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EXEQUITY

Independent Board and Management Advisors

Client Alert

A New Tax Day Dawns in the U.S.

On December 20, 2017, the U.S. Congress approved the final version of the Tax Cuts and Jobs Act.[1] The Tax Act was sent to the President, who signed it into law on December 22, 2017. This Client Alert details the provisions in the Tax Act that impact executive compensation directly.

Luckily, the original provision in the Act that would have significantly impacted non-qualified deferred compensation, and would have caused companies to completely re-think their use of certain equity awards such as stock options, did not make it into the final version of the Tax Act approved by the U.S. Congress and signed into law by the President.

The key provision in the final Tax Act that impacts executive compensation for public companies (both those with publicly traded securities as well as public debt) concerns the limitation on deductibility of compensation paid to Covered Employees in excess of $1 million.

Section 162(m) will be revised by the Tax Act, as follows:

- The **performance-based** and **commissions exemptions** to the Code Section 162(m) limit on deductibility of compensation (typically $1 million) is ***eliminated***, subjecting all pay above $1 million to a covered executive to potential nondeductibility, effective for taxable years beginning after December 31, 2017.

- Code Section 162(m) is **explicitly extended to** cover the **Chief Financial Officer/Principal Financial Officer**. In addition, an individual is a Covered Employee if the individual holds one of these positions at any time during the taxable year (it does not simply apply to those holding the position on the last day of the taxable year).

- An **individual** who **qualifies** for any tax year beginning **after December 31, 2016** as a **Covered Employee** will **forever after** be treated as a Covered Employee, even post-termination of employment, meaning that many forms of post-employment pay (e.g., severance, retirement, and vesting/exercise of long-term incentive awards after termination, including payments after the individual has died) would be potentially nondeductible.

[1] The text of the Tax Cuts and Jobs Act, H.R. 1, as enrolled (Tax Act), as well as the Conference Report for the Tax Act, can be found at: https://www.congress.gov/bill/115th-congress/house-bill/1/text

- Code Section 162(m) will **apply** to **any company that files SEC reports**, including those that merely issue debt securities to the public, but do not have publicly traded stock and all foreign companies publicly traded through ADRs.

- The Tax Act follows the Senate version and provides for a **grandfather provision**. Under the grandfather provision, remuneration that is provided pursuant to a written binding contract which was in effect on November 2, 2017, and which has not been modified in any material respect on or after that date, will not be subject to the amendments made to Section 162(m) by the Tax Act, i.e., if such remuneration qualifies as performance-based pay under the prior Section 162(m) rules, it will be deductible by the Company and not count towards the $1 million limit.

  ***Note**: According to the Conference Report for the Tax Act, a written binding contract exists if an employee has the right to participate in a plan as part of a written binding contract as of November 2, 2017, even if actual participation does not occur until after November 2, 2017. The amounts payable under the plan cannot be subject to discretion and the corporation cannot have the right to amend materially the plan or terminate the plan (except on a prospective basis before any services are performed). In addition, the Conference Report for the Tax Act states that "the fact that a plan was in existence on November 2, 2017 is not by itself sufficient to qualify the plan for the exception for binding written contracts." Reading the Conference Report for the Tax Act, we believe a conservative interpretation of the grandfather rule is that the written binding contract requirement can be satisfied if there is no discretion in the remuneration to be paid, though the normal Section 162(m) performance-based exemption requirements would also apply. This raises the question of whether bonus pool umbrella plans that employ negative discretion to adjust payments would be considered written binding contracts, even if the plan was in place before November 2, 2017. We believe Compensation Committees would need to fix the liability and certify to the performance goals before January 1, 2018 in order to preserve the tax deductibility of plans that have a discretionary element.*

***Exequity Comment:** As a result of this change to Section 162(m), companies that are taking equity compensation plans and amendments to shareholders in the 2018 proxy season should carefully consider whether the Section 162(m) limits continue to be necessary and whether any individual award limits would be desirable or beneficial to attaining shareholder approval. For existing equity compensation plans, companies should review the terms of their plans to determine whether they permit flexibility with respect to granting non-Section 162(m) qualified awards and/or whether the plan should be amended to remove Section 162(m) award limits. Companies should discuss these issues with their legal counsel; but after reading the rules of the stock exchanges, we do not expect that shareholder approval is necessary in most cases to eliminate the Section 162(m) award limits in a plan.*

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