TCJA Changes Under 162(m) and Other Compensation Considerations in SPAC Transactions

*Gabe Marinaro**

Although the transaction model with special purpose acquisition companies (SPACs) has been around for some time, the last few years have seen a significant increase in SPAC transactions. With the more compressed timeframe in connection with SPAC transactions, compensation considerations need to be addressed at the outset so as to better align pay practices when a target private company becomes publicly traded through a merger with a SPAC (often referred to as a "De-SPAC" transaction). In addition to development of new equity programs, short-term and long-term performance awards, and other compensation considerations for a new publicly traded company, recent changes under the Tax Cuts and Jobs Act of 2017 (TCJA) to Internal Revenue Code (Code) § 162(m) (which generally provides a $1 million cap on the deductibility of compensation to certain employees of a publicly traded company) need to be considered as well. Prior to the TCJA changes to Section 162(m), companies that recently completed an initial public offering (IPO) (which would also include private companies that merge with a SPAC) were able to utilize a transition rule that provided several years of relief from the Section 162(m) deductibility limitations. With this IPO transition rule repealed under the TCJA changes under Section 162(m) (with certain limited grandfather relief), newly created publicly traded companies through SPAC transaction have to deal with the Section 162(m) deductibility limitations without the benefit of this transition relief. This article will describe the TCJA changes to Section 162(m), along with other compensation-related considerations in a SPAC transaction.

In general, SPACs or "blank check" companies raise capital through an IPO with the purpose of acquiring a privately held operating company. SPACs have a limited timeframe (generally two years) to identify a target company and complete the De-SPAC transaction, resulting in a new publicly traded operating company. Due to the fast-track nature of a SPAC transaction, there are a myriad of compensation decisions that need to be made, including:

- Developing a peer group of companies for the newly created public operating company for purposes of benchmarking compensation and pay practices.
- Developing incentive

**GABE MARINARO* is a partner in Akerman's Chicago Office and advises both publicly traded and privately held clients on a variety of benefits and compensation matters that arise in corporate transactions. Mr. Marinaro also assists executives and companies with executive compensation matters, including drafting required SEC disclosures, advising on equity and bonus compensation arrangements, and assisting with compliance with IRC Sections 162(m), 409A, 280G, and other laws affecting executive compensation.

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compensation awards (both short-term and long-term) that are consistent with public company trends and otherwise reflect incentive compensation practices of peer companies.

- Designing an omnibus equity incentive plan that includes market terms for a public company (including considerations from shareholder advisory firms on problematic pay practices).

- Stock ownership guidelines and compensation philosophy.

- Employment agreements and other compensatory arrangements that are consistent with peer groups and market trends.

Private companies do not have the same disclosure obligations and scrutiny over pay practices as public companies, including considerations for pay practice guidance from shareholder advisory firms and pay ratio disclosures. If the management teams of the newly publicly traded company are not prepared for their new disclosure obligations and pay trends within their peer group, it can make for a bumpy debut after the De-SPAC transaction.

In addition to these pay design decisions, recent changes under the TCJA[1] to Code § 162(m) need to be considered as part of the De-SPAC transaction. Section 162(m) generally caps the tax deduction for any tax year at $1 million for compensation paid by publicly traded companies to certain covered employees.

For new publicly traded companies, the pre-TCJA Section 162(m) rules provided a special transition rule. This transition rule permitted up to three years of relief from the Section 162(m) deduction limitations for arrangements that were in existence prior to the company becoming publicly traded, as long as these arrangements were disclosed to prospective shareholders and not materially modified. Under these pre-TCJA rules, companies that became public through a De-SPAC transaction could enjoy a period of transition where compensation would not be subject to the Section 162(m) limitations.

The changes under the TCJA to Section 162(m) removed this special transition period, except for companies that went public on or before December 20, 2019. Thus, for SPAC transactions and IPOs that occur after December 20, 2019, the limitations to Section 162(m) deductibility limitations apply immediately. As discussed further below, this creates certain challenges for existing pay practices of a target private company, including:

- Whether pay design after the De-SPAC transaction lends itself to full deductibility under Section 162(m) or whether there will be potential for lost deductions (and any disclosure or shareholder considerations in the event that pay design creates potential lost deductibility).

- Whether there are existing or planned equity grant procedures that may not properly account for Section 162(m) deductibility concerns.

- Whether the pay design has accounted for the continued deductibility limits for "covered employees" (discussed below) even when they may no longer serve in roles or receive compensation that previously made them a covered employee.

- Whether existing compensation arrangements (including any outstanding stock options, at the target private company should be accelerated and paid (if permitted under Code § 409A) before

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the company becomes subject to the Section 162(m) restrictions after the De-SPAC transaction (also consider whether this acceleration may trigger any Code § 280G concerns (discussed below)).

As mentioned above, planning for the continued deduction limitations under Section 162(m) for "covered employees" (that is, principal executive officer (PEO) or principal financial officer (PFO) and the three highest compensated executive officers (other than the PEO and PFO)) is especially important under Section 162(m) rules after the TCJA changes, as an individual's status as a covered employee continues even if they no longer meet the definitional requirements. This can have implications when designing not only current compensation programs but also deferred compensation programs. Pay designs should account not only for when an individual is serving in a role or receiving compensation that makes him or her a covered employee but anticipate payment streams (such as nonqualified deferred compensation, and the like) that may continue to create deductibility issues even when that individual no longer serves in that role or is receiving a level of compensation that first made him or her a covered employee.

Another important change under the TCJA that may impact certain De-SPAC transaction structures is the new application of the Section 162(m) limitations to compensation paid in Up-C structures. Generally, under these new Section 162(m) changes, if compensation is paid to a covered employee by a partnership in which the publicly traded company (C-Corp) has an ownership interest (that is, an Up-C structure), Section 162(m) requires that the public company take into account its distributive share of the partnership's deduction for compensation paid by the partnership to the covered employee (even though the public company did not directly pay this remuneration) and aggregate this for purposes of the public company's deduction limitations under Section 162(m).[2]

Another important area is considering the impact of Code §§ 280G and 4999 in connection with a De-SPAC transaction. Depending on the nature of the De-SPAC transaction, existing arrangements of the target company that include acceleration of payments or vesting on certain types of change in control may trigger parachute payments (that is, compensatory payments contingent upon a change in control) to certain officers, highly compensated individuals and greater-than-1% shareholders (disqualified individuals).

Depending on the extent of these parachute payments, payments in connection with a De-SPAC transaction could create adverse tax consequences for both the disqualified individual and lost deductions for the company. As important as it is to properly design compensation for the new public company after the De-SPAC transaction, it is equally important at the outset to catalogue existing arrangements of the target private company to properly analyze any parachute payment concerns, including:

- Existing equity awards and plans need to be reviewed to see if the De-SPAC transaction will trigger accelerated vesting of any of the outstanding awards.
- Existing employment agreements and other arrangements need to be reviewed to determine whether a change in control triggers any payments to disqualified individuals (that is, single trigger payments).
- Any review proposed

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transaction bonuses or other transaction-related payments proposed for the disqualified individuals should be reviewed.

It is important to review arrangements well in advance to determine whether any payments will be triggered in connection with the De-SPAC transaction and look at planning opportunities to mitigate any potential adverse tax consequences.

With the continued popularity of the SPAC transaction model, it is important to put pay design and limitations, with a public company view, at the beginning stage of any De-SPAC transaction to avoid pay misalignment for the new public operating company, lost deductions, and potential adverse tax consequences to key employees.

NOTES:

[1]Pub. L. No. 115-97, 131 Stat. 2054 (2017).

[2]Treas. Reg. § 1.162-33(c)(ii).

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