

Section 162(m) After the Tax Cuts and Jobs Act

Gretchen Harders

NYSBA Labor & Employment (Ithaca, NY)
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Presented by



Gretchen Harders
Member of the Firm
gharders@ebglaw.com
212-351-3784

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Section 162(m) Before the Tax Cuts and Jobs Act

- Section 162(m) of the Internal Revenue Code (“Section 162(m)”) generally limits annual deductions for compensation paid to covered employees of publicly traded companies to \$1 million
- Before the enactment of the Tax Cuts and Jobs Act (TCJA) on December 22, 2017, Section 162(m) provided for exceptions to the \$1 million deduction limit by:
 1. **Excluding qualified performance-based compensation**, which covered many stock options and various forms of incentive compensation;
 2. **Generally applying only to companies with publicly traded equity**; and
 3. **Covering only the company’s CEO and the company’s next three most highly compensated executive officers (other than the CFO) for the taxable year**, which enabled deferral of payments until executive officers ceased to be covered employees.

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The Tax Cuts and Jobs Act’s Changes to Section 162(m)

- **Post-TCJA, \$1 million deductibility limit under Section 162(m) applies more broadly**
- The TCJA amended Section 162(m) by:
 1. Eliminating the qualified performance-based compensation exception;
 2. Expanding the scope of covered companies to include any company that is required to file reports under Section 15(d) of the Securities Exchange Act of 1934 (e.g., Forms 10Q, 10-K and 20-F); and
 3. Expanding the definition of a covered employee to include the CFO and to cover any individual who was a covered employee during any taxable year beginning on or after January 1, 2017, even after he terminates employment.

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Section 162(m) After the Tax Cuts and Jobs Act

- **The TCJA's changes to Section 162(m) do not apply to compensation granted under "grandfathered contracts"**

- Pursuant to a transition rule, the changes exempt written binding contracts in effect as of November 2, 2017, so long as those contracts are not materially modified

- On August 21, 2018, IRS Notice 2018-68 clarified that compensation is not grandfathered if companies are permitted to exercise *negative discretion* to reduce or eliminate the award amount, regardless of whether that discretion is exercised, *unless* the employee has a legally binding right to that compensation under state law

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How Do Changes to Section 162(m) Affect Compensation Design?

- **The elimination of the performance-based compensation exception to Section 162(m)'s \$1 million deductibility limit may not greatly affect compensation design:**

- **The lost tax deduction under Section 162(m) is worth less than before the TCJA** due to the TCJA's lowering of the top corporate tax rate from 35 percent to 21 percent
- **Companies have other reasons for seeking shareholder approval of compensation plans**, apart from complying with the now-eliminated performance-based compensation exception to Section 162(m)'s \$1 million deductibility limit
- **Performance-based compensation remains an important factor in drafting pay packages**, despite the loss of the tax advantage associated with the performance-based compensation exception:
 - Shareholders and proxy advisory firms still seek pay for performance
 - Companies still want to incentivize executives through performance-based pay

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How Should Companies React to the Changes to Section 162(m)?

- **However, consider whether to retain, amend or replace existing incentive plans:**
 - **Agreements that may have been up for amendment may be retained** to preserve the grandfathered contracts exemption from Section 162(m)
 - **Amend the executive officer pool** so that less officers would be covered employees under Section 162(m), given the now-extended duration of covered employer status
 - **Stock options may no longer be as attractive an award type** due to the elimination of the performance-based compensation exception
 - **Generous post-employment severance packages may no longer be as tax-advantageous,** due to the now-extended duration of covered employee status under Section 162(m)