Thursday, December 14, 2017

As you probably know, both the House and Senate have passed tax reform bills. Whether the two bills will be able to be harmonized and passed into law remains to be seen. Both bills include changes that will have a significant impact on a public company’s ability to deduct compensation paid to top executives in years 2018 and beyond, as described below.

Under current law (Code Section 162(m)), a public company’s deduction for compensation that it pays to its CEO and three highest officers by pay (determined on the last day of a company’s fiscal year), other than the CFO, is limited to $1,000,000 per covered employee per tax year. This deduction limit does not apply to “performance-based compensation”, such as stock options or cash or equity awards that tie vesting or payout to achievement of financial performance criteria, and because of the performance-based compensation exception many public companies are never impacted by the deduction limit even though they may pay compensation well in excess of $1,000,000 per year to one or more executives. Both the House and Senate tax reform bills include elimination of the performance-based compensation exception to the $1,000,000 limit on the tax deduction for tax years beginning in 2018 and later. Both bills also pull compensation paid to the CFO and
any employee who was the CEO, CFO or one of the three highest paid employees for any taxable year after 2016 (even if he or she is no longer in that group in a future year) into the $1,000,000 deduction limit. These changes mean that it will likely cost companies more in 2018 and beyond to pay the same executive compensation that they are paying now and that deductibility of payments made to former employees after termination, such as severance or deferred compensation payments, could also be restricted by the $1,000,000 limit.

There is one significant difference between the two bills that the conference committee will have to resolve — the Senate bill grandfathers future compensation paid under a written binding contract in effect on November 2, 2017 and the House bill includes no such grandfathering. At this point, there is no indication of which provision is likely to prevail in the reconciliation process.

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