Section 162(m) Deferred Compensation Plans: A Win/Win For Executives & Their Employers

Summary

The 2017 Tax Cuts and Jobs Act (the "2017 Act") modified Internal Revenue Code Section 162(m) which disallows the deduction of compensation paid by public companies to covered employees in excess of $1 million per calendar year. The 2017 Act increased the number of companies subject to Section 162(m), increased the number of covered employees at each company, and eliminated the exemption for performance-based compensation and commissions in excess of $1 million. Now that several years have passed since the 2017 Act, more compensation is subject to Section 162(m) limits as grandfathered employment agreements begin to expire. This paper highlights a planning opportunity for companies who already sponsor a voluntary deferred compensation plan. Minor amendments to the existing deferred compensation plan could allow the company to avoid taxation on otherwise non-deductible compensation in excess of $1 million while also helping key employees to accumulate pre-tax retirement savings with an enhanced company match contribution to the deferred compensation plan.

Section 162(m)

Effective in 1994, Internal Revenue Section 162(m) limits the ability of publicly traded companies to deduct compensation in excess of $1 million per year paid to covered employees.[1] Prior to 2017, qualified performance-based compensation and certain commissions were excluded from the $1 million limit. Also, covered employees were limited to the CEO plus each of the company's next three most highly paid executive officers for the taxable year (excluding the CFO).[2] The 2017 Act expanded the definition of covered employees to include the CFO. In addition, once an individual is identified as a covered employee for any taxable year beginning on or after January 1, 2017, they remain a covered employee for all subsequent years. Now, companies must track covered employees into future years, including beyond retirement and death. Even covered employees at predecessor employers acquired by public companies must be tracked.[3] In addition, the 2017 Act amended 162(m) to cover all compensation (including performance-based compensation and commissions) paid to covered employees with an exception for compensation paid pursuant to a grandfathered employment agreement in effect as of November 2, 2017.[4] Grandfather status is lost if the employment agreement is subject to a material modification. A material modification is any amendment which increases compensation in excess of a reasonable cost-of-living increase.[5] The full cost of the 2017 Act will become more apparent in future years when compensation no longer qualifies for special treatment provided to compensation paid pursuant to grandfathered employment agreements. Next, we will discuss how a 162(m) Deferred Compensation Plan can help mitigate the increased tax cost.

162(m) Deferred Compensation Plan

During annual enrollment for a public company's voluntary deferred compensation plan, a covered employee may elect to defer compensation that would otherwise have been paid in the next tax year. This will result in tax savings for the company if the compensation would have been non-deductible due to the 162(m) limit.

Let's review a simple example:

Covered Employee A

- *2021 Salary = $1,000,000*
- *2021 Bonus = $3,000,000*
- *10% 2021 Salary Deferral to Non-Qualified Deferred Compensation (NQDC) Plan = $100,000*
- *50% 2021 Bonus Deferral to NQDC Plan = $1,500,000*
- *Non-Deductible Compensation in 2021 without NQDC Plan Deferral = $3,000,000*
- *Non-Deductible Compensation in 2021 after NQDC Plan Deferral = $1,400,000*
- *Tax Savings to Company = $336,000 ($100,000 salary deferral + $1,500,000 bonus deferral x 21% corporate tax rate)*

By voluntarily electing to defer $100,000 of salary plus $1,500,000 of bonus that would have been paid in 2021, the covered employee saved the company $336,000 in taxes. To encourage this behavior, the company may elect to offer a 10% company match on voluntary deferrals to the deferred compensation plan (limited to deferrals elected by covered employees which apply to compensation in excess of $1 million per calendar year). If we assume the company is in the 21% federal tax bracket, the company retains tax savings equal to 11% of the amount that would otherwise have been paid in excess of $1 million (21% tax savings minus the cost of the 10% match). If the company is also subject to state tax on compensation paid in excess of $1 million, the savings to the company could be even greater. We propose calling this a **162(m) Deferred Compensation Plan** which provides benefits to both the covered employee and the company.

Benefits to 162(m) Covered Employee

- *Regular deferred compensation plan benefits including tax deferral, pre-tax earnings compounding, and potential tax rate arbitrage if in a lower tax bracket or lower-tax state during retirement*
- *10% company match contribution (in addition to any other company contributions already available via the existing deferred compensation plan)*

Benefits for the Company

- *Enhancements to the deferred compensation plan help the company attract and retain key employees*
- *Tax savings equal to 11% of any voluntary deferrals to the deferred compensation plan (limited to deferrals of compensation in excess of $1 million per year elected by covered employees)*

With benefits for both the covered employees and the company, we expect increasing interest in adopting a **162(m) Deferred Compensation Plan** as grandfathered employment agreements cover less and less compensation paid to covered employees over time. For companies looking to reduce the tax impact of the 162(m) deductible compensation limit, adopting a 162(m) Deferred Compensation Plan is one of the best strategies available.[6]

Payment Elections

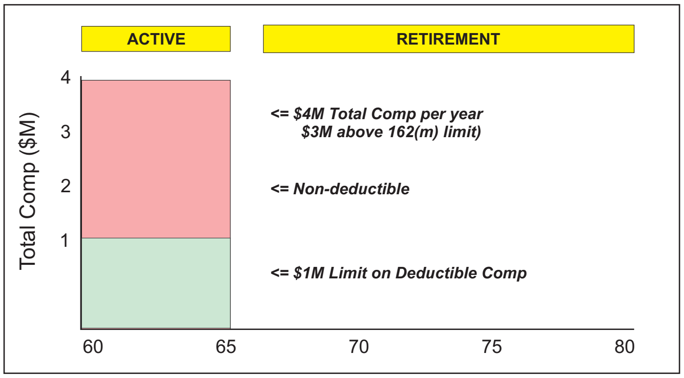
If payments from the **162(m) Deferred Compensation Plan** are properly structured, they can be paid in future years when the covered employee would otherwise receive compensation of less than $1 million per calendar year (typically after separation).

For example, if the covered employee in the example above deferred $1.6M per year over his or her final 5 years of employment, received a 10% match each year of $160,000, and elected 15 annual installment payments upon retirement, the annual payout would be $937K per year (assuming a 5% earnings rate). This would shift $8M of non-deductible compensation pre-retirement to fully deductible compensation post-retirement and save the company $1.68M in federal taxes based on a 21% corporate tax rate. This savings would be partially offset by the cost of providing a 10% match but would still result in $880,000 in tax savings to the company.

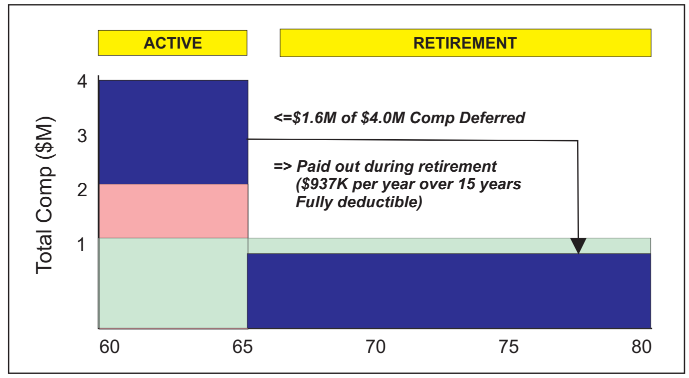
Company's Perspective

The graphs below demonstrate how contributions to a 162(m) Deferred Compensation Plan reduce non-deductible compensation paid to the covered employee while they are actively employed. Once the covered employee is retired, they receive fully deductible annual payments over 15 years which remain under the $1 million 162(m) limit assuming the covered employee receives no other income from the employer during retirement.

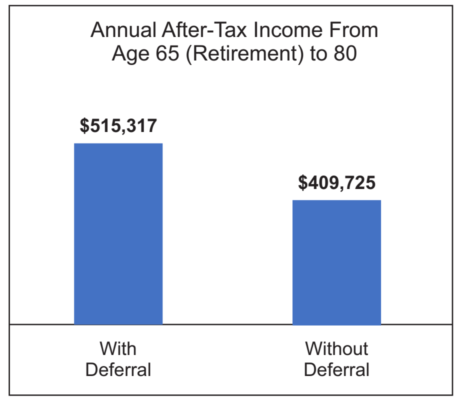
WITHOUT A DEFERRAL PLAN



WITH A DEFERRAL PLAN



Executive's Perspective



From the executive's perspective, the benefit of pretax deferral and the company match results in more than $100,000 additional annual after-tax income each year for 15 years during retirement.

This comparison is based on the same income tax rate in all years (45%) for the executive – both pre-retirement and post-retirement. You can see the detailed calculations used to generate these numbers at the end of this article.

Special note: The Internal Revenue Code Section 409A regulations which govern deferred compensation plans generally allow a payment under a deferred compensation plan to be delayed until the payment of such amount would no longer be non-deductible under 162(m).[7] For example, if a covered employee elected to receive installment payments of $1 million per year following separation of service, the company could delay payment of the first annual installment if the covered employee is expected to receive other income from the company in excess of $1 million during the first year following their separation.

Other Considerations

Deferred compensation plans allow for large voluntary pre-tax deferrals, unlimited company contributions and pre-tax earnings compounding for a select group of management or highly compensated employees. To receive favorable tax treatment, deferred compensation plans are structured as a promise from the employer to pay compensation at a future date. Until the compensation is paid, plan participants have the standing of a general unsecured creditor subject to risk in the event of corporate insolvency. The proposed 10% company match in the **162(m) Deferred Compensation Plan** helps to compensate covered employees for voluntarily assuming this insolvency risk. Employers may also employ other strategies to further protect balances in the plan. Many employers set aside money in a rabbi trust to provide benefit security in the event of a change in control. Employers may also wish to pay for insolvency risk protection via a Deferred Compensation Protection Trust (DCPT).[8] Since the DCPT is ultimately purchased by the executive to protect their own account, the employer can offer to provide a taxable cash payment to the executive to cover the premium for the DCPT.

Summary

We expect the tax cost of missed company tax deductions on compensation above the $1 million to increase each year as grandfathered employment agreements are modified or expire. The **162(m) Deferred Compensation Plan** offers a unique planning opportunity allowing the company to save money on taxes while also providing enhanced deferred compensation plan benefits for their most important employees.

[1] https://corpgov.law.harvard.edu/2018/09/26/irs-guidance-on-section-162m-tax-reform/
[2] https://corpgov.law.harvard.edu/2018/09/26/irs-guidance-on-section-162m-tax-reform/
[3] https://www.willistowerswatson.com/en-US/Insights/2020/02/key-takeaways-from-recently-proposed-162-m-regulations
[4] https://mbsfin.com/irs-guidance-162m-part1/
[5] https://www.willistowerswatson.com/en-US/Insights/2020/02/key-takeaways-from-recently-proposed-162-m-regulations
[6] https://www.winston.com/images/content/1/4/v2/148038/FINAL-presentation-for-9.6-webinar.pdf
[7] https://www.sullcrom.com/files/upload/SC-Publication-IRS-Releases-Proposed-Regulations-on-the-Limitation-on-Deduction-for-Executive-Compensation.pdf
[8] http://stockshield.com/our-products/deferred-compensation-protection-trust/

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Financial Model

The tables below provide the detailed projections for the Covered Employee A example used above. The first table is the Company perspective, the second is the Executive perspective.

COMPANY PERSPECTIVE

		Without Deferral					With Deferral					
Year	Age	Salary	Bonus	Comp Paid to Exec	Deductible Comp up to $1M	Non Deductible Comp over $1M	Exec's Total Comp	Deferred Comp 10% Salary 50% Bonus	Current Comp Paid to Exec	Deferred Comp Paid to Exec	Deductible Comp up to $1M	Non Deductible Comp over $1M
1	60	1,000,000	3,000,000	4,000,000	1,000,000	**3,000,000**	4,000,000	(1,600,000)	2,400,000	0	1,000,000	**1,400,000**
2	61	1,000,000	3,000,000	4,000,000	1,000,000	**3,000,000**	4,000,000	(1,600,000)	2,400,000	0	1,000,000	**1,400,000**
3	62	1,000,000	3,000,000	4,000,000	1,000,000	**3,000,000**	4,000,000	(1,600,000)	2,400,000	0	1,000,000	**1,400,000**
4	63	1,000,000	3,000,000	4,000,000	1,000,000	**3,000,000**	4,000,000	(1,600,000)	2,400,000	0	1,000,000	**1,400,000**
5	64	1,000,000	3,000,000	4,000,000	1,000,000	**3,000,000**	4,000,000	(1,600,000)	2,400,000	0	1,000,000	**1,400,000**
6	65	**5,000,000**	**15,000,000**	**20,000,000**	**5,000,000**	**15,000,000**				936,939	936,939	**0**
7	66									936,939	936,939	**0**
8	67									936,939	936,939	**0**
9	68									936,939	936,939	**0**
10	69									936,939	936,939	**0**
11	70									936,939	936,939	**0**
12	71									936,939	936,939	**0**
13	72									936,939	936,939	**0**
14	73									936,939	936,939	**0**
15	74									936,939	936,939	**0**
16	75									936,939	936,939	**0**
17	76									936,939	936,939	**0**
18	77									936,939	936,939	**0**
19	78									936,939	936,939	**0**
20	79									936,939	936,939	**0**
							20,000,000	**(8,000,000)**	**12,000,000**	**14,054,092**	**19,054,092**	**7,000,000**

Assumptions:
(1) Executive elects to defer 10% of salary and 50% of bonus. Deferred compensation account earns 5.00% per year.

EMPLOYEE PERSPECTIVE

		With Deferral - Deferred Comp Payments						Without Deferral - Reinvestment in Personal Account					
Year	Age	Deferred Comp 10% Salary 50% Bonus	Company Match @ 10%	Distribs	After Tax Distrib 45% Tax	Inv Earnings @ 5.00%	Account Balance	Comp Paid Out	Taxes @ 45%	Net to Invest	After Tax Distribs	Inv Earnings @ 3.50%	Account Balance
1	60	1,600,000	160,000	0	**0**	88,000	1,848,000	1,600,000	(720,000)	880,000	**0**	30,800	910,800
2	61	1,600,000	160,000	0	**0**	180,400	3,788,400	1,600,000	(720,000)	880,000	**0**	62,678	1,853,478
3	62	1,600,000	160,000	0	**0**	277,420	5,825,820	1,600,000	(720,000)	880,000	**0**	95,672	2,829,150
4	63	1,600,000	160,000	0	**0**	379,291	7,965,111	1,600,000	(720,000)	880,000	**0**	129,820	3,838,970
5	64	1,600,000	160,000	0	**0**	486,256	10,211,367	1,600,000	(720,000)	880,000	**0**	165,164	4,884,134
6	65			(936,939)	**(515,317)**	463,721	9,738,148				**(409,725)**	156,604	4,631,013
7	66			(936,939)	**(515,317)**	440,060	9,241,269				**(409,725)**	147,745	4,369,034
8	67			(936,939)	**(515,317)**	415,217	8,719,547				**(409,725)**	138,576	4,097,884
9	68			(936,939)	**(515,317)**	389,130	8,171,737				**(409,725)**	129,086	3,817,245
10	69			(936,939)	**(515,317)**	361,740	7,596,538				**(409,725)**	119,263	3,526,783
11	70			(936,939)	**(515,317)**	332,980	6,992,578				**(409,725)**	109,097	3,226,156
12	71			(936,939)	**(515,317)**	302,782	6,358,421				**(409,725)**	98,575	2,915,006
13	72			(936,939)	**(515,317)**	271,074	5,692,556				**(409,725)**	87,685	2,592,966
14	73			(936,939)	**(515,317)**	237,781	4,993,397				**(409,725)**	76,413	2,259,654
15	74			(936,939)	**(515,317)**	202,823	4,259,280				**(409,725)**	64,748	1,914,677
16	75			(936,939)	**(515,317)**	166,117	3,488,458				**(409,725)**	52,673	1,557,625
17	76			(936,939)	**(515,317)**	127,576	2,679,094				**(409,725)**	40,177	1,188,077
18	77			(936,939)	**(515,317)**	87,108	1,829,263				**(409,725)**	27,242	805,594
19	78			(936,939)	**(515,317)**	44,616	936,939				**(409,725)**	13,855	409,725
20	79			(936,939)	**(515,317)**	0	0				**(409,725)**	(0)	(0)
		8,000,000	**800,000**		**(7,729,750)**			**8,000,000**			**(6,145,873)**		

26% *<- Increase in Income with Deferral*

Assumptions:
(1) With deferral, executive elects to defer 10% of salary and 50% of bonus. Deferred compensation account earns 5.00% per year.
(2) Without deferral, executive's personal investment account earns 5.00% pretax. With a 30% blended tax rate, the net investment rate is 3.50%.