TAX REFORM ACT - IMPACT ON EXECUTIVE COMPENSATION

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International Tax Update

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Tax Reform Act - Impact on Executive Compensation

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The Act (formerly known as the Tax Cuts and Jobs Act or the "Act") makes several changes to Section 162(m) of the Internal Revenue Code of 1986, as amended (the Code). This update summarizes certain effects of the Act on publicly held corporations that maintain incentive-based compensation programs and similar arrangements for their key employees and executives. If you have any questions or concerns about these changes or how the Act may impact your business, please contact any of the authors of this update.

Executive Summary

- The Act's changes to Section 162(m) of the Code effectively eliminate the ability of a publicly held corporation to deduct annual compensation paid to a "covered employee" that is in excess of $1 million.
- All (non-grandfathered) compensation in excess of the $1 million threshold will be non-deductible, including "qualified performance-based compensation" and commissions.
- The scope of individuals who are "covered employees" is expanded to include the principal financial officer (e.g., a CFO), as well as individuals who were "covered employees" at any time on or after January 1, 2017.
- The scope of entities that are "publicly held corporations" for purposes of Section 162(m) is expanded to include companies that are required to file reports with the Securities and Exchange Commission solely due to public debt.
- These changes to Section 162(m) apply for tax years beginning on and after January 1, 2018.

Changes to Internal Revenue Code Section 162(m)

Current Law: Under current law, employers generally may deduct the reasonable compensation it pays for personal services as an ordinary and necessary business expense. However, Section 162(m) of Code provides a $1 million annual limit on the deductibility of compensation expenses with respect to a "covered employee" of a "publicly held corporation." Nonetheless, for the last 24 years, "qualified performance-based compensation" and commissions have been exempt from this $1 million deduction limit. For these purposes, "qualified performance-based compensation" included stock options, stock appreciation rights (SARs) and other compensation that was payable solely on account of the attainment of one or more pre-established performance goals if certain outside director and shareholder approval requirements were met. For the past 10 years, Section 162(m) has defined "covered employees" as the chief executive officer (CEO) and the three most highly compensated officers for the taxable year (other than the CEO or CFO) as of the close of the taxable year.

Amended Statute: For tax years beginning on and after January 1, 2018:

- The Act amends Section 162(m) to eliminate the "qualified performance-based compensation" and commission exceptions to the $1 million annual deduction limitation. As a result (and other than with respect to grandfathered arrangements described below), while compensation paid in excess of $1 million for "covered employee" by publicly held corporations will no longer be deductible, such employers will no longer need to comply with the strict rules that were necessary to maintain qualified performance-based compensation arrangements.
- The definition of "covered employees" subject to the $1 million deduction limit under Section 162(m) is expanded under the Act to include CFOs, former covered employees and their beneficiaries. This expansion to cover former employees will, absent grandfathering, subject severance pay, deferred compensation and other payments and benefits on or after termination of employment to Section 162(m) as well.
- Finally, the definition of "publicly held corporations" subject to Section 162(m) is expanded to include companies that are required to file SEC reports under Section 15(d) of the Securities Exchange Act of 1934, which will pick up companies that report solely due to public debt, such as many private equity portfolio companies.

Transition Relief: Fortunately, the Act provides for limited grandfathering relief that preserves the deductibility of existing qualified performance-based awards, stock options and SARs that pay out after 2017. This grandfathering relief applies to qualified performance-based compensation arrangements that were maintained under "written binding contracts" as of November 2, 2017 and are not materially modified thereafter. It is likely that the scope of this transition relief will be developed further by the IRS as part of the regulatory process, and until the IRS issues additional guidance, modifications to existing performance-based compensation arrangements should be avoided when possible.

Potential Planning Opportunities: Companies subject to the $1 million deduction limitation of Section 162(m) in 2018 may want to consider accelerating payment of compensation otherwise payable in 2018, such as 2017 year-end bonuses (see additional discussion below) or severance payouts scheduled for 2018, to 2017 (to the extent this acceleration is permissible under Section 409A of the Code). The acceleration of these payments may afford the company a deduction for compensation payments that would no longer be deductible in 2018. Accelerating these payments may provide tax advantages in the following situations:

- An executive (for example, the CFO or a former executive) is not considered a covered employee in 2017 but will become a covered employee in 2018 under the Act;
- The company is not subject to Section 162(m) in 2017 but will become subject to Section 162(m) in 2018 under the Act (for example, a company with public debt); or
- The company would prefer to take the compensation deduction in 2017 rather than under the reduced corporate income tax rates in effect for 2018.

For similar reasons, some executives in high tax jurisdictions may prefer that these payments are accelerated into 2017 in order for the state and local taxes on these amount to be deductible on the executives' personal tax returns. Of course, lower top marginal rates for federal income taxes in 2018 is a significant counterbalancing consideration that may cause executives to be better off recognizing income in 2018.

Annual bonuses in respect of 2017 are worthy of particular (and quick) examination. Bonuses that are paid before March 15, 2018 may be deductible in 2017 if the "all events test" necessary to fix the liability for the bonuses have been met as of December 31, 2017. Companies that typically would take actions in 2018 to exercise discretion to determine 2017 bonuses may consider taking some binding corporate action before year-end to fix at least a portion of their bonus liability so that it may be deducted in 2017 against a higher corporate tax rate.

Other Action Items: Additionally, employers should review their incentive plan documents, incentive award agreements, compensation committee documentation, severance agreements and employment agreements in light of the removal of the exception for qualified performance-based compensation. These documents likely have been drafted with the requirements of the Section 162(m) performance-based compensation exception in mind. However, awards made after November 2, 2017 will not provide additional deductions by following the strict rules for such performance-based compensation. Companies should consider amending these documents to provide for greater flexibility such as: employer discretion to adjust payouts upward (instead of downward only discretion currently required by Section 162(m)); using a more flexible set of performance objectives other than the more rigid shareholder-approved objectives determined in advance (including objectives that would allow for mid-year changes to the performance metrics when appropriate); allowing for acceleration of performance-based pay at target or maximum upon certain terminations instead of based only on actual performance; etc.

Careful consideration will need to be given to determine if any of these changes require shareholder approval under the plan document or stock exchange listing rules. Finally, companies will need to revise their proxy statement disclosures to account for these new rules and to disclose the payment of nondeductible compensation.

Stay Tuned: The IRS will presumably issue interim guidance and eventually new regulations under Section 162(m), clarifying the transition rules in particular. Additionally, the shareholder advisory firms will almost certainly issue additional guidelines regarding how they will view amendments to existing incentive plans and how they will rate performance-based compensation in the absence of Section 162 (m)'s strict requirements. It remains to be seen whether these guidelines will continue to permit the flexibility that the Act seems to make available for employers.

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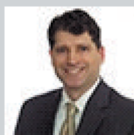

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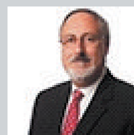

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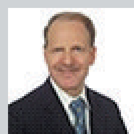

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