

CHANGES TO EXECUTIVE COMPENSATION: THE TAX CUTS AND JOBS ACT'S IMPACT ON SECTION 162(M)

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On December 22, 2017, President Trump signed the bill popularly referred to as the “Tax Cuts and Jobs Act” (the “Act”) into law. The Act contains significant changes to Section 162(m) of the Internal Revenue Code that are effective for taxable years beginning after December 31, 2017. In this article, we provide a summary of the changes to Section 162(m) and suggest planning considerations for publicly held corporations.

Summary of Changes to Section 162(m).

Among other changes to Section 162(m), the Act eliminated the performance-based compensation exception to the \$1 million deduction limitation under Section 162(m). The Act amended the scope of the covered employees, corporations, and compensation for purposes of the \$1 million limitation on the deduction for compensation paid to certain employees under Section 162(m). The changes to Section 162(m) include the following:

- Eliminating the performance-based compensation and commission exceptions from compensation subject to Section 162(m). Under the prior rules of Section 162(m), performance-based compensation and commission were excluded from the \$1 million deduction limitation. This change means that a corporation’s compensation committee no longer will be required to establish objective performance goals within 90 days of the start of an applicable performance period and that shareholder approval of the compensation terms and maximum amounts payable no longer is required for Section 162(m) purposes.
- Expanding the definition of publicly held corporations to include corporations that file reports under Section 15(d) of the Securities Exchange Act of 1934, as amended, which will subject certain corporations with publicly traded debt and certain foreign private issuers to the deduction limitation of Section 162(m). Under the prior rules, only corporations with publicly traded equity were subject to Section 162(m).
- Expanding the definition of covered employee to include any individual who served as the CFO during the taxable year. In addition to the CEO and CFO, the definition continues to include the

three other highest compensated officers required to be reported to shareholders under the Securities and Exchange Commission rules. The prior rules excluded the CFO.

- Expanding the definition of covered employee to include any individual who was a covered employee in any taxable year beginning after December 31, 2016, so that once an employee is covered under Section 162(m) for any year, that individual will continue to be covered for all future years. Under the prior definition, covered employees were determined each year without regard to whether an individual was a covered employee in a prior year. With this change, payments to former employees (such as severance payments and stock option exercises) will be subject to the \$1 million deduction limitation.
- Expanding the scope of compensation subject to Section 162(m) to include amounts paid to an individual other than the covered employee, including a covered employee's beneficiary following the employee's death.

Transition Rule for Contracts in effect on November 2, 2017

The Act includes a transition rule under which the changes to Section 162(m) will not apply to compensation paid pursuant to a written binding contract that was in effect on November 2, 2017, provided that no material modification is made after that date. [The Act's conference agreement between the House and Senate](#) makes clear that a contract that was in place prior to November 2, 2017, and that is renewed after that date, will be treated as a new contract that will no longer qualify for the transition rule. The requirement of a written binding contract under the transition rule raises issues such as whether a contract or plan subject to the compensation committee's discretion to adjust a performance award downward will result in the contract being ineligible for the transition rule. We expect that future guidance from the Internal Revenue Service will address these issues and will provide additional guidance as to what constitutes a written binding contract and a material modification.

Considerations in Planning for the New Section 162(m).

Corporations covered by Section 162(m) should review their current compensation arrangements now to identify the contracts and plans that may take advantage of the transition rule. We recommend the following:

- In order to determine what constitutes a written binding contract, it may be helpful to look to applicable state law or analogous federal laws, until we have further guidance from the IRS.
- Once identified, any change to a contract should be carefully reviewed to determine whether it will cause the arrangement to lose the benefit of the transition rule. In the absence of guidance from the Internal Revenue Service, guidance and interpretations under other tax laws that included transition relief for agreements that had not been subject to a material modification,

such as Section 409A of the Internal Revenue Code, may be helpful in determining whether such a modification has been made.

- In addition, because contracts eligible to take advantage of the transition rule are subject to the prior Section 162(m) rules, they must be administered in compliance with the prior requirements related to performance-based compensation, including the requirement to certify the attainment of the performance goals.

For new performance-based compensation arrangements, the repeal of the performance-based pay exception allows corporations increased flexibility in the establishment and operation of performance-based pay programs.

- Performance goals no longer need to be pre-established or objectively determinable. This change will permit compensation committees greater flexibility in taking into account events that occur during the performance period when determining whether the performance goals have been satisfied.
- Performance goals no longer need to be approved by the compensation committee within 90 days of the beginning of the performance period.
- The compensation committee may reserve the discretion to adjust performance-based awards up or down based on actual performance.
- To limit the impact of the repeal of the performance-based pay and commission exceptions, a corporation may consider permitting or requiring covered employees to defer receipt of all or a portion of the individual's compensation or extending the payment schedule over a period of years in a manner such that the payments would fit within the \$1 million deduction limit for the year. These strategies may implicate additional legal requirements applicable to deferred compensation which should be taken into account, including under Section 409A.

In addition, the changes to Section 162(m) may present state tax deduction issues in states which conform sections of their tax code to the federal tax code. In states that permit deductions for performance-based pay under state tax laws mirroring the prior version of Section 162(m), the performance-based pay deduction may continue to be available for performance-based plans that comply with the prior rules of Section 162(m) until the state brings its tax law into conformity with the new federal Section 162(m). Amended or newly established performance-based plans designed under the new federal Section 162(m) may lose a state tax deduction for performance-based pay in states that have not conformed to the new federal Section 162(m) because these plans will not comply with the prior Section 162(m) performance-based pay exception rules.

Finally, in addition to planning for compliance with the transition rule and the repeal of the performance- and commission-based compensation exceptions, corporations should consult with

their outside advisers to determine whether and how to describe the changes relating to Section 162(m) in their proxy statements.

The changes to Section 162(m) and the repeal of the performance- and commission-based pay exceptions pose a significant change in the tax rules governing executive compensation and, likely, a major shift in how corporations will compensate their executives as a result. We expect future guidance from the Internal Revenue Service will be issued to assist with compliance. With this in mind, corporations subject to Section 162(m) should consult with their legal counsel, compensation consultants, and other outside advisers to implement any changes to their compensation programs and comply with the new rules.

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