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Day 1
162(m) - Where Things Stand
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Speaker1: So, this panel is going to talk about where things stand. Welcome to Renata Ferrari of Ropes & Gray, our very own Mike Melbinger, also of Winston & Strawn, and Rob Neis of Eversheds Sutherland**.** I will turn it over to Mike to talk about why deductibility still matters. Mike…

Mike Melbinger: Okay. Thanks, Liz, and welcome everyone. So, why deductibility still matters. Well, deductions, in my experience, in our clients, always matter. Okay. Sometimes, for some companies with loss years or some companies with NOL carryforwards**,** deductions may not matter in one year. For some companies that are just not profitable, deductions don't matter. But for most companies, in all situations, deductibility does matter. And it's a lot of money. And potentially next year, we will see corporate tax rates go up; nobody knows for sure. And if they do, deductions will matter even more. So, that's an easy one to dispose of. I'll turn it back to Renata Ferrari.

Renata Ferrari: Hi, and I need to apologize for any of you who saw me pop into the last panel three times, I was having some technical difficulties. So, deductions do matter. Having said that, I will say, at least in my experience, companies haven't focused that much on ways to mitigate the impact of 162(m) or try to preserve deductions, in part because there's not absent, you know, not paying more than a million dollars a year which isn't anything that has caught on in terms of a mitigation strategy. There's some things that can be done but, you know, ultimately if a company is paying what they typically pay to their executives is going to be more than a million dollars a year and also, amounts will be taken into income in a way that can't be planned for because of, for example, stock options, exercises, things like that.

But in terms of possible mitigation strategies, I think there's, the two most important… I'll do the first one at the beginning and the second one at the end, is the first one is to try to keep your named executive officer groups consistent. So, with the new proposed regulations and the notice, there's this idea that once you are a covered employee, you are always a covered employee. So, anyone who was a covered employee, I think starting at the taxable year beginning 01/01/17 is a covered employee forever. And so, if I'm an executive officer and I become an NEO one year because of, let's just say a large equity grant or some type of retention or grant and I'm in for one year, my compensation will be subject to the 162(m) limitations on deductibility for so long as I'm an employee and even after I cease to be an employee and so having someone pop into the table one year can have impacts for the rest of that person's career with the company.

And obviously you don't want to, you know, sometimes you can't, you don't want to manage to this, there's obviously reasons for companies to be paying potentially more to one person one year than the other, but if possible try to keep your group of NEOs relatively consistent to try to minimize people going in and out. The other thing is, I think most companies have a pretty tight definition of executive officers. Sometimes at least for some of the newly public companies, they may have a broader group of people that they consider executive officers. They really want to show that everyone who's part of the team is an executive officer. You know, if your company is in that boat, think about obviously within the rules, there's, Exchange Act rules to find who an executive officer is. But think about, you know, do you really have the right group of executives?

And so, those two trying to keep a stable group of NEOs as well as making sure you have the right group of people who are your executive officers. One way to mitigate the impact of 162(m) or if it doesn't do anything for the people who are your NEOs and will always be your NEOs, you know, your CEO and now your CFO. But, you know, at least it can help around the edges. Some of the other things that people have talked about, although I don't, I haven't seen them really being implemented because of 162(m) but extending vesting schedules of at least time-based awards so, less on stock options which can be exercised at any time after, generally can be exercised at any time after they vest but on RSUs, maybe trying to extend out the vesting schedules, trying to at least plan a little bit in terms of the amount of compensation that will be taken into account in each year sort of on the fixed types of compensation.

You know, now with 162(m), and Rob will talk about the expanded scope of 162(m), but it used to be the case that generally former employees were not covered by 162(m) because you had to be serving in office at the end of the fiscal year and so, now if you have severance, you know, paying it in a lump sum versus installments before didn't really matter. There are reasons to pay severance in installments anyway, a lot of companies like it because they think it's a better tie in terms of the non-compete or, you know, restrictive covenants that they're getting. But, you know, paying severance out over time could help a little bit with deductibility. There is an ability under 162(m) and under 409A to defer amounts that are payable until they are reasonably expected to be deductible under 162(m) so, some companies had already done that, but of course, you know, when they did that say five years ago, there was a real sense that they'd be paying out these amounts on employment termination.

That may not be case now but, you know, companies could think of imposing mandatory deferrals. That's a little hard because you don't actually really know when the amounts will be paid, especially if you have stock options that can be exercised over time, if you have PSUs that potentially continue to pay out based on performance after you terminate. But a company could defer until the deduction was available. The flip of that is if you do have those arrangements right now where you have forced deferrals until your able to deduct under 162(m), as I said, a lot of companies put those in where they thought "Well when an NEO terminates, we can then just pay it out and not be limited." In the proposed 162(m) regulations, the IRS gave relief and said that companies could amend out those provisions, which is the exact opposite of what I'm talking about. But could amend out those provisions requiring deferral but would have to do so by 12/31/20.

So, if you have one of those provisions and you want to think about lifting it, now's the time to do that. So, you know, those are all possibilities, right? I don't think any of them are, none of them are going to be, other than deferring, until it's deductible are not going to be a failsafe way to minimize the impacts of 162(m). I think keeping the NEOs consistent to the maximum extent impossible is going to help. The other thing that will help companies, and this we'll get in, Rob is going to talk about grandfathering and what's a material modification, is not de-grandfathering amounts. Because for a lot of companies, we've sort of gone through, PSUs should all, you know, the grandfathered one's should all have paid out. You might have some stock options for companies that, grant stock options that are still outstanding but sort of, a lot of the grandfathered compensation is sort of playing out by its terms.

What is still around for a lot of companies is non-qualified deferred comp. and for companies that have surp. balances. Now, the IRS in the proposed regulation, in I think both sets of items, the notice and the proposed regulations, it was not as generous as tax-payer's would have liked and as practitioners would have liked in terms of determining the grandfathered amounts for non-qualified deferred comp. and surp. plans but it still, I mean, ideally what people wanted was any earnings on grandfathered amounts would also be grandfathered. We didn't get that but there are still significant amounts of compensation at certain companies for which the deduction is available because those amounts are grandfathered and, you know, assuming they're paid out following termination of employment then you should still be able to get a deduction for those amounts.

And so really, for those amounts and for the companies for which this is relevant, the biggest way to mitigate the impact of the changes to 162(m) is to not grandfather because there are at least a significant number of companies that have outstanding deferred comp., their NEOs have outstanding deferred comp. balances and if they don't de-grandfather the plans, there's at least a deduction available for those amounts. So, I don't know if Mike or Rob has anything else to say about mitigation strategies.

Rob Neis: No.

Mike Melbinger: No, I'm good.

Rob Neis: Mike, sorry. Nope.

Mike Melbinger: There might be a couple more, but we thought of, you know, with our thinking caps but we haven't seen anyone use them so, it's not worth our time.

Renata Ferrari: Yeah, yeah.

Rob Neis: Well, as Renata mentioned, one of the sort of strategies for maintaining deductibility or maximizing deductibility is to sort of not un-grandfather an award or an amount that is grandfathered. Just to remind everybody that if an amount is grandfathered, it doesn't mean that it's automatically deductible, it just means that it's subject to the old section 162(m) rules, not the new section 162(m) rules. And so, under the old rules, more amounts were deductible and that's really what we're talking about here is just that the old 162(m) rules apply rather than the new ones. You still have to satisfy all the requirements of the old 162(m) rules pre- Tax Cuts and Jobs Act rules in order to have the amounts be deductible but anyway, that can be very helpful.

As Renata said, the proposed regulations didn't really relax the grandfathering rules very much; they're still quite strict. Basically, an amount's grandfathered if it's payable under a written, binding contract that is in effect on November 2nd and wasn't modified after that date and what I want to talk about here for just a few minutes or just a minute is the modification rules. What does it mean to modify or to not modify an agreement? So, a contract is materially modified and thus loses its grandfathered status really only if it's amended to increase the amount that's paid. So, that's actually a pretty helpful standard. The proposed rules make the point, emphasize that a contract is, actually I should say, in addition to increasing the amount, accelerating the amount at time which the payment is made can also result in a loss of the grandfathered status unless the accelerated amount is discounted to take into account the time value of money.

What's not a material modification, though, and that's pretty helpful, is that deferral of a payment, making a payment later, is not a material modification. It doesn't result in an increase in the amount paid. Unless of course the deferral is accompanied by some other form of increase in amount, an increase that's greater than what a reasonable rate of interest would be on the deferral. Again, that's taking into account the time value of money. The rules also clarify that accelerating the vesting of an invested amount is not a material modification. That's also very helpful. But one thing that the rules do emphasize though, is that even if you don't sort of modify a contract but you simply pay the executive more for essentially the same services, you're paying them more based on the same, I think the rules refer to it as "elements and conditions", as the amount that's otherwise grandfathered.

If that additional amount is sort of more than just a reasonable cost of living increase, that amount can result, the payment of that amount, either by modifying a contract or just paying the amount separately and not modifying any contract, you know, can result in a loss of the grandfathered status. So, that's something I think really important to keep in mind, even if you don't actually change an agreement or contract **paying (14:00)** amount. If you just end up paying **____ (14:02)** despite the **payment amount (14:03),** again sort of based on the same elements and conditions of the original amount, you can lose the grandfathering status there. Mike…

Mike Melbinger: Okay, thanks. Now, let's talk a little bit about negative discretion. Okay, we all know that based on the performance-based compensation exception that existed before the Tax Cuts and Jobs Act, nearly every incentive plan, long term and short term, contained the ability or reserved to the board or the comp. committee the ability to decrease awards that has negative discretion but not to increase awards. I'm sorry, increase the award. Now, given that this rule was in everybody's plans solely because of a performance-based compensation or because of pre- Tax Cuts and Job Acts law, one would have hoped that the IRS would take that into account and not take a hardline application of it.

Certainly, that's what compensation professionals argued in the name of, you know, common sense and fairness but that's not what has happened in the proposed regs. But all is not lost because there is some language in the pre-amble to the proposed regs. that does acknowledge that even with negative discretion, there still may be a legally binding obligation to pay a compensation to an executive under agreements that seem to have negative discretion. What do they say, even though, well I'm not going to read the exact language but you can double check and take my word for it on that. So, some performance-based compensation awards with negative discretion, we believe and are highly confident that they may be grandfathered.

Well, maybe with the simplest example without going into a lot of detail is a situation where there is negative discretion, there's always been negative discretion yet the compensation committee has never paid below a certain amount based on performance, based on a, you know, achieved target let's say. They've always paid "x". And the theory there would be that "Okay, if we achieved 'x' this year, and the board or the comp. committee were to pay less, then the executive **_____ (16:35)** has a cause of action. A breach of the contract of good faith, it's a state law test that would require research but that would be the argument. So, overall, not so good news on negative discretion but still a little hope left. Back to you, Rob.

Rob Neis: Sure. So, as Renata, and I think Mike both mentioned, kind of the number of employees who can be covered employees has sort of generally expanded under the post-Tax Cuts and Jobs Act definition of covered employee. Basically, before the Tax Cuts and Jobs Act, under old law, covered employees were the CEO and generally the top four highest compensated executive officers other than the CEO as of the end of the year. The Tax Cuts and Jobs Act expanded the definition to include basically anyone serving at any point during the year as one, the principal executive officer really at any time during the year, the CEO at any time during the year, the principal financial officer or somebody serving in that capacity at any time during the year and then the top three highest paid officers for the year.

So, whether or not they're employed on the last day of the year. And, very importantly, anyone who was a covered employee in a prior year. So, that's sort of the once a covered employee, always a covered employee rule. All of the covered employees are determined really without regard to whether their compensation has to be disclosed in the proxy. The officer's compensation is determined using the SEC rules, but again, the officer can be a covered employee if he or she is among the top three highest compensated officers really without regard to whether they're disclosed in the proxy or not.

Another important thing to remember is that the covered employees' compensation is determined basically on a taxable year basis, not a fiscal year basis like under the SEC rules. And then the proposed regs. also do emphasize that only executive officers, as defined under the SEC rules can be covered employees. So, in addition though, to expanding what the definition of what a covered employee is, the Tax Cuts and Jobs Act also significantly expanded what the definition of a publicly held corporation is. And so, this also then results in kind of an expansion of the number of covered employees that may be subject to these deduction limits under 162(m).

Prior to the Tax Cuts and Jobs Act, you know, a publicly held corporation was defined as just a corporation that issued equity securities that were required to be registered under section 12 of the Securities Exchange Act. TCJA expanded that to include corporations issuing any securities that are required to be registered under section 12 and then also any corporation required to file reports under section 15 of the act. And so, most notably, this picks up corporations that issue publicly traded debt that are required to file reports under the Exchange Act. So, you can have one group of affiliated companies with multiple publicly held corporations in them and each publicly held corporation has it's own set of covered employees and for many affiliated groups, this can significantly expand the number of individuals who are treated as covered employees subject to the deduction **length (20:57).** Renata, I think you were going to talk about some mechanics here.

Renata Ferrari: Sure, so you have all these people, more than you had before. What do you do, right, and sort of how do you track them all? I think a lot of companies, hopefully all of you if your public, have your list of specified employees, your top 50, and you do that every year. The 162(m) list is basically, I think once you're on you never come off, sort of like the Hotel California. But so, you go on, I mean you'll come off if there's no more payments to you, but you will go on that list and so, you know, basically if you have ever been a covered employee starting as of 01/01/17, so there's a question, you know, if you're in one year and you come out, at least under the proposed rules, and I don't think this will change, you're a covered employee for, you know, the rest of the time you're receiving payments from the company.

So, you're going to have to keep track of anyone who is a covered employee for any fiscal year and once you go on that list, you'll stay on that list. For smaller reporting companies and EGCs, the rules basically make these companies determine their covered employees as if they were subject to the disclosure rules applicable to non-smaller reporting companies. So, you know, for a smaller reporting company or EGC, you typically only have three NEOs but effectively, and this could be the case with also non-smaller reporting companies but the group of covered employees is going to be broader than the group of employees that you provide disclosure for.

And so, I don't know how many companies are actually going through it now and saying, "Who would our top five be if we were subject to rules that we're not currently subject to?" But, you know, that's an extra exercise for these companies to determine who their covered employees are. So, if you think that's sort of hard enough and too much of a pain, the other thing that's going to be difficult, at least for some companies, not difficult but basically just add another administrative burden is the way the 162(m) proposed regulations work is that you look at the public company and any of it's predecessors.

So, if you work in a company that's inquisitive, so you're a public company that likes to buy up a bunch of other public companies, your list of covered employees are not only your covered employees, your own companies covered employees, but the covered employees of the target company you bought, if you bought that company and the stock dealer bought more than 80 percent of its assets, and let's just say that target company was just like you and really liked to do a lot of transactions, you will be inheriting their covered employees which may not just be their covered employees.

So, for a public company that is very inquisitive, your list of covered employees can be quite long. Now, at some point, people will go off the list, right, if they terminate employment, they're not receiving any more payments from the company, they'll go off the list. But at least for a while there may be a significant number of people on that list and people for whom you would have thought there would be no limit on the deductibility of their compensation because they never touched your summary compensation table but there may be limitations on the deductibility of their compensation. Rob, do you want to talk about…

Rob Neis: Sure.

Renata Ferrari: **_____ (24:32)** come back?

Rob Neis: Yeah, sure. So, be careful about taking people off the list too quickly because again the rule is once a covered employee, always a covered employee. So, even covered employees who terminate employment and who come back at a later time, either as employees or even as independent contractors, are still treated as covered employees. Interesting though, the proposed rules take the position that if a covered employee comes back again as an independent contractor, they use most frequently the example of a director but I think they make it clear it applies even in other context. The payments they receive as independent contractors from the company are still subject to these deduction limits and I think that's an important thing to keep in mind. Mike?

Mike Melbinger: Okay. We're close to the end but we started late so I understand we've been given a little extra time and one of the last items we'll talk about then is how much to disclose about lost deductions on your proxy statements or whether to address the issue at all. This is an evolving topic as best practices tend to evolve. Of course, we've got **402(b)(212) (25:57)** that requires, or I should say provides that for the CD among the material elements of compensation that could be discussed is the impact of accounting and tax treatments on particular forms of compensation.

That's a little vague. I guess a company could say that we pay no attention to the deductibility rules, which frankly I think is a bit of the position we're in now. Everybody's not getting their deduction because of the changes to 162(m) so they're just not worrying about it. However, you know, that's kind of a short answer. I will say, immediately after these rules came out, or I should say after really the deduction, the performance-based exception was repealed, we at compensationstandards.com and others had sort of urged for more fulsome disclosure on the impact of 162(m) such as what is the amount of lost deduction we experienced, the company, for the compensation we pay.

I have to say, I haven't seen that occurring. I would have thought, perhaps, investors would demand it, ISS would demand it, but they haven't. At least not that I've seen. Maybe one of you two have seen it? I've not seen it and it's a little difficult to encourage clients to do it when no one else is doing it, so I have not been doing it. Either of you two? Renata? Rob?

Renata Ferrari: I have not seen that. My pipe dream is to just take out the tax disclosure because it's not a required element so it's one of those optionals if it's material. For most companies, it's no longer material. When we're looking at comp. committee books, they're not including the loss deduction, you know, in terms of the compensation that they're paying. I'm not saying someone isn't looking at it, at the company; I'm sure there are many people looking at it. But it's not a material element, at least of the decisions that are, the compensation committee is making, at least in my experience.

So, in an ideal world, I would take it out, but I can't say I've seen that many companies that have done it and I'm not sure if I'm brave enough to do it. But, right now, as it stands, it's sort of not even about 162(m), it's more a lot of them are performance-based compensation is really important to us and even though the deduction, the availability of a deduction for it is no longer there, we still pay it and it's, you know, we will continue to pay it. So, it's sort of morphed a little bit from tax anyway to just generally just because 162(m) doesn't give us a benefit for including, for doing this, we're still doing it. And so, it's a little, it's not quite as responsive in any event.

Rob Neis: My experience has been the same as both of yours.

Mike Melbinger: Okay, I guess what we do see, of course, is companies that have grandfathered amounts preserved are taking great care to preserve those and they are disclosing that. But since the big boss is here, I think maybe we're done.

Speaker1: Well, I don't know about that, but I know people, at least, depending on their time zones might be getting hungry for lunch so, thank you all. Thank you, Renata, Mike, and Rob for making a technical subject a little bit more easy to understand, I appreciate that and I just want to remind everyone before we break about the course materials. If you haven't already opened those which are under the "more" tab, you might want to use those to follow along and refer back to them after the conference.

Remember, those are only available to conference attendees so make sure to take advantage of them and, of course, for resources on proxy disclosure and executive compensation, you should also definitely take advantage of what we offer on the CorporateCounsel.net and CompensationStandards.com. That includes our proxy disclosure treatise which we just printed and we will be updating that with an eBook supplement this winter for the changes to Reg S-K and if they're adopted this Wednesday, the Rule 14a-8 Amendments as well as our Executive Compensation Disclosure Treatise, which we just sent to the printer, and that's full of tips on navigating both the tabular and narrative disclosure about executive compensation.

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