2017 Tax Cuts and Jobs Act Eliminates Section 162(m) Performance-Based Pay Exemption and Expands Section 162(m) Coverage Generally

Generally. On December 22, 2017, President Trump signed into law the final draft of the Tax Cuts and Jobs Act (H.R. Bill 1, the "Act"), which, among other things, expands the scope of Internal Revenue Code Section 162(m) ("Section 162(m)") for tax years beginning after December 31, 2017. Section 162(m) generally imposes a $1 million cap on a public corporation's federal income tax deduction for compensation paid to certain "covered employees" (previously, the chief executive officer and each of the next three most highly compensated executive officers, excluding the chief financial officer). Public corporations have traditionally relied heavily on the performance-based pay exemption, which allowed for deductions above the Section 162(m) cap if specified requirements are satisfied. These requirements include (1) the applicable compensation being paid solely on the basis of attaining pre-established, non-discretionary and objective performance goals, (2) the applicable goals and the material terms of the compensation being submitted to, and approved by, the corporation's shareholders, and (3) a compensation committee of the corporation's board of directors both establishing the applicable performance goals and, following performance but prior to payment, certifying that the goals have been achieved.

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The Act significantly changes the scope of Section 162(m):

- **Eliminates the performance-based pay exemption altogether,** which will generally bring under the scope of Section 162(m) all performance-based compensation, including stock options.

- **Expands the definition of "publicly held corporation"** to include any corporation required to file reports under Section 15(d) of the Exchange Act. The new universe of corporations subject to Section 162(m) includes certain privately held corporations with publicly traded debt and foreign private issuers with equity traded through American depositary receipts.

- **Expands the definition of "covered employees" to include a corporation's principal financial officer.** This change aligns with the definition of "named executive officers" under Rule 402 of Regulation S-K applicable to companies that are not smaller reporting companies.

- **Expands the definition of "covered employees" to include any employee who was a covered employee in an earlier year.** This means that the deduction limit will likely apply to more than five (5) employees and will apply to compensation after an employee ceases to be a "named executive officer."

Effective Date and Transition Rule. These changes will take effect with respect to tax years beginning after December 31, 2017. However, the Act contains a transition rule for payments made pursuant to a written binding contract in effect on November 2, 2017, (the "Transition Date") as long as the contract is not materially modified following the Transition Date. Although the IRS has not yet issued additional guidance on how the transition rule will apply, the conference agreement under the Act provides additional color, including that a contract will be deemed materially modified (and, therefore, not grandfathered under the transition rule) if it is renewed after the Transition Date or is otherwise terminable or cancelable unconditionally at will by either party without the consent of the other (unless a condition of termination or cancellation is the termination of the covered employee's employment).

The scope of the transition rule is far from clear. The sole example provided in the conference agreement suggests potential requirements for grandfathering to apply (including a lack of company discretion to modify the payment terms). Until additional regulations provide a more systematized set of rules, questions will remain. For example, whether options granted under an employment agreement that provides for option grants each year for the next ten years, are considered paid "pursuant to" the pre-Transition Date employment agreement and are, therefore, grandfathered. The transition rule does not appear to be limited to the performance-based compensation exception, which could open up potential opportunities to continue to deduct certain amounts of compensation payable to chief financial officers or additional covered employees by corporations that were not previously covered by Section 162(m).

Next Steps for Companies. Following the passage of the Act, public companies should consider whether and how to change current arrangements, and how to think about deductions for tax years beginning in 2018. Areas for consideration include:

- **The impact of the transition rule on current arrangements,** particularly when a given public company is considering amending and/or renewing written binding contracts in effect as of the Transition Date.

- **Compensation package mixes** that are skewed heavily in favor of performance-based compensation. Given that performance-based compensation for covered employees will no longer be deductible and the Act's reduction of the corporate tax rate (which, in turn, decreased the value of associated tax deductions), public companies may begin to rely more on more flexible performance-based targets (e.g., subjective and/or individual-based targets) or even guaranteed compensation tools (e.g., base salary, time-vesting stock awards, etc.), particularly if an

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executive is highly sought after by competitors. Where structurally possible, companies may want to consider the use of profits interests, which are not deductible but may allow executives to pay capital gains-based tax rates.[1] These considerations should be weighed against the potentially negative impact from shareholder advisory service groups that will undoubtedly continue to push for performance-based pay.

- **Omnibus plans and individual agreements** that include restrictive Section 162(m)-based language. Most omnibus plans include individual limits on stock awards that should potentially be struck, particularly in cases where the limits are not tied to the underlying compensation being structured as performance awards under Section 162(m). At the same time, companies should consider whether any limits or requirements should be retained for good governance purposes or other legal purposes, such as ensuring qualification of incentive stock options and/or ensuring that director compensation is protected against corporate waste and other fiduciary duty-based claims. In any event, public companies will need to consider how to think about shareholder approval in general — the performance-based pay exemption rules generally required shareholder approval of the omnibus plan (and the performance goals contained therein) every five years. In the absence of that requirement, there is at least the option that omnibus plans, and the share reserves in particular, will be expected to last for much longer periods.

- **Compensation committees may similarly update their charters** to remove governance requirements linked to the performance-based pay exemption, including limitations on membership that were specifically required by Section 162(m). Companies will still need to consider the compensation committee-related independence standards set forth in Section 16(b) of the Exchange Act or otherwise in the NYSE and/or NASDAQ listing requirements when selecting members of their compensation committees. Moreover, given that the transition rule may continue to make the performance-based exemption relevant, Section 162(m)-based restrictions should remain in place as necessary to administer written binding contracts in effect as of the Transition Date.

- **Proxy disclosures** on executive compensation, particularly where discussions on tax treatment delve into the performance-based pay exemption, will likely need to be amended to account for the removal of the exemption.

- **Privately held companies with publicly traded debt** will need to consider executive compensation policies in light of Section 162(m) generally, including the impact of lost deductions on future transactions.

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1 The use of profits interests assumes the presence of an affiliate partnership, i.e., compensation would not come directly from the public corporation itself.

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