VIEWS & VISIONS

A publication of Bowles Rice LLP

Summer 2018

New Limits on Deducting Compensation Paid to Employees

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The Tax Cuts and Jobs Act ("Act") made changes to the "who, what, where and when" of deducting compensation paid to employees by modifying Section 162(m) of the Internal Revenue Code. Often called the "excessive remuneration" rule, this provision imposes new limits on how much compensation certain employers can claim as a deductible expense. Crafting employee compensation to satisfy this modified rule can help a business maximize its deductions for employee remuneration.

The rule in place prior to the Act stated that a company could generally deduct reasonable compensation to its employees as a necessary business expense, but that there was a cap on the amount that could be deducted. A publicly traded company could not deduct more than $1,000,000 in compensation to a covered employee annually. That part is still true; however, the definitions of

1) what a publicly traded company is,
2) what a covered employee is, and
3) what totals into the $1,000,000 has changed.

See the table on the opposite page to understand how these changes work.

The Act broadens what employers, what employees and what compensation is covered in the limit for deductibility. Although, on the face of it, this change may seem like an anti-employer provision because it limits a company's deduction, the silver lining is that it may serve to keep the cost of compensating a company's employees down.

The expected overall effect is to act as a disincentive to pay higher compensation to employees because the Act limits the portion of that compensation that an employer can deduct on its income taxes. Keeping costs down often results in higher profits for company shareholders, so this change may end up being a welcome one for business owners, if not for employees.

Action Steps

A company should see if the "excessive remuneration" rule now applies to them under the Act and, if so, pay close attention to any compensation arrangement in effect before November 2, 2017. If available to be "grandfathered" in, the company may want to take steps to preserve that ability by avoiding certain modifications. Going forward, a company will want to consider how the new limits will affect any new compensation arrangements or severance packages. V

Deducting Employee Compensation	Previous Rule	Current Rule
Who does the rule apply to?	Covered Employees, defined as the CEO or the one of the three highest paid employees on the last day of the company's tax year who are required to be reported on the company's proxy statement.	Covered Employees, defined as the CEO, CFO, one of the three highest paid employees on the last day of the company's tax year who are required to be reported on the company's proxy statement or anyone who has ever been one of those individuals since 12/31/16. **A covered employee stays a covered employee even after he or she stops working for the company or dies. This means that post-employment compensation, like deferred compensation, supplemental retirement payments and severance payments, is now included in the $1,000,000 cap on deduction.**
What compensation does the rule apply to?	It applied to compensation paid over $1,000,000 annually to each covered employee, but there was an exception for perfomance-based compensation, such as annual cash bonuses or stock options.	The $1,000,000 annual cap per covered employee still exists, but the exception for performance-based compensation is no longer in effect. **That means that all compensation goes into the calculation to determine what a company can deduct. No exceptions.**
Where does the rule apply?	In the U.S. to taxpayers who are domestic publicly traded companies.	In the U.S. to taxpayers who are domestic publicly traded companies **and to all foreign companies publicly traded through American depository receipts.** This includes companies required to file reports under Section 15(d) of the Securities Exchange Act of 1934.
When does this rule apply?	Pre-January 1, 2018 arrangements.	Post-January 1, 2018 arrangements, but there is a grandfather clause that applies to compensation arrangements or contracts in place by November 2, 2017.