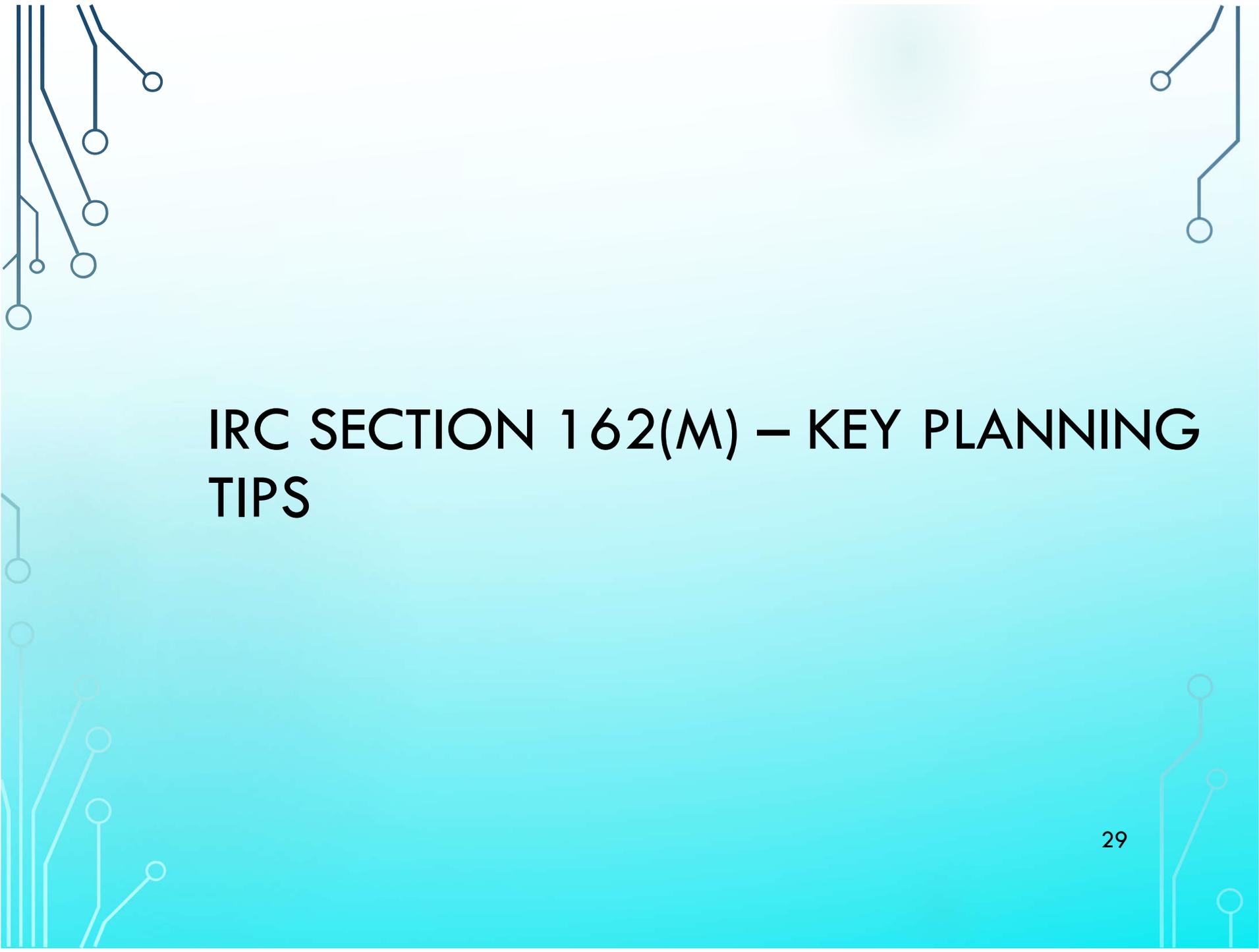
- If an otherwise grandfathered contract is materially modified after November 2, 2017, it is treated as new contract entered into on the date it is materially modified
 - Amounts paid before material modification remain grandfathered
 - Amounts paid after material modification are not grandfathered
- A material modification occurs when the otherwise grandfathered contract is amended or modified to:
 - Increase the amount of compensation payable (cost of living increases are generally ok)
 - Accelerate payment of compensation, unless discounted to reflect time value of money
 - Defer payment of compensation, unless any excess amount is based on reasonable interest rate or actual return on pre-determined investment



TRANSITION RULES – SUPPLEMENTAL PAYMENTS



- A supplemental contract or agreement providing increased or additional compensation is treated as a material modification if the increased or additional compensation is paid on the basis of substantially the same elements or conditions
 - For example, increase in an executive's base salary that is higher than provided in the executive's employment contract (and greater than a cost of living increase) is a material modification, even if not done by directly amending the employment contract
 - If executive instead receiving grant of restricted stock subject to vesting based on continued employment for duration of employment contract, not a material modification (based both on continued employment and stock price)
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IRC SECTION 162(M) – KEY PLANNING TIPS



PRACTICAL CONSIDERATIONS – TO DO NOW



- Determine grandfathered compensation and avoid material modifications
 - Manage who may become “covered employees” and track such employees
 - Consider revisiting who is an “executive officer”
 - Consider size of special payments – including severance
 - Still need “outside directors” (as defined under IRC §162(m)) to serve on compensation committees for grandfathered “multi-year” performance-based compensation
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STRUCTURING CONSIDERATIONS



- In the past, publicly held corporate taxpayers went to great lengths to ensure compliance with the performance-based compensation rules set forth in §162(m) in order to avoid loss of the related tax deduction.
 - A reduction in corporate tax rates made the deduction less valuable.
 - After TRA, a corporate taxpayer may prefer to structure its incentive compensation in a manner that best serves its business needs:
 - Purely discretionary bonuses
 - Use of subjective performance goals.
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SHAREHOLDER CONSIDERATIONS



- Purely discretionary incentives or subjective performance metrics resulting in increased payouts are strongly disfavored by institutional shareholders.
 - External pressure from shareholders and shareholder advisors such as Institutional Shareholder Services and Glass Lewis may keep corporate taxpayers from pursuing these practices.
 - Taxpayers should take care in developing new incentive compensation structures and in communicating them to shareholders and other relevant parties to avoid adverse consequences for “say-on-pay” votes and related matters.
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UNRESOLVED QUESTIONS (PART I)



- Does acceleration of options (that would otherwise be grandfathered) pursuant to authority existing at the time of grant (or as of November 2, 2017) result in loss of grandfathering?
 - Does the modification of one aspect of an employment agreement with many different provisions result in loss of grandfathering for the compensation paid under the other unrelated provisions of the agreement?
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UNRESOLVED QUESTIONS (PART II)

- If a long-standing change in control agreement provides for severance based on a multiple of base salary (e.g., 2x base salary plus target bonus, where target bonus is 100% of base salary) and the individual's salary is materially increased resulting in a materially increased severance, does this result in a loss of grandfathering?
- If a long-standing employment agreement provides for severance equal to 2x base salary plus target bonus where the base salary may not be reduced under the agreement but where the agreement does not specify a target bonus, what portion of the severance is grandfathered? What if the base salary could be reduced as part of an across the board reduction? What if the company retained discretion to reduce base salary but the reduction would give rise to a “good reason” right?



UNRESOLVED QUESTIONS (PART III)



- Is shareholder approval required to eliminate §162(m) provisions in a shareholder approved plan that was intended to qualify under §162(m) prior to TRA?



REQUESTS FOR COMMENT



- Foreign private issuers
 - IPO transition rule
 - Covered employees in corporate transactions
 - Application of SEC disclosure rules for determining three most highly compensated executive officers when tax year and fiscal year differ
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THANK YOU

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