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Issues for Compensation Committees to Consider When Grappling With Changes to 162(m) and the Death of the Performance-Based Compensation Exemption

As much has been written regarding the repeal of the performance-based exception to the $1 million dollar deduction limitation under Code Section 162(m) under the Tax Cuts and Jobs Act (the Act), we have highlighted certain issues that compensation committees should consider in the post-Act era as they review 2017 bonus payouts and chart a course forward without having the benefit of the performance-based compensation exception. The Act makes the following key changes to 162(m) effective for tax years beginning after December 31, 2017:

- With the exception of certain grandfathered arrangements, the Act eliminates the ability of covered companies to deduct compensation in excess of $1 million, including "performance-based compensation," that is paid to "covered individuals."
- The Act modifies the definition of "covered individuals" now to include the chief financial officer, in addition to the chief executive officer and the three most highly compensated officers (other than the CEO and CFO). Additionally, the requirement that the officer be an officer at the end of the year has been removed, and, as a result, once an individual becomes a covered individual, that status continues to apply even if they no longer meet the definition as a covered individual (e.g., post-termination or retirement, post-interim officer status, etc.).
- The Act expands the universe of entities subject to the 162(m) deductibility limitation to include companies that are required to file with the SEC in connection with their issuance of public debt. Accordingly, investment fund portfolio companies whose stock is not publicly traded, but who have public debt, may now have to grapple with deduction limitations that were not applicable to them in the past.

Do modifications to performance awards granted prior to November 2, 2017, destroy grandfathered status?

An important exception under the Act to the repeal of the performance-based compensation exception is a grandfathering rule that provides that the repeal does not apply to "remuneration which is made pursuant to a written binding contract in effect on November 2, 2017 and which was has not been modified in any material respect after such date." Not only is this grandfathering rule important for annual incentive plans and awards thereunder that were established prior to November 2, 2017, the grandfathering rule could also apply to outstanding long-term cash and equity-based incentive awards that

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were granted prior to November 2, 2017, with multi-year performance or vesting periods. The question that many compensation committees have asked or should be considering going forward is: if the performance award permits the committee negative discretion to reduce the amount of the award after November 2, 2017, and such discretion is exercised, is there a "modification" to the contract and is it "material" so as to undermine grandfathered status? Another question is whether a binding contract even exists where the compensation committee retains such discretion? We await further guidance from the IRS on these points, and caution compensation committees in the interim.

Many performance-based compensation programs hardwire formulaic adjustments into their performance-based compensation programs for certain extraordinary events, including accounting changes, acquisitions, etc. Furthermore, most programs intending to meet the performance-based exception provide for committee discretion to reduce the amount of such awards, which, prior to the Act, may not have been fatal under the performance-based compensation exception.

Before making discretionary changes to awards granted prior to November 2, 2017, compensation committees should: inventory written compensation arrangements that were binding prior to November 2, 2017, and which relied on the performance-based or commission exceptions to 162(m) and seek legal counsel to discuss the implications of exercising discretion under the terms of such arrangements.

Should committees limit the grant of stock options or restrict exercisability now that they are not exempt as performance-based compensation?

Stock options and stock appreciation rights will no longer qualify as performance-based compensation, and income recognized by covered individuals on exercise will subject covered companies to the $1 million dollar deductibility limitation, under 162(m). To the extent that stock options and stock appreciation rights are a part of covered individuals' total compensation, committees should consider whether it is appropriate to limit the grant of such awards or to restrict their exercisability in an effort to reduce the impact of a lost deduction. Similarly, companies may now instead consider deferred compensation programs with fixed payment dates or formulae (instead of flexibility of exercise timing) that could account for Section 162(m)'s deduction limitation.

Should performance-based compensation be deferred beyond vesting to spread out the income inclusion?

With the Act's repeal of the performance-based exception to 162(m) and the existence of potentially large sums of compensation tied to multi-year performance-based goals, committees could consider whether amounts payable as a result of the achievement of these goals should be automatically deferred to a future year (or spread out over multiple years) to reduce the impact of the deductibility limitation for covered individuals. Although many incentive programs provide the opportunity to defer some or all of an individual's performance-based compensation, committees have not previously had to consider whether such deferrals should be mandatory or formulaic to preserve greater deductibility for the company as payments come due under these incentive programs. Given that disclosure will be made regarding non-deductibility of certain compensation, committees would be wise to at least explore options that could better preserve the possibility of deduction.

Should committees revise non-grandfathered performance-based compensation programs to provide more flexibility now that the performance-based exception is no longer a factor?

Committees of covered companies should look at their current cash and equity incentive compensation programs to see what modifications could be made to post-2017 programs, since committees are no longer constrained by the requirements of 162(m)'s pre-Act performance-based exception. For example, a committee may wish to consider the ability to upwardly adjust the payment of incentive compensation, adjust payout amounts for certain extraordinary items that may have not been considered at the time of the award, and add performance measures that were not previously approved by shareholders. Further, in the post-Act era, at least with respect to non-grandfathered compensation, boards may wish to expand the makeup of committee members given that 162(m)'s committee framework for performance-based compensation will no longer apply. Although performance-

based compensation will likely continue to be utilized as part of an executive's compensation package due to continued pressure by shareholders and shareholder advisory groups, the repeal of the performance-based compensation exception (and all of the related requirements), should provide committees with additional flexibility in designing and administering certain performance-based compensation going forward.

In the post-Act era, compensation committees and boards must pay careful attention to the impact of the deduction limitation on new and old programs, on engaging highly compensated personnel on a long-term or temporary basis, and shareholder concerns over tax efficient performance-based compensation programs.

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