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State Tax Implications of Federal Tax Changes to Section 162(m)

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Due to the varying methods of state conformity to the Internal Revenue Code, both the prior and current versions of Section 162(m) continue to be a consideration for state taxes.

The Tax Cuts and Jobs Act of 2017 (Act) introduced numerous significant changes to Section 162(m) of the Internal Revenue Code (IRC), which has imposed an annual deduction cap of $1 million since 1994 on the compensation of certain top executives of publicly held companies, although numerous exceptions have been applied to the types of covered compensation, the affected employees, and to post-termination payments of compensation. The Act methodically eliminates nearly all of these historic exceptions, subject only to a transition rule that grandfathers compensation payable under written binding contracts in place as of November 2, 2017, and likely also subject to a longstanding regulatory transition rule for companies that have recently undergone an IPO. For example, the Act eliminates the exception for “performance-based compensation,” includes any CFO in the affected executive group, and applies the limitations to the broader executive group on a permanent basis, even after retirement. (To learn more about how the Act impacts 162(m), see here and here.)

These changes raise many questions about how companies will adapt with respect to disclosure practices and pay structures. One question that has not been raised, but will also have an impact on employers, is what these changes to Section 162(m) will mean for state taxes. Most states will begin the calculation of state taxable income with federal taxable income either before (line 28) or after (line 30) net operating losses and special deductions. However, due to the varying methods of state conformity to the IRC, the federal tax changes proposed in the Act may not necessarily flow to the state level.

The key to evaluating how federal tax reform will impact state corporate income tax is examining a state’s conformity to the IRC. States are generally split in one of two ways: (1) conforming to the IRC as of a fixed date, which may or may not be the most recent version of the IRC (static conformity) (e.g., Virginia); and (2) conforming to the IRC that is currently in effect (rolling conformity) (e.g., New York). Additionally, some states may choose to adopt or conform to specific IRC sections on a rolling or fixed date conformity basis (selective conformity) (e.g., New Jersey).

As a general matter, rolling conformity states will automatically incorporate the income tax base changes resulting from the changes to Section 162(m) unless they choose to affirmatively decouple from these provisions in the Act. In contrast, static conformity states with fixed dates before the passage of the Act would not adopt the changes to Section 162(m) unless they amend their laws to conform to the Act. As such, taxpayers in these states will still have to separately track their starting point for state corporate income purposes, using the IRC in effect as of its fixed date (i.e., before the passage of the Act).

Takeaways

While we cannot yet know the full span of how states will react to the Act, we can be certain that the state corporate income tax impact resulting from the changes to Section 162(m) is significant. Companies should evaluate the state conformity rules in the states where they do business and carefully consider these state corporate income tax issues following the passage of the Act.

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