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New Tax Laws: Maximizing Deductions After Elimination of Compensatory Deductions Under Section 162(m)

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As was discussed in last month's newsletter, the recently enacted Tax Cuts and Jobs Act of 2017 (the "TCJA") amended the Internal Revenue Code of 1986 to eliminate the performance-based exception to the $1mm deduction limit under Section 162(m) of the Internal Revenue Code of 1986 ("Section 162(m)"). This article discusses some alternatives for attempting to maximize deductions on executive compensation.

Business Point

Even though (i) the performance-based exception to the $1mm deduction limitation has been repealed and (ii) the $1mm deduction limitation now applies to covered employees for life (*i.e.*, once a covered employee, always a covered employee), it is important to remember that $1mm per year is still fully deductible. To maximize deductions, companies will want to think about whether it makes sense to spread compensation payments out over several years, particularly for periods following termination of employment or retirement, to reduce the likelihood that the $1mm limit is exceeded in any given year (or at least to minimize any excess).

Technical Points

The definition of "covered employee" for purposes of the $1mm deduction limitation has been expanded. Previously, a "covered employee" generally included only the CEO and the next three highest paid officers (other than the CFO), determined as of the last day of the year. Under the TCJA, "covered employee" now includes the CEO, the CFO and the three highest paid officers other than the CEO and the CFO. In addition, the TCJA now requires that once an individual becomes a "covered employee" for Section 162(m) purposes, that individual remains a covered employee with respect to that company for life, even after termination of his or her employment. Consequently, amounts paid by the company to a former officer who was a covered employee (and thus would continue to be a covered employee) are subject to the $1mm deduction limitation.

The following are among some of the ways companies might seek to minimize the amount of compensation that is not deductible under Section 162(m):[1]

- Grant equity and incentive awards that vest and pay out ratably over time rather than all at once (*e.g.*, 3-year vesting at 33 1/3% per year rather than 3-year cliff vesting);

- Grant equity and incentive awards that vest over a longer period of time (*e.g.*, 5-year vesting at 20% per year rather than 3-year vesting at 33 1/3% per year);

- Defer payment of compensation until after retirement or other termination of employment—particularly in the case of retirement, compensation payable to a former officer is very often less than amounts paid during active employment (*e.g.*, no salary, bonus payable after termination), so the possibility of exceeding the $1mm limitation should decrease;

- Pay severance in installments rather than a lump sum—decreasing the amount paid per year following termination of employment increases the likelihood that the amount payable during any given year is fully deductible (or at least reduces the amount of the lost deduction);

- Extend post-termination exercise periods for stock options and stock appreciation rights so as to permit exercises over a longer period of time and place a cap on the percentage of outstanding stock options and stock appreciation rights that a covered employee can exercise in a single year after termination of employment;

- Make full use of the grandfathering exception under the TCJA, which provides that the performance-based exception is still available with respect to written binding contracts in effect on November 2, 2017, and which are not subsequently materially modified (generally including all such agreements with the CFO)—while general concepts behind this grandfathering have been set forth in the TCJA and associated documentation, we are awaiting further guidance from the IRS;

- If the CEO or CFO position is open and will be filled for an interim period while a permanent replacement is sought out, consider filling such position with an individual who is already a covered employee, as the person filling the interim role will be a covered employee for life;

- If officers other than the CEO and CFO have annual compensation that can fluctuate widely, be mindful from year to year of such fluctuations as such officers may end up being one of the three highest paid officers (other than the CEO and CFO) for a particular year, resulting in that individual being a covered employee for life.

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1. The following does not take into account, among other things, the potential impact of Section 409A of the Internal Revenue Code or the views of proxy advisory firms.

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