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Tax Bill Would Eliminate Performance-Based Exception to Compensation Deduction Limitation

The tax bill passed by the Senate late Friday night, like the bill that passed the House of Representatives on November 16, would eliminate the performance-based exception to the $1 million per-executive annual limitation on the deductibility of compensation paid to specified executives under §162(m) of the Internal Revenue Code.

Both the Senate and House bills include several provisions that would expand the reach of §162(m), most notably by (1) eliminating the performance-based exception for tax years following 2017, (2) providing that the deduction limitation applies to CFOs who are currently excluded from its scope and (3) applying the limitation in taxable years beginning in 2018 to any individual who was a §162(m) covered employee during any prior taxable year beginning after 2016, thereby eliminating a corporation’s existing ability to deduct amounts paid during and following the year of employment termination. Significantly, the Senate bill would grandfather “written binding contracts” in effect on November 2, 2017 that are not materially modified thereafter.

Notably, neither bill includes the prohibition on deferred compensation originally included in initial versions of the House bill. Accordingly, non-qualified stock options would continue to be taxed upon exercise, rather than vesting, such that options will remain a viable and attractive compensation vehicle for companies, although they will lose their favored status under §162(m), with respect to which they currently can easily qualify for the performance-based exception.

Applying the §162(m) deduction limit to all compensation above $1 million – a threshold that has remained unchanged since the original enactment of §162(m) in 1992 – creates an unduly punitive result in the current marketplace, where compensation for top talent often exceeds that amount and where public companies must compete for talent with private firms.

Enactment of the changes to §162(m) appears sufficiently likely that companies should prepare for the elimination of the performance-based exception and evaluate whether any actions prior to year-end would be prudent if the legislation passes. In particular, companies should consult with their tax accounting advisors as to any necessary steps to ensure that 2017 bonuses payable in 2018 will be deductible in 2017. In addition, companies may wish to consider...
accelerating into 2017 payments that would be made to their CFOs or to a 2016 named executive officer who has terminated employment, to the extent that such payments would not otherwise satisfy the grandfathering exception and to the extent permissible under other applicable tax rules.

Although sound incentive strategy and investor pressures will likely result in compensation continuing to be heavily performance-based, if the proposed changes are adopted companies should feel greater flexibility of design, without the need to satisfy the rigid framework of the performance-based exception. Boards of directors setting compensation will need to take into account loss of deductibility that will result from the legislation, along with continuing to consider other factors, such as risk management, investor perception, and of course corporate objectives and incentives. However, it will remain entirely within the business judgment of the board to set compensation at the levels and in the manner that it determines to be appropriate for the corporation to attract and retain the executives the board believes will best serve the needs of the corporation.

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