



Compensation
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CAPintel // January 2, 2018

Tax Cuts and Jobs Act: Amendment of Section 162(m)

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Congress approved the Tax Cuts and Jobs Act on December 20th, 2017, achieving its objective of delivering a bill for President Trump's signature before Christmas. The Act makes many dramatic changes to the tax code, including sharp reductions in the corporate tax rate, modest reductions in individual tax rates and some progress in simplifying the tax code. The biggest change from an executive compensation perspective involves amendment of Section 162(m).

Since going into effect in 1994, Section 162(m) has limited the deductibility of remuneration to covered employees to the extent the amount exceeds \$1,000,000. Under current law, important exceptions to the limits on deductibility apply to stock options, other performance-based compensation and commissions. The amendments in the Act greatly expand the limits on deductibility by eliminating these exceptions.

Highlights of the Amendments to Section 162(m)

Amendment	Implication
Exceptions allowing deductibility of stock options, other qualifying performance-based compensation and commissions are eliminated	Effectively caps deductibility of senior executive compensation to \$1 million per year and raises company cost of compensation
Definition of covered employees aligned with SEC disclosure rules	Expands coverage to include any person serving as Principal Executive Officer (PEO) and Chief Financial Officer (CFO) during the tax year, as well as the three highest paid executive officers other than the PEO and CFO
Expands coverage to include compensation of covered employees for all future years of employment whether or not they remain in the proxy, payments made after retirement, death or other termination of employments and payments to beneficiaries	Widens the net by eliminating loopholes allowed under current law, such as leaving the role of PEO before the last day of the year and making non-qualified deferrals of compensation until after termination
Amendments apply to taxable years beginning after December 31, 2017, except that the amendments shall not apply to remuneration provided pursuant to a written binding contract in effect on November 2, 2017, and not modified in any material respect on or after such date	Effectively grandfathers existing arrangements and provides companies with an opportunity to capture tax deductions as existing arrangements wind down over time

Possible Benefit from Amended Section 162(m): More Flexibility for Compensation Committees

Public companies subject to Section 162(m) use a variety of techniques to comply with the current law and maximize tax deductibility. Going forward, for new awards that are not made under grandfathered written binding contracts, these techniques will no longer be needed. Tax deductibility will be capped at \$1,000,000 regardless of plan design:

- “Plan within a plan” structure, also known as an “umbrella plan,” will no longer be necessary, providing companies with an opportunity to simplify current plans.
- Tax incentives to grant performance-based compensation will be eliminated in most instances, encouraging greater use of time-based awards.
- Potentially more flexible performance metrics may be instituted over time. Non-GAAP metrics, individual goals and metrics that incorporate discretion are likely to occur more frequently.
- Tax penalties for adjusting or restating performance targets will be eliminated in most instances.
- Compensation committees will have greater opportunities to exercise discretion, including positive discretion.

- While amendments clearly raise the cost of compensation for companies, the corporate tax rate cut makes the lost tax deductions less valuable, with a deduction on \$1 million of compensation declining from \$350,000 to 210,000.

What Should Companies Do Now?

Companies should take the following steps now to develop a clear picture of their particular situation with respect to the amendment of Section 162(m):

1. **Take an inventory.** Make a list of outstanding compensation arrangements and awards to determine which may continue to be deductible going forwards. These would include contractual benefits and other awards made under written binding contracts in place on or before November 2, 2017.
2. **Double check your assessment with tax counsel.** Make sure internal resources and outside advisors agree with your analysis and conclusions.
3. **Determine administrative processes needed to capture tax deductions going forward.** For example, achievement of the goals of a grandfathered performance share award must be certified by the Compensation Committee prior to payment to comply with current Section 162(m) rules.
4. **If contractual arrangements and awards will continue over time, continue to seek re-approval of the material terms of incentive plans every 5 years.** Shareholder approval of metrics, maximum awards and the class of participants are required to comply with current law. Obtaining shareholder approval of these proposals is almost always easy to accomplish.
5. **Be wary of making changes.** Modification to awards or arrangements in effect on or before November 2, 2017 could result in the loss of valuable tax deductions.
6. **Determine which executives appear in the proxy and become covered employees under amended Section 162(m).**
7. **Do your best to limit new entrants into the proxy disclosed group.** Once an executive becomes subject to amended Section 162(m), the limits on deductibility become permanent.
8. **Prepare a pro forma showing current law and amended law to review with the Compensation Committee.** It is important to brief the Committee and senior management to avoid surprises. All will benefit from understanding the magnitude of lost deductions.
9. **Review your proxy disclosure.** Determine how best to address the issue of tax deductibility in the CD&A.
10. **Follow case law as it develops.** Without a doubt, companies will test the amendments and new thinking will develop. You will benefit if you track the issue as it is tested in the marketplace.

We will keep our readers informed of new developments. Undoubtedly the Tax Cuts and Jobs Act will have other implications for executive compensation.



Please contact us at (212) 921-9350 if you have any questions about the issues discussed above or would like to discuss your own executive compensation issues. You can access our website at www.capartners.com for more information on executive compensation.