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Tax Reform Changes to §162(m) Impact Executive Pay at Public Companies

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On December 22, 2017, President Trump signed into law a comprehensive tax reform bill, H.R. 1, which was originally known as the Tax Cuts and Jobs Act (the 2017 tax act).[1] While the headlines in the popular press focus on the major changes affecting businesses and individuals, the act also impacts many of the Internal Revenue Code provisions regarding executive compensation.[2] In particular, it significantly expanded the applicability of §162(m), which limits a publicly held corporation's ability to deduct certain compensation paid to top executives. This article discusses these changes to §162(m) and what they mean for public companies.

BACKGROUND AND PRIOR LAW

Section 162(m) limits a publicly held corporation's ability to take an income tax deduction for compensation paid to its ''covered employees'' in excess of $1 million for a taxable year (the ''$1 million deduction limit''), subject to certain important exceptions. The $1 million deduction limit applies to a broad range of compensation types, including a covered employee's salary, bonus, equity awards, and nonqualified deferred compensation payments, but excludes payments from qualified retirement plans and certain amounts otherwise excludable from the employee's gross income. Thus, §162(m) has played a critical role in shaping executive compensation at publicly held corporations, as employers often design compensation programs to mitigate the impact of the $1 million deduction limit.

Prior to the enactment of the 2017 tax act, a corporation's ''covered employees'' generally consisted of its chief executive officer (CEO) and its three most highly compensated officers other than the CEO and chief financial officer (CFO) whose compensation is required to be reported to shareholders. Thus, under the prior rules, the $1 million deduction limit could apply to compensation paid to no more than four individuals for any taxable year. In addition, a corporation's CFO was not considered a covered employee, regardless of his or her compensation level, due to an unresolved glitch between the original legislation and a subsequent change to SEC disclosure rules. Further, an individual was generally considered a covered employee only if he or she was employed in the covered position on the last day of the taxable year for which the deduction applied, meaning post-termination payments (such as severance and deferred compensation payments) were exempt from the $1 million deduction limit. In addition, amounts paid to a beneficiary of a covered employee were not subject to the $1 million deduction limit.

Section 162(m) also provided that compensation payable solely on account of attainment of objective performance goals was not subject to the $1 million deduction limit, so long as a compensation committee comprised solely of outside directors determined the goals and certified that the goals were satisfied, and the material terms of the compensation were disclosed to and approved by the corporation's shareholders

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[1] Pub. L. No. 115-97.

[2] All section references are to the Internal Revenue Code of 1986, as amended (the Code), and the regulations thereunder, unless otherwise specified.

prior to payment. To qualify, these objective performance goals either had to be approved by shareholders directly or based on criteria approved by shareholders at least every five years. The performance-based compensation exception thus provided a financial incentive for publicly held corporations to emphasize pay-for-performance in their compensation packages for top executives. Accordingly, public companies commonly designed their incentive programs for top executives such that some or all such performance-based compensation was exempt from the $1 million deduction limit.

Similarly, compensation payable on a commission basis also was not subject to the $1 million deduction limit.

WHAT CHANGED?

The 2017 tax act revised §162(m) to expand the definition of "covered employee" and thus the scope of individuals whose compensation is subject to the $1 million deduction limit. The definition of "covered employee" now includes the employer's CEO, its CFO, and the three most highly compensated officers (other than the CEO and CFO) whose compensation is required to be reported to shareholders. Thus, going forward, the $1 million deduction limit will apply to compensation paid to at least five individuals for any taxable year. In addition, if an individual is considered to be a covered employee at any time during a tax year commencing after 2016, he or she will remain a covered employee permanently. Thus, unless the "grandfather rule" described below applies, all future payments to such individuals would be subject to the $1 million deduction limit, even if the individual had ceased to be an officer or had terminated employment at the time of payment. Payments to a covered employee's beneficiary are now subject to the $1 million deduction limit, as well.

In addition, the 2017 tax act eliminated the performance-based and commission-based compensation exceptions. As a result, generally all incentive compensation and commission-based compensation paid to covered employees with respect to the 2018 tax year and subsequent tax years will be subject to the $1 million deduction limit (unless such compensation meets the grandfather rule below).

Further, §162(m) now applies to any corporation that is an issuer under §3 of the Securities Exchange Act of 1934 that is required to register its securities under §12 of that Act or is required to file reports under §15(d) of that Act. This means that both listed corporations and certain unlisted corporations that register debt or equity securities with the Securities and Exchange Commission, including foreign companies publicly traded through American depositary receipts (ADRs), are now subject to the §162(m) limitations.

EFFECTIVE DATE AND GRANDFATHER RULE

The changes to §162(m) are generally applicable for tax years beginning after December 31, 2017. However, the 2017 tax act provides a special rule (the "grandfather rule") with respect to compensation provided under a written binding contract that was in effect on November 2, 2017, and that is not materially modified on or after such date. Under the grandfather rule, such compensation would be subject to the §162(m) rules in effect prior to the enactment of the 2017 tax act — including the performance-based compensation exception.

The IRS has not yet provided detailed guidance on the applicability of the grandfather rule, though it is likely to do so in the future. However, we expect the rule to apply to amounts covered by a plan or agreement where there is an outstanding award and the amount of compensation is objectively determinable and not subject to unilateral change or reduction. Further, no material changes can be made to applicable terms for such amounts after November 2, 2017. Thus, we expect that a benefit should meet the grandfather rule if:

- a covered employee had a right to such amounts under a plan or agreement on November 2, 2017;
- the employer did not have the right to unilaterally reduce or terminate the covered employee's right to such benefit (e.g., by exercise of discretion or discretionary amendment); and
- no material changes have been made with respect to such benefit after November 2, 2017.

Many employers have existing plans and programs that are designed to meet the performance-based compensation exception to the $1 million deduction limit. To the extent these arrangements became effective on or before November 2, 2017, then pursuant to the grandfather rule these employers may still be able to take advantage of the performance-based compensation exception going forward. However, it appears not all plans in effect on November 2, 2017, will meet the narrow requirements of the grandfather rule. In particular, the grandfather rule may not apply to:

- plans or agreements that permit an employer to retain discretion to reduce or eliminate the amount of compensation payable pursuant to an award, even if the employer never actually reduces or eliminates the amount of the award; or
- plans or agreements that require the employer to exercise discretion to renew or extend the agreement, for the period after such renewal or extension.

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In general, pending further guidance from the IRS, discretionary changes in payment timing for amounts otherwise expected to be subject to the grandfather rule should be approached with caution, as such changes could be treated as material modifications.

IMPACT ON SPECIFIC TYPES OF EXISTING PLANS AND ARRANGEMENTS

Incentive Programs and Performance-Based Equity Awards

Annual or long-term bonus programs in process on, as well as equity awards granted on or before, November 2, 2017, that were considered performance-based compensation may satisfy the grandfather rule, and can continue to use the performance-based compensation exception to avoid the §162(m) deduction limit. However, plans or awards that allow the company to exercise negative discretion or unilaterally terminate or reduce the award may not satisfy the grandfather rule. If an award may be subject to reduction, but not below a certain threshold amount or percentage, the amount of the award that exceeds such threshold may not satisfy the grandfather rule.

Stock Options and SARs

Fair market value-based options and stock appreciation rights (SARs) outstanding as of November 2, 2017, may also satisfy the grandfather rule if exercised during their remaining exercise period. Extensions of the exercise period that are not embedded in the option or SAR as of November 2, 2017, may constitute a material modification that causes the award to fail the grandfather rule. Compensation from options or SARs exercised by covered employees after November 2, 2017, would be subject to the §162(m) deduction limits if the grandfather rule does not apply.

Nonqualified Deferred Compensation

Amounts deferred under a nonqualified deferred compensation plan, such as a supplemental account balance plan or defined benefit plan (e.g., a supplemental executive retirement plan (SERP)), on or before November 2, 2017, may be subject to the grandfather rule. In order to avoid the loss of the tax deduction on existing deferred compensation benefits payable to present and future covered employees, employers should work with their record keepers to identify the deferred compensation and SERP benefits as of November 2, 2017, for all participants, and track these amounts as subject to the grandfather rule. Other rights to future benefits under the deferred compensation plans (and any relevant employment agreements) should be carefully reviewed to determine if they too can fall within the protective umbrella of the grandfather rule.

Deferral Strategies for Mitigating Code §162(m) Exposure

Many employers have planned around the $1 million deduction limit by having non-performance-based compensation paid after the employee ceases to be a covered employee (e.g., after termination of employment). As a result of the changes to §162(m), that strategy is not as effective for compensation earned after 2017, because covered employee status is now permanent. If a covered employee's compensation is likely to exceed the $1 million deduction limit in a taxable year, a portion of his or her compensation could be deferred to a future taxable year in which the employee is less likely to exceed the $1 million deduction limit. However, this strategy may be of limited effectiveness for large amounts and could also be significantly impacted by the effects of long-term earnings credits, which could increase nondeductible amounts in future years. Thus, affected employers should review their plan documents for provisions requiring deferral of amounts subject to §162(m) and consider amending these documents to the extent permissible under §409A and the related regulations. Also, if the employer has historically delayed payments as necessary to avoid the loss of the deduction under §162(m), the changes to §162(m) may impact how such a delay needs to be administered.

LOOKING FORWARD

The changes to §162(m) will likely force many companies with publicly held securities to include in their taxable income millions of previously deductible dollars, although because the 2017 tax act also reduces the corporate income tax rate to 21%, the relative value of deductions may be lower than in prior taxable years. However, it is far from clear how much of an impact the new rules will have on employers' willingness to meet top executives' compensation expectations. The new rules may also cause shareholders to revisit how they approach say-on-pay voting, and prompt shareholder advisory firms to revise their voting guidelines.

In addition, the changes to §162(m) obviate the need for public companies to comply with the performance-based compensation rules. However, the process of establishing performance-based compensation programs in conformity with the prior rules has

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become a widely accepted exercise. Indeed, many publicly held corporations have integrated the performance-based compensation rules into their compensation committee charters and plan documents. These and other documents should be reviewed to consider whether any changes, such as the removal of unnecessary procedures or performance thresholds, are desirable going forward. However, it remains to be seen whether shareholders or shareholder advisory firms will approve of major changes to the process merely because §162(m) no longer requires it. Thus, at this time employers should be cautious when considering major changes to their incentive compensation programs, and take care to follow through on requirements for deductibility under prior law to the extent still applicable under the grandfather rules.

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