



## ***Federal Tax Client Alert***

# **Tax Cuts and Jobs Act: Executive Compensation *Repeal of Performance-Based Compensation Deduction***

**January 26, 2018**

This is a summary of a major change in federal income tax law affecting executive compensation made by repeal of the “performance-based compensation” exception to the \$1,000,000 limit on deduction of compensation paid to certain covered employees by publicly held corporations. The change was enacted by the Tax Cuts and Jobs Act (the “Act”) signed into law by the President on December 22, 2017.

The change is effective for taxable years beginning after December 31, 2017, subject to a “transition rule.” It can affect a publicly held corporation and now prevent it from claiming a tax deduction for payment of incentive compensation to executives that is based on the achievement of specified business and financial performance goals.

Existing executive compensation plans and agreements of publicly held corporations that were written and designed to come within the performance-based compensation exception should be reviewed in light of this change to determine its effect on such plans and agreements and if the transition rule applies to them.

Planning and adoption of new executive compensation arrangements by publicly held corporations subject to the \$1,000,000 deduction limit in 2018 and future years will need to give consideration to this change and that it will now make performance-based compensation paid to covered employees under an incentive compensation plan or agreement subject to the deduction limit.

### **Prior Law.**

General \$1,000,000 Executive Compensation Deduction Limit. Section 162(m) of the Internal Revenue Code (“Code”) provides that publicly held corporations generally cannot deduct compensation that exceeds \$1,000,000 paid to certain covered employees per tax year. For purposes of this \$1,000,000 deduction limit, a “publicly held corporation” has been defined as a corporation that has issued common equity securities required to be registered under the Securities Exchange Act of 1934, and a “covered employee” has been defined to include any employee at the close of the taxable year who is chief executive officer (or an individual acting in such capacity), or among the four (4) highest compensated officers for the taxable year (other than the chief executive officer).

Performance-Based Compensation Exception and Deduction. The law has provided, as an exception to the \$1,000,000 deduction limit, that the limit does not apply to certain “performance-based compensation” payable to a covered employee solely on account of attaining qualified performance goals. For purposes of this exception, “performance-based compensation” is defined to mean compensation payable to a covered employee for attaining one or more pre-established, objective performance goals established by a compensation committee of the board of directors made up solely of outside directors, and which performance goals meet specified disclosure, shareholder approval and certification requirements. Thus, if an amount of “performance-based compensation” was paid by a publicly held corporation to an executive who was a “covered employee,” that amount was tax deductible by the corporation even if the resulting total of all compensation paid to the executive exceeded \$1,000,000.

For example, assume that in 2016, a publicly held corporation paid its chief executive officer \$1,000,000 annual salary, and bonus compensation of \$300,000 for attaining a pre-established, objective performance goal (year-end corporate sales increase of at least 5 percent) established in accordance with section 162 (m). The \$300,000 performance-based compensation paid would not be subject to the \$1,000,000 deduction limit, and the \$300,000 amount would be deductible by the corporation for federal income tax purposes.

### **Tax Cuts and Jobs Act.**

Repeal of “Performance-Based Compensation” Exception Deduction. The change in federal tax law made by the Act eliminates the exclusion of “performance-based compensation” (and commissions) from compensation subject to the \$1,000,000 deduction limit. Thus, “performance-based compensation” now must be included with and treated the same as other compensation paid to a covered employee for a taxable year, which if it exceeds \$1,000,000 will not be deductible for federal income tax purposes. For facts similar to the above example, under the Act if pursuant to an incentive compensation plan adopted by a publicly held corporation in 2018 a chief executive officer was paid bonus compensation of \$300,000 for attaining a pre-established objective performance goal, that \$300,000 along with other compensation paid the chief executive officer would be subject to the deduction limit and not be deductible if it exceeded the deduction limit.

“Covered Employee” and “Publicly Held Company” Changes. The Act changes the definition of “covered employees,” who will now be the principal executive officer and the principal financial officer and the three (rather than four) most highly compensated officers for the taxable year (other than the principal executive officer or principal financial officer). An individual who is a covered employee for a taxable year beginning after December 31, 2016, remains a covered employee for all future years. The Act also expands the definition of a “publicly held corporation” subject to the \$1,000,000 deduction limit.

Effective after 2017; Transition Rule. The changes made by the Act are effective for taxable years beginning after December 31, 2017, subject to an important transition rule. The transition rule provides that the repeal of the allowance of a deduction for “performance-based compensation” for taxable years beginning after December 31, 2017, shall not apply to

“performance-based compensation” which is provided pursuant to a written binding contract which was in effect on November 2, 2017, and which was not modified in any material respect on or after such date. The explanation of the Act published by Congress states that compensation paid pursuant to a plan qualifies under the transition rule if the right to participate in the plan is part of a written binding contract with the covered employee in effect on November 2, 2017.

If you have questions or would like to discuss the new federal tax law, and the effects of this change in it, please contact any attorney of GableGotwals you know or our Tax Law Practice Group.

GableGotwals attorneys who practice and assist clients with respect to federal taxation include:

Sheppard F. Miers, Jr.  
smiers@gablelaw.com  
Direct dial: 918-595-4834

David McKinney  
dmckinney@gablelaw.com  
Direct dial: 918-595-4860

John Russell  
jrussell@gablelaw.com  
Direct dial: 918-595-4806

James Scears  
jscears@gablelaw.com  
Direct dial: 918-595-4879

100 West Fifth Street, Suite 1100, Tulsa, Oklahoma 74103-4217 918-595-4800 [www.gablelaw.com](http://www.gablelaw.com)

*This summary is provided for information purposes based upon initial review of the Act and the published legislative history, which could be subject to other interpretation or explanation upon further analysis and review. It does not contain legal advice or create an attorney-client relationship, and is not intended or written to be used and may not be used by any person for the purpose of avoiding penalties that may be imposed under federal tax laws. The information provided should not be taken as an indication of future legal results; and any information stated should not be acted upon without consulting legal counsel.*