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## IRS issues initial guidance on application of Code Section 162(m) as amended by the Tax Cuts and Jobs Act

On August 21, the Internal Revenue Service (IRS) issued Notice 2018-68 containing much-awaited interpretive guidance on Section 162(m) of the Internal Revenue Code as amended by last year's tax reform act (Tax Act), including the operation of the so-called "grandfather rule" under amended Section 162(m) (new Section 162(m)). The grandfather rule preserves the federal income tax deduction for certain compensation paid to covered officers of a public corporation under written binding contracts in effect as of November 2, 2017 if specified requirements are met. Under the new IRS guidance, the grandfather rule may have its greatest impact on the deductibility of compensation paid under arrangements in effect on November 2, 2017 to individuals who are covered employees under new Section 162(m), but who would not have been covered employees under Section 162(m) before it was amended.

The IRS guidance also addresses "covered employee" determinations under new Section 162(m) for officers other than the chief executive officer or the chief financial officer, and indicates that the corporation is to make these determinations without regard to whether an officer retains his or her position on the last day of the corporation's fiscal year. The guidance on covered employee determinations under new Section 162(m) departs from the SEC executive compensation rules on the determination of named executive officers for purposes of disclosure in a company's annual proxy statement. As a result, public companies will have to identify separately their officers for purposes of the two regulatory regimes.

Notice 2018-68 may be viewed [here](#).

### Background

Before the enactment of the Tax Act, Section 162(m) generally limited to US\$1 million the federal income tax deductibility of some forms of compensation paid in one year to the chief executive officer and the three other most highly compensated officers of a "publicly traded corporation" employed at the end of the year (other than the chief financial officer) and provided that "qualified performance-based compensation" could qualify for an exception from the limit on deductibility. As a result of the enactment of the Tax Act in December 2017, significant changes were made to Section 162(m) effective for taxable years beginning after December 31, 2017. The Tax Act includes transition relief under which the changes to Section 162(m) will not apply to compensation (1) that is paid under a written binding agreement that was in effect on November 2, 2017 and that is not subsequently materially modified or renewed and (2) that otherwise would have been deductible under Section 162(m) before the effective time of the Tax Act.

Before it was amended by the Tax Act, Section 162(m) limited to US\$1 million per year the deductibility of compensation paid to its covered employees by a "publicly traded corporation," which is a corporation with a class of equity security listed under Section 12 of the Exchange Act. New Section 162(m) expands the class of affected corporations to include "publicly held corporations" required to file reports under Section 15(d) of the Exchange Act.

The US\$1 million deduction limitation under Section 162(m) before the amendment applied only to payments made while an officer was a covered employee. Payments

made after termination of employment or after an officer ceased to be a covered employee were not subject to the deduction limitation. The Tax Act amended Section 162(m) to make permanent the classification of an employee as a covered employee, thereby extending the reach of the deduction limitation to post-termination and even post-death payments.

The Tax Act also eliminated the exception from the deduction limitation formally extended under Section 162(m) to payments made as qualified performance-based compensation. This compensation included most income recognized from stock options and certain other equity plan awards.

### Application of grandfather rule

Under new Section 162(m), any amount paid under a written contract containing a binding payment provision in effect as of November 2, 2017 remains deductible if the payment would have been deductible under Section 162(m) before it was amended, unless the payment occurs after a material modification or renewal of the contract. A contract is binding as to a payment provision if the employer is obligated to make the payment under applicable law. The contract is not binding as to a payment provision which the employer may unilaterally terminate or cancel, or as to the amount of a payment which the employer may reduce under applicable law in its discretion, including through the exercise of negative discretion.

**Termination or cancellation of contract.** The IRS indicates in its guidance that, if an employer may immediately terminate or cancel a written binding contract prospectively by taking unilateral action, only those amounts payable under the contract as of November 2, 2017 can benefit from grandfathered treatment. Plan documents routinely reserve for the employer the right prospectively to terminate the plan, so that, for example, a deferred compensation plan generally would permit the sponsor to freeze balances or accruals or terminate the plan at any time. In such cases, only the November 2, 2017 balance (plus subsequent earnings on or increases in value of that balance, unless the sponsor can freeze those, too) would be grandfathered under the new guidance. Similarly, no severance payable under an executive severance plan would be grandfathered if, as is often the case, the plan permits the employer to terminate the plan at any time. However, a contract would not be treated as immediately

cancellable if the employer would have to terminate the employee's employment in order to accomplish the contract termination. Accordingly, absent an earlier material modification of the contract, severance payments promised under an "at-will" employment contract likely would qualify for grandfathered treatment for the balance of the contract's existing term. As soon as a contract enters a renewal term, however, payments in respect of employment for the renewal term and thereafter would not be grandfathered and therefore would be subject to the deduction limitation under new Section 162(m).

**Material modification of contract.** New Section 162(m) will apply to all payments made under a contract that otherwise would be grandfathered after a material modification of the contract. A contract amendment to increase compensation payments constitutes a material modification, unless the increase is consistent with a reasonable cost-of-living increase. New agreements for a different form of compensation or different payor will not necessarily be deemed to constitute a material modification to an existing contract. An amendment to defer compensation and increase its amount is not a material modification as long as the increase is based on a reasonable rate of interest or a predetermined actual investment.

The IRS illustrates the application of these principles in Notice 2018-68. The IRS in its guidance describes a CFO's employment agreement in which salary was set at US\$1,800,000 before November 2, 2017, increased in a subsequent year by US\$40,000 to US\$1,840,000 (consistent with a reasonable cost-of-living increase), and increased in yet another year by US\$560,000 to US\$2,400,000. Under the guidance, the first, US\$40,000 increase would not impair grandfathered treatment of the CFO's salary, while the second, US\$560,000 increase would disqualify the salary for this treatment. Because it represented greater than a reasonable cost-of-living salary increase, the latter increase would result in a material modification of the contract by creating US\$1,400,000 of excess, nondeductible compensation for the year of the modification and years thereafter, without regard to whether the contract was in a term that otherwise would have enabled it to benefit from grandfathered treatment. By contrast, if the additional pay were provided as a restricted stock grant — representing a different form of compensation — rather than a salary increase, the grant

would be nondeductible, but the US\$840,000 salary amount in excess of US\$1 million would continue to be deductible for the grandfathered term.

**Implication of negative discretion.** Public company compensation committees have found negative discretion to be a useful tool in structuring annual- and long-term cash incentive arrangements and in designing performance stock units and other stock-based awards. By using one or more hard-wired, objective financial measures to produce an amply-sized award (gross award amount), an employer then can use softer financial measures, even subjective ones, to deliver the appropriate amount of pay by scaling back the gross award amount earned to levels consistent with the target range communicated to executives.

Before the Tax Act, such an award would have qualified for an exception to Section 162(m)'s deduction limitation as qualified performance-based compensation. Based on the new guidance, however, in the absence of special facts, it seems likely that under new Section 162(m) the reservation of negative discretion to completely eliminate the award would render the award ineligible for grandfathered treatment. However, employers exercising negative discretion under arrangements that use pre-approved objective measures in the scaling-back process — such as by assigning points that are then converted into a specific dollar amount or number of stock units to be delivered — might find that a partial payment is grandfathered for awards outstanding as of November 2, 2017, because rather than permitting the complete elimination of the award, the negative discretion instead would operate to create an objectively discernable minimum amount that must be paid. This minimum amount would be eligible for grandfathered treatment.

### Determination of covered employees

New Section 162(m) treats the following executives as covered employees on a permanent basis:

- The CEO and the three other most highly compensated officers (other than the CFO) reported in the annual proxy statement for a fiscal year beginning in 2017
- The CEO or CFO for *any portion* of a taxable year of the corporation beginning in 2018 or thereafter
- The three most highly compensated officers, other than a CEO or CFO, for *any portion* of a taxable year of the corporation beginning in 2018 or thereafter

Before the amendment of Section 162(m), covered employees would not have included (1) the CFO, (2) a CEO not serving on the last day of the corporation's fiscal year, or (3) any officer among the three most highly compensated officers who was not serving as an officer on the last day of the corporation's fiscal year. Further, no officers of a company newly treated as "publicly held" would have been covered by Section 162(m). For these individuals swept into the new Section 162(m) regime, existing compensation arrangements, such as time-vesting restricted stock grants, and salary and severance payments under employment agreements, may be eligible for continued deductibility as grandfathered payments.

For purposes of determining covered employees under new Section 162(m), there is no distinction made between different types of public companies based on their classification under SEC rules for reporting purposes. As a result, smaller reporting companies and emerging growth companies that benefit from scaled disclosure obligations must undertake the same determinations as other covered public companies.

### Current considerations

- *Salary increases:* A company with extended-term employment agreements outstanding as of November 2, 2017 should consider the new IRS guidance before implementing salary increases. In the normal process of setting pay for 2018, many companies already might have implemented changes resulting in a material modification to salary payments, thereby making salary and severance payments ineligible for grandfathered treatment.
- *Stock options and stock appreciation rights:* Stock options and SARs granted before November 2, 2017 are eligible for grandfathered treatment unless materially modified. The new guidance leaves many questions unanswered, such as whether extending an option exercise period in connection with a termination of employment results in a material modification.
- *Determination of covered employees:* Since covered employees (once so classified) are forever covered employees for purposes of new Section 162(m), public companies will now have to compile and maintain a list of covered employees even if they do not currently pay compensation in excess of US\$1 million for use in the event they pay compensation over this limit in

the future (whether due to changes in pay practices, deferred compensation payments or a change of control).

- *Determination of covered employees in successor context:* Depending upon future IRS guidance concerning employee determinations for successor corporations, acquisitive companies not only will have to track their covered employees but also those of all public companies they have acquired since the enactment of new Section 162(m), since those covered employees will forever be subject to new Section 162(m) if they continue employment with a successor. As a result, acquisitive companies may begin seeking representations and warranties from target companies regarding their list of covered employees and taking possible future limits on deductibility into account in assessing the financial terms of a transaction.

### Looking ahead

The IRS has requested public comment on future guidance related to the following issues:

- The application of the definition of “covered employee” to an employee who was a covered employee of a predecessor of the publicly held corporation
- The application of the definition of “publicly held corporation” to foreign private issuers

- The application of Section 162(m) to corporations immediately after they become publicly held either through an initial public offering or a similar business transaction
- The application of the SEC executive compensation disclosure rules for determining the three most highly compensated officers for a taxable year that does not end on the same date as the last completed fiscal year

The narrow interpretation of the grandfather rule and the expansive interpretation of covered employee determinations in the IRS guidance underscores that the IRS views revenue raising as the central rationale for new Section 162(m). Although Notice 2018-68 is likely not the final word from the IRS on new Section 162(m), it provides insight into the framework that the IRS envisions for enforcement of new Section 162(m) and indicates that public companies will now have to manage additional challenges related to compliance with this provision.

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