

2017 TAX REFORM § 162(M) CHANGES INITIAL BRIEFING

January 2018

§ 162(M) PRE-2017

Corporate deduction disallowed for -

Compensation paid in excess of \$1 million in a taxable year

by Publicly Held Corporations

to Covered Employees

Unless an exception applies

- Disallowance does not apply to non-taxable amounts
- U.S. publicly traded companies and certain ADRs
- CEO and 3 other most highly compensated executive officers other than CFO
- Status determined as of 12/31 each year
- Performance based pay
- Commissions
- Newly public companies

➤ ***Does not affect employee's tax treatment (no excise or additional tax like in 280G and 409A)***

SUMMARY OF CHANGES TO § 162(M)

- Expands companies covered
- Expands officers covered
 - Covered employees **FOREVER** retain status as covered employees (even after termination of employment)
- Repeals performance pay & commission exceptions
- Transition relief applies to existing “written binding contracts” that are not “materially modified”: scope unclear

TRANSITION RELIEF FOR CERTAIN EXISTING ARRANGEMENTS

- Under transition relief, amendments made to §162(m) by the legislation would not apply to-
 - **Written binding contracts** as of 11/2/2017
 - That are not modified in **material respects**
- Relief raises significant questions re-
 - Executive with individual employment letters or agreements
 - Outstanding equity awards
 - Non-qualified deferred compensation plans
 - Umbrella plans designed to meet performance pay exception

COVERED EMPLOYEE EXPANSION

KEY TAKEAWAY:

- 🔑 Any CEO/CFO (or acting CEO/CFO) and each top-3 highest paid officer for years starting in 2017 will *forever* remain a covered employee of the company.

EXPANSION OF “COVERED EMPLOYEE”

- CFO added back to list
- Covers individuals who are CEO or CFO (or acting as such) at any point during the year (not just last day)
- Covered employees (starting in 2017) FOREVER retain status
 - Even after termination of employment
 - Perhaps even after company is acquired (reference to “predecessor” of taxpayer is not defined)
 - Captures pay that previously avoided the reach of §162(m)
 - **Deferred compensation**
 - Death benefits
 - More consequential for companies with greatest churn among highest-paid executive officers

IMPACT ON NQ DEFERRED COMPENSATION

KEY TAKEAWAYS:

- 🔑 NQ deferred comp now will be limited by §162(m).
- 🔑 Extent to which transition relief protects current plans is not yet clear.
- 🔑 Employers may want to amend plans to maximize deduction. But existing §409A rules may limit the ability to do this.

NQ DEFERRED COMPENSATION: SCOPE OF TRANSITION RELIEF

- Transition relief grandfathers “binding contracts.” But some NQ plans have-
 - Broad amendment authority, or
 - Restrictive covenants with broad company discretion to enforce, each of which may raise question of whether there is a binding contract.
- Assuming plan is a binding contract, does relief apply to-
 - Only vested amounts?
 - Only existing accruals?
 - Only existing participants?
- “Material modification” – will require IRS guidance as to what is material and whether modification imperils entire arrangement.

NQ DEFERRED COMPENSATION: DELAY TACTICS

- Company may want to delay payments (for example, pay in installments rather than lump sums)
- Some plans may already allow for – or require – §162(m) delay
 - Most common in plans in which executives were permitted to elect in-service payments
 - But language might have been drafted too broadly, forever limiting an executive's post-termination compensation to \$1 million per year now that §162(m) changed
- §409A limits the ability delay

NQ DEFERRED COMPENSATION: CHALLENGES UNDER §409A

- Delay permitted under §409A as long as-
 - Payment is made either in first taxable year when deductible or upon separation from service
 - Delay must be treated as subsequent deferral election (5-year delay) unless ALL scheduled payments are delayed that could be
 - Payments upon separation from service must further comply with 6-month delay rule for specified employees
 - Executives may not be given election to choose delay
- Mechanics of delay can be very cumbersome – and some issues have always been thorny (for example, in what order does pay need to be delayed?)

UMBRELLA PLANS (AKA “PLAN WITHIN A PLAN”)

KEY TAKEAWAYS:

- 🔑 Not relevant going forward because performance pay exception is eliminated.
- 🔑 Extent to which transition relief available is not clear – “negative discretion” might prevent availability of relief.

UMBRELLA PLANS: BACKGROUND

- Many companies meet performance-based pay rules by establishing an umbrella plan-
 - Shareholders approve the material terms of the umbrella plan based on relatively simplified performance metric (e.g., percentage of net income)
 - Umbrella plan thus sets forth maximum allowable payout
 - Comp Committee certifies goals have been satisfied
 - Comp Committee retains discretion to decrease individual awards and generally does so based on “inside plan” that determines actual payouts using individual and specific performance goals
- Umbrella plans no longer relevant going forward, because performance pay exception is repealed

UMBRELLA PLANS: SCOPE OF TRANSITION RELIEF

- Transition relief is intended to grandfather existing performance pay, even if paid in future years
- Does “binding contract” concept accomplish this?
 - “Negative discretion” (to reduce awards) is expressly permitted under the existing performance pay exception and is a key component of most Umbrella Plans.
 - But employees may not have a “binding contract” in light of the negative discretion built into the umbrella plan.
 - Even if employees have a “binding contract” under the “inside plan,” that inside plan does not itself generally meet the performance pay exception.

CORPORATE TRANSACTIONS

KEY TAKEAWAYS:

- 🔑 Not clear whether covered employees of seller will automatically be covered employees of buyer.
- 🔑 Will need IRS relief to address how to handle multiple transactions (going private and then going public again).

CORPORATE TRANSACTIONS: INITIAL OBSERVATIONS

- §162(m) would look back to covered employees of a “predecessor.” Not clear if this means-
 - Any seller/ target company,
 - Companies purchased in stock transaction only, and/or
 - Spin-offs, reorganizations, etc.
- Regardless, between private and public company, may want private company to retain NQ plans & other obligations.
- Parachute payment deduction disallowance may be less meaningful (although 20% excise tax would still fall on employee).

NEXT STEPS & PLANNING OPPORTUNITIES

RECOMMENDED ACTION

- Review plan documents, award agreements, and individual employee agreements covering future payments
- Determine what is covered (or potentially covered) by transition relief
 - Evaluate amendment authority provisions
 - For NQ plans, evaluate ability to separately track (and administer, if desired) grandfathered amounts
- Determine whether changes to existing plan documents will be needed: e.g., existing § 162(m) delay provisions

PLANNING OPPORTUNITIES

- Qualified plan benefits exempt (e.g., QSERP)
- Non-taxable benefits (e.g., retiree medical) exempt
- Installment payments could be favored: company may want to change payment to installments or encourage election of installments for future accruals
- Company may want stock option exercises spaced out
- Consulting arrangements



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