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The Impact of COVID-19 on Executive Compensation

ISS and Glass Lewis Implement COVID-19 Policy Changes

New Proposed Regulations under Internal Revenue Code Section 162(m)

A Word from the Editor

The COVID-19 pandemic has had a wide-ranging impact on our daily lives, and we are all hopeful that we will soon see the light at the end of the tunnel. In the meantime, many public companies have found themselves in the midst of an extremely volatile stock market and a very challenging economic environment, with little clarity as to when and how overall public health and business conditions will improve. The resulting uncertainty has caused public companies to evaluate many aspects of their business and operations, including executive compensation.

Beginning on pg 2, we discuss the impact of COVID-19 on annual equity grants, including the effect of the crisis on issues such as grant timing, grant pricing, long-term incentive targets, repricing, sell-to-cover transactions and employee messaging.

We next turn to how COVID-19 is affecting annual bonus programs. Beginning on pg 4, we address the impact on setting and evaluating performance targets given the significant level of uncertainty brought about by the pandemic and the measures taken to control the spread of COVID-19.

On pg 5, we address the extent to which ISS and Glass Lewis have revisited various policies during the 2020 proxy season due to the impact of the COVID-19 pandemic.

Shortly before the COVID-19 pandemic began to dominate the headlines, the IRS released much anticipated proposed regulations on the changes to Internal Revenue Code Section 162(m) that were made by the Tax Cuts and Jobs Act of 2017. Beginning on pg 6, we address the details of those proposed regulations and the key considerations for companies.

As we navigate these troubled times, we hope our readers are staying safe and healthy, and we all look forward to more peaceful and coronavirus-free days ahead.

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The Impact of COVID-19 on Executive Compensation

The COVID-19 pandemic had a swift and volatile impact on business operations and the financial markets. The crisis arising from COVID-19 and the efforts taken to prevent its spread occurred simultaneously with the annual incentive award cycle of many companies, forcing companies to address incentive setting and employee retention in a rapidly changing environment.

Annual Equity Grants

Grant Timing. Companies making equity grants in 2020 have considered delaying their annual grants, particularly if company practice has been to make grants based on the grant date fair value of the awards (as opposed to awards over a fixed number of shares). Before taking such an action, companies should review their prior SEC disclosures, grant policies and plan terms to determine whether there are any contractual restrictions on grant timing or whether they have made past public statements on grant timing policy. Any plan amendments that impact awards to executive officers or directors may trigger Form 8-K reporting. Even if no mandatory Form 8-K is triggered, companies may consider voluntarily disclosing grant timing changes.

Delaying grants may be most appropriate in the case of multi-year performance awards and may ultimately preserve the number of shares available for grant over the life of the relevant equity plan. However, delaying grants may be de-motivating to employees at a time of substantial uncertainty and increased commitment. Companies should carefully craft related employee communications to emphasize the importance of, and explain the reasoning behind, any changes in equity grant cadence.

Some boards and compensation committees—particularly those that have weathered significant prior business disruptions—may choose to stay the course and not delay grants. Proceeding with the typical annual grant timing could, when judged in hindsight, create the impression that management received an unjustified windfall, because equity grants were made when the company's share price was artificially (and temporarily) low. Shifting the grant timing could alleviate some of that pressure, but it could also exacerbate it given current uncertainties. An alternative to consider is staggering the annual equity grant to be made over the year (i.e., semi-annually or quarterly) to reduce the effects of continuing market volatility and supply chain disruption.

Grant Pricing. Related to the issue of grant timing, given the volatility of the market generally, companies that make grants based on the grant date fair value of the awards using a spot price (such as a daily closing price) may want to consider instead using a trailing average price to avoid anomalous pricing on an extreme up or down market day. Publicly traded companies should keep in mind that "fair market value" for establishing stock option exercise or strike prices may not be determined by a trailing average of more than 30 consecutive trading days in order for the options to be exempt from Section 409A of the Internal Revenue Code. For equity awards other than stock options, we recommend companies think about using a longer period (for instance, 60 or 90 days) when setting the trailing average. Companies considering this approach should ensure the governing plan documents allow for alternate valuation methodologies. Companies should also consult with their auditors to understand the accounting impact of any proposed changes.

Other Innovative Design Features. To address the challenge of making grants when business operations and share prices are changing drastically from day to day, companies might consider more novel approaches to their award design for 2020. In addition to the timing and pricing considerations already mentioned, equity grant practice tweaks could include revisiting the mix of equity awards (percentage of full share awards vs. options), performance award minimum and maximum payout ranges and levels of discretionary authority for compensation committees and boards to adjust payouts at the end of vesting periods.

<u>Long-Term Incentive Targets.</u> Setting multi-year performance targets is always challenging, but it is much more so in 2020. Companies may consider delaying setting long-term performance award targets until the market is somewhat less volatile, while proceeding with other incentive components. If companies choose to set long-term performance targets now, they may consider using relative as opposed to absolute performance metrics and providing the plan administrator with sufficient discretion to adjust awards when ultimately determining achievement levels.

After tax reform was passed in late 2017, the limitations of Section 162(m) of the Internal Revenue Code regarding adjustments to performance targets no longer create an obstacle to such changes for new awards, as all compensation in excess of $1 million is no longer deductible, thus allowing for additional flexibility without causing negative tax effects. However, companies should avoid letting too much of the applicable performance period go by before goal setting. In addition, companies should review plan documents to confirm plans do not still have adjustment restrictions, even where the award is not intended to qualify under Section 162(m). If the board or compensation committee is thinking of adjusting long-term incentives granted in prior years, consideration should be given to the plan terms regarding adjustments, whether they are grandfathered for Section 162(m) purposes, and the accounting and disclosure ramifications of any changes, which should be balanced against the overhang of the awards and their reduced retentive value. In some cases, it may be more beneficial to terminate longer-term awards and replace them with new grants with more achievable long-term targets.

<u>Repricing.</u> Stock options can pose particular challenges, given the potential for drastic spreads and the risk of outstanding options going "underwater." After a long bull market, we may begin to see a resurgence in discussions regarding option repricing, which would revive issues last considered broadly during the 2008 financial crisis. Repricing requires shareholder approval under applicable listing rules, unless a company's equity compensation plans explicitly permit it, which is rare at present. Additionally, repricing is disfavored by proxy advisory firms and institutional investors.

<u>Dilution.</u> As share values decline, authorized share plan pools may deplete dramatically because grant sizes will necessarily increase as a consequence. For those companies that have not yet filed their proxy statements for this year's annual meeting, consider whether to include a proposal to amend equity plans to account for higher than expected burn rates. As the effects of COVID-19 unfold, later this year, we may see an increase in equity grants made contingent upon subsequent shareholder approval and special shareholders' meetings to approve new plans, increases in authorized share pools and repricing of outstanding awards. Companies should review their equity plans if they have upcoming automatic grants—for example, shareholder approved formula director compensation grants—to confirm there are sufficient shares remaining to make these awards.

<u>Sell-to-Cover Transactions.</u> Market volatility can also pose a challenge to ordinary sell-to-cover transactions as awards vest and settle. For example, take a restricted stock unit that vests and settles on a Friday (when the employer's stock closes at $10). The tax due is calculated based on the price on the settlement date, but the market sales to cover the withholding obligation do not occur until the trading day on Monday (at a time when the stock drops to $7 in intraday trading). When such drastic market swings occur, the broker must sell significantly more shares to raise sufficient funds to settle the tax liability. In times of significant market volatility, companies might consider moving away from broker-assisted sell-to-cover programs for tax withholding and instead use company net share

settlement or withhold from other income of the award holder, if possible. Note that companies should maintain consistency with past practice in determining the date on which awards are valued for tax purposes, and should review their plan documents to ensure compliance.

Employee Messaging. Employee messaging is particularly important in times of anxiety and uncertainty. Management should consider what information employees receive about operations, disruption and workplace policies, as well as compensation, with greater than typical sensitivity. Care should be taken in how that information is delivered, and employers should ensure that employees understand why any changes are being made and how the company's interests are being protected.

Annual Bonus Programs

Setting annual performance targets in this rapidly evolving landscape has been more challenging than under ordinary circumstances. Companies sponsoring annual bonus plans fall into two categories at this point: those that have already set their annual performance targets for 2020, and those that have not yet taken action.

What if Performance Targets Have Already Been Set? Those companies that have already set performance targets under their annual bonus programs may be considering appropriate and necessary adjustments to targets in light of the COVID-19 outbreak and its impact on businesses worldwide. Without making adjustments, companies may render their annual incentive programs fruitless in terms of providing employees with much needed motivation, a sense of possibility of achievement of pre-established goals and retentive hooks. However, adjusting targets too soon may necessitate further adjustments as the impact of COVID-19 on the business is evaluated. Any adjustments should be made in compliance with the applicable plan documents and in consultation with the company's auditors. Another alternative would be for the board or compensation committee to consider setting new and additional shorter-term goals (such as quarterly goals) relating to COVID-19 response and recovery targets while longer-term impacts on a business remain uncertain.

What if Performance Targets Have Not Yet Been Set? For companies that have not yet acted on their annual performance targets, boards and compensation committees should consider delaying until more is known about the impact of COVID-19. Boards and management may wish to maintain focus on business continuity and emergency preparedness, rather than trying to predict potential outcomes under incentive programs at this time. In addition to the changes on performance target adjustments noted above, the amendments to Section 162(m) allow for more flexibility in the timing of performance target setting. Previously, Section 162(m) required targets to be set within a certain period (for instance, annual targets had to be set by March 31 for calendar year companies) in order for the related compensation to qualify as "performance based," and therefore be deductible by the employer when paid. Nonetheless, compliance with plan terms, accounting impact and employee reactions should be kept in mind when determining how long to delay target setting.

If companies choose to proceed and to set annual performance targets, they may consider using relative as opposed to absolute performance metrics to account for uncertain conditions. Companies can also consider individual performance metrics that tie, for example, to effective crisis response. Alternatively, or in conjunction, companies should take steps to provide the plan administrator with sufficient discretion to make adjustments to annual bonus targets. All discretion should be circumscribed as tightly as possible to outline when it can (and cannot) be applied to better align employee and shareholder expectations, and to ensure that investors will view the compensation derived as performance based. Boards and compensation committees should receive updated information throughout the year on the business—such as revenue, inventory, supply chain, human capital issues and geographic disruptions—to ensure that any discretion is thoughtfully applied at year end.

Next Steps

Boards and management teams should consult with their legal, tax and accounting advisors before making any decisions regarding changes to their approach to equity and incentive compensation. Further, all actions should be taken with a mindful eye on the potential reactions of all constituents: shareholders, proxy advisors, activist investors and especially employees. To that end, shareholder engagement efforts, in particular during the 2021 proxy season, with respect to say-on-pay voting and whether additional shares will be needed under equity plans, should be considered.

We thank Doreen Lilienfeld of Shearman & Sterling for providing these insights regarding the impact of COVID-19 on executive compensation.

ISS and Glass Lewis Voting Policy Changes Due to COVID-19

ISS and Glass Lewis revisited aspects of their voting guidelines and policies given the circumstances arising from the COVID-19 pandemic. ISS recognized that it needed to apply its policies during the 2020 annual meeting season with understanding and flexibility, and adjusted its approach as noted below:

- If boards decide to hold virtual-only annual shareholder meetings, ISS encourages them to disclose the reason for their decision and to strive to provide shareholders with a meaningful opportunity to participate as fully as possible, and boards are also encouraged to commit to return to in-person or hybrid meetings (or to put that matter to shareholders to decide) as soon as practicable;
- ISS will generally consider both the board's explanation for its adoption of a shareholder rights plan (also known as a "poison pill"), including any imminent threats, as well as the specific provisions, such as the triggers, terms, qualified offer provisions and waivers for passive investors, noting that a severe stock price decline as a result of the COVID-19 pandemic is likely to be considered valid justification in most cases for adopting a shareholder rights plan of less than one year in duration;
- With respect to director participation in board and committee meetings, ISS acknowledges that SEC disclosure rules count electronic participation as full participation in board and committee meetings; however, ISS encourages companies to provide shareholders with adequate information to allow them to make informed judgments about directors' absences from board and committee meetings;
- If boards need to fill vacancies due to the disability or incapacity of a director or need to urgently add critical expertise due to the COVID-19 pandemic, ISS will consider such changes on a case-by-case basis and ISS will adjust the application of its policies as appropriate for the exceptional circumstances arising from COVID-19;
- ISS encourages boards to provide contemporaneous disclosure to shareholders of their rationales for making compensation changes, and, with respect to long-term compensation plans, ISS will evaluate midstream changes to awards that cover multi-year periods on a case-by-case basis;
- ISS applies its case-by-case approach to option repricing;
- ISS supports broad discretion for boards

that seek to set dividend payout ratios that fall below historic levels or customary market practice;

- ISS will generally continue to recommend in favor of share repurchase authorities within customary limits; however, the board's actions related to repurchases will be reviewed in 2021 "to consider if the directors managed risks in a responsible fashion for any repurchases undertaken under the authority;" and
- ISS will continue to apply its case-by-case approach to capital-raising proposals.

Like ISS, Glass Lewis adapted its policy approach in light of the COVID-19 pandemic. Glass Lewis indicates that it expects "all governance issues and most proposal types to be impacted by the pandemic and we will exercise our existing discretion and pragmatism to prioritize timing, certainty, disclosure and voting on any affected proposals."

For the period March 1, 2020 through June 30, 2020, Glass Lewis considers the extenuating circumstance of the COVID-19 pandemic when applying its policy on virtual-only shareholder meetings. Glass Lewis reviews virtual-only shareholder meetings on a case-by-case basis and has noted whether companies state their intention to resume holding in-person or hybrid meetings under normal circumstances. During this period, Glass Lewis "will generally refrain from recommending to vote against members of the governance committee on this basis, provided that the company discloses, at a minimum, its rationale for doing so, including citing COVID-19."

With regard to shareholder rights plans, Glass Lewis acknowledges that it remains generally skeptical of shareholder rights plans, and notes that current policy is designed to apply a "nuanced, contextual assessment of these provisions." Glass Lewis indicates that, during the COVID-19 pandemic, its contextual approach ensures that the firm "can apply the appropriate discretion and pragmatism to prioritize timing, certainty, disclosure and voting on such proposals."

New Proposed Regulations under Internal Revenue Code Section 162(m)

On December 20, 2019, the IRS released proposed regulations on the changes to Code Section 162(m) made by the Tax Cuts and Jobs Act of 2017 ("TCJA"). The proposed regulations follow up on Notice 2018-68 (the "Notice"), by which the IRS provided guidance on these issues last summer. As we feared, but expected, it is mostly bad news. That is, the proposed regulations confirm most of the unfavorable interpretations of the Notice and add even more. However, there are a few bits of good news in the 129 pages of dense reading.

Definition of Covered Employee

The proposed regulations clarify that a covered employee for any taxable year means any employee who is among the three highest compensated executive officers for the taxable year, regardless of whether he or she is serving as an executive officer at the end of the publicly traded corporation's taxable year, and regardless of whether the executive officer's compensation is subject to disclosure for the last completed fiscal year under the applicable SEC rules.

The proposed regulations also clarify that, if after separation from service as an employee, a former covered employee returns to provide services to the corporation in any capacity, including as an employee, director or independent contractor, then any deduction for compensation paid to the covered employee is subject to the deductibility cap of Section 162(m). Compensation paid to a covered employee (i) other than as an employee (*e.g.*, as a director or consultant) or (ii) by a related partnership, is included. This interpretation of the definition of compensation subject to the deduction limitation is unfavorable and had not been included in the Notice.

Predecessor Corporation/Entity. Any individual who was a covered employee of the corporation (or any predecessor of the corporation) for any preceding taxable year beginning after December 31, 2016, remains a covered employee subject to 162(m) forever. (For taxable years beginning prior to January 1, 2018, covered employees are identified in accordance with the pre-TCJA provisions of 162(m).) An individual who was a covered employee of a corporation subject to 162(m) — a "predecessor corporation" — will remain a covered employee or again be treated as a covered employee of a successor corporation that is subject to 162(m). A "predecessor corporation" is one that:

- Was a publicly traded corporation subject to 162(m) and became part of an affiliated group that is subject to 162(m);
- Was a publicly traded corporation subject to 162(m), became privately traded, but then, within 36-months of the end of the year for which it was last publicly traded, again became a publicly traded corporation subject to 162(m);
- Was a publicly traded corporation subject to 162(m), which then was acquired by a privately traded corporation, if the private company then becomes a publicly traded corporation within 36 months of the acquisition;
- The stock or assets of which were acquired by a publicly traded corporation subject to 162(m) in a Section 368(a)(1) corporate reorganization;
- Was spun-off to the shareholders of a publicly traded corporation subject to 162(m) in a distribution or exchange qualifying under Section 355(a)(1) (but only with respect to covered employees of the distributing corporation who perform services for the spun-off corporation within 12 months before or after the distribution);
- Was a publicly traded corporation subject to 162(m), when another corporation subject to 162(m) acquired at least 80% of its operating assets (but only with respect to covered employees of the target who perform services for the acquirer within the period beginning 12 months before or after the date of the transaction); or
- Is a PTP that would be a predecessor of a publicly traded corporation subject to 162(m) if under the same facts and circumstances, a corporation substituted for the PTP would be a predecessor of the corporation subject to 162(m).

Definition of Applicable Employee Remuneration

Code Section 162(m)(4) defines the term "applicable employee remuneration." Before the TCJA, applicable employee remuneration did not include remuneration payable on a commission basis or performance-based compensation. The TCJA amended the definition of applicable employee remuneration to eliminate these exclusions, and added a special rule for remuneration paid to beneficiaries. For simplicity, the proposed regulations generally use the term "compensation" instead of "applicable employee remuneration."

The proposed regulations also confirm that any amounts paid to a beneficiary of a deceased covered employee following the covered employee's death would continue to be subject to Section 162(m).

Grandfather Rules

The TCJA explicitly provides that "The amendments made by this section shall not apply to remuneration which is provided pursuant to a written binding contract which was in effect on November 2, 2017, and which was not modified in any material respect on or after such date (hereafter, a "Grandfathered Contract"). The Notice had suggested the narrowest possible application of this "grandfathering" language.

The proposed regulations elaborate on the "written binding contract" determination, which could allow a corporation to take limited advantage of the pre-TCJA Section 162(m) rules. In general, compensation is grandfathered only to the extent that, as of November 2, 2017, the corporation was obligated to pay, under applicable law, the compensation if the covered employee performed services or satisfied the applicable vesting conditions, further subject to the requirement that the contract not be materially modified on or after that date. The proposed regulations clarify key aspects of the "written binding contract" and "material modification" concepts.

Favorable to companies, but not included in the Notice, if amounts are paid to a covered employee from more than one Grandfathered Contract (or if a single written document consists of several Grandfathered Contracts), then a material modification of one written binding contract *does not* automatically result in a material modification of the other contracts unless the material modification affects the amounts payable under those contracts.

The deduction limits of Section 162(m) apply to compensation earned by an employee *before* he or she became a covered employee. Therefore, the grandfathering rules are critical to all business entities.

<u>Discretion and Performance-Based Pay.</u> In accordance with pre-TCJA Section 162(m), many performance-based compensation plans and agreements included the discretion to reduce (but not increase) payouts of incentive compensation such as annual performance bonuses and performance share awards. The Notice suggested that the existence of such discretion could reduce or even eliminate the amount of compensation that a corporation is obligated to pay pursuant to a Grandfathered Contract under the grandfathering provisions.

Given that the existence of negative discretion provision in compensation plans and agreements was attributable to compliance with the pre-TCJA Section 162(m) performance based pay rules, executive compensation professionals urged that, consistent with fairness and common sense, these negative discretion provisions generally be disregarded in determining the amount of compensation a corporation is obligated to pay pursuant to a written binding contract. Unfortunately, the proposed regulations did not adopt this approach.

However, the preamble to the proposed regulations includes an interesting and potentially helpful statement. "The Treasury Department and the IRS are aware, however, that compensation arrangements may purport to provide the corporation with a wider scope of negative discretion than applicable law permits the corporation to exercise. In that case, the *negative discretion is taken into account only to the extent the corporation may exercise the negative discretion under applicable law."* [Emphasis added.] Therefore, some performance-based awards that reserve to the board or compensation committee the right to reduce individual or group payouts below the target levels achieved still may be protected by the grandfathering provisions of the statute.

<u>Renewal and Termination Issues.</u> If a Grandfathered Contract i*s renewed* after November 2, 2017, the limit applies to any payments made after the renewal. A written binding contract that is terminable or cancelable by the corporation *without* the employee's consent after November 2, 2017, is treated as renewed as of the earliest date that any such termination or cancellation, if made, would be effective. Thus, for example:

- If the agreement provides that it will be automatically renewed or extended as of a certain date *unless either the corporation or the employee* provides notice of termination of the contract at least 30 days before that date, the contract *is treated as renewed as of the date that termination would be effective if that notice had been given*.

- If the agreement provides that the contract will be terminated or canceled as of a certain date *unless* either the corporation or the employee elects to renew within 30 days of that date, the contract is treated as renewed by the corporation as of that date (unless the contract is renewed before that date, in which case, it is treated as renewed on that earlier date).
- However, if the corporation will remain legally obligated by the terms of a contract beyond a certain date *at the sole discretion of the employee*, the contract will not be treated as renewed as of that date if the employee exercises the discretion to keep the corporation bound to the contract.
- Additionally, a contract is not treated as terminable or cancelable if it can be terminated or canceled *only by terminating the employment relationship of the employee*. A contract is not treated as renewed if, upon termination or cancellation of the contract, the employment relationship continues but would no longer be covered by the contract. However, if the employment continues after such termination or date, payments with respect to such post-termination or post-cancellation employment are not made pursuant to the contract (and, therefore, are not grandfathered amounts).

The proposed regulations confirm that an increase in salary does not constitute a material modification of Grandfathered Contract if it is less than or equal to a reasonable cost-of-living increase. The proposed regulations provide an example in which an increase of $40,000 to a salary of $1,800,000 is less than a reasonable cost-of-living increase and, therefore, is not a material amendment, but an increase of $560,000 exceeds a reasonable, annual cost-of-living increase, and is a material modification (assuming 3% is a reasonable rate of interest for this period). The deduction for the $40,000 increase would be subject to the deduction limit, but the $1,800,000 would not. However, the material modification to the Grandfathered Contract ends its grandfathered status, which means that *all* salary paid to the covered employee after the modification is subject to the $1 million deduction limit.

In addition, the failure, in whole or in part, to exercise negative discretion under a contract does not result in the material modification of that contract.

The proposed regulations confirm that the adoption of a supplemental contract or agreement that provides for increased compensation, or the payment of additional compensation, would be a material modification of an otherwise Grandfathered Contract if the facts and circumstances demonstrate that the additional compensation to be paid is based on substantially the same elements or conditions as the compensation that is otherwise paid pursuant to the Grandfathered Contract. For example, in the case of a Grandfathered Contract with a CFO providing for salary, if the corporation were to add a separate agreement promising to pay the CFO an additional $20,000 per month, IRS could view this as a supplemental agreement to increase salary, which would be a material modification and end the grandfathering protection. As in other cases, a cost-of-living increase over the payment made in the preceding year under the Grandfathered Contract would not be a material modification and would not end the grandfathered status of all the salary.

Finally, the proposed regulations clarify that employment agreements in effect as of November 2, 2017, which contain evergreen renewal provisions subject to notice of non-extension by the employer, will be deemed to be renewed, and thus materially modified, as of the earliest date that any such notice of non-extension would be effective, unless termination of the contract also results in termination of the employment relationship.

Grandfathering Provisions for Non-Qualified Plans. For most companies, the accrued benefits and accounts under a non-qualified deferred compensation plan or SERP ("NQ Plans") are the amounts and payments very likely to qualify for grandfathering protection. An NQ Plan in effect on November 2, 2017, should be a Grandfathered Contract until it is materially modified. However, like the Notice, the proposed regulations provide that future benefits accrued and accounts under a plan that reserves to the corporation the right to amend or terminate the plan prospectively will only be grandfathered to the extent the corporation is legally obligated to pay such amounts. Since nearly all NQ Plans reserve to the corporation the right to amend or terminate the plan prospectively, generally only a portion of the benefits and accounts (*e.g.*, the amount of benefit accrued or in the covered employee's account as of November 2, 2017) will be grandfathered from the impact of the 162(m) deduction limit.

Importantly, earnings on grandfathered amounts, credited after November 2, 2017, are grandfathered if the corporation is obligated to pay the earnings under applicable law pursuant to a Grandfathered Contract. For example, if the terms of an NQ Plan give the corporation the right to terminate the plan at any time, but require the corporation to continue to credit earnings during the 12-month holding period after terminating the plan (required by Section 409A for certain terminations), then those earnings would be grandfathered along with the covered employee's account balance as of November 2, 2017.

Ordering Rule for Payments Consisting of Grandfathered and Non-Grandfathered Amounts. Some NQ Plans provide for a series of payments instead of a lump sum. For an NQ Plan arrangement that is a written binding contract entered into prior to November 2, 2017, only a portion of the amounts payable under the arrangement might be grandfathered. To identify the grandfathered amount when payment under the arrangement is made in a series of payments, the proposed regulations provide that the grandfathered amount is allocated to the first otherwise deductible payment paid under the arrangement. If the grandfathered amount exceeds the payment, then the excess is allocated to the next otherwise deductible payment paid under the arrangement. This process is repeated until the entire grandfathered amount has been paid. For example, assume that an NQ Plan arrangement provides for an annual payment of $100,000 for three years, and only $120,000 is grandfathered. Pursuant to the proposed regulations, the entire $100,000 paid in the first year is grandfathered. In the second year, only $20,000 of the $100,000 payment is grandfathered; the remaining $80,000 paid in the second year is not grandfathered. In the third year, none of the $100,000 payment is grandfathered.

Grandfathering - Acceleration Issues. Consistent with the Notice, the proposed regulations provide that a modification of a Grandfathered Contract that accelerates the payment of compensation is a material modification of the contract, *unless* the amount of compensation paid is discounted to reasonably reflect the time value of money. However, the proposed regulations go on to clarify that a modification resulting in the lapse of a substantial risk of forfeiture, *e.g.*, accelerated vesting of an equity award, will *not* constitute a material modification of the contract.

GAAP Accruals. The proposed regulations provide a compensation amount payable under a contract in effect on or before November 2, 2017, would not be treated as a written binding Grandfathered Contract simply because the amount payable under the contract was accrued (or could have been accrued) as a cost under Generally Accepted Accounting Principles (GAAP).

Favorable Treatment of the CFO. For many corporations, the best hope for grandfathered compensation amounts may be for their CFOs. Under the proposed regulations (and in our experience), CFOs are the most likely class of current executives to enjoy grandfathering protection for amounts paid pursuant to a Grandfathered Contract. Prior to November 2, 2017, a corporation's CFO was not a covered employee under Section 162(m) and, therefore, not subject to the $1 million deductibility limit. Thus, compensation paid or accrued to the CFO pursuant to a Grandfathered Contract that is not materially modified could be exempt, *even if the amounts are not performance-based.* The proposed regulations provide the following example, edited herein for brevity:

On October 2, 2017, the corporation executed a three-year employment agreement with its CFO for an annual salary of $2,000,000 beginning on January 1, 2018. The agreement provides for automatic extensions after the 3-year term for additional 1-year periods, unless the corporation exercises its option to terminate the agreement within 30 days before the end of the 3-year term or, thereafter, within 30 days before each anniversary date. Termination of the employment agreement does not require the termination of the CFO's employment with the corporation. Under applicable law, the agreement for annual salary constitutes a written binding contract, in effect on November 2, 2017, to pay $2,000,000 of annual salary to the CFO for three years through December 31, 2020. Because the October 2, 2017, employment agreement:

- is a written binding contract to pay the CFO an annual salary of $2,000,000, and
- the CFO is not a covered employee for the corporation's 2018 through 2020 taxable years.

The deduction for the CFO's annual salary for the 2018 through 2020 taxable years is not subject to the deduction limit of Section 162(m). However, the employment agreement is treated as renewed on January 1, 2021, unless it is previously terminated, and the $1 million limit will apply to the deduction for any payments made under the employment agreement on or after that date (not grandfathered).

The foregoing example also illustrates the complicated contract renewal and termination issues that apply to agreements that otherwise would be grandfathered.

<u>Grandfathering and Severance.</u> The proposed regulations provide special rules and examples for that severance paid pursuant to a Grandfathered Contract that is not materially modified. Importantly, if amounts are paid to a covered employee from more than one written binding contract (or if a single written document consists of several written binding contracts), then a material modification of one written binding contract *does not automatically* result in a material modification of the other contracts unless the material modification affects the amounts payable under those contracts. Each component of a severance formula under a Grandfathered Contract is analyzed separately to determine the amount of severance that is grandfathered.

Assume that a corporation executed a 3-year written employment agreement with its CFO in October 2017 (a Grandfathered Contract), providing for an annual salary of $2,000,000 beginning on January 1, 2018. Assume that the employment agreement also required the corporation to pay the CFO severance equal to the sum of two times CFO's annual salary plus two times CFO's discretionary bonus (if any) paid within 12 months preceding termination, if the corporation terminates the CFO's employment without cause prior to December 31, 2020.

The CFO would not be a covered employee for the corporation's 2018 through 2020 taxable years, and the $1 million deduction limit would not apply to the CFO's annual salary. But the deduction limit *also would not apply to the $4,000,000 severance paid* to the CFO if he or she is terminated without cause prior to December 31, 2020.

Discretionary Bonus and Severance: Suppose that this corporation paid the CFO a *discretionary bonus* of $10,000. Because the October 2017, employment agreement is a written binding contract to pay the CFO $4,000,000 if the CFO is terminated without cause prior to December 31, 2020, and $20,000 if the corporation terminates CFO's employment without cause prior to October 31, 2018, the deductibility limit does not apply to the deduction for CFO's severance payment of $4,020,000.

Now, suppose that in May 2018, the corporation paid a $600,000 discretionary bonus to the CFO and, in April 2019, terminated the CFO's employment without cause. Pursuant to the terms of the employment agreement for severance, in May 2019, the corporation must pay the CFO $5,200,000 in severance payment. Because the October 2017 agreement is *not* a written binding contract to pay the CFO a discretionary bonus, the deduction for $1,200,000 (based on the discretionary bonus) of the $5,200,000 severance payment would be subject to the deductibility limit.

Salary Increase and Severance: Suppose the October 2017 employment agreement provides for discretionary increases in salary and, on January 1, 2019, the corporation increased the CFO's annual salary from $2,000,000 to $2,050,000. Because the October 2017 agreement is a Grandfathered Contract to pay the CFO an annual salary of $2,000,000 and severance of $4,000,000, the deduction limit would not apply to the deduction for the $4,000,000 severance *unless the change in the payment is a material modification of the employment agreement*. Even though the $100,000 increase in severance (two times the $50,000 increase in salary) would be paid on the basis of substantially the same elements or conditions as the severance that would otherwise be paid pursuant to the written binding contract, the $50,000 increase in salary on which it is based does not constitute a material modification of the written binding contract since it is less than or equal to a reasonable cost-of-living increase. However, the deduction for the $50,000 increase and the deduction for the $100,000 increase in severance would be subject to the $1 million limit.

<u>Clawback Issues.</u> The proposed regulations set forth the circumstances under which certain amounts under a Grandfathered Contract could lose their grandfathering protection, depending on whether the corporation's right to recover (*e.g.*, "clawback") the amounts is mandatory or discretionary. The answer depends on the specific terms of the Grandfathered Contract and the facts of the case.

If the compensation paid under a Grandfathered Contract is subject to claw back in the corporation's discretion, and the clawback event does not occur, again the entire grandfather amount remains exempt. However, if the compensation paid under a Grandfathered Contract is subject to clawback in the corporation's discretion, and the clawback event does occur, but the corporation does not clawback, the amount of the compensation that remains exempt must be determined under applicable law, taking into account the corporation's ability to exercise discretion and its past exercise of such discretion with respect to a recovery in a clawback event. Similarly, if the compensation paid under a Grandfathered Contract is subject to clawback in the corporation's discretion, the clawback event occurs, and the corporation claws back an amount of the compensation, the amount of the compensation that is retained by the employee, which remains exempt must be determined under applicable law, taking into account the corporation's ability to exercise discretion and its past exercise of such discretion with respect to a recovery in a clawback event.

If the compensation paid under a Grandfathered Contract is subject to mandatory clawback and the clawback event (*e.g.*, a termination for cause or restatement of the corporation's financial statements) does not occur the entire grandfather amount remains exempt.

Definition of Public Company

The TCJA amended the definition of "publicly held corporation" in 162(m), extending its application to any corporation that is required to file reports under section 12 or section 15(d) of the

Securities Exchange Act of 1934 (the "Exchange Act"). Therefore, the deductibility cap now applies to many corporations that are not literally publicly traded and have never thought of themselves as "public," including corporations that have issued debt securities in a public offering and certain large private C or S corporations.

A significant portion of the text of the proposed regulations is devoted to the TCJA's amendment of the definition of "publicly held corporation," including 26 examples. Corporations that have publicly traded debt, *i.e.*, bonds, are easy to identify because they currently file a Form 10-K, but not a proxy statement. And, of course, the deductibility cap applies to companies that do not (or no longer) qualify for the exemption from registration available under section 12(g) for companies with total assets not exceeding $10,000,000 and a class of equity security held by either (i) 2,000 persons, or (ii) 500 persons who are not accredited investors (note that the 500 accredited investor exception is not available to banks, savings and loan holding companies, and bank holding companies).

More complicated are the rules for foreign private issuers with traded ADRs, disregarded entities, and affiliated groups of corporations in which one or more is required to be registered under section 12 or required to file reports under section 15(d).

<u>Foreign Private Issuer with ADRs.</u> Generally, if the ADRs are listed on a national securities exchange (with or without a capital raising transaction), the foreign private issuer would be subject to 162(m). However, if the ADRs are traded in the over-the-counter market or quoted on the over-the-counter bulletin board ("OTCBB"), generally the foreign private issuer would not be subject to 162(m) if it qualifies for an exemption from registration under Rule 12g3-2(b) (*e.g.*, it maintains a listing of the subject class of securities on an exchange in a foreign jurisdiction that constitutes the primary trading market for those securities and it posts certain categories of company-related information in English on its website.). This is true even when the depositary bank is required to register the ADRs under the Securities Act.

<u>Affiliated Groups of Corporations One or More of Which are Public</u>. The proposed regulations for an affiliated group of corporations are complicated, but offer planning opportunities. The proposed regulations adopt the definition of affiliated group of corporations from Code Section 1504 (without regard to Section 1504(b)).

A publicly held corporation *includes* an affiliated group of corporations that includes one or more publicly held corporations. In the case of an affiliated group that includes two or more publicly held corporations, each member of the affiliated group that is deemed a publicly held corporation is separately subject to the deduction limits of Section 162(m), *and* the affiliated group as a whole is subject to the limit. Additionally, each subsidiary has its own set of covered employees (although it is possible that the same individual may be a covered employee of both subsidiaries), and the amount disallowed as a deduction may be prorated among the corporations.

For example, assume that the President of Parent corporation performs services and receives compensation from Parent corporation *and* Subsidiary corporation, members of an affiliated group of corporations. Parent is a publicly held corporation. Subsidiary is a direct subsidiary of Parent corporation, but is also a publicly held corporation. The total compensation paid to the President from all affiliated group members is $3,000,000 for the taxable year, of which Parent pays $2,100,000 and Subsidiary pays $900,000.

In this case, even though Parent and Subsidiary are *each* publicly held corporations and separately subject to this section, they are still members of the affiliated group. Because the President is a covered employee of both Parent and Subsidiary, which are each a separate publicly held corporation, the determination of the amount disallowed as a deduction is made separately for each publicly held corporation.

Accordingly, Parent has a nondeductible compensation expense of $1,100,000 (the excess of $2,100,000 over $1,000,000), and Subsidiary has no nondeductible compensation expense because the amount it paid to the President was below $1,000,000.

Next, assume an affiliated group composed of three corporations: Parent corporation, which is a publicly held corporation; Direct Subsidiary corporation, a privately held corporation, which is a direct subsidiary of Parent; and Indirect Subsidiary corporation, another privately held corporation, which is a direct subsidiary Direct Subsidiary. The CEO is a covered employee of Parent, but performs services for, and receives compensation from, Parent, Direct Subsidiary *and* Indirect Subsidiary, all of which are members of an affiliated group of corporations.

The total compensation paid to CEO from all affiliated group members is $3,000,000 for the year, of which Parent pays $1,500,000, Direct Subsidiary pays $900,000 and Indirect Subsidiary pays $600,000.

The compensation paid by all affiliated group members is aggregated for purposes of the Section 162(m) deduction limit, so $2,000,000 of the aggregate compensation paid is nondeductible. Parent, Direct Subsidiary, and Indirect Subsidiary are each treated as paying a ratable portion of the nondeductible compensation. Thus, two thirds of each corporation's payment will be nondeductible. Parent has a nondeductible compensation expense of $1,000,000 ($1,500,000 x $2,000,000/$3,000,000). Direct Subsidiary has a nondeductible compensation expense of $600,000 ($900,000 x $2,000,000/$3,000,000). Indirect Subsidiary has a nondeductible compensation expense of $400,000 ($600,000 x $2,000,000/$3,000,000).

Suppose, instead, that *each* of Parent, Direct Subsidiary, and Indirect Subsidiary is a publicly held corporation, and the CEO is a covered employee of both Parent and Direct Subsidiary, but is *not* a covered employee of Indirect Subsidiary. The CEO does not perform any services for Indirect Subsidiary and does not receive any compensation from it. In this example, the total compensation paid to the CEO from all affiliated group members is still $3,000,000 for the taxable year, but Parent and Direct Subsidiary each get to apply the deductibility limit separately, so only $1,100,000 of the aggregate compensation is not deductible. That lost deduction is prorated between Parent and Direct Subsidiary.

To take advantage of this rule, the "multiple public companies" would have to each be truly publicly traded, not just covered by 162(m) because they are affiliates of a publicly traded parent, and the covered employee must receive compensation from each of the publicly traded companies.

Note also, that in corporate spin-off transactions, acquisitions and divestitures, corporations should be alert to the possibility of spreading around the liabilities for future payments to covered employees among the corporate parties, including predecessor corporations.

Disregarded Entities. Not surprisingly, where a disregarded entity that is an issuer of securities that are required to be registered under section 12(b) or is required to file reports under section 15(d) of the Exchange Act is owned by a privately held corporation, the proposed regulations treat the privately held corporation as a publicly held corporation for purposes of section 162(m).

The proposed regulations provide guidance for determining covered employees in the case of disregarded entities and Subchapter S corporations. The executive officers of an S corporation (or a qualified subchapter S subsidiary ("QSub") of the S corporation) are subject to the covered employee rules of 162(m) if either the S corporation or the QSub issues securities required to be registered under section 12(b) or is required to file reports under section 15(d). Similarly, the executive officers of the entity that is disregarded as an entity separate from its corporate owner are subject to the covered employee rules of 162(m) if the corporate owner is subject to 162(m).

A publicly traded partnership (“PTP”) that is not treated as a corporation for Federal tax purposes is not subject to 162(m), but a PTP that is treated as a corporation under Code Section 7704 (or otherwise) is subject to 162(m), if its securities are required to be registered under section 12 or it is required to file reports under section 15(d) of the Exchange Act. The proposed regulations would make the partnership or limited liability company in a so-called “Up-C” structure (*i.e.*, a C corporation holding company, the ole material asset of which is an equity interest in a partnership or limited liability company, which it operates and controls), subject to the deduction limits of Section 162(m). The proposed regulations would reverse the conclusion of private letter rulings previously granted to UPREITs. Under the Proposed Regulations, a REIT’s distributive share of any compensation deduction paid to its “covered employees” by the REIT’s operating partnership would become subject to the Section 162(m) limitation at the REIT level.

Demise of IPO Transition Rule

The proposed regulations confirm that the IPO transition rule, which previously allowed newly public corporations a transition period before the Section 162(m) deductibility limits would apply, no longer applies. Section 162(m) now applies to any compensation that would otherwise be deductible with respect to the taxable year ending on or after the date that a corporation becomes publicly traded. The preamble to the proposed regulations explains that the elimination of the performance-based compensation exception rendered the IPO transition period irrelevant, as it was intended to give newly public corporations time to adopt compensation arrangements that would comply with the performance-based compensation exception.

Application of Section 409A

The Preamble to the proposed regulations clarifies the rules in the final Section 409A regulations, which allowed a corporation to defer of amounts that were previously presumed to be deductible under Section 162(m) until the date that the amounts in fact would be deductible. The proposed regulations eliminate the “consistency” rule in the Section 409A regulations so that a corporation only may defer grandfathered amounts, and not any other amounts. The proposed regulations also would permit a corporation to amend certain plan language regarding deferrals subject to Section 162(m), prior to December 31, 2020, without violating Section 409A. Taxpayers may rely on the language in the preamble. The IRS intends to amend the Section 409A regulations in conformity with the preamble in the near term.

Applicability of the Proposed Regulations

The proposed regulations are subject to a 60-day comment period and will become generally effective for taxable years beginning on or after the date the regulations are published as final, with certain exceptions described below. In the interim, corporations may choose to rely on the proposed regulations until the applicability date of the final regulations, provided that they apply the proposed regulations consistently and in their entirety. Corporations may no longer rely on the Notice for taxable years ending on or after December 20, 2019.

The exceptions to the general effective date are as follows:

First, the definition of covered employee is proposed to apply to taxable years ending on or after September 10, 2018, the publication date of the Notice, which first provided guidance on the definition of covered employee. However, the proposed regulations provide that, for a corporation whose fiscal and taxable years do not end on the same date, the rule requiring the determination of the three most highly compensated executive officers to be made pursuant to the rules under the Exchange Act applies to taxable years beginning on or after December 20, 2019.

Second, the provisions defining a predecessor corporation of a publicly held corporation are proposed to apply to corporate transactions for which all events necessary for the transaction occur on or after the date of publication of the final regulations. With respect to the rules that apply to corporations that change from publicly held to privately held status or vice-versa, the definition of the term predecessor corporation of a publicly held corporation applies to a privately held corporation that again becomes a publicly held corporation on or after the date of publication of the final regulations.

Third, as discussed in the preamble, the rule that the definition of compensation includes an amount equal to the publicly held corporation's distributive share of a partnership's deduction for compensation expense attributable to the compensation paid by the partnership is proposed to apply to any deduction for compensation that is otherwise allowable for a taxable year ending on or after December 20, 2019.

Fourth, the guidance on the applicability of section 162(m)(1) to the deduction for any compensation otherwise deductible for a taxable year ending on or after the date when a corporation becomes a publicly held corporation is proposed to apply to corporations that become publicly held after December 20, 2019. A corporation that was not a publicly held corporation and then becomes a publicly held corporation on or before December 20, 2019 may rely on the transition relief as provided in §1.162-27(f)(1) until the earliest of the events provided in §1.162-27(f)(2).

Fifth, the definitions of written binding contract and material modification are proposed to apply to taxable years ending on or after September 10, 2018.

Correction

In our September-October 2019 issue, we addressed tax planning for non-U.S. executives who are beginning or ending an assignment in the United States. On pg 4 of that issue, under the heading "Mechanics of Making a Section 83(b) Election for an NRA," the second sentence of the first paragraph should state: "An NRA could file Form 1040NR (U.S. Nonresident Alien Income Tax Return) with the Section 83(b) election attached." In addition, the second and third paragraph under that heading are replaced with the following paragraph:

"Importantly, since 2016, a taxpayer no longer needs to include the election with his or her income tax return. However, the Taxpayer must maintain records sufficient to demonstrate a timely 83(b) election, but need not file a copy of the election with the IRS. This change is helpful to non-US residents who wanted to make an 83(b) election—but were unable to do so because of the requirement in Reg. § 1.83-2(c) that the tax-payer submit a copy of the 83(b) election with the return."

We apologize for this error, and we have made these corrections in the electronic copy of the September-October 2019 issue.

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