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Guest column: Tax Cuts and Jobs Act makes changes to executive compensation

BY LOIS COLBERT AND HARRISON TAYLOR
Contributing Writers


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Internal Revenue Code section 162(a) permits tax deductions for all ordinary and necessary business expenses. For almost every business, compensation paid to employees is an ordinary and necessary business expense. Section 162(m), introduced in 1993 as part of the Clinton administration's efforts to curb perceived excessive executive compensation, limits a public company's tax deduction for compensation in excess of $1 million paid to its chief executive officer and three other executives employed on the last day of the year required to be reported in the company's proxy statement (the "Covered Employees"). By limiting public companies' deduction, section 162(m) was designed to increase costs of paying compensation in excess of $1 million to Covered Employees.

It had limited impact since the deduction cap did not apply to performance-based compensation or commissions. From 1993 to 2017, public company executives' earnings still increased significantly.

The Tax Cuts and Jobs Act (the "Act") instituted major changes to section 162(m) in connection with reducing the corporate tax rate from 35% to 21%. These changes include eliminating the performance-based compensation and commission exceptions to the cap and expanding the compensation, executives, and companies subject to section 162(m)'s limitations. Paying compensation to Covered Employees over $1 million is expected to become more expensive. The Act's most significant changes to section 162(m) are outlined below.

Covered Employees

The Act realigns section 162(m)'s definition of Covered Employee with the Securities and Exchange Commission's proxy reporting guidance. Accordingly, section 162(m)'s deduction limit applies to compensation paid to any employee who serves as the principal executive officer or the principal financial officer during the tax year and the three other highest-paid, proxy-reportable executives of the company. Once an executive is a Covered Employee, he or she will always be a Covered Employee of that company because Covered Employees for a tax year now include all individuals classified as Covered Employees in any prior tax year since 2017. As a result, beginning in 2018, there is no cap on the number of executives that can be Covered Employees. In addition, compensation subject to the cap will include amounts paid on a Covered Employee's behalf, even after his or her death.

Covered Companies

Prior to 2018, section 162(m) applied only to companies required to register their securities with the SEC. The Act broadens this scope to include all domestic publicly traded corporations and foreign companies publicly traded on U.S. stock exchanges through American depository receipts, as well as some non-public corporations that issue public debt.

What's Next

Many of the details regarding how section 162(m) will apply in 2018 and beyond depend upon IRS guidance that has yet to be released. Also, it isn't clear whether the Act's changes to section 162(m) will fully reshape executive compensation because shareholder advisory firms still consider performance-based compensation a best practice. Despite the uncertainty, we expect to see changes in the composition of executive compensation and in the payment terms for deferred compensation arrangements, which involve navigating the complex rules of Internal Revenue Code section 409A.