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# Employee Benefits in Focus

January 2018

## 2017 TAX REFORM ACT

# Expanded Scope of §162(m) Deduction Limit on Executive Pay

The 2017 tax reform act limits the deductibility of "excessive" executive pay under § 162(m). It applies similar rules (via an excise tax) to non-profit pay. The changes could have a significant impact on existing and future compensation arrangements. In brief:

1. Expansion of Covered Companies. Publicly-held companies subject to § 162(m) now include companies required to file reports under section 15(d) of the Exchange Act. This expansion now includes entities with publicly traded debt and some foreign issuers. Many foreign issuers were already covered under existing law but may not have had any covered employees.

2. Expansion of Covered Employees. The definition of "covered employee" now includes:

- CFO at any time during the year (not previously covered at all);
- CEO at any time during the year (previously covered only if CEO as of last day of year);
- Any "covered employee" of the company or a "predecessor" of the company in the prior year. This provision "looks back" to tax years beginning on or after 1/1/2017; and
- Top-3 highest paid officers who would be reported if SEC reporting were required (previously only if actually required to report).

3. Repeal of Performance Pay and Commission Exceptions. Performance pay was a significant exception under § 162(m). This exception and the exception for commissions are now repealed. Although deductions may be lost, some tax departments will be relieved not to have to deal with the technical requirements of the performance pay rules, which included several traps for the unwary. These rules could continue to apply for arrangements preserved under transition relief.

4. Deferred Compensation and Retirement Pay Deduction Now Limited. Under prior law, individuals ceased to be covered employees upon terminating employment. Accordingly, deferred compensation payable post-termination was deductible even when it exceeded $1 million. SERPs and excess plans are common arrangements that therefore were previously unaffected by § 162(m). That will no longer be the case. Unfortunately, changing these arrangements can raise complications under IRC § 409A.

5. Transition Relief for Existing Arrangements Available, but Scope is Uncertain. The old rules will continue to apply to "binding agreements" as of 11/2/2017 that are not materially modified. Unfortunately, there are many unanswered questions regarding what constitutes a binding contract with an employee. Furthermore, these determinations typically require an individualized look at the relevant arrangement and applicable plan/award documents.

# QuickChart: Who is a Covered Employee Under §162(m)?

| TITLE | 2018 AND SUBSEQUENT TAX YEARS[1] | 2017 TAX YEAR (PRIOR LAW) |
|---|---|---|
| **CEO** | Yes, if CEO or Acting CEO at *any point* during year | Yes, if CEO or Acting CEO as of last day of year |
| **CFO** | Yes, if CFO or Acting CFO at *any point* during year | No |
| **Top 3 highest paid executive officers other than CEO or CFO** | Yes, if required to be reported on proxy or *would be required*[2] if reporting requirement applied | Yes, if employed on last day of tax year and required to be reported on proxy |
| **Other Employees** | Anyone who was a Covered Employee[3] of the taxpayer or a predecessor[4] in a prior year (starting with 2017) | No |
| **Directors and Other Non-Employees** | No, not with respect to fees for service as non-employee | No |

1 Except as provided in transition relief, the changes to § 162(m) are effective for "taxable years" starting after 12/31/2017.

2 Under prior rules, if a company was not required to report its covered employees, § 162(m) did not apply. This arose, for example, if the taxpayer was not a public company on the last day of the year, such as due to a merger with another entity or because the taxpayer was exempt from reporting as a foreign issuer.

3 As written, the new law is potentially ambiguous about whether the lookback to "covered employees" in prior years applies the new definition of "covered employee" (e.g., picking up the CFO) or the old definition. The difference could matter particularly for companies with CEOs or CFOs in 2017 who continue to be employees but in a different role, or companies involved in acquisitions and mergers in 2017.

We think Treasury/IRS should conclude that the old definition applies. The alternative approach could have the anomalous result of turning someone into a covered employee for future years even though she was never actually a covered employee in past years.

4 Guidance is needed regarding what "predecessor" means for these purposes.

## What Transition Relief is Available?

- The § 162(m) changes do not apply to remuneration paid pursuant to a "***written binding contract***" in effect on 11/2/2017 and which is "***not modified in any material respect***."
- This relief means that pre-2018 rules apply to these "grandfathered" arrangements. For example, the performance-based pay exception, the exclusion of the CFO as a covered employee, the exclusion of post-termination pay could all still apply to preserve deduction of at least some future pay.
- Companies should review existing arrangements to determine whether the relief is available. These include individual employment, severance, or CIC agreements; equity/ bonus awards and plan documents; and non-qualified deferred compensation plans.

## QuickChart: What Pay Exceeding $1 million* is Limited by § 162(m)?

| | 2018 and Subsequent Tax Years | 2017 Tax Year (prior law) |
|---|---|---|
| **Salary** | Not deductible | Not deductible |
| **Taxable fringe benefits (e.g., gross-ups, taxable reimbursements)** | Not deductible | Not deductible |
| **Non-taxable benefits (e.g., health coverage, tax-free reimbursements)** | Deductibility not affected by IRC §162(m) | Deductibility not affected by IRC §162(m) |
| **Annual and long-term bonuses** | Not deductible, unless covered by transition relief and meets "performance-based pay" rules | Deductible if meets "performance-based pay" rules |
| **Commissions** | Not deductible, unless covered by transition relief | Deductible |
| **Pay deferred until after termination of employment:**<br>• Severance<br>• Excess 401(k) plans/ SERPs<br>• Retirement pay<br>• Deferred pay | Not deductible, unless covered by transition relief | Deductible |
| **Death benefits** | Not deductible, unless covered by transition relief | Deductible |

* The $1 million limit continues to be reduced by the amount of parachute payments disallowed under § 280G.

## § 162(m) Design Challenges Moving Forward

In the near term, companies should determine the extent to which they can preserve deductions under the transition relief, and fiscal year companies may want to accelerate payment to newly covered executives. In the longer term, companies will want to consider new strategies, which might include:

1. Carefully managing turnover among the highest paid officer list. This will be most beneficial for companies with many officers who earn more than $1 million in a given year, and/or companies aiming to preserve deductibility of lump sum payouts greater than $1 million payable upon termination of employment. Perversely, this approach could encourage paying more to a covered employee to keep him in the top 3 highest paid (even if the executive is underperforming), to avoid losing longer future deductions on future pay to others.

2. Delaying payments. Some plans include provisions that defer payment in order to stay under the $1 million per year cap (either automatic deferral or at the company's discretion). Employers will want to review and reconsider existing language. Executives may be concerned that the recent law changes could subject them to unanticipated payment delays.

Payment delays to comply with § 162(m) are restricted under Section 409A rules, and those rules are not entirely consistent with the changes to § 162(m). We believe Treasury/IRS may need to update these rules in order to accommodate additional delay.

3. Encouraging installments. Companies may want to require or encourage deferred compensation to be paid in installments (or have equity awards exercised over time). Unless Treasury/IRS provide relief, Section 409A significantly limits election changes for deferred compensation. Furthermore, Section 409A's existing anti-toggle rules generally prevent having payment forms differ due to the amount of the benefit.

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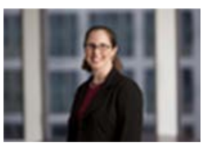

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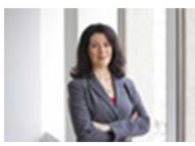

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## IPB In The News



Kevin O'Brien and Spencer Walters participated in the Compensation & Benefits Tax Reform panels in DC Bar sponsored Tax Cuts and Jobs Act Conference (Jan. 25, 2018)

Kevin O'Brien and Spencer Walters interviewed by Tax Notes on 162(m) transition rule in Tax Cuts and Jobs Act (Dec. 20, 2017)

Carroll Savage profiled by D.C. Bar as 401(k) Plan pioneer, in member spotlight (Dec. 11, 2017)

Ivins selected as one of the Best Law Firms in America for 2018 by U.S. News & World Report (Nov. 2017)

Steve Witmer, Robin Solomon, Ben Grosz and Doug Andre taught an EBEC half-day seminar for the Tax Executives Institute, Los Angeles CA chapter (Nov. 3, 2017)

Robin Solomon and Jodi Epstein spoke on fiduciary best practices at "Best of" Plan Sponsor National Conferences in Chicago IL and New York NY (Oct. 24 & 26, 2017)

Ben Grosz shared insights at the 2017 Healthcare & Retirement Plan Summit in Baltimore MD (Oct. 24, 2017)

Doug Andre presented on global mobility at the Tax Executives Institute Annual Conference in Toronto Canada (Oct. 23, 2017)

Robin Solomon and Jodi Epstein led a panel on IRS/DOL Audits at fifth annual Women, Influence & Power Conference (WIPL) in Washington, DC (Oct. 12, 2017)

Jodi Epstein served as a panelist at the Pensions & Investments West Coast Defined Contribution Conference in San Diego CA (Oct. 9, 2017)

## EB Update Archives

December 2017: Six Strategies to Accelerate Employee Benefit Deductions

November 2017: Tax Cuts and Jobs Act

March 2017: American Health Care Act

March 2017: HSAs

Sept 2016 EB Update

June 2016: DOL Fiduciary Rule