ALERT

September 7, 2018

# IRS RELEASES GUIDANCE ON APPLICATION OF AMENDED SECTION 162(m)

On August 21 the IRS published guidance (Notice 2018-68 or the "Guidance") with respect to several significant interpretative issues concerning section 162(m) of the Internal Revenue Code. Section 162(m) is the Tax Code section that generally limits the compensation deduction for "covered employees" to $1 million. The Tax Cuts and Jobs Act (the "TCJA"), enacted in 2017, amended and changed 162(m) in numerous respects. In particular, effective for tax years beginning in 2018, its scope was greatly expanded by the elimination of the exception from the $1 million limit for performance-based compensation. The Guidance focuses on uncertainties under the new rules with respect to two major issues--(1) which executive officers ("officers") of an issuer are considered "covered employees" and (2) which contracts are not covered under the new rules due to an exception in the TCJA for "written binding contracts in effect on November 2, 2017."

The answers in the Guidance are generally unlikely to please employers. In particular, two of the key provisions are:

- "Covered employee" status no longer requires employment at the end of the fiscal year, as had previously been the case.
- The exception for written binding contracts does not apply to the extent the employer has discretion under the contract to reduce the amount of compensation payable, which was a commonly found structure in annual bonus plans.

## Guidance on Covered Employees

### *Expansion of Individuals Considered Covered Employees*

The amendments modified the definition of "covered employees" as follows:

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| Old Definition of Covered Employees | New Definition of Covered Employees |
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| • Employed as principal executive officer (PEO) at end of taxable year<br>• Employed as officer at end of taxable year and among the company's three most highly compensated officers (other than the PEO or the principal financial officer (PFO) (for technical reasons the PFO was not a covered employee under the old rules) | • PEO or PFO at any time during the taxable year<br>• The three officers (excluding the PEO and PFO) who have the highest compensation for the year<br>• Covered employee status for any taxable year beginning after 12/31/16 applies to all future years |

### *Guidance on the Application of the Amended Definition of Covered Employee*

This portion of the Guidance principally focuses on two questions:

1. Does an employee have to serve as an executive officer at the end of the taxable year to be a covered employee?
2. Can an employee whose compensation is not required to be disclosed under the SEC rules be a covered employee?

*Does an employee have to serve as an officer at the end of taxable year to be a covered employee?*

No. According to the IRS, "the statutory provisions do not impose an end-of-year requirement, and nothing in the legislative history indicates that Congress intended such a requirement to apply." As additional support for its viewpoint on the issue, the IRS noted how SEC disclosure requirements for executive compensation (e.g., in the proxy statement) do not limit the disclosure of compensation only to officers serving at the end of the completed fiscal year but rather include executives whose compensation would have been disclosed if still an officer at the end of the completed fiscal year.[1] This position in the Guidance is a change from the prior IRS rules, which required employment at the end of the year.

*Can an employee whose compensation is not required to be disclosed under the SEC rules be a covered employee?*

Yes. The new IRS approach appears to prescribe a uniform methodology for all companies that are public companies as of the end of their taxable year. Their covered employees include (1) anyone who was a PEO or

[1] The SEC rules include up to two former officers if they would have been included among the three highest officers (excluding the PEO and the PFO) if employed at the end of the year.

a PFO at any time during the taxable year and (2) the three officers with the highest compensation during the year (as generally computed for SEC Summary Compensation Table (SCT) purposes).[2] This approach marks a significant difference from the current IRS regulations, which limit covered employee status to individuals employed at the end of the fiscal year.

This new rule means that the covered employee list will no longer be limited to the executives disclosed in the SCT but rather it will expand for companies reporting fewer than five executives on an annual basis. In particular, the SEC rules for smaller reporting companies and emerging growth companies may allow them to only report three officers in the SCT. Nevertheless, they will still end up with five covered employees for the year if they have five officers employed during the year.[3]

There is, in fact, a particularly complicated example in the Guidance dealing with the rare situation where a public company has a taxable year end that does not coincide with the fiscal year end being used for SEC reporting purposes (the example involves a calendar year public company that becomes an 80% subsidiary of a private company on July 31, with the result that it has a short tax year ending July 31, but continues to file on a calendar basis for SEC purposes). The example appears to indicate that covered employees are determined for the short fiscal year as if an SCT were to be prepared for that short period, even though no SEC filing is required.

An example may be helpful to illustrate the scope of these two changes. Assume that, in addition to the PEO and PFO (who are employed the full year), Company C has six other officers during the year. A, B, and C are officers throughout the year and had Summary Compensation Table (SCT) compensation of $3 million, $2 million, and $1 million, respectively. D, E, and F were officers who terminated employment prior to the end of the year and each had SCT compensation of $3.5, $3.4 million, and $3.3 million. Under the old rules, in addition to the PEO, A, B, and C would be covered employees. Under the new rules the PEO and PFO would be covered employees, as well as D, E, and F, even though F would not even be a named executive officer (NEO) under the proxy statement rules. Also, under the "once a covered employee, always a covered employee" rule, A, B, and C will also be covered employees if they were covered employees for any taxable year beginning after 2016.

## Guidance on the "Grandfather" rule

The amendments to Section 162(m) included a carve out for "written binding contracts" in effect on and not materially amended after November 2, 2017. Compensation provided under such contracts remains exempt from the new deduction limitation to the extent it was exempt under the old rule. The Guidance clarifies the following:

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[2] The SCT computations are somewhat different for smaller reporting companies; for example, the SCT does not include the change in pension values. It is unclear if smaller reporting companies must use the same SCT methodology as larger companies.

[3] While the discussion in the Guidance is not entirely clear, it appears to indicate that the expansion to five employees for smaller reporting companies and emerging growth companies is a function of some technical language in the TCJA, so that, for years before the effective date of the TCJA, only three employees would be covered.

### *Guidance on when there is a written binding contract*

Compensation is treated as payable under a written binding contract if the corporation is obligated under applicable law (e.g., state law) to pay such amounts if the employee performs services or satisfies applicable vesting conditions. Amounts that are subject to discretionary reduction after November 2, 2017 do not qualify even if the corporation chooses not to exercise negative discretion (e.g., both bonus and long-term incentive awards where payout is subject to negative discretion). The written binding contract exemption expires when a contract is renewed after November 2, 2017. For "evergreen" agreements that automatically extend unless the employer or employee gives notice to terminate, renewal is considered to occur as of the termination date if notice were provided.

### *Guidance on where there is a material modification to a written binding contract*

A change to a written binding contract is treated as material modification when the contract is amended to increase amounts payable to the employee. If a modification accelerates the timing of payment, it will be considered a material modification unless the amount is discounted to reasonably reflect the time value of money. Similarly, if a contract is modified to defer compensation, an increase will not be considered a material modification if the additional amount payable is based on a reasonable rate of interest or a predetermined actual investment.

Compensation payable under a supplemental contract that provides for increased or additional compensation will also be treated as a material modification if the additional compensation is paid on substantially the same basis as under the grandfathered agreement. There is an exemption if the additional amount is less than or equal to a reasonable cost-of-living increase (although the additional amount itself is not grandfathered). Amounts previously paid under a written binding contract prior to the material modification remain exempt from the amendments to 162(m) (i.e., the loss of "grandfather" status is prospective).

### *Considerations*

The benefits of grandfathering may be greatest for compensation payable to employees newly brought within 162(m) as covered employees, for example, PFOs. For these employees, all compensation under a written binding contract will be exempt from the deduction limitation. For covered employees under the pre-amendment definition, there is a fairly narrow scope of compensation that will qualify for the grandfather exception. Examples include:

- Gains from option exercises and stock awards with respect to pre-November 2, 2017 awards, to the extent awards were structured to comply with the old exception for performance-based compensation, and
- Payout of pre-November 2, 2017 deferred compensation, if such compensation was originally exempt from the 162(m) deduction limitation.

Companies will need to carefully assess in-process performance-based awards to determine whether compensation qualifies for the grandfather exception. In particular, if the payout is subject to negative discretion, then the grandfather exception will not apply to the extent of the negative discretion. One example is the payout of annual executive bonuses, where such plans often provide for initial funding based on

achievement of objective performance measures and final bonus determinations subject to discretionary adjustment by the compensation committee (including the ability to reduce bonuses to zero). If the bonus determination was made after November 2, 2017, then the portion of the bonus subject to discretionary reduction would be subject to the 162(m) deduction limitation[4]. The same issue could extend to a company's long-term performance plans, to the extent such awards included similar negative discretion provisions.

It is worth noting that the issue of negative discretion may involve more than simply examining the literal terms of the award agreement. For example, even if a plan's literal terms provided for discretionary reduction down to zero, depending on the company's communications to employees and its historical practice (for example, always paying in accordance with the stated financial metrics), companies may argue that they were precluded by state law contract doctrines from completely eliminating the bonus, so that some grandfathering applies.

Moreover, it is not entirely clear that the presence of *any* discretion in award agreements necessarily voids the grandfather exception for the entire award. One issue that may come up with respect to negative discretion is what one might call "partial" negative discretion. For example, the award agreement may define a payout pursuant to specific metrics, but go on to say something like, "the committee retains the discretion to modify the payout downward to the extent changed financial circumstances make such modification appropriate." Alternatively, the agreement could include a clause allowing for reductions where the participant engages in behavior causing reputational harm to the company. This clearly gives the committee some authority to deviate from the stated metrics, but it just as clearly does not give the committee unlimited discretion. To the extent there is downward discretion, but the discretion is subject to some kind of standard, we expect many issuers to claim that the grandfather rules apply, at least to some extent.

## Request for Further Comment

The IRS included a request for comments on additional issues for further guidance, including specifically the application of 162(m) to newly public companies [that are otherwise initially exempt] and foreign private issuers, as well as the application of the rules for covered employees in the event that a taxable year does not end of the same date as the last completed fiscal year (like the example of a public company becoming an 80% subsidiary of a private company described above).

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[4] The changes to 162(m) are effective for fiscal years beginning after 12/31/17. Regardless of whether awards are deductible under new section 162(m), companies with fiscal years beginning in 2017 that have not yet ended may still have an opportunity to deduct annual bonuses for covered employees if the deduction can be claimed in the current fiscal year. The pre-amendment provisions still need to be satisfied, which requirements include compensation committee certification of performance results prior to payment. Companies should review the necessary steps with outside tax counsel, which likely include moving up bonus approvals and related performance certification earlier than historical practice.

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