Client Alert

December 2017

$1 Million Deduction Limit on Executive Pay

The Tax Cut and Jobs Act (the "Act") makes significant changes to Section 162(m) of the Internal Revenue Code. Section 162(m) imposes an annual limit of $1 million on the deduction that a publicly held corporation may claim for compensation paid to any "covered employee." The Act amends Section 162(m) with respect to the companies and individuals who are subject to the deduction limit and repeals important exceptions to the limit. The changes are generally effective for deductions that would be claimed in tax years beginning after 2017.

Publicly Held Corporation

Prior to the Act, Section 162(m) defined "publicly held corporation" to mean a corporation whose *common equity securities* are required to be registered under Section 12 of the Securities Exchange Act of 1934 (the "Exchange Act"). Under the Act, the term publicly held corporation means a corporation that (a) issues *any securities* that are required to be registered under Section 12 or (b) is required to file reports under Section 15(d) of the Exchange Act. The new definition means that Section 162(m) will apply to corporations that have issued *any* publicly traded securities, including debt (even if their common stock is not publicly traded) as well as some non-publicly traded companies with many shareholders.

Covered Employees

Under current Internal Revenue Service (IRS) guidance, the individuals who are "covered employees" (and thus subject to Section 162(m)) generally have been limited to the principal executive officer (or "PEO") and the other three most highly compensated officers, other than the principal financial officer (or "PFO"), for whom disclosure is required under the disclosure rules of the Securities Exchange Commission (the "SEC").[1] IRS guidance also provided that the identification of these covered employees was made as of the last day of the corporation's fiscal year.

The Act changes the definition of covered employee to include any person who served as the corporation's PEO or PFO at any time during the year and the three most highly compensated officers (other than the PEO or PFO) for whom disclosure is required by the SEC. Significantly, if an individual is a covered employee at any time after 2016, then the individual must be treated as a covered employee in future years. The "once a covered employee, always a covered employee" principle means that Section 162(m) will continue to apply to compensation that is paid to a covered employee following his or her termination of employment (as well as compensation payable to a beneficiary following the death of the covered employee).

Compensation Previously Exempt from Section 162(m)

Prior to the Act, compensation that qualified as commission income and compensation that qualified as performance-based compensation was not subject to the deduction limit. For example, Section 162(m)

[1]The covered employees of a "smaller reporting company" are the PEO and the other two most highly compensated officers (which may include the PFO). It is not clear whether the Act's new definition of covered employee will apply to smaller reporting companies.

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did not limit the deduction that could be claimed for performance-based compensation regardless of the amount of other compensation paid to a covered employee and regardless of the amount of the performance-based compensation. Stock options and stock appreciation rights typically qualified for the performance-based compensation exception (even if vesting was based on continued employment rather than the attainment of performance goals). Other compensation, including cash bonuses and restricted stock or stock unit awards, often were designed to assure deductibility under the performance-based compensation exception.

The Act repeals these exceptions to the deduction limit. As a result, the deduction for virtually all of the compensation payable to a covered employee is subject to the Section 162(m) limit.

Transition Relief

The Act's changes do not apply to compensation that is provided under a "written binding contract" that was in effect on November 2, 2017, and that is not modified thereafter in any material respect. There are a number of open questions about the application of this transition rule, including (a) what constitutes a written binding contract, (b) whether an automatic renewal or extension of the agreement after November 2, 2017, ends the transition relief, and (c) the extent to which the transition relief applies to an equity or incentive *plan* (as contrasted with individual contracts or award agreements).

The transition relief certainly could preserve reliance on the performance-based compensation exception for compensation payable under grandfathered agreements. For example, it could preserve the deduction for the exercise of stock options and stock appreciation rights even if the exercise occurs after 2017. The transition relief also could preserve the deduction for cash incentives and restricted stock or stock unit awards that would qualify as performance-based compensation under pre-Act Section 162(m) and that are reflected in a grandfathered agreement.

It seems that the transition relief also could preserve the deduction under grandfathered agreements that provide for payments in years following termination of employment (*i.e.*, when the individual would not have been a covered employee under pre-Act Section 162(m)). This would seem to be the case even if the payments would not have qualified as performance-based compensation under pre-Act Section 162(m).

It also seems that the transition relief could protect the deduction for amounts paid under a grandfathered agreement to an individual who was the PFO in 2017 (and otherwise not subject to Section 162(m)). This would seem to be the case even if the compensation would not have qualified as performance-based compensation under the pre-Act Section 162(m) and even if the individual is a covered employee in the year of payment.

Companies should consider the transition relief before amending any plan or agreement that was in effect on November 2, 2017.

Impacts of the Changes

The repeal of the performance-based compensation exception and the new provision stating that a covered employee always remains subject to Section 162(m) means that virtually all of a covered employee's compensation in excess of $1 million for the year will be nondeductible. Lower corporate tax rates will likely soften the impact of the loss of deduction. Further, the deduction for some compensation may be preserved under the transition relief.

The repeal of the performance-based compensation exception means that there is no longer a Section 162(m) advantage to payments or awards that qualify as performance-based compensation. We doubt that repeal of the exception will result in a widespread shift to awards that are immediately vested or that vest solely on account of continued employment. We expect that investor relation considerations and

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governance principles will encourage companies to continue designing executive compensation programs that include some degree of performance vesting.

However, executive compensation programs now may include greater flexibility or discretion (even with companies that continue to incorporate some element of performance objectives in their programs). For example, companies may allow the use of positive discretion (which hasn't been allowed under Section 162(m)) in determining the amounts that have been earned. Also, performance goals will not have to be objective or based on performance measures or criteria identified in a shareholder-approved plan.

Incentive and equity compensation plans that were designed to comply with Section 162(m) included individual award or payment limits. The repeal of the performance-based compensation exception means that the individual grant limits are no longer required. Some companies may want to amend their plans to remove the limits. (Companies that consider doing so should consider whether those changes must be approved by shareholders under the terms of the plan and the stock exchanges may announce a position on whether approval is required.)

Stock options and stock appreciation rights have been easy to qualify as performance-based compensation under pre-Act Section 162(m), and that ease created a bias in favor of those types of grants. The repeal of the performance-based compensation will eliminate that bias and could lead to greater use of cash compensation or "full value" awards such as restricted stock and stock units.

The performance-based compensation exception required that the relevant decisions be made by a committee (or subcommittee) comprised solely of individuals who qualified as "outside directors" under Section 162(m). The members of a compensation committee will no longer need to qualify as outside directors. Note, however, that the outside director requirement may still be relevant for purposes of agreements eligible for the transition relief.

Compensation committees will want to consider the possible non-deductibility of executive pay (in conjunction with consideration of all other pertinent facts and circumstances) in approving executive compensation programs and payments.

If you have any questions or want to discuss the Act's changes to Section 162(m), please contact one of the attorneys listed below.

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