

# Compensation Season 2018: Section 162(m) and Related Considerations Post-Tax Reform

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**Authors:** [Dov M. Gottlieb](#), [Henrik Patel](#), [Jeffrey Li](#)

On December 22, 2017, the Tax Cuts and Jobs Act (the “Act”) was signed into law. The Act includes significant changes to the executive compensation deduction rules contained in §162(m) of the Internal Revenue Code (the “Code”) that could significantly impact the way many companies design and administer executive compensation programs. As boards of directors and compensation committees begin to focus on the 2018 compensation and proxy season, there are certain key considerations related to the impact of the Act that should be taken into account.

## Changes to §162(m) and Related Considerations

**Overview of §162(m).** §162(m) limits the deductibility of annual compensation paid to certain “covered employees” of a publicly held corporation to \$1 million per executive. Prior to the Act, “covered employees” included each of the CEO and the next three highest paid executive officers (excluding the chief financial officer (“CFO”)), determined as of the end of a taxable year, and the limit applied to covered employees of a corporation with publicly traded equity. In addition, §162(m) previously provided that performance-based compensation (which included stock options and other performance-based equity awards) and commissions were not subject to this deduction limit.

**No Performance-Based Exception to §162(m).** The Act eliminates the performance-based exception to the \$1 million per-executive annual limit on the deductibility of compensation for certain public company executives under §162(m). This change will result in a significant increase in disallowed tax deductions. While this may alter compensation considerations for covered employees, boards must continue to use appropriate business judgment to make compensation decisions to attract and retain the executives that will best serve the needs of the corporation.

**Scope of Covered Employees.** The Act expands the definition of “covered employees” for purposes of §162(m) to include CFOs and makes “covered employee” status permanent for any executive who was a “covered employee” for any tax year beginning after December 31, 2016. This increases the number of employees who will be “covered employees” in a given year and eliminates a company’s ability to deduct amounts in excess of \$1 million paid following employment termination.

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**Grandfathering of Certain Existing Arrangements.** The changes to §162(m) do not apply to compensation under “written binding contracts” in effect as of November 2, 2017, so long as the contracts are not materially modified thereafter. Subject to Treasury Department guidance on the scope of this exception, it should allow companies to deduct compensation (i) under existing performance-based arrangements, including existing stock options and other performance-based equity awards, (ii) for amounts earned and deferred under deferred compensation arrangements as of November 2, 2017 and (iii) under existing arrangements with CFOs and any individual who would be covered by §162(m) solely by virtue of that individual’s permanent “covered employee” status. However, a contract that is in effect as of November 2, 2017, but is renewed after that date is treated as a new contract entered into on the date that the renewal takes effect; companies should carefully consider any proposed amendments to arrangements that would disqualify those arrangements from grandfathering.<sup>1</sup>

**Expansion of Definition of “Publicly Held Corporation”.** While §162(m) had previously only applied to corporations with publicly traded equity, the Act expands the companies subject to §162(m) to include corporations with publicly traded debt and foreign companies publicly traded through American depositary receipts. Previously, foreign private issuers (“FPIs”) were not subject to the §162(m) deduction limitation based on various IRS private letter rulings; however, the conference report states that the definition of “covered employee” would now include “such officers of a corporation not required to file a proxy statement but which otherwise falls within the revised definition of a “publicly held corporation”, which could include FPIs. Further guidance is expected from the Treasury Department regarding the extension of §162(m) to all FPIs, but the timing is not yet known.

## Practical Considerations and Action Items

**Considerations for Existing Incentive Plans.** Companies should review existing incentive plans to determine whether any changes should be made to the plan design, including elimination of §162(m) specific provisions such as: (i) list of performance metrics, (ii) definition of outside directors, (iii) annual individual limits by type of equity award (other than ISOs) and (iv) §162(m) specific language on compensation committee certification of achievement of performance goals.<sup>2</sup> Companies may also consider implementing longer vesting periods for equity awards, spreading out the income realized to maximize deductibility. Companies should review equity plan prospectuses to eliminate references to §162(m) requirements and related federal tax implications. Given the grandfathering provisions discussed above, it may be some time before companies remove all references to §162(m) from their compensation plans, as the concepts will still be relevant for grandfathered awards.

**Impact on Compensation Committees.** Companies should maintain a compensation committee of §162(m)-qualified outside directors in order to certify performance results for grandfathered performance-based arrangements. In any case, the continuing applicability of the compensation committee independence rules of the major stock exchanges and of the SEC “non-employee director” definition for purposes of exempting certain compensation from the short-swing profit rules make it unlikely that the Act will affect the composition of compensation committees at most companies. However, companies should expect to update their compensation committee charters to eventually eliminate references to the §162(m) performance-based requirements.

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<sup>1</sup> The statutory language and the limited commentary in the conference agreement leave open questions as to how the transition rule may apply to certain contracts and specific circumstances. While stock options, stock appreciation rights, performance stock units and performance shares outstanding on November 2, 2017, would appear to qualify under the transition rule, it is unclear how the transition rule would apply to, for example, 2017 annual performance-based cash bonus awards (particularly in cases where the compensation committee retains discretion to reduce the amount of an award or not pay an award) or performance-based cash and equity awards granted under existing plans going forward. In the absence of further guidance, companies should consult their advisers before relying on this rule.

<sup>2</sup> It is not clear how proxy advisory firms will view proxy proposals (in the event that shareholder approval is required) to amend plans to remove §162(m) provisions.

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**Opportunity to Change Compensation Design.**<sup>3</sup> Companies should have more flexibility to design their compensation plans and awards and to include performance metrics, without worrying about compliance with the strict rules under §162(m). For example, 2018 and later compensation plans can: (i) include discretion to adjust performance goals (up or down) during a performance period and discretion (negative or positive) to determine final awards based on actual performance, (ii) establish performance goals more than 90 days into a performance period and (iii) provide for severance payouts at target level, instead of achievement at actual performance level. Companies may consider longer vesting periods, spreading out the income realized from equity awards to maximize deductibility. While it is expected that companies will continue to link pay to performance (see below), they will no longer need to limit themselves to the rigid framework of the §162(m) performance-based exception.

**Impact on Stock Options.** The elimination of the performance-based exception removes a tax incentive for the grant of stock options. However, it is expected that most companies that currently utilize stock options will continue to do so, as companies generally grant options because they view them as an appropriate retention and motivation tool, rather than because of any potential tax treatment.

**Plan Design and Approval.** Companies will no longer need to (i) have cash bonus plans approved by shareholders, (ii) include performance goals in their equity plans or (iii) obtain shareholder approval of applicable performance goals every five years. Individual award limits also will be unnecessary in equity plans, other than for companies that grant tax-qualified incentive stock options (although it remains to be seen what limits the proxy advisory services may demand). Going forward, the expiration of a plan term or the need to increase shares available under a plan will be the principal reasons to seek shareholder approval of equity plans, including for new public companies whose equity plans were adopted and approved prior to becoming public. Depending on the regulations that are to be issued by the Secretary of the Treasury, in the short term we expect that companies will adopt new plans, rather than amend existing plans in order to minimize the risk of losing grandfathered status of any existing arrangements, when the plan expires or the company requires additional plan shares.

**Continued Use of Performance-based Compensation Programs.** Even though the tax deductibility of qualified performance-based compensation will no longer be available, most companies will still choose to maintain performance-based compensation programs in order to appropriately incentivize executives and respond to the demands of pay-for-performance by proxy advisory firms and shareholders. Proxy advisory firms have become increasingly interested in the application of performance goals, and this trend is likely to continue even as companies will have more flexibility to establish performance goals without being limited to shareholder-approved goals under §162(m). Companies should continue to take into account the views of proxy advisory firms and shareholders when designing performance goals in future years.

White & Case LLP  
1221 Avenue of the Americas  
New York, New York 10020-1095  
United States  
T +1 212 819 8200

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<sup>3</sup> Note that if companies plan to take advantage of the additional flexibility in designing compensation programs for 2018, consideration should be given to how the new awards will be disclosed in the compensation tables of the 2019 proxy statement. For example, adopting a discretionary performance program in place of a §162(m) umbrella plan could have a significant impact on how amounts are disclosed in the Summary Compensation and Grants of Plan-Based Awards tables.