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Tax Reform: A Deeper Dive into Amended Section 162(m)

Editor's note: This article addresses recent tax law developments affecting non-qualified deferred compensation plans sponsored by publicly traded corporations and non-public organizations that are required to file statements with the Securities and Exchange Commission.

Executive Summary

- Internal Revenue Code (the "**Code**") Section 162(m) limits the corporate tax deduction on C-Suite officer compensation paid by a public company to $1 million per employee per year. Before 2018, shareholder-approved performance pay and commissions were fully deductible, regardless of the $1 million limit. Payments made after termination of employment were fully deductible, including severance pay and payments from non-qualified retirement plans.
- 2017 tax legislation, known as the Tax Cuts and Jobs Act of 2017 (the "**Act**")
  - Eliminates an exception to the $1 million limit for performance pay and commissions
  - Applies the cap to compensation paid after termination of employment
  - Applies the limit to widely held non-public companies who are required to file reports with the Securities and Exchange Commission (the "**SEC**")
- Sponsors of non-qualified plans should evaluate the effect of the change on pre-2018 and post-2017 accruals of deferred compensation.
  - Sponsors should look for Treasury guidance to come in 2018
  - After guidance, evaluate whether to separately identify their pre-Act deferred compensation obligations in order to deduct the payments under the pre-Act version of 162(m) and 409A regulations that permit delaying scheduled payments until they are deductible
  - For future accruals, consider extending payments beyond termination of employment and/or limiting the maximum annual payment from a non-qualified plan
- Newport Group does not expect the changes to affect the design or amount of incentive compensation paid to C-Suite officers or the use of non-qualified deferred compensation to promote the recruiting and retention of executive talent.

Executive compensation continues to be an area of focus for policy makers, as evidenced by the changes made to Internal Revenue Code (the "**Code**") Section 162(m) under the Tax Cuts and Jobs Act of 2017 (the "**Act**"). The changes to 162(m) could indirectly affect the design or operation of a public company's non-qualified deferred compensation plans.

By way of background, Code Section 162(m) generally limits deductions against business income to "reasonable" business expenses. The general limit on reasonable expenses includes compensation paid to employees.

Pre-Act 162(m) Covered Employee and Employers

In 1993, Code Section 162(m) was enacted in response to reports of record-setting executive compensation pay packages and the perception that the Board of Directors had internal conflicts of interest when approving executive pay. Section 162(m) attempted to rein in excessive pay by adopting a statutory dollar limit on deductible compensation at $1 million for each "covered employee."

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Covered employees included the "principal executive officer" (the CEO) and the top three highest paid officers of a publicly held company shown on the company's annual proxy statement, determined as of the last day of the taxable year. A "publicly traded" corporation meant corporations with publicly issued stock subject to registration under the Securities Exchange Act of 1934.

Pre-Act 162(m): Fully Deductible Performance Pay, Severance and Non-Qualified Retirement Payments

The $1 million limit applied to most forms of compensation but allowed a full deduction for "performance-based pay." Performance pay was viewed as a desirable form of compensation that aligned the interests of management with the interests of shareholders. In order to provide an objective test for identifying exempt performance pay and to address perceived conflicts of interest at the board level, 162(m) defined performance based pay as amounts paid (a) under a set of written, objective performance criteria (b) with the performance criteria and compensation amounts approved by two or more board members who were outside directors (c) with the approval by the shareholders prior to payment and (d) after certification by the independent directors that the objective criteria were met prior to payment.

Although not specifically identified as an exempt form of compensation under 162(m), payments made to a former covered employee were fully deductible. A terminated executive was no longer a "covered employee" so any deferred compensation and severance payment were fully deductible. Although this would seem to have been an unintended loophole, the Treasury Department at least acknowledged if not outright endorsed this result when it adopted Treas. Reg. 1.409A-2(b)(7)(i). That regulation allowed scheduled payments of non-qualified deferred compensation to be rescheduled to a later year if—during the current year—the corporation reasonably believed that the compensation would not be deductible as originally scheduled.

- *Example: If Executive's salary was $900,000 and a scheduled deferred compensation payment in Year 1 was $300,000, the corporation could pay and deduct $900,000 of salary and $100,000 of the deferred compensation (total $1 million) and reschedule the remaining $200,000 of deferred compensation for the following year. The rescheduled deferred compensation could continue to be delayed in each subsequent year until deductible or until separation from service when the employee was no longer a "covered employee."*

162(m)'s "carrot and stick" approach could be viewed as a policy promoting good corporate governance policy as much or more than it was about raising revenue. The SEC proxy disclosure rules dovetail with 162(m)'s corporate governance rules by requiring the compensation committee to explain to shareholders whether the approved compensation packages will be deductible and if not, the rationale for paying nondeductible compensation. Over the years, some commentators have observed that 162(m) did not substantially change the amount of executive pay as much as it changed how the pay packages were designed, approved and monitored.

The Act Changes 162(m) by Eliminating the Exceptions and Extending Application to More Companies.

The Act represents a shift away from the "good governance" approach under prior 162(m) to an absolute deduction limit of $1 million on all forms of compensation paid to covered employees and by expanding the rule's coverage. The Act achieves this in four ways:

- Defining a larger group of companies subject to 162(m). In addition to companies with publicly traded stock, the covered employers now include any company that files statements with the SEC under section 15(d) of the Exchange Act. This is a much larger group of employers, including foreign corporations with ADRs traded in on US exchanges, widely held C and S corporations and corporations with publicly traded debt even though no common stock has been publicly issued.
- Adding the CFO as a covered employee. There are now five rather than four officers subject to the limit including the CEO, CFO and the three highest paid officers.
- Providing that once an individual is a covered employee, he or she remains a covered employee.
- Specifically excluding the exemption for performance based pay.

The change to 162(m) is effective for compensation paid on or after January 1, 2018 to covered employees determined as of December 31, 2017 for a corporation with a calendar taxable year. Corporations with non-calendar taxable years may have a later effective date during 2018.

A Transition Rule Applies Pre-Act Rules to Compensation Under Written Binding Agreements Effective On or After November 2, 2017.

Compensation paid in 2018 or later under the terms of a written binding contract in place on or before November 2, 2017 is eligible for a transition rule that allows the compensation to continue to be deductible under the pre-Act version of 162(m). The transition rule will only apply if the contract is not modified. If a contract can be extended or renewed for future services, the transition rule will apply only to the compensation paid under the contract term in effect as of November 2, 2017.

As of this writing we do not have Treasury guidance as to all of the types of compensation or contracts that may qualify for the transition relief. We believe it will include performance-based pay approved by the shareholders before November 2, 2017 that is paid in 2018 and beyond (a multi-year LTIP, for example).

Transition Relief for Non-Qualified Deferred Compensation.

The legislative history of the Act indicates that some form of transition relief is available to non-qualified deferred compensation earned or deferred under an agreement in place prior to November 2, 2017. The Conference Report provides the example of a covered employee hired October 2, 2017 under a written employment contract that provides the employee is eligible to participate in the company's executive deferred compensation plan in accordance with the terms of the plan. In the example, the employee becomes eligible for participation in six months, the amounts payable under the plan are not subject to discretion and the company does not have the right to amend materially the plan or terminate the plan except on a prospective basis before any services are performed. The report states the compensation is subject to pre-Act 162(m), even though the employee was not actually a participant in the plan on November 2, 2017.

Although the legislative history is helpful in identifying potentially "grandfathered" deferred compensation, it isn't clear how grandfathered deferred compensation will be treated. The only forms of fully deductible compensation under pre-Act 162(m) were performance pay and commissions—non-qualified deferred compensation was never an exempt form of compensation. We are speculating at this point that Treasury guidance will allow employers to fully deduct grandfathered compensation paid after termination of employment. Grandfathered deferred compensation paid during employment would confer little benefit unless employers are permitted to use the pre-Act rules for identifying the covered employees on an annual basis (disregarding the "once a covered employee, always a covered employee" rule). If the Treasury regulations head down this path, employers will need to keep two lists of covered employees, one to track post-Act deductibility under the new rules and one to track pre-Act deductibility of grandfathered deferred compensation.

Impact of 162(m) on Executive Pay and Sponsors of Non-Qualified Deferred Compensation Plans

Executive Compensation Packages Will Continue to Emphasize Performance-Based Pay

One question sponsors will be asking in 2018 is whether the new limitation on deductibility will change their pay practices for senior management. For most companies, the analysis is likely to be resolved on an aggregate basis, taking into account all of the tax benefits under the Act as well as the "take-aways." To give some sense of the scale

of the dollars involved, the Joint Committee on Taxation estimated the cost of the corporate rate deduction from 35% to 21% to be approximately $1.4 trillion while the new revenue under 162(m) is $9.2 billion. The ratios do not translate to an individual company, but do give some sense of the relative importance of the 162(m) deduction limit. Full deductibility under 162(m) is not a factor in realizing the overall tax benefits of the Act.

Because the business objectives predominate over tax objectives for most companies, we do not anticipate any significant change in the use of short and long-term performance based pay. Initial feedback from Newport Group's Compensation Consulting Services group indicates that there is no significant "across the board" movement to change performance based pay packages in 2018 nor are they expected to occur in the future because of 162(m). Long-term incentive pay continues to be favored by shareholder groups and is a key element in attracting and retaining talent. Some practitioners have taken the view that the elimination of the 162(m) oversight provisions will allow corporations to more flexibly designed incentive pay programs.

One possible trend to watch for is the re-emergence of incentive stock options (ISOs). ISOs were disadvantaged because they were never deductible under a separate section of the Code but are now on somewhat of a level playing field with nondeductible cash incentives. ISOs also confer capital gains tax rates on the employee. However, ISOs are restricted to $100,000 in newly vested shares per year which may limit the size of these awards.

Sponsors of Non-Qualified Deferred Compensation Plans Should Evaluate Grandfathering and Future Plan Design Changes After Treasury Issues Guidance.

Sponsors of deferred compensation plans will need to weigh the cost benefit of grandfathering plans in effect on November 2, 2017. For elective deferral plans, grandfathering may be available only for elections that became irrevocable before November 2, 2017 (a mid-year 2017 enrollment for bonus would likely be the last eligible election). Elections filed in the fall of 2017 for 2018 salary and other compensation are likely ineligible where the elections become irrevocable on the last day permitted under 409A (December 31, 2017). SERPs may be easier to grandfather as they are less dependent on annual enrollments and the entitlement is based on eligibility rather than participant deferral elections. Where eligibility is determined annually (a form of contract "renewal"), grandfathering may be limited.

The benefits of grandfathering may also be limited if "material modification" is defined broadly. For example, most non-qualified plans permit participant payment modifications. One would hope Treasury would adopt rules similar to grandfathered split dollar and other grandfathered arrangements where the exercise of a right under the grandfathered arrangement is not treated as a material modification.

The change in deductibility under 162(m) may also impact the company's balance sheet. Companies with deferred compensation liabilities record the expected tax deduction for the future payment as a current asset on the balance sheet, known as a "deferred tax asset" or "**DTA**." If the assumptions about taking the deduction change as would be the case if the deduction is lost due to changes in the tax code, the company may need to change the amount recorded as a DTA. Grandfathering would preserve the deferred tax asset to the extent payments continue to be deductible under reasonable assumptions. If existing deferrals under a plan cannot be grandfathered, as discussed above, the company will need to record a current year charge to earnings and a reduction in the balance sheet asset for the existing liabilities. Newport Group's Tax and Accounting group is available to assist sponsors on the accounting issues associated with the change under 162(m).

We expect non-qualified deferred compensation will be more valuable going forward as the ability to stretch payments over several years is likely to increase the percentage of total compensation that is deductible. This is particularly true at separation from service where there will be few if any forms of competing compensation, resulting in the application of the full $1 million deduction allowance to the deferred compensation payments. Corporations also can promote longer payment schedules by using a little-known provision of the 409A regulations that allows the plan to limit annual payments to a pre-determined amount. Sponsors can also incentivize participants with additional credits if they select longer payment schedules.

Next Steps

Newport Group will be issuing future updates once the Treasury Department releases guidance. We are available to assist our clients in working through the effects of the tax law changes and, if decided, to assist in segregating pre-Act deferrals for grandfathered treatment under 162(m).

Contact your Newport Group representative for more information.

Disclaimers

Note that the views expressed above do not constitute investment advice; readers are encouraged to consult their own legal counsel. This release is a high-level summary of a complex subject that is intended for Newport Group's clients and intermediary partners and should not be understood as providing a comprehensive discussion of all issues or requirements under the regulations or as a guide to compliance.

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