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## Section 162(m) Has More "Bite" After Tax Reform

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Congress passed a reconciled tax reform package on December 20, 2017, generally referred to as the Tax Cuts and Jobs Act. Although the previous months have been a rollercoaster ride of proposals affecting a variety of employee benefit programs, very few made it through to the final bill. This Alert covers one of the more impactful changes that was ultimately included in the final bill – the Act revises Internal Revenue Code Section 162(m) to make it more likely that public companies will exceed the \$1,000,000 deduction limit on compensation paid to executives.

Code Section 162(m)(1) currently disallows the deduction of compensation paid to a “covered employee” of a publicly-held corporation to the extent the payments exceed \$1m in a year. This limit, however, does not apply to “performance based compensation.” Regulations provide a long list of conditions (such as prior shareholder approval of the performance criteria, and compensation committee objective certification that the performance goals were met), but as long as compensation is structured to satisfy those conditions, it is exempt from the \$1m limit. This exception means that many executives of public companies have multi-million dollar compensation packages when compensation such as stock options, cash performance bonuses, and other equity grants are taken into account.

Under current law, the 162(m) deduction limit defined “covered employee” in a way that leaves several gaps. Namely, the CFO of the company is not generally subject to the limits, and compensation paid to former executives (such as deferred compensation or severance) are also not limited.

The Tax Cuts and Jobs Act changes this landscape significantly. In sum, the final tax reform package makes the following changes, effective for company fiscal years beginning after December 31, 2017:

- eliminates the “performance-based compensation” and commission exceptions;
- designates the principal financial officer as a “covered employee”;
- provides that a covered employee on or after January 1, 2017 will remain in the covered employee group; and
- expands the coverage of Section 162(m) beyond the current scope of companies with publicly traded stock, now to also include companies with publicly traded debt and possibly even foreign private issuers.

The Act includes a transitional rule. The changes to 162(m) will not apply to compensation paid under a written binding contract that was in effect on November 2, 2017, provided that the contract is not materially modified.

As a result of these significant changes, impacted companies should

consider the following planning and compliance-related issues:

- **Identify Affected Parties and Pay Arrangements.** Public companies will need to update their process of tracking which executives are subject to 162(m) (to include financial officer, and to carry over “covered employee” status in perpetuity). They should also identify all components of compensation, and note any components that may qualify for the transitional rule and avoid, if possible, modifications that might make the compensation nondeductible.
- **Accelerate Compensation and Company Deductions.** To the extent an individual will become a 162(m) covered employee after 2017 as a result of tax reform and is likely to have compensation in 2018 or later that exceeds \$1m, the company could consider accelerating that compensation or taking steps to ensure that any amounts paid in 2018 are deductible for 2017 under the all events test. (Note that since the company's corporate tax rate will be reduced in 2018, there is an additional advantage that deductions in 2017 are effectively more valuable to the company than they will be in 2018.)
- **New Compensation Strategies.** With the elimination of the “performance-based compensation” exception and the expanded list of “covered employees,” many public companies will be faced with a deduction loss in 2018 compared with prior years. Companies should evaluate compensation strategies that could help recoup some of the projected deduction losses. For example, perhaps a deferred compensation program could be designed to smooth compensation that would otherwise be nondeductible over multiple years.
- **Institutional Shareholder Influence.** Even though the performance-based compensation regime will no longer be helpful for deduction reasons, there still might be advantages to attaching performance incentives to executive pay, and institutional shareholder services might be expected to weigh in on the subject.
- **Securities Disclosure.** To the extent securities disclosure documents contain a discussion of the company's 162(m) strategy, they may need to be revised.

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