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First IRS Guidance on Expanded Section 162(m)'s $1 Million Deduction Limitation: No Grandfathering Relief For Negative Discretion Amounts; Many Questions Remain

Summary

The Internal Revenue Service recently released Notice 2018-68, which provides initial guidance about the 2017 amendments to Internal Revenue Code Section 162(m). [Click *here* to see our January 3, 2018 memo on the 2017 tax act (the "Act").] The Notice addresses only two topics: (i) the scope of the Act's grandfather rule, and (ii) the new rules on identifying the expanded group of persons, referred to as "covered employees," whose compensation is potentially subject to Section 162(m). In general, subject to grandfathering exceptions, the new rules apply to tax years starting after 2017.

Corporate compensation arrangements that qualify for grandfathering are exempt from the Act's new rules. Some – perhaps many – public corporations previously subject to Section 162(m) hoped that their performance-based compensation arrangements would qualify for grandfathering under the Act. Those companies will be disappointed because the Notice takes the position that grandfathering is unavailable if the employer can reduce officer incentive compensation using "negative discretion" – a very common feature in public company plans (more on this below).

This Client Alert takes a close look at how Notice 2018-68 affects 2018 compliance with amended Section 162(m).

Background

Section 162(m) has been on the books for over 25 years; prior to its amendment by the Act, Section 162(m) imposed a $1 million limit on a public corporation's annual tax deduction for compensation payable to each of the CEO and three other most highly compensated executive officers (other than the CFO) identified in the company's annual proxy statement.

The 2017 amendments (i) expanded the group of affected corporations to include those required to file reports under Section 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act") (so that it includes not only issuers of public equity but also, for example, ADR companies and issuers of public debt), (ii) eliminated the original law's important exceptions to the $1 million limit for performance-based and commission compensation and (iii) expanded the group of "covered employees" whose compensation would be targeted by Section 162(m).

The Grandfather Rule

The Act's significant expansion of the individuals whose compensation is subject to the deduction limitation, combined with the removal of the commonly used performance-based compensation exception, will result in significant losses of potential deductions for many corporations – making the availability of grandfathering important. Payments under grandfathered arrangements will be deductible under the rules in effect before the 2017 Act changes. So, for companies that are subject to new Section 162(m) after 2017, post-2017 deductions won't be prejudiced by the new Section 162(m) rules if the post-2017 payments are made under a written binding contract in effect on November 2, 2017 and would have been deductible had old Section 162(m) continued in effect: thus, post-2017 payments under a November 2, 2017 contract would be deductible by a public debt issuer which had never before been subject to Section 162(m); similarly, if provided for in grandfathered contracts, certain severance, SERP and other deferred compensation arrangements can escape the non-deductibility taint that might otherwise apply under amended Section 162(m).

Under the Act's grandfather rule, the 2017 changes are generally inapplicable after 2017 to compensation paid under a written binding contract in effect on November 2, 2017 unless the contract is subsequently materially modified.

The Notice strictly interprets the "written binding contract" and "material modification" elements of the grandfathering rule. The text of the Act's grandfather rule is almost identical to the previous grandfather rule under original Section 162(m), and the guidance in the Notice is substantially consistent with the existing regulations interpreting that old grandfather rule.

Written Binding Contract. The Notice provides that remuneration is regarded as payable under a written binding contract in effect on November 2, 2017 (and thus eligible for grandfathering) only to the extent that the corporation is obligated under applicable law to pay the remuneration under such contract if the employee performs services or satisfies the applicable vesting conditions. The Act's amendments to Section 162(m) would apply to any amount of remuneration that exceeds the amount that applicable law obligates the corporation to pay under a written binding contract in effect on November 2, 2017, if the employee performs services or satisfies the applicable vesting conditions.

This means that the commonly used "negative discretion" arrangements are likely ineligible for significant (if any) grandfathering. For example, assume a public Company's otherwise grandfathered bonus contract provides for a formula payout amount that can be reduced by the Compensation Committee in its discretion, but not below $400,000: under the Notice, if in a future year the formula-prescribed payout was $700,000, only $400,000 could qualify for the grandfather exemption; if complete grandfathering were available, all $700,000 could be deducted. Under the Notice, the mere existence of the right to use negative discretion to reduce a payment means that the amount of compensation that can be treated as subject to a written binding contract on November 2, 2017 is the minimum amount that the corporation is actually obligated to pay if it exercised such negative discretion in full. This principle leads to the unsatisfying conclusion that if the Compensation Committee had the right to reduce a payout all the way to zero, then no compensation under the arrangement would be grandfathered.

Some public companies may want to explore whether their old Section 162(m) performance-based formula bonus plans may qualify for grandfathering under the Notice, on the theory that the reserved power of negative discretion is *unexercisable* under applicable state law, perhaps because of an unbroken record of never having exercised that power.

The Notice further provides that:

- The grandfather rule ceases to apply if the contract is renewed after November 2, 2017.
- Contracts that are terminable or cancelable unilaterally by the corporation after November 2, 2017 are treated as renewed as of the date any such termination or cancellation would be effective.
- Contracts that the employee can unilaterally elect to remain in effect beyond a given date are not treated as renewed if an employee exercises discretion to keep the corporation bound to the contract.
- Contracts are not treated as terminable or cancelable if termination or cancellation is accomplished only by terminating the employment relationship.
- Contracts are not treated as renewed if upon termination or cancellation of the contract the employment relationship continues but would no longer be subject to the contract (but payments in respect of such continued employment are not grandfathered, of course).
- If a written compensation plan or arrangement is binding, an amount required to be paid as of November 2, 2017 under such plan or arrangement is grandfathered even though the employee was not eligible to participate as of such date. However, the grandfathering rule will not apply in such case unless the employee was employed on November 2, 2017 by the corporation that maintained the plan or arrangement, or had the right to participate in the plan or arrangement under a written binding contract as of such date.

Material Modification. Under the Notice, a material modification occurs when the contract is amended to increase the amount of compensation payable to the employee.

Where the Compensation Committee has the right to exercise negative discretion and reduce a formula-prescribed payout from, for example, $700,000 to a minimum required payout of $400,000, but fails to exercise that right and decides to instead pay a higher amount ($700,000) – that could arguably be interpreted as a decision by the Compensation Committee to increase the amount of compensation that the corporation otherwise was obligated to pay by $300,000 – which increase would be a material modification that would result in the loss of grandfathering. However, the Notice clarifies that the failure, in whole or in part, to exercise negative discretion under a contract does not result in a material modification.

So the IRS gives with one hand but takes with the other: the IRS will ignore whether the corporation actually exercises negative discretion in determining whether a contract is materially modified; however, the grandfather is only available in the first instance if there is some minimum amount of compensation that the corporation is obligated to pay under a contract in effect on November 2, 2017. Most plans that provide the Compensation Committee with negative discretion do not limit this discretion (essentially permitting the Compensation Committee to decide to pay $0) – as a result, the material modification question becomes moot, because there is no compensation that the corporation would be considered obligated to pay (and thus no amount available to be grandfathered).

The Notice further provides that:

- A contract that is materially modified is treated as a new contract as of the date of the material modification.

- A modification of the contract that accelerates the payment of compensation is a material modification unless the amount of compensation paid is discounted to reasonably reflect the time value of money. If a contract is modified to defer compensation, any compensation paid (or to be paid) that is in excess of the amount that was originally payable to the employee under the contract will not result in a material modification if the additional amount is based on either a reasonable rate of interest or a predetermined actual investment (whether or not assets associated with the amount originally owed are actually so invested) such that the amount payable at the later date will be based on the actual rate of return (positive or negative) on the predetermined actual investment.

- The adoption of a supplemental contract or agreement that provides for increased compensation (or payment of additional compensation) is a material modification if the facts and circumstances demonstrate that the additional compensation is paid on the basis of substantially the same elements or conditions as the compensation otherwise paid under the original written binding contract; however, a supplemental payment that is not more than a reasonable cost of living increase over the preceding year's payment under the contract is not a material modification.

Expansion of "Covered Employees"

The Act amended the definition of "covered employee" to include:

- the principal executive officer (PEO) or principal financial officer (PFO) at any time during the taxable year, or an individual acting in such capacity,

- any employee whose total compensation for the taxable year is required to be reported to shareholders under the Exchange Act because such employee was among the three highest compensated officers for the taxable year (other than an employee described in the preceding bullet), or

- an employee who was a covered employee of the taxpayer or any predecessor for any preceding taxable year beginning after December 31, 2016.

In addition, a covered employee includes any employee who would be described in the second bullet above if the reporting of his or her compensation were required as so described. The Notice provides that the legislative history indicates that a covered employee includes officers of a corporation not required to file a proxy statement but which otherwise falls within the revised definition of a publicly held corporation, and officers of a publicly traded corporation that would otherwise have been required to file a proxy statement for the year (e.g., but for the fact that the corporation delisted its securities or underwent a transaction that resulted in the nonapplication of the proxy statement requirement).

With respect to any individual who is a covered employee by reason of being a covered employee of the publicly held corporation (or any predecessor) for any taxable year beginning after December 31, 2016, the determination of who is a covered employee for taxable years beginning prior to January 1, 2018, is determined under old Section 162(m). So, corporations subject to Section 162(m) after 2017 will need to maintain a list of historical covered employees, because any person designated as a covered employee for the taxable year beginning in 2017 and thereafter would continue to be a covered employee for subsequent taxable years.

SEC Rules Not Always Dispositive. The Notice states that the IRS and Treasury have determined that there is no requirement that an officer be serving in that capacity as of the end of the taxable year in order to be a covered employee. This is the case even though the SEC reporting requirements (under Item 402 of Regulation S-K) generally apply in the first instance to those three highest paid executive officers who were serving in such capacity as of the end of the year. The Notice provides that while certain aspects of Section 162(m) are interpreted consistent with SEC rules, the SEC rules do not serve as the sole basis for interpreting Section 162(m). Thus, executive officers of publicly held corporations (as defined under the Act's amendments) can be covered employees even if the executive officer is not serving at the end of the corporation's taxable year, and even if the executive officer's compensation is not subject to disclosure for the last completed fiscal year under applicable SEC rules.

For example, assume a corporation with a December 31 fiscal year had six executive officers (other than the PEO and PFO or an individual serving in such capacity) serve during 2018, but the top three such highest paid executive officers for 2018 all retired prior to December 31. Even though the SEC rules would require disclosure of the compensation for the 2018 fiscal year for the fourth-, fifth- and sixth-highest paid executive officers (under Item 402(a)(3)(iii) of Regulation S-K), as well as the first- and second-highest paid executive officers (under Item 402(a)(3)(iv) of Regulation S-K), the individuals who would be considered the covered employees from this group for Section 162(m) purposes would still include only the first-, second- and third-highest paid executive officers. Further, if the corporation described above were a smaller reporting company or an emerging growth company under SEC rules, the determination of the corporation's covered employees would not change (even though the specific executive officers whose compensation would be required to be disclosed under SEC rules would differ).

Under the Notice, the determination of the amount of compensation to be used to identify the three most highly compensated executive officers who are covered employees is to be made consistent with the instructions to the applicable portion of Item 402 of Regulation S-K. If a publicly held corporation's last completed fiscal year and the taxable year do not end on the same date (e.g., due to a short taxable year as a result of a corporate transaction), the publicly held corporation will have three most highly compensated executive officers for the taxable year. Until additional guidance is issued, taxpayers should base their determination of the three most highly compensated employees (other than the PEO and PFO or an individual serving in such capacity) upon a reasonable good faith interpretation of the statute, taking into account the guidance in the Notice.

Effective Date

The Treasury Department and the IRS anticipate that the guidance in the Notice will be incorporated into future regulations that (with respect to the issues addressed in the Notice) will apply to any taxable year ending on or after September 10, 2018. The Notice provides that any future guidance (including regulations) that address the issues covered by the Notice in a manner that would broaden the definition of "covered employee" or restrict the application of the definition of a "written binding contract" will apply prospectively only.

Request for Comments

The Treasury Department and the IRS have requested comments on additional issues that guidance should address. Specifically, comments are requested on the following four issues:

- the application of the definition of "publicly held corporation" to foreign private issuers, including the reference to issuers that are required to file reports under section 15(d) of the Exchange Act;
- 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 Section 162(m) to corporations immediately after they become publicly held either through an initial public offering or a similar business transaction; and

- the application of the SEC executive compensation disclosure rules for determining the three most highly compensated executive officers for a taxable year that does not end on the same date as the last completed fiscal year (for example, due to a short taxable year as a result of a corporate transaction).

We will continue to monitor these developments. If you have questions, please contact any of the undersigned.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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