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IRS Provides Guidance on Application of Code Section 162(m) as Amended by the Tax Cuts and Jobs Act of 2017

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On August 21, 2018, the IRS issued initial guidance (Notice 2018-68) to assist companies in determining how the changes made to Internal Revenue Code Section 162(m) ("Section 162(m)") by the Tax Cuts and Jobs Act of 2017 (the "Act") affects the deductibility of their compensation arrangements. The guidance focused on two aspects: (1) determining who is a "covered employee" under the new Section 162(m) rules and (2) defining when an arrangement is considered "grandfathered," such that the arrangement may continue to be governed by the old (pre-tax reform) Section 162(m) rules. This article focuses on the guidance related to determining when a compensation arrangement is grandfathered. We previously addressed the guidance about determining "covered employees" in a separate article.

Background

Section 162(m) limits the tax deduction a publicly held company can take with respect to compensation paid to its "covered employees" to no more than $1 million per year.

The Act made the following notable changes to the Section 162(m) rules for tax years beginning on or after January 1, 2018:

- The definition of "covered employee" was expanded to include anyone acting as CEO or CFO at any time during the year and the three other most highly compensated executive officers (determined with reference to Securities and Exchange Commission rules)
- Once an individual becomes a "covered employee" under the new Section 162(m) rules, he or she always remains a "covered employee" (even following termination of employment)
- "Performance-based compensation" paid to covered employees is now subject to the $1 million deduction limitation

The Act included significant transition relief (referred to as the “grandfathering rules”), under which none of the changes to Section 162(m) apply to compensation provided pursuant to a written binding contract that was in effect on November 2, 2017, and not modified in any material respect on or after such date. This means that “grandfathered” compensation will be deductible under the more expansive older Section 162(m) rules, including that qualified performance-based compensation will not count toward the $1 million limit and grandfathered compensation paid to the CFO is generally going to be fully deductible.

What Constitutes a “Written Binding Contract?”

For compensation to be grandfathered, it must be provided pursuant to a “written binding contract” in effect on November 2, 2017.

“Binding” Means Obligated Under Law

The IRS guidance clarifies that compensation is payable under a written binding contract in effect on November 2, 2017, only to the extent the company is obligated under “applicable law” to pay that compensation, as long as the employee performs any required future services or satisfies applicable vesting conditions. In many cases, “applicable law” will be state contract law.

The grandfathered compensation is therefore limited to the amount of the company’s obligation as of November 2, 2017; additional amounts will not be grandfathered.

Discretion

Under the IRS guidance, if a contract gives the company the discretion to reduce the amount of compensation payable, and applicable law takes that negative discretion into account, then any amount that could be reduced will not be treated as grandfathered (even if the company does not exercise that negative discretion).

> **Practice Note:** *Many companies reserved negative discretion under their annual bonus plans and performance-based equity arrangements as part of their Section 162(m) compliance strategy or to maintain flexibility to take into account unexpected events. Unfortunately, this discretion could, under the IRS guidance, cause awards that were in effect prior to November 2, 2017, to be ineligible for grandfathering. We recommend reviewing all award documentation and participant communications in light of state law to determine whether there is negative discretion that will result in a determination that the arrangement is not a “written binding contract” and is therefore not grandfathered.*

Renewals

Any grandfathered employment agreement or other written binding contract will lose its grandfathered status if the agreement is renewed. If a contract is terminable or cancelable by the company without the employee’s consent, then it is treated as renewed as of the date that any termination or cancellation could be effective if the company had taken action.

The IRS guidance includes the following examples of when a contract will be treated as “renewed”:

- An “evergreen” contract that automatically renews on a specified date unless either the

company or the employee provides notice of termination at least 30 days in advance of that date. The contract is treated as renewed (and therefore no longer subject to the grandfathering rules) as of the date that the contract would terminate if the notice were given.

- An “opt-in” contract providing that it will be terminated or canceled as of a certain date unless either the company or the employee elects to renew within 30 days is treated as renewed if and when it is actually renewed.

- A contract that gives the employee discretion over whether to keep the company legally obligated is not treated as renewed if the employee exercises discretion to keep the company bound.

Some exceptions are:

- A contract is not treated as terminable or cancelable if it can be terminated or canceled only by terminating the employee’s employment

- A contract is not treated as renewed if it provides that, upon its termination or cancelation, the employment relationship continues (but not under the contract)

What Constitutes a “Material Modification?”

A grandfathered compensation arrangement will lose its grandfathered status (and become subject to the new Section 162(m) rules) if the arrangement is “materially modified” after November 2, 2017. Amounts paid before the modification will remain grandfathered (and subject to the old Section 162(m) rules), but all amounts paid after the modification date are subject to the new Section 162(m) rules to determine deductibility.

Basic Definition of Material Modification: Amendment that Increases the Amount of Compensation

In general, any amendment to increase the amount of compensation payable to the employee will be treated as a material modification. There is a limited exception for supplemental payments that are no more than a reasonable cost-of-living increase over a payment made in the preceding year under the contract.

Acceleration is a Material Modification Unless Discounted

If a grandfathered arrangement is modified to accelerate the payment of compensation, then it is treated as materially modified unless the amount paid is discounted to reasonably reflect the time value of money.

Deferrals are Not Material Modifications Unless Amount Increased Beyond Reasonable Interest or Investment Return

If a grandfathered arrangement is modified to defer when the compensation is payable , then the arrangement will be treated as materially modified unless the amount paid is increased only by a reasonable rate of interest or the return on a predetermined actual investment (which must reflect

decreases as well as increases in the investment).

Substitutions

If the company and the employee enter into a separate agreement that provides for increased or additional compensation related to the compensation payable under a grandfathered arrangement, then the IRS will evaluate whether the new arrangement should be treated as materially modifying a grandfathered arrangement on a facts and circumstances basis. The IRS will look at the facts and circumstances to determine whether the additional compensation is paid on the basis of substantially the same elements or conditions as the grandfathered compensation.

You Have a Grandfathered Arrangement That Has Not Been Materially Modified – What Does That Mean?

The IRS guidance confirmed that, if compensation is grandfathered for Section 162(m) purposes, it is not subject to any of the changes made to Section 162(m) under the Act.

Some practical implications of this are:

- Grandfathered compensation paid to someone who is a “covered employee” under the new Section 162(m) rules solely because of his or her CFO status does not count toward the $1 million limit on deductibility

- Grandfathered compensation that is payable after termination of employment (such as severance or nonqualified deferred compensation paid after termination) generally does not count toward the $1 million limit on deductibility. Note that the amount considered grandfathered under nonqualified deferred compensation arrangements will generally be limited to the amount accrued as of November 2, 2017, and potentially the future earnings on that accrued amount.

- Grandfathered compensation that otherwise qualifies as “performance-based compensation” under the old Section 162(m) rules will not count toward the $1 million limit on deductibility if the requirements of the old Section 162(m) rules, including certification of achievement of the performance goals by a committee consisting solely of “outside directors,” are met. As noted above, the grandfathering of performance-based compensation arrangements may be severely limited by any negative discretion provisions within the arrangement.

- Stock options and stock appreciation rights (SARs) granted before November 2, 2017, should be considered grandfathered.

Further Guidance and Open Items

The IRS guidance indicated that the IRS intends to issue proposed regulations to cover the items discussed in the Notice. The IRS also requested public comment on some issues not addressed in its guidance, including the application of the definition of “covered employee” to an employee who was a covered employee of a predecessor company and the application of Section 162(m) to newly public companies. As a result, we expect additional guidance related to these issues to be forthcoming following the public comment period.

Companies should start or further review compensation arrangements that were in effect on November 2, 2017, to determine what arrangements may be “grandfathered” under the new Section 162(m) rules. In addition, companies should develop processes and procedures to (i) avoid any unintentional modifications of grandfathered arrangements and (ii) track all covered employees.

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