IRS Issues Initial Guidance on Section 162(m) Revisions

On August 21, 2018, the Department of the Treasury and the Internal Revenue Service issued Notice 2018-68, their initial guidance on the changes made to the $1 million deduction limit of Section 162(m) of the Internal Revenue Code by the Tax Cuts and Jobs Act of 2017 (the "Tax Act"). This guidance clarifies the scope of the changes made by the Tax Act in two key areas:

- The determination of who is subject to the $1 million deduction limit (so-called "covered employees"); and
- The scope of the transition provision which exempts compensation payable pursuant to a written binding contract that was in effect on November 2, 2017 from the deduction limit if such amount qualifies as "performance-based compensation."

This Thoughtful Pay Alert summarizes the recent guidance and offers our initial observations on its potential impact on publicly-held corporations.

Background

Generally, prior to the Tax Act, Section 162(m) disallowed publicly-held corporations a federal income tax deduction for compensation in excess of $1 million paid to their "covered employees" (specifically, the chief executive officer and the three other most highly-compensated executives (other than the chief financial officer) as of the last day of the company's taxable year) unless such compensation qualified as "performance-based compensation."

For tax years beginning after December 31, 2017, the Tax Act amended Section 162(m) in several significant ways, including the following:

- Expanded the Definition of "Covered Employees" – Added a publicly-held corporation's chief financial officer to the group of "covered employees" subject to the $1 million deduction limit and clarified that once an executive becomes a "covered employee," he or she will be subject to the $1 million deduction limit indefinitely.
- Eliminated the "Performance-Based Compensation" Exemption – Subject to one exception, eliminated the exemption for "performance-based compensation." Consequently, beginning in 2018 amounts paid to any covered employee over the $1 million deduction limit are no longer deductible, including specifically gains resulting from the exercise of stock options, the payment of performance-based cash bonuses, and the earning of performance-based equity awards. However, this change does not apply to compensation that is provided pursuant to a written binding contract which was in effect on November 2, 2017, and which is not subsequently modified in any material respect (the "Grandfather Rule").

The Initial Guidance

Notice 2018-68 addresses two specific areas: who is a "covered employee" and the operation of the Grandfather Rule.

"Covered Employees"

Using a series of examples, Notice 2018-68 makes the following points about how to identify which of a publicly-held corporation's senior executives are covered employees subject to the $1 million deduction limit:

- CEO and CFO - The guidance clarifies that any employee of a publicly-held corporation who served as the corporation's principal executive officer or principal financial officer (or acted in either of such capacities) at any time during the year is a covered employee.
- Most Highly-Compensated Executive Officer – The guidance clarifies that, in addition to all CEOs and CFOs, the three most highly-compensation executives of a publicly-held corporation for the year are also covered employees, without regard to whether such individuals are employed at the end of the year or whether their compensation is required to be disclosed under the SEC's executive compensation disclosure rules.
- Emerging Growth and Smaller Reporting Companies – The guidance clarifies that, in the case of both emerging growth companies and smaller reporting companies, the CEO, CFO, and three most highly-compensation executive officers are covered employees notwithstanding the fact that only the compensation of the CEO and the two most highly-compensation executive officers must be disclosed under the SEC's executive compensation disclosure rules.

Initial Observations: While the addition of the CFO to the "covered employee" group (to remedy an anomaly in Section 162(m) resulting from the SEC's revisions of its executive compensation disclosure rules in 2006) has long been expected, the guidance makes clear that the terms "covered employee" and "named executive officer" are not synonymous. In some instances, a former executive officer who is no longer with the company but who has total compensation that is greater than the total compensation

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of the three most highly-compensated executives serving at fiscal year-end will be a covered employee.

Coupled with the new requirement that a covered employee retains that status indefinitely, you will need to carefully identify your covered employees each year and then maintain clear records of the compensation paid and payable to such individuals to ensure that you are correctly applying the $1 million deduction limit each year. In short, you may no longer be able to simply refer to the named executive officer group in your most recent proxy statement to identify the individuals who are your "covered employees" in a given year for purposes of Section 162(m). This will certainly be true for emerging growth companies and smaller reporting companies.

Scope of Grandfather Rule

Similarly, using a second series of examples, Notice 2018-68 sets forth the following principles for determining whether an agreement that was in effect on November 2, 2017 constitutes a "written binding contract" so that the compensation payable pursuant to the agreement by a publicly-held corporation is exempt from the $1 million deduction limit:

- Written Binding Contract – The guidance provides that an agreement is a "written binding contract" only to the extent that a corporation is obligated under state contract law to pay the compensation if the employee performs services or satisfies a vesting requirement.
- Compensation Subject to Discretionary Reduction – The guidance clarifies that compensation will not be considered payable pursuant to a written binding contract to the extent that the amount payable can be reduced or eliminated in the corporation's discretion after November 2, 2017.
- Compensation Subject to Condition Subsequent – The guidance clarifies that compensation will not be considered payable pursuant to a written binding contract if the compensation (such as the grant of an equity award) remained subject to a condition (such as board of board committee approval) after November 2, 2017.
- Renewal of Agreement – The guidance clarifies that a written binding contract as of November 2, 2017 that is renewed on or after that date is considered a new agreement and, therefore, is no longer eligible for the protection of the Grandfather Rule. Moreover, in the case of an agreement with an automatic renewal provision, the agreement will be considered renewed (and no longer covered by the Grandfather Rule) as of the date that termination would have been effective if notice had been given.
- Material Modification – Even if an agreement constitutes a written binding contract as of November 2, 2017, if it is materially modified after that date the compensation payable pursuant to the agreement is subject to the $1 million deduction limit. Generally, a "material modification" includes any amendment that increases the compensation payable to a covered employee under the agreement, including the following:
  - Revising a written binding contract to either accelerate or defer the payment of compensation will be a "material modification" unless the amount payable is either discounted to reflect the time value of money (in the case of a payment acceleration) or, to the extent increased, based on a reasonable rate of interest (in the case of a payment deferral).
  - Increasing compensation, or entering into a supplemental agreement providing for increased compensation on the basis of substantially the same elements or conditions as the compensation that is otherwise payable under a written binding contract will be a "material modification" unless the payment is equal to or less than a reasonable cost-of-living increase. Thus, if the agreement specifies a specific base salary and the agreement is amended to increase the base salary above a reasonable cost-of-living increase, the agreement will be deemed to be "materially modified."

Initial Observations: Given the typical design of the incentive compensation arrangements for most technology and life sciences companies, as well as the narrow interpretation of the Grandfather Rule, it is unlikely that the rule will be of much utility to most companies. Based on our understanding of the guidance, the probable treatment of most incentive compensation arrangements under the Grandfather Rule will be as follows:

- *Stock options* – Stock options granted before November 2, 2017 that qualify as "performance-based compensation" under Section 162(m) as it existed prior to the Tax Act will continue to be deductible as long as they are not materially modified after that date. Note that because the acceleration of vesting of equity awards is not addressed by the guidance, you should proceed cautiously before taking any action that could be considered a material modification of an option.
- *Performance-based stock awards* – Performance share and performance unit awards that were granted prior to the Tax Act that would have qualified as performance-based compensation may not be eligible for the protection of the Grandfather Rule if they reserve to the company the discretion to reduce or eliminate payouts of the award.
- *Annual bonus plans* – Annual incentive plans that did not have their specific terms and conditions approved prior to November 2, 2017 will not be eligible for the protection of the Grandfa-

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ther Rule for this reason, as well as if they reserve to the company the discretion to reduce or eliminate bonus payments under the plan.

Generally, you should exercise caution in amending or modifying any compensation arrangements that have been identified as eligible for "grandfathering." We strongly recommend that you consult with your tax or legal advisor about the compensation arrangements outstanding as of November 2, 2017 for your senior executives to both determine which, if any, qualify as "written binding contracts" for purposes of the Grandfather Rule and to understand what actions pertaining to these arrangements are still permitted that will not threaten their status as "performance-based compensation."

Effective Date

The Treasury Department and the IRS anticipate that the guidance will be incorporated in future regulations that, with respect to the matters addressed in Notice 2018-68, will apply to any taxable year ending on or after September 10, 2018. They go on to say that any future guidance, including regulations, addressing the matters covered in the Notice in a manner that would broaden the definition of a "covered employee" (as described in the guidance) or restrict the application of the definition of a "written binding contract" (as described in the guidance) will apply prospectively only.

What's Next?

As noted above, the Treasury Department and the IRS indicate that they expect to issue further guidance on other aspects of Section 162(m) in the future. In this regard, they are soliciting public comment until early November on specific topics that this future guidance should address, including, among other things, the application of Section 162(m) to corporations immediately after they become publicly-held either through an IPO or a similar business transaction.

Need Assistance?

Compensia has extensive experience in helping technology and life sciences companies understand the impact of tax laws and other legislation on the design and operation of their executive and equity compensation programs. If you have any questions on the subjects addressed in this Thoughtful Pay Alert or would like assistance, please contact your Compensia engagement manager.■

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