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Client Alert Commentary

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IRS Provides Initial Guidance on Section 162(m) Tax Reform Changes

Notice 2018-68 clarifies certain Section 162(m) issues with respect to covered employees and grandfathering of written binding contracts.

Key Points:

- "Covered employee" determination is not affected by whether or not the individual is employed at year-end or whether or not the individual's compensation is required to be disclosed for SEC purposes.
- Compensation will only be considered payable pursuant to a written binding contract to the extent that the company is obligated under applicable law to pay such compensation (assuming that the employee continues to provide services and/or satisfies vesting conditions). The company is not considered obligated to pay compensation if the company has the discretion to reduce the amount of the compensation pursuant to the contract *(i.e.*, negative discretion).
- Subject to limited exceptions described below, amendments to a written binding contract that increase the amount of compensation payable are generally material modifications and will preclude grandfathering of such contracts.

On August 21, the Internal Revenue Service (IRS) issued guidance in the form of Notice 2018-68 with respect to changes made to Section 162(m)[1] pursuant to the enactment of the Tax Cut and Jobs Act in December 2017. This guidance focuses on the rules for identifying covered employees and the operation of the transition rule applicable to written binding contracts in effect on November 2, 2017 (generally referred to as the grandfather rule) and will apply for tax years ending on or after September 10, 2018.

Covered Employees

Section 162(m) generally limits the deduction allowed for compensation paid to a "covered employee" during a taxable year to US$1 million. Under Section 162(m), a covered employee includes any employee of a publicly held corporation if any of the following apply:

a) Such individual is (or acted as) the chief executive officer or chief financial officer at any time during the taxable year

b) Such individual is among the three highest paid officers for the taxable year

c) Such individual was a covered employee of the taxpayer for any preceding taxable year beginning after December 31, 2016

The guidance clarifies the following points with respect to identifying covered employees:

- ***No Year-End Employment Required***. Prior to tax reform, executives would only constitute covered employees if they were employed as of the end of the applicable tax year. However, under the new guidance, the IRS has clarified that Section 162(m) does not require that the individual be employed as of the year-end in order to be considered a covered employee (and, as noted above, covered employees can include individuals who were not employed at any point during the applicable tax year, if they were covered employees for a preceding taxable year).

- ***SEC Disclosure Not Determinative***. The determination as to whether or not an individual is a covered employee is not affected by whether or not such individual is a "named executive officer" for Securities and Exchange Commission (SEC) purposes. If an employee served as the chief executive officer or chief financial officer, or was among the three highest paid officers, for a taxable year, he or she will constitute a covered employee for purposes of Section 162(m) even if SEC reporting of his or her compensation is not required.

  For example, a company treated as a smaller reporting company or emerging growth company under the SEC rules is permitted to disclose only the compensation of its chief executive officer and its two other most highly compensated executive officers for SEC purposes; however, for purposes of Section 162(m), the chief financial officer and the three most highly compensated executive officers (other than the chief executive officer and chief financial officer) would still be considered covered employees. Conversely, there may be named executive officers for SEC purposes who are not covered employees under Section 162(m). For example, if there is an executive officer of a company (other than a smaller reporting company or emerging growth company) who is not employed as of the end of the applicable tax year but earned higher compensation than one of the three most highly compensated executive officers (other than the chief executive officer and chief financial officer) who were employed as of the end of the applicable tax year, all four such executives would be named executive officers. However, only the three of such executives who earned the highest compensation would be covered employees.

  This broad application also could expand the scope of Section 162(m)'s deduction limitation to foreign private issuers and their affiliated group members, including US subsidiaries. Prior to the issuance of this guidance, the IRS held in private letter rulings that executive officers of a foreign private issuer and its affiliated group members were not covered employees if their compensation was not required to be reported under SEC rules, and that therefore those entities were not subject to Section 162(m)'s deduction limitation.[2] This recent guidance may indicate a change in the IRS' view, and those executive officers could be covered employees regardless of whether their compensation is required to be disclosed under SEC rules. However, the IRS has requested comments on the application of the definition of "publicly held corporation" to foreign private issuers, which indicates that the application of Section 162(m) to foreign private issuers and their affiliated group members remains open.

- ***Covered Employees for 2017***. For purposes of determining who is a covered employee for 2017 (and thus who continues to be a covered employee under prong (c) of the definition above), the guidance clarifies that Section 162(m) as in effect prior to tax reform applies to determine the covered employees for the 2017 tax year. As a result, the named executive officers in a company's 2018 annual proxy statement who remained employed on December 31, 2017 (excluding the chief financial officer for companies that are not smaller reporting or emerging growth companies) will generally constitute its covered employees for 2017.

Grandfather Rule

The amendments made to Section 162(m) pursuant to tax reform generally do not apply to compensation payable pursuant to written binding contracts that were in effect on November 2, 2017, absent material modification of such contracts on or after such date. As a result of the grandfather rule, Section 162(m)'s deduction limitation may continue to not apply to certain performance-based compensation, to compensation payable to executive officers following termination of employment, and, for companies other than smaller reporting companies and emerging growth companies, to certain compensation payable to the chief financial officer.

The guidance clarifies the following points with respect to the operation of the grandfather rule:

- ***Status as a Written Binding Contract***. Compensation will be considered payable pursuant to a written binding contract only to the extent the company is obligated under applicable law (*e.g.*, state contract law) to pay such compensation (assuming the employee's continued services or satisfaction of vesting conditions). Further, to the extent any obligations under a contract remain subject to further corporate actions (*e.g.*, board action), such obligations may not constitute a part of a written binding contract for purposes of Section 162(m). Similarly, if the company retains the discretion to unilaterally cease making contributions under an arrangement, the grandfather rules will not apply to contributions made following November 2, 2017.

- ***Effect of Negative Discretion***. If a company has discretion to reduce amounts payable under a contract, amounts that could be subject to such negative discretion will not be considered payable pursuant to a written binding contract subject to the grandfather rule.

  Example: A written binding contract that was entered into on January 1, 2017 with respect to a performance-based bonus that meets the requirements of qualified performance-based compensation under Section 162(m) provides that if certain performance goals are met then the executive officer will receive a bonus of US$1.5 million; however, the company retains the right to reduce the bonus to no less than US$400,000 if, in its judgment, other subjective factors warrant a reduction. Following the end of the performance period, even though the performance goals were met, the compensation committee uses its discretion to reduce the bonus payment to US$500,000. For purposes of Section 162(m), US$400,000 would not be subject to the deduction limitation pursuant to the grandfather rule while the remaining US$100,000 would likely be subject to the deduction limitation.

- ***Renewal or Extension of Grandfathered Contract.*** A written binding contract that is renewed after November 2, 2017 will no longer be subject to the grandfather rule with respect to compensation payable after renewal. Additionally, a contract that contains an automatic renewal or extension provision that applies unless the company (or either the company or the employee) provides notice to terminate will be treated as renewed as of the date that the termination of the agreement would have been effective absent renewal or extension. Therefore, the grandfather rule will generally cease to apply with respect to contracts subject to automatic renewals as of the renewal date (unless the option to renew or extend is solely retained by the employee).

- ***Material Modifications***. An amendment to increase the compensation payable under a written binding contract is generally treated as a material modification that will cause the compensation payable under the agreement following the material modification to be subject to the deduction limitations of Section 162(m). However, the guidance clarifies that the following actions will not constitute a material modification:

  - Acceleration of a payment if the payment is discounted to reasonably reflect the time value of money

  - Deferral of any payment if any amount paid in respect of the deferred payment in excess of the amount originally payable is based on a reasonable interest rate or the return/loss on a predetermined actual investment

- ***Supplemental Compensation.*** New agreements may be treated as a material modification of a grandfathered agreement if the compensation under the new agreement is paid based on substantially the same elements or conditions as the compensation under the original agreement (unless any increase in the same element of compensation is limited to a reasonable cost of living increase). New equity compensation awards would generally not be considered based on substantially the same elements or conditions as base salary under a grandfathered agreement. Any compensation derived from such equity compensation award, however, would not be eligible for the grandfather rule.

Bottom Line

While additional guidance on Section 162(m) in the form of proposed regulations is forthcoming, this initial guidance from the IRS clarifies certain open issues with respect to identifying covered employees. The guidance indicates that the IRS generally appears to be taking a narrow view of the application of the grandfather rule.

Based on the initial guidance, companies may wish to consider the following actions with respect to Section 162(m):

- ***Determine Scope of Covered Employees for 2018 and Future Years***. Companies should identify all employees who may be considered covered employees (separately from those who may be named executive officers for proxy reporting purposes) to understand the implications of compensation decisions under Section 162(m).

- ***Assess Existing Arrangements for Grandfathered Status.*** Companies should review existing executive compensation arrangements in effect as of November 2, 2017 and consider whether given the initial guidance these arrangements can reasonably be expected to meet the requirements of the grandfather rule. In particular, the inclusion of negative discretion under any cash- or equity-based incentive arrangements may prevent the grandfather rule from being applicable to all or a part of the compensation paid under such arrangements. Further, compensation committees should review and assess the effects of any future compensation changes on grandfathered arrangements to avoid inadvertent, adverse effects on the company's tax position. Companies other than smaller reporting companies and emerging growth companies should pay particular attention to arrangements in which the chief financial officer participates.

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Endnotes

1 All references to "Section" refer to sections of the Internal Revenue Code of 1986, as amended.

2 For example, private letter ruling (PLR) 200916012 held that the Section 162(m) deduction limitation did not apply to Corporation X, a foreign private issuer that was not required to file a "summary compensation table" as described in Item 402 of Regulation S-K, 17 C.F.R. 229.402 (Item 402) and was therefore deemed not to be subject to the executive compensation disclosure rules under the Securities Exchange Act of 1934, as amended. See also PLRs 200406013, 200129016, 200609015, 201103008, and 200021050. In these PLRs, the IRS held that executive officers of a foreign private issuer's affiliated group members (including US subsidiaries) were not covered employees if their compensation was not required to be reported under Item 402, and that therefore the US subsidiaries were not subject to Section 162(m)'s deduction limitation.