

# Fulcrum Partners LLC



## Rethinking Executive Compensation While Awaiting Section 162(m) Guidance

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Effective for tax years beginning on or after January 1, 2018, the Tax Cuts and Jobs Act (the “Act”) made significant changes to Section 162(m) of the Internal Revenue Code. The changes eliminate the ability for publicly held corporations (and certain large private C and S corporations) to deduct compensation in excess of \$1 million paid to any of an increased number of executives in a given year.

## Overview

Prior to the Act, Section 162(m) limited a publicly held corporation's deduction for compensation paid to covered employees to \$1 million during a year. The covered employees included the corporation's CEO and the three highest paid executive officers (other than the CEO and CFO) whose compensation must be disclosed to shareholders. However, performance-based compensation and commissions were not subject to this limitation. Performance-based compensation generally included (i) compensation payable to a covered employee upon satisfaction of objective performance goals set by a committee composed of outside directors based on shareholder-approved goals and (ii) stock options or stock appreciation rights under a shareholder approved plan.

The Act significantly changed Section 162(m) by:

- Expanding the definition of "publicly held corporations" that are subject to Section 162(m);
- Enlarging the group of covered employees in a given year;  
*and*
- Repealing the exceptions to Section 162(m) for performance-based compensation and commissions, thereby eliminating the ability to deduct compensation in excess of \$1 million paid to any covered employee during a year.



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## Publicly Held Corporations

Section 162(m) previously applied to domestic corporations with publicly traded equity and certain foreign issuers. Under the Act, companies that have publicly traded debt, as well as foreign companies publicly traded through American depositary receipts, now are subject to the \$1 million deduction limit under Section 162(m).

## Covered Employees

The Act enlarges the covered employee group by including the CFO and adopting an “eternal covered employee” rule. The covered employee group for any given year now consists of:

- The CEO, CFO and the three highest paid executive officers (other than the CEO and CFO) whose compensation is required to be reported to shareholders (or whose compensation would be subject to such reporting requirements if the company was subject to these disclosures); *and*
- Any individual who became a covered employee of the corporation (or any predecessor) for any tax year beginning after December 31, 2016, since he or she retains the covered employee status for all future years, including after separation from service or death.

These changes to Section 162(m) effectively eliminate a corporation’s ability to deduct compensation in excess of \$1 million for an increased number of covered employees in a year



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and preclude the ability to preserve deductions by deferring compensation to a point when the individual is no longer a covered employee. All post-termination payments including severance, deferred compensation from nonqualified plans, and death payments received by a covered employee (or beneficiary) will be subject to the limitation.

### **No performance-based compensation deduction**

Unlike prior law, there is no exception to the \$1 million deduction limit for performance-based compensation or commissions. As such, all compensation in excess of \$1 million, paid to a covered employee during the year, is nondeductible.

However, the Act provides a transition rule under which the changes to Section 162(m) will not apply to compensation payable under a written binding contract that was in effect on November 2, 2017, and which is not materially modified after that date.

### **Planning considerations**

For applicable corporations that pay their executives significantly greater than the \$1 million limit each year, tax planning may be very limited. Due to the elimination of the deductions for performance-based compensation and commissions and the broader covered employee group, the lost deductions may become a cost of doing business and a trade-off for the tax benefits corporations receive from the reduction



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in the corporate tax rate from 35% to 21% (i. e. , at a 21% rate, the “cost” of the lost deduction is lower than under prior law). Pending guidance by the Internal Revenue Service (IRS), corporations paying compensation closer to the \$1 million limit may consider any of the potentially applicable techniques to preserve the compensation deductions or maximize other benefits.

- **Use nonqualified deferred compensation annuities.** Prior to the commencement of the year in which a corporation reasonably anticipates the compensation payable to a covered employee will exceed \$1 million during such year, replace the nondeductible cash payments with a promise to pay amounts to a covered employee in the form of an annuity. As long as the future payments to the covered employee are less than \$1 million per year, the payouts will be fully deductible. The nonqualified deferred compensation plan must be structured to comply with the rules under Section 409A and may be designed to serve other business objectives:
  - Incentive compensation, which determines the amount of the employer contributions to the plan;
  - Employee retention, since the amounts may be forfeited upon a voluntary termination; *and*
  - Favorable state tax treatment for those retiring in a state with no or lower income tax rates since distributions from a nonqualified deferred compensation plan with substantially equal periodic payments over a period of 10 or more years would be



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taxable in the state of residence at time of receipt (and not taxable in the state earned).

A corporation may unilaterally shift the timing of payments under its bonus and incentive compensation plans from active pay to post-termination distributions. However, the employee's consent may be required to change the timing of other forms of pay such as base salary and in-service distributions of deferred compensation. While delaying tax on the compensation is an incentive for an employee to agree to the deferral that facilitates the employer's deduction, many covered employees may not be inclined to accept the risk of being an unsecured creditor in the event of bankruptcy and subjecting any assets earmarked to pay nonqualified deferred compensation to the claims of the employer's creditors. Further, an employee's exercise of non-grandfathered options is outside of the employer's ability to keep annual compensation within the deductible limit.

- **Maintain grandfathered plans.** Review equity and incentive plan documents, award agreements, employment agreements and other compensation arrangements for grandfathered status. A deduction for pay in excess of \$1 million may still be available under these arrangements, as long as the requirements are met. In the absence of guidelines specifying actions that constitute a "material modification" to a grandfathered arrangement, avoid making any modifications to such plans. Pending IRS guidance on



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whether an equity incentive plan document itself qualifies for grandfathering (such that new awards under the plan inherit the grandfathered status), avoid modifying these plans and use the share reserve sparingly to grant performance-based awards only (e. g., stock options, stock appreciation rights, and performance stock awards). Adopt another equity incentive plan to award nonperformance-based awards.

- **Set more challenging performance goals.** For non-grandfathered incentive compensation, consider making the performance goals more challenging such that satisfaction of the higher metrics produces additional cash flow to fund the lost deductions or reduces the payout and lost deductions upon forfeiture for goals that were not met. The company should retain discretion to adjust the rewards and punishments under the more demanding pay system that places the executive's compensation at greater risk. The elimination of the performance-based compensation deduction provides corporations with greater flexibility to design incentive plans that allow for discretionary payments, which was not permitted under the rigid rules that previously applied under Section 162(m). Notably, the discretionary payments may still be constrained by the demands of institutional investors and proxy advisors.
- **Spread vesting.** Implement longer vesting schedules for incentive compensation plans and restricted stock such that no single year exceeds \$1 million in compensation to a



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covered employee.

- **Award incentive stock options (ISOs).** If a company is already losing deductions on equity awards, the downside of issuing ISOs is eliminated. ISOs may provide better tax consequences for the recipients who are willing to hold the stock, particularly since the Act significantly increased the alternative minimum tax (AMT) exclusion. Notably, the \$100,000 limit on options first exercisable in a single year, the potential for the alternative minimum tax to still apply upon exercise, and the executive's desire to immediately sell the stock upon exercise could reduce their utility.

### Other considerations

Section 162(m) planning should also take into account other tax consequences, including the nonqualified deferred compensation rules under Section 409A and the golden parachute rules under Section 280G. Based on one of several interpretations, a provision within the Section 409A regulations could be utilized to delay payments to a year when the amount would be deductible under Section 162(m). For purposes of the golden parachute rules, such strategies of deferring payments and stretching out vesting, but accelerating payout and vesting upon a change in control event, will have the effect of lowering an individual's five-year average pay ("base amount") and causing greater acceleration and therefore higher parachute values, thereby amplifying the individual's penalty exposure.



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Given the reduction in the corporate income tax rate, the broader covered employee group, the elimination of performance-based compensation deductions, and preserved deductions for grandfathered plans, companies should model the costs of their executive compensation arrangements. Visualizing the results will help companies determine the appropriate total compensation strategy suitable for their financial and business objectives.

Fulcrum Partners advises you to always consult your own tax, legal, and accounting advisers.



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