Administering Compensation Programs in the Wake of the Tax Cuts and Jobs Act – New Section 162(m)

January 31, 2018

The Tax Cuts and Jobs Act (TCJA) significantly changes Section 162(m) of the Internal Revenue Code, effective for tax years beginning after December 31, 2017. While supplemental regulatory guidance is likely, the impact on companies' compensation programs and planning processes is immediate. This memorandum discusses some of the more significant changes, ways companies can address these and areas where the new rules present uncertainty.

Former Section 162(m) Generally

Section 162(m), which became effective in 1994, provides that a publicly traded corporation may not deduct compensation in excess of $1 million per year paid to any "covered employee" of the corporation. Prior to the passage of the TCJA:

- the deduction limitation excluded amounts that constituted "qualified performance-based compensation";
- "covered employees" included the corporation's chief executive officer and each of the corporation's next three most highly compensated executive officers with respect to the year in question, other than the chief financial officer; and
- the rules generally only applied to companies with publicly traded equity securities.

The TCJA expands the scope of Section 162(m) by eliminating the exception for "qualified performance-based compensation," broadening the covered employee group and expanding the types of companies subject to it.

Elimination of the Performance-Based Compensation Exception

The TCJA eliminates the performance-based compensation exception for tax years beginning after December 31, 2017, other than for arrangements that are grandfathered under the "written binding contract" exception (discussed further below).

Q1: If a company[1] has existing shareholder approved plans, will awards granted under such plans after December 31, 2017 that would have been qualified performance-based compensation under old Section 162(m) be exempt from the Section 162(m) deduction limit going forward?

A1: No. Generally speaking, the performance-based compensation exception has been repealed for any tax year starting after December 31, 2017. Only amounts payable in future tax years pursuant to the grandfathered written binding contract exception or that satisfied the "all events" test described later in this memorandum will be deductible if paid in tax years beginning after December 31, 2017.

[1] Except as noted, this memorandum assumes that companies are calendar year taxpayers – that is, that their tax year starts on January 1 and ends on December 31.

Q2: If a company used its existing shareholder approved annual plans to grant awards during tax years ending December 31, 2017 that were qualified performance-based compensation, and such awards will be paid out (or settled) on or after January 1, 2018, will that compensation be exempt from the Section 162(m) deduction limit?

A2: Compensation paid on or after January 1, 2018 to covered employees that would otherwise be deductible in the company's 2018 tax year is generally no longer eligible for deduction under the performance-based compensation exception, even if that compensation relates to 2017. Compensation paid in 2018 or later may be deductible, however, under two possible exceptions: (1) the company is eligible to take a deduction in 2017 under the "all events" test and takes the measures required to pay that compensation by March 15, 2018 or (2) that compensation is grandfathered under the written binding contract exception, each as discussed further below.

Q3: What is the "all events" test?

A3: If a company's compensation satisfied the requirements of the "all events" test as of December 31, 2017, then, assuming that the company is an accrual basis taxpayer and the compensation is paid by March 15, 2018, the company may be able to deduct the compensation for its 2017 tax year. The "all events" test establishes conditions that must be met prior to the end of the tax year in order for a company to be able to deduct compensation for that tax year, even when the payment will occur in the following tax year. Companies should consult their tax advisors regarding the application of the "all events" test to their particular facts.

Q4: If a non-calendar year taxpayer company (e.g., a company whose 2018 tax year started on December 1, 2017) had used its existing shareholder approved plans to establish qualified performance-based compensation for a tax year that ends after December 31, 2017 and the company intends to pay out (or settle) that compensation within the first 2-1/2 months following the end of its 2018 tax year, can that compensation be exempt from the Section 162(m) deduction limit?

A4: The company might be able to satisfy the "all events" test prior to the end of its 2018 tax year (i.e., in this example, prior to November 30, 2018) and take the measures required to pay that compensation in accordance with this action within the first 2-1/2 months following the end of its 2018 tax year in the manner summarized above. Because the new rules are effective for tax years starting after December 31, 2017, if the compensation is tax deductible for a tax year that started prior to this date, it might still be eligible for the qualified performance-based compensation exception (provided the compensation meets the requirements of the rule).

Expansion of Covered Employees

The $1 million deduction limit under Section 162(m) applies to employees who are considered "covered employees" for the tax year in which the deduction would otherwise be taken.

Under old Section 162(m), covered employees included any individual who was, as of the last day of the tax year in which the deduction could be taken, (1) the principal executive officer (i.e., the CEO) or (2) among the three highest compensated executive officers (other than the CEO or CFO) included in the company's Summary Compensation Table (SCT) relating to the relevant year under the SEC's proxy disclosure rules. The CFO was excluded under old Section 162(m) due to an anomaly of the interplay between Section 162(m) and the proxy disclosure rules.

Old Section 162(m) also provided that in order to be considered a covered employee, an individual had to be employed as an executive officer of the company on the last day of the tax year in which the deduction could be taken. For example, a CEO who stepped down a day prior to the end of the tax year would not be considered a covered employee and any compensation received by that CEO in that tax year or any future year was not subject to the Section 162(m) $1 million deduction limit.

Under new Section 162(m), the list of covered employees has been expanded to expressly include the CFO. Additionally, if an individual was a covered employee at any point during a particular tax year beginning on or after January 1, 2017, the individual will be considered a covered employee for that year and all subsequent years, even after the employee terminates employment. As such, all amounts paid to an individual during or after the first tax year that the individual becomes a covered employee will be subject to the Section 162(m) $1 million deduction limit, including payouts of incentive awards, severance benefits and deferred compensation that are not exempt under the grandfathered contract exception (discussed further below) and are not otherwise exempt under another applicable Section 162(m) exemption, such as the qualified pension or medical benefit exceptions.

M&A transactions provide an example of the expanded scope of new Section 162(m). Under old Section 162(m), change in control payments and benefits received by a target company's senior executives often avoided the $1 million deduction limit either because the target company ceased to be an SEC reporting company as of the change in control and therefore did not file a proxy statement with an SCT identifying executives who would be covered employees or because the relevant executives terminated employment prior to the end of the year in which they received the change in control payments and benefits, again, ceasing to be covered employees. To the extent that these payments and benefits are tax liabilities of the target, they will now be subject to the $1 million deduction limit because new Section 162(m) applies a rule of "once a covered employee, always a covered employee."

Q5: For purposes of compensation deductible for a company's tax year commencing before January 1, 2018 (e.g., a tax year ended December 31, 2017), who are the company's covered employees?

A5: The covered employees for 2017 are determined under old Section 162(m). They will be the individual serving as CEO as of December 31, 2017, plus the three next most highly compensated executive officers (other than the CEO or CFO) who were actively in their executive roles as of December 31, 2017 and are included as such in the SCT in the company's 2018 proxy statement. While new Section 162(m) includes individuals who were covered employees in tax years beginning after December 31, 2016, it only applies to tax years beginning after December 31, 2017, so it does not affect the determination of who is a covered employee for purposes of the 2017 tax year.

Q6: Who are the company's covered employees for purposes of compensation deductible for a company's tax year commencing after December 31, 2017 (i.e., for purposes of 2017 annual incentives paid in 2018 that are not deductible for 2017 and other incentives for 2018 and subsequent years)?

A6: The covered employees for amounts otherwise subject to deduction in a company's tax year commencing on or after January 1, 2018 include (1) any individual who has served as CEO or CFO for any period from January 1, 2018 through December 31, 2018, including departed CEOs and CFOs and interim CEOs and CFOs and (2) any individual who is among the next three most highly compensated executive officers for 2018 serving as such as of December 31, 2018 and listed in the SCT in the company's 2019 proxy statement.

New Section 162(m) also includes a lookback to 2017, but the scope of the lookback is not entirely clear. Under the lookback it appears that a company's covered employees for its 2018 and subsequent tax years will include all of its covered employees for its 2017 tax year, i.e., the individual serving as CEO as of December 31, 2017, plus the next three most highly compensated executive officers (other than the CFO) who were actively in their executive roles as of December 31, 2017 and are included as such in the SCT in the company's 2018 proxy statement. It is less clear whether the lookback would also pull in the individual serving as CFO as of December 31, 2017 or other individuals who might have served in the CEO and CFO roles during 2017 but were not in those roles as of the end of 2017. Accordingly, *companies who have changes in their CEO and CFO roles might be left a bit confused without further IRS guidance.*

Q7: Will all of the above executives be covered employees for the company's 2019 tax year and any tax years thereafter?

A7: Yes. In addition, the covered employees will include any other executives that appear in the SCT of the company's 2020 proxy statement and any following years who (1) occupied the roles of CEO or CFO at any time during 2019 or later, plus (2) the three most highly compensated executives as of the end of 2019 and each year thereafter who are listed as such in the SCT in the company's 2020 proxy statement and each proxy statement filed thereafter.

Q8: How does the new Section 162(m) affect an emerging growth company (EGC) or smaller reporting company (SRC) whose SCT only includes the CEO and the next two most highly compensated executive officers?

A8: The answer is not entirely clear. New Section 162(m) states that a company's "covered employees" include the company's CEO and CFO and its three highest compensated officers whose compensation is required to be reported in the company's SCT and any employee who would be among the three highest compensated officers if reporting of their compensation were required under the applicable disclosure rules. EGCs and SRCs are only required to include the CEO and the two next most highly compensated officers in their SCT. Under old Section 162(m), the IRS allowed EGCs and SRCs to limit their covered employees to the executives listed in the SCT. Until the IRS provides guidance on the treatment of EGCs and SRCs, it will remain unclear how the expanded covered employee rule under new Section 162(m) will apply to them.

Expansion of Covered Companies

Under the prior rules, the deduction limit only applied to covered employees of companies with equity securities required to be registered under Section 12 of the Securities Exchange Act of 1934, as amended (the Exchange Act). New Section 162(m) expands the scope to include any company that is required to file reports under Section 15(d) of the Exchange Act (such as Forms 10-Q, 10-K and 20-F).

Q9: A company is a foreign private issuer (FPI) registered under the Exchange Act. The company files an annual Form 20-F in compliance with Section 15(d) of the Exchange Act, but is not required to include in its Exchange Act reports an SCT or specific information on its executive officers' compensation. Is it now subject to the deduction limits of Section 162(m)?

A9: Perhaps, to the extent that it would deduct such compensation on a U.S. tax return. Under old Section 162(m) the IRS had provided that if an FPI did not include an SCT in its Exchange Act reports, it would not be deemed to have any covered employees for purposes of Section 162(m), since covered employees were identified by reference to a company's SCT. New Section 162(m) provides that starting in 2018 covered employees will include individuals who would be disclosed as holding the roles of CEO or CFO or as one of the three next most highly compensated executive officers of the company, if the company was required to prepare an SCT. Pending further clarification, this may require an FPI to follow the requirements of new Section 162(m) in the same manner as a U.S. public company. This will only impact annual compensation above $1 million to the extent allocated to a U.S. taxpayers' tax return (i.e., with respect to a covered employee whose services are sufficiently dedicated to the U.S. such that the FPI's U.S. subsidiary could claim a deduction for compensation paid to the covered employee). We await guidance from the IRS as to whether FPIs are intended to be covered.

Q10: A company does not have any listed equity securities on an exchange and its equity is held 100% by a U.S. public parent entity, but the company has made a registered debt offering. It files an annual Form 10-K but is not required to include an SCT in its Form 10-K. Is it now subject to the deduction limits of Section 162(m)?

A10: Perhaps. The company will have registered its debt securities under the Exchange Act and will be required to file a Form 10-K for at least one year following the debt offering. Therefore, it could be subject to the limits of new Section 162(m) after December 31, 2017. If so, it will need to determine who its covered employees would have been if it prepared an SCT and it will be subject to the $1 million annual compensation deduction limit on those employees in the same manner as other public companies. We await guidance from the IRS as to whether wholly-owned debt issuers are intended to be covered.

Q11: A company does not have any registered debt or equity securities and is not legally required to file reports under Section 15(d) of the Exchange Act, but voluntarily files quarterly Forms 10-Q and annual Forms 10-K because it wants to retain the ability to access U.S. capital markets or has entered into a credit agreement under which it has agreed to file these reports. Is it subject to the deduction limits of new Section 162(m)?

A11: Presumably not. New Section 162(m) includes as covered companies any company "required to file reports under Section 15(d) of [the Exchange Act]." Although a contractual obligation to file reports under a credit agreement could conceivably be viewed as a "requirement" to file reports, new Section 162(m) presumably intended to encompass only companies that are statutorily required to make Exchange Act filings.

Grandfathered Contracts

New Section 162(m) provides that a "written binding contract" in effect on November 2, 2017 (the date the TCJA was initially proposed) will be grandfathered and subject to the rules and exceptions provided under old Section 162(m). A contract that is modified in any material respect or renewed after November 2, 2017 ceases to qualify for the exception after the modification or renewal date.

Q12: What constitutes a "written binding contract" eligible for the grandfather? Will a company's 2017 annual incentive plan or program constitute a written binding contract?

A12: Generally, whether or not a written binding contract exists is determined under applicable state law. In regulations and rulings for an analogous grandfather provision under old Section 162(m), the IRS confirmed that state law is determinative as to the existence of a binding contract. In connection with the enactment of new Section 162(m), a joint report by the Senate/House Conference Committee (the Joint Report) notes that the existence of a plan alone is not sufficient to constitute a binding contract. However, participation in a plan might arguably be grandfathered if amounts under the plan are not entirely discretionary, and the employer cannot terminate or materially amend the plan, except on a prospective basis for future service periods.

Whether a company's annual incentive plan or program for 2017 constitutes a written binding contract will depend on the facts and circumstances, but annual incentive expectations are often set at the beginning of the annual period and employees typically continue to provide services through the year in reliance on those expectations. Under some states' laws, expectations of compensation can give rise to legal entitlements even though companies often resist and settle such claims.

Q13: A CEO has an employment contract, entered into in May 2017, that provides for a lump sum severance payment of over $1 million in the event of specified termination events. The agreement has a three-year term, subject to automatic renewal (with a company opt-out right) each year thereafter. The CEO's employment is terminated in June 2018. Is the severance payment subject to the new Section 162(m) limits?

A13: No. Severance payments generally were deductible under old Section 162(m) since by design they pay out following termination of employment when an executive would have ceased to be a covered employee. This is no longer the case under the "once a covered employee, always a covered employee" rule of new Section 162(m). But in this scenario, the severance payment would be made pursuant to a written binding contract in place prior to November 2, 2017 and prior to the renewal date of that contract.

Q14: Same facts as above, but the CEO's employment is terminated in December 2020, after the contract automatically renewed. Is the severance payment subject to the new Section 162(m) limits?

A14: Yes. In May 2020, the contract automatically renewed, and is treated as a new contract entered into as of the renewal date. Accordingly, the payment is not made pursuant to a grandfathered contract.

Q15: Prior to November 2, 2017, a company issued stock options and PSUs to executives under arrangements that were intended to qualify as performance-based compensation under old Section 162(m). If these stock options and PSUs are held by employees who are covered employees and the stock options are exercised and the PSUs are earned and settled in future years, will they be subject to the new Section 162(m) limits?

A15: No. Assuming that the stock options and PSUs were issued pursuant to written award agreements which were binding (and the PSUs did not provide for discretion to be applied at payout), and the terms of the payouts are not materially modified, they should qualify as payments pursuant to grandfathered contracts. Where a contract permits a company to exercise unilateral discretion without a right of challenge by a covered employee, the facts will need to be considered (e.g., does the contract include a minimum payout, is the discretion unappealable, etc.)

Q16: Same as above except the awards are time-vesting restricted share awards. Are the awards subject to the new Section 162(m) limits?

A16: Generally, yes. Although the awards were provided under a pre-November 2, 2017 written binding contract, awards that are only subject to time-based vesting were generally never treated as performance-based compensation under old Section 162(m), so there was no exemption available to be grandfathered. However, the awards should be grandfathered if, for example, they were granted as payment of an incentive that separately qualified as performance-based compensation for 2016 (e.g., the restricted share award was part of the payout made in early 2017 under an annual qualified performance-based compensation incentive for 2016).

Q17: A covered employee was hired by a company on October 2, 2017 and under the terms of a written employment agreement that provided that the employee was guaranteed the right to participate in the company's supplemental executive retirement plan after the first six months of employment. The employee participates in the plan from the six-month date through retirement in 2025 and upon retirement receives a lump sum benefit of $2 million. Is any of the benefit payment subject to the new Section 162(m) limits?

A17: No. Again, supplemental retirement benefits are designated to pay out after retirement when the employee would no longer be a covered employee under old Section 162(m). Because the employee had a pre-November 2, 2017 contractual right to participate in the plan, if the plan provided a nondiscretionary, formulaic benefit, the employer will be entitled to the treatment applied under old Section 162(m), i.e., it will be exempt because it provides for payout after the employee would have ceased to be a covered employee under old Section 162(m).

Q18: Same as above except that the employee did not have an employment agreement that expressly provided for participation in the supplemental executive retirement plan. Nevertheless, the employee participated in the plan for a period commencing before November 2, 2017 through retirement in 2025. Participation in the plan was technically at the pleasure of the company's compensation committee. The committee approved new participants from time to time, but never removed a participant unless the participant was demoted to a role that was not deemed a qualifying executive role. Is any of the benefit payment to the covered employee subject to the new Section 162(m) limits?

A18: Certainly, the portion of the benefit accrued as of November 2, 2017 is exempt under the grandfathered contract exception. With respect to the benefit accrued after that date, while theoretically the covered employee could have been removed from the plan by action of the compensation committee, such an action would have been unprecedented. Further IRS guidance may be needed to distinguish these cases.

Q19: What is a material modification that causes a grandfathered compensation arrangement to lose its grandfathered status?

A19: There is not yet guidance under new Section 162(m), but guidance under the old Section 162(m) regulations provided that material modifications include modifications that provide an increase in compensation or accelerate or defer the payment of compensation (without adjusting the payment amount to recognize the economic impact of the acceleration or deferral).

Continued Compliance with Terms and Procedures of Performance-Based Compensation Arrangements

In order to comply with the rules for qualified performance-based compensation under old Section 162(m), companies historically adopted either or both types of performance-based compensation plans: (1) menu plans and (2) umbrella plans.

Menu plans include a list of possible performance metrics approved by the company's shareholders and reapproved every five years. The compensation committee uses the approved menu of metrics to make awards by establishing an objective performance payout formula based on one or more of the metrics.

An umbrella plan, sometimes called a negative-discretion plan or formula plan, typically provides for an annual inactive amount, or pool, based on a standing objective formula fixed in a plan that has been approved by shareholders. The compensation committee then exercises negative discretion at the end of the annual period to determine the actual bonus payments, for example by paying bonuses in a lesser amount pursuant to a second underlying plan or program. Under old Section 162(m), so long as the actual payment amounts are below the "umbrella" formula-determined value, the payments were exempt qualified performance-based compensation. Thus, umbrella plans provided a perennial bucket from which to pay qualified performance based compensation awards.

Both menu plans and umbrella plans were subject to a number of procedural conditions under old Section 162(m), including a strict limitation on deviating from the objective formulas established and a requirement for compensation committee certification of performance results.

The exception for qualified performance-based pay is no longer available for tax years beginning after December 31, 2017, other than under grandfathered contracts as discussed above. Companies must now consider what purpose, if any, current program structures might serve going forward, and what requirements remain in effect in light of prior shareholder approval.

Q20: Should a company comply with the performance-based award provisions of its plans for annual incentives previously granted for its 2017 tax year?

A20: Yes, particularly if the company is using the "all events" test to deduct such incentives in 2017 or has grandfathered contracts that require compliance with the performance-based award provisions of its plans. In any case, it will typically be relatively easy to carry through compliance with the performance-based compensation procedures for 2017 incentive compensation and, unless there is a compelling reason not to, we recommend that companies do this to ensure fulfilment of prior-established award and governance procedures and avoid inadvertently forfeiting a potential grandfathered contract exemption for any 2017 performance-based compensation.

Q21: Should a company comply with the performance-based compensation provisions applicable to long-term awards such as PSUs or long-term cash awards granted before 2018 that will be earned and settled in 2018 or future years?

A21: Generally, yes. Many of these awards will be eligible for the grandfathered contract exception and should be administered as originally contemplated to avoid forfeiting the exception. In any case, complying with the initially contemplated terms for these awards avoids inadvertently violating applicable plan terms and ensures adherence to good governance principles.

Q22: For annual incentives for 2018 and future years, can a company cease complying with its annual incentive umbrella plan?

A22: Generally, yes. As described above, most of these plans merely established maximum pools of Section 162(m) deductible compensation from which lesser actual incentives were determined and paid. A company should carefully review its umbrella plan and its prior disclosure regarding the plan, but in most cases companies are free to table or terminate their umbrella plans.

Q23: Beyond an umbrella plan, can a company cease complying with the incentive award provisions of its annual and long-term incentive plans for awards granted for periods after January 1, 2018?

A23: Unless the plan and the awards to be granted constitute part of a grandfathered contract or payments of amounts under a grandfathered contract, there is no tax benefit in complying with the strictures and formalities of the performance-based compensation provisions of a plan for annual incentives granted for tax years beginning after December 31, 2017 or long-term incentives granted in 2018 or future years.

A menu plan will typically include a per person maximum limit and an exclusive list of performance metrics and award procedures for awards under the plan, in order to comply with requirements under old Section 162(m). In some cases these terms expressly apply only if an award is intended to qualify as performance-based compensation, while in other cases these terms might be stated as universal plan requirements and limitations. A company will need to assess whether the particular plans and provisions are mandatory or important to its incentive philosophy and approach, either as a practical matter or in terms of the way in which the company has described its incentive pay to relevant constituencies, e.g., employees, shareholders, proxy advisory firms. In any event, before deviating from a plan or a traditional practice a company should review the plan and its prior disclosures to ensure that it has the latitude to deviate. Companies should exercise caution before removing any shareholder-friendly provisions from incentive plans and awards simply because they are no longer required for purposes of new Section 162(m), as shareholders and proxy advisory firms may react negatively to such actions. That said, most companies will likely enjoy some increased latitude in the operation of their incentive plans and programs.

Q24: A company has an omnibus incentive plan for which it needs shareholder approval for a new share reserve in 2018. Is there a reason to continue to include Section 162(m)-specific award limits and process?

A24: No. For new or amended plans going forward, companies will no longer need to (1) have cash bonus plans approved by shareholders, (2) include performance goals or metrics in their equity plans, (3) obtain shareholder approval of applicable metrics in menu plans every five years or (4) have shareholders approve specific award limits (other than for Incentive Stock Options).

However, for awards granted prior to November 2, 2017 that are eligible for the grandfathered contract exception, companies will generally need to continue to follow any standards and procedures originally applicable to those awards. Companies will need to ensure they do not disqualify any potentially grandfathered contract by making changes to an existing plan, either by exercising caution in drafting plan changes or by simply adopting a new plan for future awards.

Q25: What other latitude do companies now have given the repeal of the performance-based compensation exception?

A25: So long as companies are not seeking to qualify an award under the grandfathered contract rule, companies may amend awards (subject to the award and plan terms) since there will no longer be a deduction exception that companies need to preserve. Companies will also not be limited to paying out awards upon a termination of employment only to the extent performance goals are achieved, and can provide for prorated target payouts if this otherwise makes sense.

Q26: In order to qualify as performance-based compensation, under old Section 162(m) the performance goals were required to be established by a compensation committee comprised solely of two or more "outside directors." Do companies still need to comply with the "outside directors" requirement under new Section 162(m) with respect to their compensation committee members?

A26: Generally no. This requirement pertains only to the performance-based compensation exception, which is eliminated by the TCJA. However, the independent director test with respect to compensation committee members under stock exchange rules and the short-swing profit rules of Section 16 of the Exchange Act, which are different from the "outside directors" requirement under Section 162(m), are still applicable to most public companies and should still be complied with. To the extent that a company's compensation committee charter references satisfying the "outside directors" requirement under Section 162(m) as part of committee membership criteria, the company may remove such reference from the charter. But again, a company should consider whether any outstanding incentive awards under a grandfathered contract might require final certification of payout by an outside director committee.

Q27: Should companies update their Section 162(m) disclosure in the CD&A section of their annual proxy statements?

A27: Yes. If a company currently discloses in the CD&A that certain executive compensation was structured to qualify for the performance-based compensation exception under Section 162(m), the company should update the disclosure to indicate the repeal of such exception by the TCJA. In addition, companies may want to mention that they will continue to monitor developments in this area and will reserve the right to pay nondeductible compensation if it is in the best interest of the company and consistent with the company's business needs. Many CD&As already say this, but companies might want to adjust the language a bit.

IPO Transition Period

The existing Section 162(m) regulations provide a transition period for privately held companies that become public. In the case of companies that were not publicly held and then become publicly held, the $1 million deduction limit of Section 162(m) does not apply to any remuneration paid pursuant to a compensation plan or agreement that existed during the period in which the company was not publicly held if the plan or agreement was disclosed to investors in connection with the going public transaction. For companies that become publicly held in connection with an initial public offering (IPO), this transition period lasts until the first shareholder meeting that occurs following the close of the third calendar year following the calendar year in which the IPO occurred, provided that the relevant plan is not materially modified, depleted or terminated earlier. For companies becoming public as the result of a spin-off from a public company, a narrower exception is available with a shortened transition period, ending as of the first shareholder meeting that occurs after 12 months following the spin-off. The regulations also provide that the exemption from Section 162(m) will apply to any compensation received pursuant to the exercise of a stock option or stock appreciation right, or the vesting of restricted property (but not a restricted stock unit or performance stock unit), even after the transition period, as long as the grant occurred during the transition period.

The transition period was only included in the regulations and not the statute itself. Accordingly, it appears that companies should continue to have the benefit of the IPO/spin-off transition period in spite of new Section 162(m) although it is possible that the IRS could issue guidance narrowing or eliminating the IPO/spin-off transition period rule.

Q28: If a private company became public through an IPO or spin-off prior to January 1, 2018 and its transition period continued past January 1, 2018, would that transition period be affected by new Section 162(m)?

A28: It is possible that the IRS could curtail existing transition periods in light of the strict words of new Section 162(m), but this would be draconian.

Q29: Is a company that becomes public through an IPO or spin-off after January 1, 2018 eligible to use the applicable transition period under the existing Section 162(m) regulations?

A29: Yes, until the IRS provides guidance to the contrary. As a general matter, there should be no difference between a company that becomes public before or after January 1, 2018, but the IRS might be more inclined or at least more comfortable curtailing the transition period exception for IPOs/spin-offs occurring after the effective date of new Section 162(m).

Q30: Assume that a company had its IPO in 2014 and to date has only paid compensation in excess of $1 million pursuant to plans that satisfy the transition period exception. When the company's transition period ends after its annual shareholder meeting in 2018, who will the company's covered employees be for 2018?

A30: Subject to any guidance the IRS might provide, the covered employees will likely include anyone who was CEO or CFO during 2018 and anyone who was among the top three highest paid active executive officers as of the end of 2018, plus anyone who was CEO or CFO during 2017 and anyone who was among the top three highest paid active executive officers as of the end of 2017. These individuals would be among the company's covered officers as of and after the end of the transition period in 2018, even if they ceased to be in these roles at that time. This assumes that the company is not an EGC or SRC. See the discussion of the expansion of the covered employees earlier in this memo for a description of the new covered employee provisions and questions about how these provisions might affect EGCs or SRCs.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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