

Tax Reform to Impact Compensation Deduction Claimed by Foreign Private Issuers

February 9, 2018 – Cross-Border Counselor
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While the recently enacted U.S. tax reform legislation did not overhaul executive compensation to the extent proposed in early forms of the bill, Section 162(m) of the U.S. Internal Revenue Code was dramatically revised in a way that affects Canadian companies that file reports with the SEC and that employ, or may in the future employ, executives in the United States. Previously, Section 162(m) limited the amount of compensation that an SEC reporting company that was a “domestic issuer” for securities law purposes, or its subsidiaries, could deduct with respect to its most senior executives. Important for many of our Canadian clients, we believe that under the rule changes, U.S. tax deductions for compensation paid to key executives of any SEC reporting company, including foreign private issuers, and their subsidiaries, will now be subject to the limitations of Section 162(m). In addition, the rule changes eliminate a major exception for qualifying performance-based compensation. This article identifies the important changes to Section 162(m) and addresses the limited transition and grandfathering opportunities companies should now consider.

Section 162(m), as amended, limits the amount of compensation an SEC reporting company can deduct with respect to its CEO, CFO, and the next three highest earners in the company’s controlled group to US\$1 million per individual per year. As mentioned above, compensation paid to key U.S. executives of foreign private issuers likely no longer escapes the reach of Section 162(m). It appears that regulations that formerly exempted key employees from public companies that were not subject to SEC proxy statement requirements (*i.e.*, were not obligated to file a summary compensation table) have been undermined by the revised Section 162(m). Included in Section 162(m)(3) is now a statement that covered employees, aside from the CEO and CFO, are determined without regard to whether the compensation of such employees is required to be reported to shareholders. Absent any future clarifying regulations from the U.S. Treasury to the contrary, foreign private issuers should take note that certain key employees will be considered covered employees under Section 162(m) going forward. To the extent that compensation paid to a covered employee was intended to be claimed as a compensation expense deduction on a corporation’s U.S. federal income tax return, it will

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be important to recognize that any such compensation in excess of US\$1 million annually to a covered employee will not be deductible.

A major exception that exempted qualifying performance-based compensation from the reach of this limitation has been removed effective in 2018. Therefore, whereas public companies had been able to deduct large compensatory payments above the basic US\$1 million limit to key executives relating to the exercise of stock options and/or the issuance of stock awards payable because of the achievement of pre-set performance objectives, this exception will no longer be available going forward. Removal of the performance-based exception will disadvantage public companies that have intentionally structured their compensation to be predominantly performance-based in order to deduct key employee compensation to the greatest extent possible. However, the overall reduction in the U.S. corporate income tax rate from 35% to 21% in the tax legislation will more than compensate for any lost deductions in most cases.

Once an executive is a “covered employee” of a company for purposes of Section 162(m), the executive now will remain a covered employee forever. As a result, compensation deductions for payments made after an executive is no longer among the company’s top earners, whether received as severance, or even paid to beneficiaries after an executive’s death, will be limited under Section 162(m).

While there have been reports of some companies reacting to the loss of the performance-based compensation exception under Section 162(m) by shifting executive compensation formerly payable as performance-based to base salary, the impact on employers generally remains to be seen. We encourage companies to discuss with U.S. tax counsel how the revisions to Section 162(m) may impact the ability to deduct compensation paid to key officers who are covered employees. In particular, a transition rule under the new Section 162(m) rules exempts remuneration paid pursuant to written binding contracts in effect as of November 2, 2017, from the new rules, so long as such contracts have not been materially modified or extended. The transition rule may impact whether and to what extent a company decides to modify arrangements such as employment agreements, deferred compensation plans, and bonus plans. Understanding how the transition rules impacts a company’s existing arrangements will allow for planning opportunities to maximize compensation deductions and the tracking of disallowed compensation deductions going forward.