



GMS Flash Alert

Global Compensation Edition

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United States - Proposed Revisions to Section 162(m) Bite As Hard As They Bark

On November 16, 2017, the U.S. House of Representatives passed H.R. 1, the "Tax Cuts and Jobs Act." On December 2, 2017, the U.S. Senate passed its version of the tax reform bill. In this *GMS Flash Alert*, we discuss the proposed revisions to Internal Revenue Code section 162(m) in the House and Senate bills.¹

The House and Senate bills are very similar with respect to section 162(m). The Senate version is the same as the House version, but also provides for a transition rule. The bills effectively expand the scope of section 162(m) and eliminate significant exemptions that currently apply to section 162(m). Since its 1993 enactment, commentators have observed that section 162(m) barked a lot harder than its bite. With these legislative changes, section 162(m) not only bites just as hard, but also harder than many expected.

WHY THIS MATTERS

The proposed legislative changes would expand the number of executives covered by section 162(m) and the \$1 million deduction limitation, thereby substantially limiting deductions going forward. The proposals would eliminate the popular exception for performance-based compensation with a possible transition period. This could lead to complicated tracking of existing arrangements that cross over the transition period, as well as tracking payments to covered employees.

Overview of Current Status and Proposed Changes

Congress enacted section 162(m) as part of the Omnibus Budget Reconciliation Act of 1993, to generally limit to \$1 million the amount of current compensation paid to a Named Officer (described as a "covered employee" in section 162(m)) that can be deducted by a publicly traded corporation in a taxable year. An exemption for "performance-based compensation" is the most important exemption from the impact of section 162(m). To qualify for the exemption from the section 162(m) limitations, the incentive compensation plans must be approved by shareholders and, except in the case of stock options and stock appreciation rights, subject to "objective performance goals" established by outside directors at the beginning of the period to which the performance relates.

Chief financial officer (CFO) pay was initially subject to section 162(m), but a misalignment due to revisions of Securities and Exchange Commission (SEC) disclosure rules meant that CFO pay has not been subject to the limitation for the last 10 years.

The proposed changes expand section 162(m)'s scope as well as eliminate the performance-based exemption. (For prior coverage, see GMS [Flash Alert 2017-178](#), December 5, 2017.)

Specifically, the proposed revisions expand section 162(m) to include CFOs in addition to chief executive officers (CEOs) and the next three highest compensated named executives. Furthermore, once someone is identified as a covered employee (identified as of the 2017 tax year forward), the limitation continues to apply to payments made to that employee in all future years even if the employee would not otherwise be classified as a covered employee in such years, thereby impacting severance pay and other arrangements normally not subject to section 162(m) currently.

The definition of public companies under the proposed section 162(m) rules is also potentially expanded to include certain foreign filers and, according to committee commentary, potentially large private companies, as well as S Corps.

Furthermore, the proposals repeal the performance-based compensation exemption that many companies have relied on in designing their compensation plan to reward executives while maintaining deductibility of the payments.

A transition period in the Senate version provides that section 162(m) expansion would not apply to compensation under a written binding contract in effect on November 2, 2017, that was not materially modified.

KPMG NOTE

In addition to substantially limiting deductions going forward, these changes could lead to complicated tracking of existing arrangements that crossover the transition period as well as tracking payments to covered employees.

If enacted, the section 162(m) revisions would represent a dramatic shift in the ability to deduct executive compensation to certain executives. Nonetheless, employers should consider whether they may have opportunities to bring deductions forward to 2017, before the revised limitations apply. They should also track and capture the impact going forward with a "holistic" approach to benchmarking, compensation and benefits design, as well as the tax considerations so that they may remain competitive in the marketplace. To capture potential opportunities, employers will need to move quickly before the 2017 tax year-end.

FOOTNOTE:

1 For related coverage, see the following issues of GMS *Flash Alert*: [2017-178](#) (December 5, 2017) and [2017-177](#) (December 3, 2017).

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