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Post-Tax Reform Strategy for Public Company Executive Compensation

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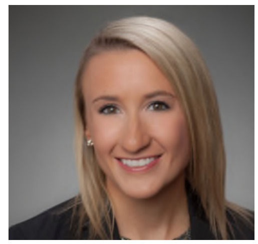
Today's Speakers



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Agenda

- Overview of Code Section 162(m) Prior to Tax Cuts and Jobs Act Changes
- Changes to Code Section 162(m)
- Practical Strategies for Maximizing Deductions under new Code Section 162(m) rules and Other Considerations

Pre-Tax Reform Section 162(m)

- Recently enacted Tax Cuts and Jobs Act (the "Act") significantly modifies a publicly-traded company's ability to deduct executive compensation
- Prior to the Act:
  - Covered companies included only publicly-traded companies
  - Covered employees included only the:
    - CEO and the 3 highest compensated officers (other than CFO)
    - As reported in summary compensation tables per SEC rules
    - Employed on the last day of the company's taxable year

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Pre-Tax Reform Section 162(m)

- Prior to the Act:
  - A covered company's deduction was capped at $1 million per covered employee per fiscal year
  - Qualifying performance-based compensation and commissions did not count against $1 million limit

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Pre-Tax Reform Section 162(m): Elements of Performance-Based Compensation

- Pre-established and objective performance goals (other than options/SARs, which are inherently performance-based)
- Set by Compensation Committee made up of independent directors
- Pursuant to shareholder-approved plan
- Attainment of goals certified by Compensation Committee

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Pre-Tax Reform Section 162(m): Application of the $1 Million Deduction Limit

CEO Compensation For FY 2017

(FY18 for Non-Calendar Year Companies)

Compensation Type	Amount	Performance-Based Exclusion
Base Salary	$750,000	n/a
Performance Incentive Bonus	$1,500,000	$1,500,000
Option Exercise	$2,200,000	$2,200,000
Restricted Stock Vesting – time based vesting	$650,000	n/a
Taxable Perquisites	$15,000	n/a
Total Compensation **(Less Performance-Based Amount)**	$5,115,000 ($3,700,000) $1,415,000	$3,700,000
Nondeductible Amount in Excess of $1M	**$415,000**	

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Post-Tax Reform Section 162(m): What Has Changed

- Effective for company FY beginning on or after January 1, 2018, the Act makes the following changes to Code Section 162(m):
  - Expands companies subject to new rules
  - Expands who is a covered employee
  - Eliminates the exception for performance-based compensation
  - Adds an exemption for compensation payable under “grandfathered arrangements”

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Post-Tax Reform Section 162(m): What Has Changed

- Definition of Covered Company
  - Old: Corporations with publicly-traded equity
  - New: Corporations with publicly-traded equity and any company required to file reports under Section 15(d) of the Securities Exchange Act of 1934
    - Pulls in issuers of American Depository Receipts and other foreign issuers, companies with publicly-traded debt
    - Does not pull in voluntary filers

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Post-Tax Reform Section 162(m): What Has Changed

- Definition of Covered Employee
  - Old: CEO plus top 3 officers by pay, determined on last day of fiscal year
    - CFO excluded
    - Former employees excluded
  - New: Any employee who was the CEO, the CFO or a top 3 officer by pay any time in fiscal years beginning after December 31, 2016
    - Once a covered employee, always a covered employee
    - Pulls in compensation paid to a covered employee after termination of employment

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Post-Tax Reform Section 162(m): What Has Changed

- Elimination of Performance-Based Compensation and Commissons Exception (unless grandfathered)
  - Old: Performance-based compensation and commissions not counted toward the $1 million limit on deductible compensation, always deductible
  - New: Performance-based compensation and commissions exception eliminated, all taxable compensation counts toward the $1 million dollar limit on deductible compensation

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Post-Tax Reform Section 162(m): What Has Changed

- Addition of Grandfathering Rule
  - Changes will not apply to compensation payable pursuant to a written binding contract that
    - Was in effect on November 2, 2017, and
    - Is not materially modified after that date

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Post-Tax Reform Section 162(m): Application of Grandfathering Rule

- Currently, very little guidance on what constitutes a written binding contract or a material modification
- New rules could be similar to grandfathering rules that were applied when Section 162(m) was enacted
  - Grandfathering lost on the date an arrangement could be unilaterally amended or terminated by the company
  - Grandfathering lost as of the date of renewal if either employee or company can elect not to renew
  - Grandfathering lost upon amendment to increase compensation or accelerate or delay payment

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Post-Tax Reform Section 162(m): Application of Grandfathering Rule

- Identify Arrangements and Amounts that May Be Grandfathered
  - Identify contracts in effect on November 2, 2017 that call for payments that would have been excluded from 162(m):
    - Employment, severance, change in control and retention agreements
    - Performance-based equity awards (*e.g.*, options, performance shares, performance share units) and incentive bonus plans
    - Nonqualified plans, deferred compensation plans, SERPs

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Post-Tax Reform Section 162(m): Application of Grandfathering Rule

- Determine Whether Payment Obligations are "Binding"
  - Can company unilaterally amend or terminate the contract?
  - Is payment subject to company discretion to reduce or eliminate?
  - When does contract expire/renew?
- Determine deferred compensation balance and SERP accruals as of November 2, 2017

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Post-Tax Reform Section 162(m): Application of Grandfathering Rule

- Be Aware of Open Issues
  - If parties may agree to terminate an arrangement it could be viewed as nonbinding
  - All binding CFO obligations may be exempt, even if not performance-based – e.g., salary guaranteed under grandfathered employment agreement
  - Treatment of earnings on grandfathered amounts (e.g., SERPs, deferred compensation) unclear
- Consult Your Lawyer Before Making Any Changes
  - New agreements can result in loss of grandfathering of other agreements– *e.g.*, full vesting of equity awards under a severance agreement will cause the awards to lose grandfathering
  - Right choice may be to make a change but it should be an informed choice

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Post-Tax Reform Section 162(m): Identification of Covered Employees

- Once a Covered Employee, Always a Covered Employee
  - Identify the company's "top three" for fiscal years beginning after December 31, 2016
  - Keep an ongoing list of covered employees and their compensation arrangements
  - Consider impact of one-time payments or awards that could bump an employee into the top three for one year
  - Consider possible impact of naming interim CEO or CFO (will remain covered employee forever)

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Post-Tax Reform Section 162(m): Application of the $1 Million Deduction Limit Example 1

CEO Compensation for FY19

Compensation Type	Amount	Grandfathered Exclusion
Base Salary	$750,000	n/a
Performance Incentive Bonus	$1,500,000	n/a
Option Exercise – grandfathered	$1,600,000	$1,600,000
Option Exercise – nongrandfathered	$600,000	n/a
Restricted Stock Vesting	$650,000	n/a
Taxable Perquisites	$15,000	n/a
Total Compensation **(Less Grandfathered Amount)**	$5,115,000 ($1,600,000) $3,515,000	$1,600,000
Nondeductible Amount in Excess of $1M	**$2,515,000**	

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Post-Tax Reform Section 162(m): Application of the $1 Million Deduction Limit Example 2

Former CEO Compensation for FY20

Compensation Type	Amount	Grandfathered Exclusion
Severance Pay	$ 1,000,000	n/a
Performance Incentive Bonus	$ 750,000	n/a
Option Exercise - Grandfathered	$1,200,000	$1,200,000
Option Exercise – Nongrandfathered	$ 500,000	n/a
Deferred Comp Payout - Grandfathered	$4,600,000	$4,600,000
Deferred Comp Payout - Nongrandfathered	$ 375,000	n/a
Total Compensation **(Less Grandfathered Amount)**	$8,425,000 ($5,800,000) $2,625,000	$6,800,000
Nondeductible Amount in Excess of $1M	$1,625,000	

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Practical Application: The Silver Lining?

- Companies will have more freedom in designing executive compensation programs
  - Performance pay could be based on goals that aren't "objectively determinable and pre-established"
  - Independent compensation committee members don't have to approve performance pay (but companies will remain subject to NYSE and NASDAQ listing standards and Securities Exchange Act Section 16(b) rules on director independence)
  - Positive adjustment of performance pay is permitted – *e.g.*, could increase incentive bonus based on subjective criteria
  - Severance or retirement payout of bonuses could now automatically be at target or a predetermined amount rather than based on actual performance

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Practical Application: The Silver Lining?

- Could forego performance bonuses altogether and simply pay additional salary (*a la* Netflix)

BUT

- Many companies will still want to utilize performance compensation to
  - Properly incentivize executives
  - Respond to ISS and other shareholder advisory firm concerns

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Practical Application: The Silver Lining?

- In general, companies will no longer have to obtain shareholder approval of equity and incentive plans every five years (but will still need shareholder approval for reservation of additional shares to plan and other changes)
- Decrease in the corporate tax rate minimizes impact of lost deduction

Practical Application: Strategies for Maximizing Deductions

- Spreading payments out over time
  - Amend deferred compensation plans to only allow installment distributions of future accruals or to cap annual distributions of future accruals at a certain dollar amount
  - Apply longer vesting periods to equity awards
  - Cap option and stock appreciation right exercise value per year
  - But, spreading out vesting can have negative impact

Practical Application: Strategies for Maximizing Deductions

- Control your company's top three
  - Structure payments so that executives aren't bumping into the top three for just one year
  - Consider timing of taxation of equity awards and option/SAR exercises

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Other Considerations

- Review equity plan and analyze whether 162(m) provisions will be needlessly restrictive
  - Award limits
  - Performance goals
- Educate your compensation committee and impacted executives (rationale for changes to plans/grants, etc.)

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Questions?

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Thank You

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