
Tax Act: Deductibility of Executive Compensation After Tax Reform

JANUARY 12, 2018

Section 162(m) of the Code generally disallows the deduction of compensation in excess of \$1 million paid by a public company to a “covered employee” in any single taxable year. The Tax Act makes the following changes to Section 162(m): expands the definition of a covered employee to include a company’s principal financial officer and makes “covered employee” status, once obtained, perpetual; eliminates the performance-based exception to Section 162(m) entirely; and expands the types of companies subject to the deduction limitation.

Key Tax Act Changes to Section 162(m)

- Realigns the definition of a “covered employee” with the definition of a “named executive officer” in Item 402 of SEC Regulation S-K and makes “covered employee” status perpetual.
- Eliminates performance-based compensation exception to deduction limitation.
- Expands the types of entities to which Section 162(m) applies to include all domestic publicly traded corporations, all foreign companies publicly traded through ADRs and certain private corporations that are subject to certain SEC filings.

Changes to the definition of “Covered Employee.” Since 2007, the term “covered employee” has applied to (i) the chief executive officer of the corporation (or an individual acting in such capacity) and (ii) the three other most highly compensated employees (excluding the chief financial officer) whose total compensation is required to be reported to shareholders under the Securities Exchange Act of 1934, provided in each case that the individual was acting in a covered capacity on the last day of the corporation’s taxable year. (For a discussion of the evolution of the definition of a “covered employee,” refer to [our prior client alert here](#).) The Tax Act restores the alignment between the definition of “covered employee” and the definition of “named executive officer” in Item 402 of Securities and Exchange Commission Regulation S-K. Following enactment of the Tax Act, a covered employee now includes any individual who is, at any time during the taxable year, the principal executive officer or the principal financial officer of the corporation, as well as the corporation’s three most highly compensated officers for the taxable year (other than the principal executive officer and the principal financial officer). As amended by the Tax Act, Section 162(m) now

also provides that if an individual is a covered employee with respect to a corporation for a taxable year beginning after December 31, 2016, that individual remains a covered employee for all future years. As a result, the deductibility of payments to an individual who is a covered employee at any time on or after January 1, 2017, is limited to the \$1 million per year cap even if those payments are made after the individual has retired or otherwise left the company, subject to the transition rules described below.

Elimination of the Performance-Based Compensation Exception to Section 162(m). Until the Tax Act was signed into law, an important exception to the Section 162(m) deduction limitation applied to qualified “performance-based” compensation. Generally, to the extent compensation was paid under a shareholder-approved plan following the achievement of one or more pre-established, objective performance goals that were established, and subsequently certified, by a compensation committee solely made up of two or more “outside directors,” the compensation was not subject to the deduction limitation. The Tax Act eliminates this exception entirely.

Changes to the companies subject to Section 162(m). The Tax Act amends what it means to be a publicly held corporation for purposes of Section 162(m) to include, in addition to all domestic publicly traded corporations, all foreign companies publicly traded through ADRs. In addition, certain large private corporations may now also be subject to the deduction limitation if they are subject to SEC filings with respect to public debt or publicly held stock that is not listed on an exchange.

The changes to Section 162(m) are effective for corporate taxable years beginning on or after January 1, 2018. However, a transition rule applies to compensation paid pursuant to a written binding contract which was in effect on November 2, 2017, and which is not modified in any material respect on or after that date.

[Read more commentary from WilmerHale lawyers on the Tax Act.](#)

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