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Changes to 162(m) Made by Tax Cuts and Jobs Act

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The final Tax Cuts and Jobs Act (the "Act") signed into law December 22, 2017, and effective January 1, 2018, contained three significant changes to Internal Revenue Code section 162(m) in connection with reducing the corporate tax rate from 35% to 21%. First, the Act eliminated the commission and performance-based compensation exceptions to the $1 million deductibility limitation in Section 162(m). Second, the Act expanded the employees, companies, and compensation covered by the 162(m) limitation. Third, the Act exempted from these changes certain compensation arrangements that were in effect on November 2, 2017. Each of these changes is summarized here.

Eliminating Exceptions for Commissions and Performance-Based Compensation

Under Code section 162(a), most taxpayers are allowed to deduct from income all ordinary and necessary business expenses, including a reasonable allowance for salaries or other compensation. Section 162(m)–introduced in 1993 to curb perceived excessive executive compensation–limits a public company's tax deduction for compensation in excess of $1 million paid to its CEO as of the last day of the year and the three other executives required to be reported in the company's proxy statement employed on the last day of the year (the "covered employees"). By limiting public companies' deduction, section 162(m) discouraged compensation in excess of $1 million by increasing the company's cost of providing it to covered employees.

As in effect until 2018, section 162(m) had a limited impact since the deduction cap did not apply to performance-based compensation (for example, bonuses tied to the company's stock price or other performance metrics) or commissions. Indeed, from 1993 to 2017, public company executives' earnings increased significantly, despite the presence of section 162(m), due in part to compensation practices shifting from fixed salaries and bonuses into 162(m) exempted performance-based remuneration.

Section 13601 of the Act eliminates the exceptions in 162(m) for commissions and performance-based compensation, making these forms of remuneration no longer deductible by publicly held corporations to the extent the covered employee's remuneration including these forms exceeds $1 million. Although the performance-based exception may be grandfathered for some compensation paid to some executives (see "Transition Rule for Existing Contracts" below), paying compensation to covered employees over $1 million is expected to become more expensive to publicly traded companies.

Broadening the Definition of "Covered Employee," "Publicly Held Corporation," and "Remuneration"

The Act expanded the definition of "covered employee" to include more employees that will be subject to

the $1 million cap. Before enactment, covered employees under 162(m) and its implementing regulations and guidance included the chief executive officer *as of the close of the tax year* and the three highest compensated officers of the company (other than the CEO) required to be reported on the company's proxy statement employed on the last day of the taxable year. To align the definition of covered employee with other SEC proxy reporting requirements, the Act modifies this covered employee definition to now include all employees who are the "principal executive officer" and the "principal financial officer" (as defined under SEC rules) *at any time* during the tax year, in addition to the three highest compensated officers of the company (other than the PEO and PFO). The Act adds an additional provision making covered employee status permanent, meaning covered employees for a tax year now include any individual who met the requirements to be a covered employee in the current tax year *or any prior tax year* beginning in 2017 or later. As a result, a publicly held corporation may already have (and inevitably will have) more than five covered employees for a tax year.

The Act broadened the definition of "publicly held corporation" to include, in addition to issuers of equity securities required to be registered under section 12 of the Securities Exchange Act of 1934, issuers of any security that is listed on an exchange and any issuer of any kind of security that is required to file reports under section 15(d) of the '34 Act. The expanded provision was designed to bring within 162(m) coverage all domestic publicly traded corporations and all foreign companies publicly traded on U.S. stock exchanges through American depositary receipts (ADRs) that may have previously been exempt, as well as certain additional corporations that are not themselves publicly traded but issue publicly traded debt.

The Act added a new subsection (4)(F) to clarify that remuneration will not fail to be applicable employee remuneration merely because it is includible in the income of, or paid to, a person other than the covered employee, including after the death of the covered employee. This would bring within the scope of 162(m) payments to beneficiaries and also undercuts certain 162(m)-avoidance structures that attempt to rely on indirect payments to corporations or other entities).

Transition Rule for Existing Contracts

Congress provided a transition rule to preserve pre-Act law for existing contracts. The changes to 162(m) made by the Act will not apply to any remuneration paid pursuant to a written binding contract in effect on November 2, 2017, if that contract is not materially modified on or after this date. While the private sector is hoping that this transition rule will be interpreted quite broadly, the breadth of the transition rule may be restricted based on prior regulations, language from the Joint Explanatory Statement of the Conference Committee accompanying the legislation, and prior interpretations under Code section 409A.

The IRS is expected to issue regulations confirming the scope of the transition rule. The Second Quarterly Update to the IRS 2017-2018 Priory Guidance Plan ("PGP") issued on February 7, 2018, adds guidance under 162(m) as part of the package of initial guidance implementing the Act that the IRS intends to issue by June 30, 2018. However, given the volume of guidance expected on a large number of

priorities, and the resignation of the IRS deputy assistant secretary for tax policy on February 22, 2018, guidance on some items may appear later than the PGP's expressed target date.