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US tax reform

Impact of Section 162(m) changes and transition relief on excessive compensation

Overview

Background

Employers can generally deduct reasonable compensation for personal services as an ordinary and necessary business expense. An explicit exception under Section 162(m) limits the deductibility of compensation expenses by certain applicable employers. The otherwise-allowable deduction for compensation with respect to a "covered employee" of a "publicly held corporation" is limited to no more than $1 million per year unless specific exceptions apply.

Section 162(m) updates

Prior law

Before tax reform legislation:

- The $1 million deduction limitation did not apply to certain performance-based compensation and commissions.
- Applicable employers were only entities that were issuers of securities that are subject to the registration requirements of Section 12 of the Securities and Exchange (SEC) Act of 1934 (the "Exchange Act").

- Covered employees included the principal executive officer and next three highest-paid employees, as disclosed in SEC filings, as of the last day of the employer's taxable year. The principal financial officer (i.e., chief financial officer) was excluded from the definition of a covered employee.
- Status as a covered employee was a discrete determination for each taxable year.

New law

Effective for tax years beginning on January 1, 2018 or later, tax reform legislation modifies those rules to:

- Repeal the performance-based compensation and commission exceptions to the Section 162(m) $1 million deduction limitation.
- Expand the definition of an applicable employer to include entities that are issuers required to file reports under Section 15(d) of the Exchange Act.
- Revise the definition of a "covered employee" as follows:
  - The principal financial officer is now included as a covered employee;
  - All individuals who hold the position of either principal executive officer or principal financial officer at any time during the taxable year are now covered employees;
  - Covered employees include officers whose total compensation is required to be disclosed to shareholders by reason of them being amongst the three highest-paid officers (other than the principal executive officer or principal financial officer.). This is not an operational change but conforms the statute to IRS Notice 2007-49; and
  - for a "publicly held corporation" that is not required to file a proxy statement, covered employees are determined as if these rules applied.
- Provide that an individual who is a covered employee for any taxable year beginning after December 31, 2016 will continue to be a covered employee for all subsequent taxable years, including years after the death of the individual.

Transition

The provision applies to taxable years beginning after December 31, 2017.

A transition rule applies to remuneration, which is provided pursuant to a written binding contract that was in effect on November 2, 2017.

Additional considerations

Is relief available under the November 2, 2017 Transition Rule?

In general, the transition rules will allow payments to be deductible based on the application of the Section 162(m) rules in effect prior to the change if the payments are made pursuant to a "written binding contract" that was in effect on November 2, 2017, and has not since been materially modified.

Because the transition rule only applies to "written binding contracts," it may not apply in cases where an agreement provides that an employer retains discretion to reduce or eliminate a payment.

Employers should give careful consideration to the impact that the transition rules may have on their existing contracts entered into on or before November 2, 2017 to identify potential benefits and avoid making any modifications to contracts without considering these rules.

Once a covered employee, always a covered employee:

Prior to the new Section 162(m) rules, upon certain events compensation paid to individuals who were covered employees during the year was no longer subject to the Section 162(m) limitations. The new Section 162(m) rule could impact companies in a meaningful way:

- In the event of a merger or acquisition involving public companies, many targets are not required to report summary compensation tables under SEC rules for the short period prior to the change in control (CIC). Such companies would not have covered employees under the old Section 162(m) rules, resulting in significant CIC payments being exempt from the deduction limits of Section 162(m). Under the new Section 162(m) rules, individuals who were previously classified as covered employees will continue to be covered employees through the transaction. Consequently, deductions associated with CIC payments may be limited. This limit applies in addition to any deduction limit under Section 280G (the "golden parachute" rules).

- In the event of a covered employee termination (or change in status) that occurred before the last day of the fiscal year, the CEO and top paid officers would cease to be a covered employee. As a result, all payments (including severance payments and distributions from nonqualified deferred compensation plans) made to these individuals during the fiscal year (and thereafter) were exempt from Section 162(m) and deductible to the company. Under the new Section 162(m) rules, these individuals will remain covered employees and the deductions will be limited.

Deferred tax asset (DTA) considerations:

- DTAs recognized in the financial statement as of the enactment date related to deferred compensation expense and share-based compensation expense should be evaluated to determine if the new Section 162(m) rules would impact the ability to claim a deduction in the future and adjusted accordingly.
- Going forward, a DTA should only be recognized for future compensation expense recognized for deferred compensation plans and share-based awards if a tax deduction is expected under the new rules, taking into account transition, when the deferred compensation is paid to the employee and when the share-based awards are exercised or vested.

Deloitte's view

As a next step, employers should:

- Look for any additional guidance from the Internal Revenue Service on how the new rules are applied;
- Review the population of current and potential covered employees;
- Review existing contracts, plans, and agreements to determine which may qualify for transition relief;
- Calculate value of any lost tax deductions and consider how these changes will impact existing and future DTAs; and
- Revisit executive compensation practices, policies, and programs to determine whether prospective changes are appropriate.