VOL. 33, NO. 4 WINTER 2020

BENEFITS LAW JOURNAL

Executive Compensation

Interim Section 162(m) Guidance: Days Dwindling for NQDC Plan Amendments to Delete Nondeductible Deferred Compensation Delays

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The Tax Cuts and Jobs Act of 2017 (*TCJA*) amended Section 162(m) of the Internal Revenue Code of 1986 (the Code). Section 162(m) generally limits the ability of publicly held corporations to deduct compensation amounts in excess of one million dollars in any year with respect to certain executives of the company that are deemed to be "covered employees" under Section 162(m). The TCJA made a number of changes to Section 162(m),

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including changing who is a covered employee under that section and generally eliminating the ability of publicly held corporations to exempt performance-based compensation from the one million dollars deduction limitation of Section 162(m), subject to a grandfather rule for certain arrangements. On August 21, 2018, the Treasury Department and the Internal Revenue Service (IRS) released Notice 2018-68, which provides interim guidance on certain issues under the amended Section 162(m). On December 20, 2019, proposed regulations were issued.[1] This column will review some of the issues under Section 162(m), as amended by the TCJA, discussed in this interim guidance including whether publicly held corporations that sponsor nonqualified deferred compensation plans (NQDC) need to review these arrangements to determine whether the plans contain a provision that would require the sponsor to defer distribution of compensation or benefits if the sponsor reasonably anticipates that such distribution would limit the employer's tax deduction due to the limits imposed by Section 162(m). Any NQDC plans with language requiring such a delay must be amended by no later than December 31, 2020, in order to permit earlier distribution of such amounts.

HISTORY OF SECTION 162(M)

Section 162(m) generally disallows the corporate tax deduction by any publicly held corporation for remuneration paid with respect to any covered employee to the extent that such remuneration for the taxable year exceeds one million dollars. Section 162(m) was added to the Code in 1993 with the passage of the Omnibus Budget Reconciliation Act of 1993. The intended purpose of the rule was to attempt to dissuade employers from paying excessive executive compensation by substantively increasing the after-tax cost of paying specified key executives amounts over one million dollars. However, the initial rule contained an exception for "performance-based" compensation for "covered employees."

> Before the TCJA, [S]ection 162(m)(4)(C) defined performance-based compensation as "any remuneration payable solely on account of the attainment of one or more performance goals, but only if—
>
> (i) the performance goals are determined by a compensation committee of the board of directors of the taxpayer which is comprised solely of 2 or more outside directors;

(ii) the material terms under which the remuneration is to be paid, including the performance goals, are disclosed to shareholders and approved by a majority of the vote in a separate shareholder vote before the payment of such compensation; and

(iii) before any payment of such remuneration, the compensation committee referred to in clause (i) certifies that the performance goals and any other material terms were in fact satisfied.[2]

Prior to the TCJA, whether an executive was a covered employee was determined on a year-to-year basis that enabled employers to defer payment of excess compensation (*i.e.*, amounts over one million dollars) to a year when such executives were no longer considered covered employees and, hence, the compensation would be deductible.[3]

As a result, the rule prior to the TCJA often failed to produce the desired result, as many employers were able to utilize the performance-based compensation exception to have amounts be fully deductible or were able to defer compensation to a later year when the rules would not limit the deductibility of compensation. Accordingly, publicly held corporations were generally able to continue to establish executive compensation packages at whatever levels they deemed essential to offer competitive total rewards programs.

Consequently, Congress sought to strengthen Section 162(m) under the TCJA by eliminating the above-referenced performance-based compensation exception and by revising the definition of a covered employee to apply over the lifetime of the executives, regardless of their employment status. These revisions did provide some relief to corporations by including a transition rule applicable to certain outstanding compensatory arrangements (commonly referred to as the grandfather rule), which will be discussed below.

The following is a summary of the key terms and features included in the interim guidance under Notice 2018-68 and the Proposed Regulations to Section 162(m).

Applicable Employee Remuneration

Prior to the TCJA, the term "applicable employee remuneration" was generally defined with respect to any covered employee for any taxable year as "the aggregate amount allowable as a deduction under this chapter for such taxable year (determined without regard

to this subsection) for remuneration for services performed by such employee (whether or not during the taxable year)."[4]

Before the TCJA, applicable employee remuneration did not include remuneration payable on a commission basis or performance-based compensation. The TCJA amended the definition of applicable employee remuneration to eliminate these exclusions, while also adding a special rule for remuneration paid to beneficiaries. This special rule provides that remuneration shall not fail to be applicable employee remuneration merely because it is includible in the income of, or paid to, a person other than the covered employee, including after the death of the covered employee.[5]

Compensation Paid by a Partnership to a Covered Employee

Prior to the TCJA, four private letter rulings issued between 2006 and 2008 included analysis stating that if a publicly held corporation is a partner in a partnership, then Section 162(m) does not apply to the corporation's distributive share of the partnership's deduction for compensation paid by the partnership for services performed for it by a covered employee of the corporation.[6] Accordingly, such rulings did not limit the otherwise deductible compensation expense of the publicly held corporation for compensation the partnership paid the covered employee. However, upon further review, the IRS determined that such ruling created a potential for abuse, and thus the current guidance states that the application of Section 162(m) is limited to deductions for compensation paid by the publicly held corporation and also covers the deduction for compensation paid to the corporation's covered employees by another party to the extent the corporation is allocated a share of the otherwise deductible item.[7] For example, if a publicly held corporate partner is allocated a distributive share of the partnership's deduction for compensation paid by the partnership, the allocated distributive share of the deduction is subject to Section 162(m) even though the corporation did not directly pay the compensation to the covered employee. As a result, the publicly held corporation must take into account its distributive share of the partnership's deduction for compensation expense paid to the publicly held corporation's covered employee and aggregate that distributive share and the corporation's otherwise allowable deduction for compensation paid directly to that employee in determining the amount allowable to the corporation as a deduction for compensation under Section 162(m).[8]

The Proposed Regulations provide certain transition relief for current compensation arrangements while prohibiting the formation or

expansion of these types of structures for the purpose of avoiding the application of Section 162(m). "Specifically, in order to ensure that compensation agreements are not formed or otherwise structured to circumvent this rule, with respect to compensation paid by a partnership, the rule will apply to any deduction for compensation that is otherwise allowable for a taxable year ending on or after December 20, 2019, but will not apply to compensation paid pursuant to a written binding contract in effect on December 20, 2019, that is not materially modified after that date."[9]

Compensation for Services in a Capacity Other than an Executive Officer

Unless specifically excluded, the deduction limitation under Section 162(m) as amended by the TCJA generally applies to all remuneration for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash, unless specifically excluded.[10] Accordingly, if an individual is a covered employee for a taxable year, the deduction limitation applies to all compensation not explicitly excluded from the deduction limitation, regardless of whether the compensation is for services as a covered employee and regardless of when the compensation was earned.[11] This rule reinforces the IRS position that compensation earned by a covered employee through a nonemployee position, such as director fees, is not excluded and has always been considered applicable employee remuneration for which the deduction is limited by Section 162(m). Under the amended Section 162(m) rules, a covered employee includes any individual who was a covered employee of the publicly held corporation (or any predecessor) for any taxable year beginning after December 31, 2016.[12] Therefore, under the amended Section 162(m), a covered employee remains a covered employee after separation from service. Accordingly, if, after separation from service as an employee, a covered employee returns to provide services to the publicly held corporation in any capacity, including as a common-law employee, a director, or an independent contractor or consultant, then any deduction for compensation paid to the covered employee is subject to Section 162(m).[13]

Privately Held Corporations that Become Publicly Held

Section 162(m), as amended, applies to the deduction for compensation paid to a covered employee that is otherwise deductible

for a taxable year of a publicly held corporation. The interim guidance provides that in the case of a corporation that is a privately held corporation that becomes a publicly held corporation, Section 162(m) applies to the deduction for any compensation that is otherwise deductible for the taxable year ending on or after the date that the corporation becomes a publicly held corporation. Furthermore, a corporation is considered to become publicly held on the date that its registration statement of 1933 or the Securities Exchange Act of 1934 (the Exchange Act).[14]

Covered Employee Definition

Before the TCJA, covered employee was generally defined as any employee of the taxpayer if:

- As of the close of the taxable year, such employee is the chief executive officer of the taxpayer or is an individual acting in such capacity; or

- The total compensation of such employee for the taxable year is required to be reported to shareholders under the Exchange Act by reason of such employee being among the four highest compensated officers for the taxable year (other than the chief executive officer).[15]

Section 13601(b) of the TCJA amended the definition of covered employee so that covered employee now means any employee of the taxpayer if:

- The employee is the principal executive officer (PEO) or principal financial officer (PFO) of the taxpayer at any time during the taxable year, or was an individual acting in such a capacity;

- The total compensation of the employee for the taxable year is required to be reported to shareholders under the Exchange Act by reason of such employee being among the three highest compensated officers for the taxable year (other than the PEO and PFO); or

- The individual was a covered employee of the taxpayer (or any predecessor) for any preceding taxable year beginning after December 31, 2016.[16]

Section 13601(c) of the TCJA also provided that a covered employee includes any employee whose total compensation for the taxable year places the individual among the three highest compensated officers for the taxable year (other than any individual who is the PEO or PFO of the taxpayer at any time during the taxable year, or was an individual acting in such a capacity) even if the compensation of the officer is not required to be reported to shareholders under the Exchange Act.[17]

The U.S. Securities and Exchange Commission (SEC) executive compensation disclosure rules generally require disclosure of compensation of the three most highly compensated executive officers if they were employed at the end of the taxable year and up to two executive officers whose compensation would have been disclosed but for the fact that they were not employed at the end of the taxable year.[18] Notice 2018-68 provided that a covered employee for any taxable year means any employee who is among the three highest compensated executive officers for the taxable year, regardless of whether the executive officer is serving at the end of the publicly held corporation's taxable year, and regardless of whether the executive officer's compensation is subject to disclosure for the last completed fiscal year under the applicable SEC rules.[19]

The SEC executive compensation disclosure rules require disclosure of compensation executive officers and defines "executive officers" as follows:

> The term executive officer, when used with reference to a registrant, means its president, any vice president of the registrant in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions for the registrant. Executive officers of subsidiaries may be deemed executive officers of the registrant if they perform such policy making functions for the registrant.[20]

The preamble to the Proposed Regulations further provides:

> Under the amended definition of covered employee, a PEO and PFO are covered employees by virtue of having those positions or acting in those capacities. The three highest compensated officers (other than the PEO or PFO) are covered employees by reason of their compensation … Because the SEC executive compensation disclosure rules that require disclosure of the three highest compensated executive officers apply only to executive officers, only an executive officer may qualify as a covered employee under [S] ection 162(m)(3)(B).[21]

In the event, a publicly held corporation owns an interest in a partnership, an officer of such partnership is deemed to be an executive officer of such publicly held corporation if the officer performs a policy-making function for the publicly held corporation. As a deemed executive officer of the publicly held corporation, the officer of the partnership may be a covered employee if the officer is one of the three highest compensated executive officers of the publicly held corporation.[22]

TAXABLE YEARS NOT ENDING ON SAME DATE AS FISCAL YEARS

The SEC executive compensation disclosure rules are based on a corporation's fiscal year. Most corporations' fiscal and taxable years end on the same date. There are exceptions, such as the case of a short taxable year as a result of a corporate transaction that does not result in a short fiscal year. In such cases, (1) the publicly held corporation will have three most highly compensated executive officers for the short taxable year (instead of the fiscal year) and (2) the three most highly compensated executive officers are the officers whose compensation is required to be (or would be required to be) reported to shareholders under the Exchange Act. Therefore, the determination of the three most highly compensated executive officers is made pursuant to the rules under the Exchange Act and the amount of compensation used to identify the three most highly compensated executive officers is determined pursuant to the executive compensation disclosure rules under the Exchange Act, which uses the taxable year as the fiscal year for purposes of making the determination.[23] The following examples illustrate these points:

> **Example 1.** A publicly held corporation uses a calendar year fiscal year for SEC reporting purposes, but has a taxable year beginning July 1, 2019, and ending June 30, 2020. For this corporation, the three most highly compensated executive officers are determined for the taxable year ending June 30, 2020, by applying the executive compensation disclosure rules under the Exchange Act as if the fiscal year ran from July 1, 2019, to June 30, 2020. The same rule applies to short taxable years.[24]

> **Example 2.** Assume the same facts as in Example 1, except that, due to a corporate transaction, the corporation's taxable year ran from July 1, 2019, to March 31, 2020. In this situation, the three most highly compensated executive officers would be determined

for the taxable year ending March 31, 2020, by applying the disclosure rules as if the fiscal year began July 1, 2019, and ended March 31, 2020.[25]

COVERED EMPLOYEES AFTER SEPARATION FROM SERVICE

As discussed above, under the TCJA, any covered employee identified for taxable years beginning after December 31, 2016, will continue to be a covered employee for all future taxable years. Accordingly, if an individual is a covered employee for a taxable year after such date, the individual remains a covered employee for all subsequent taxable years, including for years during which the individual is no longer employed by the corporation and years after the individual has died.[26] For example, if a publicly held corporation makes NQDC plan payments to a former PEO after separation from service, then the deduction for the payments generally would be subject to Section 162(m).[27]

PREDECESSOR CORPORATION

Under Section 162(m), as amended by the TCJA, the term covered employee means any employee who was a covered employee of the taxpayer for any preceding taxable year beginning after December 31, 2016, and also means any employee who was a covered employee of any predecessor of the taxpayer for any preceding taxable year beginning after December 31, 2016.[28] The Proposed Regulations use the term "predecessor of a publicly held corporation" instead of "predecessor."[29] An individual who is a covered employee for one taxable year (including a taxable year of a predecessor of a publicly held corporation) remains a covered employee for subsequent taxable years. In certain circumstances, the term "predecessor of a publicly held corporation" includes the publicly held corporation itself if it was a publicly held corporation for a prior taxable year. Specifically, a predecessor of a publicly held corporation includes a publicly held corporation that, after becoming privately held, again becomes a publicly held corporation for a taxable year ending before the 36-month anniversary of the due date for the corporation's U.S. federal income tax return (excluding any extensions) for the last taxable year for which the corporation was previously publicly held.[30]

The term "predecessor of a publicly held corporation" includes a publicly held corporation that is acquired (target corporation), or the

assets of which are acquired, by another publicly held corporation (acquirer corporation) in certain transactions. Accordingly, the covered employees of the target corporation in those transactions are also covered employees of the acquirer corporation.[31] The term "predecessor of a publicly held corporation" refers to the type of corporate acquisition in which a publicly held corporation is acquired and describes corporate acquisitions in the following four categories.[32] Note that certain transactions may fall within more than one category, with such redundancy intended to provide certainty as to the application of these rules if a taxpayer is unsure which category covers the acquisition in question.[33]

1. **Corporate reorganizations.** A predecessor of a publicly held corporation includes a publicly held corporation that is acquired or that is the transferor corporation in a corporate reorganization described in Section 368(a)(1) of the Code. For example, if a publicly held target corporation merges into a publicly held acquirer corporation, then any covered employee of the target corporation would become a covered employee of the acquirer corporation.[34]

2. **Corporate divisions.** A predecessor of a publicly held corporation includes a publicly held distributing corporation that distributes or exchanges the stock of one or more controlled corporations in a transaction described in Section 355(a)(1) of the Code (a 355(a)(1) transaction) if the controlled corporation is a publicly held corporation. This rule applies to the distributing corporation only with respect to covered employees of the distributing corporation who are hired by the controlled corporation (or by a corporation affiliated with the controlled corporation that received stock of the controlled corporation as a shareholder of the distributing corporation in the 355(a)(1) transaction) within the period beginning 12 months before and ending 12 months after the distribution.[35]

   For example, if a publicly held distributing corporation exchanges with its shareholders the stock of a controlled corporation for stock of the distributing corporation in a 355(a)(1) transaction, and the controlled corporation is a publicly held corporation after the exchange, then any covered employee of the distributing corporation would become a covered employee of the controlled corporation if hired by the controlled corporation within the period beginning 12 months before and ending 12 months after the exchange. Furthermore, a covered employee of the distributing

corporation who becomes a covered employee of the controlled corporation will remain a covered employee of the distributing corporation for all subsequent taxable years because if an individual is a covered employee for a taxable year, the individual remains a covered employee for all subsequent taxable years.[36]

3. **Stock acquisitions.** A predecessor of a publicly held corporation includes a publicly held corporation that becomes a member of an affiliated group (as defined in Section 1.162-33(c)(1)(ii)) of the Proposed Regulations.[37] For example, if an affiliated group that is considered a publicly held corporation pursuant to proposed Section 1.162-33(c)(1)(ii) in the Proposed Regulations acquires a publicly held target corporation that becomes a member of the affiliated group, then the target corporation would be considered a predecessor of the affiliated group. Therefore, any covered employee of the target corporation would become a covered employee of the affiliated group.[38]

4. **Asset acquisitions.** If an acquirer corporation or one or more members of an affiliated group (acquirer group) acquires at least 80 percent of the operating assets (determined by fair market value on the date of acquisition) of a publicly held target corporation, then the target corporation is a predecessor of the acquirer corporation or group. For example, if an acquirer corporation acquires 80 percent or more of the operating assets of a publicly held target corporation, then any covered employees of the target corporation that become employees of the acquirer corporation would become covered employees of the acquirer corporation. For acquisitions of assets that occur over time, the Proposed Regulations provide that generally only acquisitions that occur within a 12-month period are taken into account to determine whether at least 80 percent of the target corporation's operating assets were acquired.[39] Similarly, this asset acquisition rule provides that the target is a predecessor of a publicly held corporation only with respect to a covered employee of the target corporation who is hired by the acquirer (or a corporation affiliated with the acquirer) within the period beginning 12 months before and ending 12 months after the date on which all events necessary for the acquisition have occurred.[40]

The rules for determining predecessors are applied cumulatively, with the result that a predecessor of a corporation includes each predecessor of the corporation and the predecessor or predecessors of any prior predecessor or predecessors.[41]

COORDINATION WITH SECTION 409A: AMENDING PROVISIONS REQUIRING DELAY IN DISTRIBUTIONS

Section 409A of the Code addresses deferred compensation arrangements, including many NQDC plans, and sets forth certain requirements with respect to timing of payments that must be met to avoid current income inclusion and certain additional income tax. NQDC plans that are subject to Section 409A must designate a time and form of payment, among other requirements, to comply with Section 409A.[42] However, there is an exception under Treasury Regulation Section 1.409A-2(b)(7)(i) (the "delay distribution until deductible" rule), which provides that a payment may be delayed past the designated payment date.[43] This exception applies to the extent that the service recipient reasonably anticipates that, if the payment were made as scheduled, the service recipient's deduction with respect to such payment would not be permitted due to the application of Section 162(m).[44] Such delayed payment must generally be paid no later than the service provider's first taxable year in which the deduction of such payment will not be barred by the application of Section 162(m).[45]

If any scheduled payment to a service provider in a service recipient's taxable year is delayed in accordance with the foregoing, such delay in payment is treated as a subsequent deferral election unless all scheduled payments to that service provider that could be delayed under this rule are also delayed.[46] In addition, a subsequent deferral election will violate Section 409A if the election fails to satisfy certain requirements under Section 409A(a)(4)(C).[47] There is a similar "delay distribution until deductible" rule under Treasury Regulation Section 1.409A-1(b)(4)(ii), which permits delayed payments of compensation that otherwise qualify as a short-term deferral under Section 1.409A-1(b)(4)(i).[48]

As previously described, before passage of the TCJA, an individual who was a covered employee for one taxable year would not necessarily remain a covered employee for subsequent taxable years. As a result, he or she would not be a covered employee after separation from service. Accordingly, some NQCP arrangements anticipated that, in these cases, the corporation would have the discretion to utilize the "delay distribution until deductible" rule to postpone payment until the employee separated from service so that he or she would no longer be a covered employee. Because the TCJA amendments to the definition of covered employee fundamentally altered the premise of the "delay distribution until deductible" rule under Treasury Regulation Sections 1.409A-1(b)(4)(ii) and 1.409A-2(b)(7)(i), the question arose as to whether a service recipient may delay the scheduled payment of grandfathered amounts without delaying the payment of nongrandfathered amounts, in circumstances in

which the service recipient has discretion to delay the payment. The Proposed Regulations provide in circumstances in which the service recipient has discretion to delay the payment, a service recipient may delay the scheduled payment of grandfathered amounts without delaying the payment of nongrandfathered amounts, and the delay of the grandfathered amounts will not be treated as a subsequent deferral election.[49] Since the TCJA amendments do not apply to grandfathered amounts, the deduction for amounts grandfathered under the amended Section 162(m) is not subject to Section 162(m) when paid to a former covered employee who separated from service. Therefore, the payment of these grandfathered amounts may continue to be postponed consistent with the "delay distribution until deductible" rule.[50]

Even though the "delay distribution until deductible" rule provides that the service recipient has discretion to delay a payment, and that the discretion is not required to be set forth in the written plan, some NQDC plan sponsors may have drafted their documents to explicitly require them to delay a payment if the sponsor reasonably believes the deduction with respect to the payment will not be permitted under Section 162(m).[51] However, if an NQDC plan arrangement is amended to remove the provision requiring the sponsor to delay a payment if the sponsor reasonably anticipates at the time of the scheduled payment that the deduction would not be permitted under Section 162(m), then the amendment will not result in an impermissible acceleration of payment under Treasury Regulation Section 1.409A-3(j) and such amendment will also not be considered a material modification for purposes of the grandfather rule under Section 162(m) as amended by the TCJA.[52] However, such a plan amendment must be made no later than December 31, 2020.[53] The amendment may apply to both grandfathered and nongrandfathered amounts, but may also be limited to amounts that are not grandfathered.[54] In any event, if, pursuant to such amended plan, the corporation would have been required to make a payment (or payments) prior to December 31, 2020, then the payment (or payments) must be made no later than December 31, 2020.[55]

The Treasury Department and the IRS intend to incorporate these changes into regulations under Section 409A but have indicated that taxpayers may rely on this guidance for any taxable year beginning after December 31, 2017.[56]

Grandfather Rule

The TCJA generally provides that amendments to Section 162(m) apply to taxable years beginning after December 31, 2017. However, the TCJA further provides that such amendments do not apply to

remuneration that is provided pursuant to a written binding contract that

- Was in effect on November 2, 2017, and
- Was not modified in any material respect on or after such date.[57]

The preamble to the Proposed Regulations provide that:

> Notice 2018-68 clarified that remuneration is payable under a written binding contract that was in effect on November 2, 2017, only to the extent that the corporation is obligated under applicable law (for example, state contract law) to pay the remuneration under the contract if the employee performs services or satisfies the applicable vesting conditions. Accordingly, the TJCA amendments to [S]ection 162(m) apply to any amount of remuneration that exceeds the amount of remuneration that applicable law obligates the corporation to pay under a written binding contract that was in effect on November 2, 2017, if the employee performs services or satisfies the applicable vesting conditions.[58]

COMPENSATION SUBJECT TO DISCRETION

As applicable law (such as state contract law) determines the amount of compensation that a corporation is obligated to pay pursuant to a written binding contract in effect on November 2, 2017, some compensation arrangements may provide the corporation with a wider scope of negative discretion than is allowed under applicable law. In such a case, "the negative discretion is taken into account only to the extent the corporation may exercise the negative discretion under applicable law."[59] Such rule is illustrated by the following example:

> An amount of compensation is paid pursuant to a written binding contract under which the corporation is obligated to recover an amount of compensation from the employee if a vesting condition is later determined not to have been satisfied. For example, a vesting condition may be based on the achievement of results reported in the financial statements. In this example, if a corporation pays a bonus based on the financial statements but the financial statements are subsequently restated and demonstrate that the vesting condition was not, in fact, satisfied, then the corporation is required to recover a portion of the bonus from the employee. If, under applicable law, the employee retains the remaining portion

> of the bonus then, pursuant to the grandfather rules, that remaining portion of the bonus is grandfathered compensation that is not subject to the TCJA amendments. Similarly, if the corporation has discretion to recover compensation (in whole or in part), only the amount of compensation that the corporation is obligated to pay under applicable law that is not subject to potential recovery is grandfathered.[60]

Notice 2018-68 did not address the case where applicable law may provide a corporation with contingent discretion to recover compensation. However, the preamble to the Proposed Regulations provide that "a corporation is not treated as currently having discretion merely because it will have discretion to recover an amount if a condition occurs subsequent to the vesting and payment of the compensation and the occurrence of the condition is objectively outside of the corporation's control."[61] Such rule is illustrated by the following example:

> Pursuant to a written binding contract in effect on November 2, 2017, a corporation may be obligated under applicable law to pay $500,000 of compensation if the employee satisfies a vesting condition, but the corporation may be permitted to recover $300,000 from the employee if the employee is convicted of a felony within three calendar years from the date of payment. If the employee is not convicted of a felony within three calendar years from the date of payment, then the $500,000 is grandfathered. If, however, the employee is convicted of a felony within three years after the payment of the $500,000, then the corporation has discretion whether to recover the $300,000 from the employee. Accordingly, if the employee is convicted of a felony within three calendar years after the payment, $300,000 of the $500,000 is not grandfathered. This is true regardless of whether the corporation exercises its discretion to recover the $300,000. Because the corporation may not recover $200,000 of the $500,000 payment in any event, the $200,000 remains grandfathered regardless of whether the employee is convicted of a felony.[62]

EARNINGS ON GRANDFATHERED AMOUNTS IN ACCOUNT AND NONACCOUNT BALANCE PLANS

Earnings credited to account balance plans after November 2, 2017, are not grandfathered when the corporation retains the right under applicable law to amend the plan at any time either to stop or to reduce future credits (including earnings) to the account balance.[63]

"Earnings credited after November 2, 2017, on grandfathered amounts are grandfathered only if the corporation is obligated to pay the earnings under applicable law pursuant to a written binding contract in effect on November 2, 2017."[64]

The preamble to the Proposed Regulations provide guidance for earnings with respect plan terminations:

> Section 1.409A-3(j)(4)(ix)(C)(3) provides that, if a service recipient terminates a[n] NQDC plan, then the time and form of payments may be accelerated, but payment may not be made within 12 months of the date of termination of the plan. The definition of written binding contract in Notice 2018-68 and these proposed regulations provides that earnings credited after November 2, 2017, on grandfathered amounts are grandfathered only if the corporation is obligated to pay the earnings under applicable law pursuant to a written binding contract in effect on November 2, 2017. Accordingly, if, under applicable law, the corporation is obligated to continue to credit earnings for amounts under the NQDC plan during the 12 months after terminating the plan, then the earnings would be grandfathered. In that case, the grandfathered amount would be the amount that the corporation is obligated to pay under applicable law as of November 2, 2017, plus the 12 months of earnings that the corporation is obligated to credit under applicable law. However, any additional amounts that become payable under the plan after November 2, 2017, and earnings on those amounts would not be grandfathered. Applicable law and the terms of the plan determine the amount of earnings that the corporation is obligated to credit for amounts under the plan during the 12 months after plan termination. Thus, for example, with respect to a non-account balance plan, under applicable law, the amount of earnings that the corporation is obligated to credit might be limited to the difference between the present value of the benefit under the plan as of November 2, 2017, and any increase in present value due solely to passage of time (12 months). Furthermore, with respect to a non-account balance plan that provides for a formula amount (for example, the amount payable under the plan is based on the participant's final salary and years of service), the amount of earnings that the corporation is obligated to credit under applicable law might be limited to a reasonable rate of interest to reflect the time value of money during the passage of time (12 months) applied to the benefit under the plan as of November 2, 2017 (and not reflecting any additional salary increase or years of service accumulated after November 2, 2017).[65]

SEVERANCE AGREEMENTS

Severance payable under a severance agreement can be grandfathered under the new Section 162(m) rules.

> Severance payable under such a contract is grandfathered only if the amount of severance is based on compensation elements the employer is obligated to pay under the contract. For example, if the amount of severance is based on final base salary, the severance is grandfathered only if the corporation is obligated to pay both the base salary and the severance under applicable law pursuant to a written binding contract in effect on November 2, 2017. For this purpose, a corporation may be obligated to pay severance under a written binding contract as of November 2, 2017, even if the employee remains employed as of November 2, 2017, but only with respect to the amount the corporation would have been required to pay if the employee had been terminated as of November 2, 2017.[66]

In cases where a portion of the amount is based on a discretionary or performance bonus or other variable components, each component of the severance formula is analyzed separately to determine the amount of severance that is grandfathered.

> For example, the amount of severance may be equal to two times the sum of: (1) final base salary and (2) any bonus paid within 12 months prior to separation from service. In this example, the amount of severance is based on two components, base salary and bonus. Therefore, the entire amount of severance (based on both components) is grandfathered only if, under applicable law, the corporation is obligated to pay both portions, the base salary and the bonus pursuant to a written binding contract in effect on November 2, 2017.[67]

MATERIAL MODIFICATION

As discussed above, the grandfather rules require that written binding contract is not modified in any material respect on or after November 2, 2017. A "material modification" is defined as follows:

> A material modification occurs when the contract is amended to increase the amount of compensation payable to the employee. If a written binding contract is materially modified, it is treated as a new contract entered into as of the date of the material

> modification. Thus, amounts received by an employee under the contract before a material modification are not affected, but amounts received subsequent to the material modification are treated as paid pursuant to a new contract, rather than as paid pursuant to a written binding contract in effect on November 2, 2017.[68]

The preamble to the Proposed Regulations further provides that:

> The adoption of a supplemental contract or agreement that provides for increased compensation, or the payment of additional compensation, is a material modification of a written binding contract 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 that is otherwise paid pursuant to the written binding contract in effect on November 2, 2017. However, a material modification of a written binding contract does not include a supplemental payment that is equal to or less than a reasonable cost-of-living increase over the payment made in the preceding year under that written binding contract. In that case, only the deduction for the reasonable cost-of-living increase is subject to [S]ection 162(m) as amended by the TCJA. In addition, the failure, in whole or in part, to exercise negative discretion under a contract does not result in the material modification of that contract. Finally, if amounts are paid to an employee from more than one written binding contract (or if a single written document consists of several written binding contracts), then a material modification of one written binding contract does not automatically result in a material modification of the other contracts unless the material modification affects the amounts payable under those contracts.[69]

EARNINGS ON GRANDFATHERED AMOUNTS THAT ARE SUBSEQUENTLY DEFERRED

The preamble to the Proposed Regulations addresses the status of earnings on grandfathered amounts when a contract is modified to defer compensation:

> [I]f the contract is modified to defer the payment of 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 be treated as resulting 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 invested therein) such that the amount payable by the employer at the later date will be based on the actual rate of return on the predetermined actual investment (including any decrease, as well as any increase, in the value of the investment). The proposed regulations provide that a predetermined actual investment means a predetermined actual investment as defined in [Section] 31.312(v)(2)-1(d)(2)(i)(B), and also include examples illustrating these rules relating to the treatment of earnings. However, even though the payment of earnings will not result in the contract being materially modified, this generally does not mean that the earnings are treated as grandfathered. For situations in which an employee defers an amount of grandfathered compensation after November 2, 2017, the earnings on the deferred amount are not grandfathered if, as of November 2, 2017, the corporation was not obligated under the terms of the contract to provide the deferral election and to pay the earnings on the deferred amount under applicable law. Pursuant to the definition of written binding contract in Notice 2018-68 and these proposed regulations, these earnings are not grandfathered because, as of November 2, 2017, the corporation was not obligated to pay them under applicable law.[70]

MATERIAL MODIFICATION PRIOR TO PAYMENT OF A GRANDFATHERED AMOUNT

If a contract is materially modified after November 2, 2017, but before the payment of a grandfathered amount of compensation, the compensation is treated as paid pursuant to the new contract and therefore is no longer grandfathered.[71] "For example, if, under applicable law, a corporation is obligated to pay $100,000 on December 31, 2020, under a written binding contract in effect on November 2, 2017, then the $100,000 is grandfathered. If, on January 1, 2019, the contract is materially modified, then the $100,000 is treated as paid pursuant to a new contract and is not grandfathered".[72]

ACCELERATION OF PAYMENT OR VESTING

The Proposed Regulations address whether the acceleration of payment or vesting is a material modification under grandfather rules. The preamble of the Proposed Regulations provides:

> [A] modification of a written binding 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. For example, if a corporation is obligated under applicable law to pay compensation on December 31, 2020, pursuant to a written binding contract in effect on November 2, 2017, then the compensation is grandfathered. If the corporation pays the entire amount of compensation on December 31, 2019 without a discount to reasonably reflect the time of value of money, then the entire amount of compensation is treated as paid pursuant to a new contract and is no longer grandfathered. Furthermore, any subsequent payment made pursuant to the contract is not grandfathered because the contract itself was materially modified when the prior payment was accelerated without a discount to reasonably reflect the time value of money.[73]

The issue of the application of the rule for equity-based compensation when the payment is subject to a substantial risk of forfeiture is addressed in the preamble to the Proposed Regulations as follows:

> Compensation received pursuant to the substantial vesting of restricted property, or the exercise of a stock option or stock appreciation right that do not provide for a deferral of compensation, a modification of a written binding contract in effect on November 2, 2017, that results in a lapse of the substantial risk of forfeiture (as defined [Section] 1.83-3(c)) is not considered a material modification. Likewise, with respect to other compensation arrangements, if an amount of compensation payable under a written binding contract in effect on November 2, 2017, is subject to a substantial risk of forfeiture, then a modification of the contract that results in a lapse of the substantial risk of forfeiture is not considered a material modification. Thus, for all forms of compensation, a modification to a written binding contract that accelerates vesting will not be considered a material modification.[74]

ORDERING RULE FOR PAYMENTS CONSISTING OF GRANDFATHERED AND NONGRANDFATHERED AMOUNTS

In the event that an NQDC plan arrangement provides for a series of payments rather than a lump-sum payment, and only a portion of such payments are grandfathered, the grandfathered amount must be

identified. In such case, the preamble to the Proposed Regulations provides:

> To identify the grandfathered amount when payment under the arrangement is made in a series of payments, the rules provide that the grandfathered amount is allocated to the first otherwise deductible payment paid under the arrangement. If the grandfathered amount exceeds the payment, then the excess is allocated to the next otherwise deductible payment paid under the arrangement. This process is repeated until the entire grandfathered amount has been paid. For example, assume that a NQDC plan arrangement provides for an annual payment of $100,000 for three years, and only $120,000 is grandfathered. Pursuant to the Proposed Regulations, the entire $100,000 paid in the first year is grandfathered. In the second year, only $20,000 of the $100,000 payment is grandfathered; the remaining $80,000 paid in the second year is not grandfathered. In the third year, none of the $100,000 payment is grandfathered.[75]

IN CONCLUSION

All publicly held corporations should review the interim guidance on Section 162(m) to see how it affects their corporation, including whether their corporation is covered by the rules, determining who is a covered employee, and what contracts and compensation amounts are grandfathered under the new rules. To the extent that there are grandfathered amounts, such amounts must be separated and administratively aggregated to ensure that there are no material modifications to such amounts that would void their grandfathered status. All publicly held NQDC plan sponsors should also review their written NQDC plan documents for provisions requiring the sponsor to delay a payment if the sponsor reasonably anticipates at the time of the scheduled payment that the deduction would not be permitted under Section 162(m). In the event that the NQDC plan documents do contain the above-described distribution delay provisions, the documents must now be amended to remove such language by no later than December 31, 2020, so that the sponsor no longer is required to delay such payments. Accordingly, NQDC plan sponsors should contact their legal, tax, and employee benefit consultants in order to review these options and determine which alternative more closely aligns with their business objectives and budgetary planning.

NOTES

1. *See* 84 Fed. Reg. 70356 (Dec. 20, 2019), that provide further interim guidance on Section 162(m) as amended by the TCJA.

2. 84 Fed. Reg. 70,364; *See, also,* Treas. Reg. §§1.162-27(e)(2) through (e)(5).

3. *See, ante,* footnote 14 for definition of covered employee prior to TCJA.

4. IRC § 162(m)(4).

5. 84 Fed. Reg. 70,363; 26 C.F.R. § 1.162-33(c)(3)(i).

6. PLR 200837024, PLR 200727008, PLR 200725014, and PLR 200614002; 84 Fed. Reg. 70,363.

7. Fed. Reg. 70,363.

8. *Id.; See also* Treas. Reg. § 1.702-1(a)(8)(ii) and (iii).

9. 84 Fed. Reg. 70,363, 70,364.

10. 84 Fed. Reg. 70,364.

11. *Id.*

12. *Id.*

13. *Id.*

14. 84 Fed. Reg. 70,364,70,365.

15. 84 Fed. Reg. 70,359; Under Treas. Reg. § 1.162-27(c)(2), covered employee is defined as follows:

(i) General rule. A covered employee means any individual who, on the last day of the taxable year, is

(A) The chief executive officer of the corporation or is acting in such capacity; or

(B) Among the four highest compensated officers (other than the chief executive officer).

(ii) Application of rules of the Securities and Exchange Commission. Whether an individual is the chief executive officer described in paragraph (c)(2)(i)(A) of this section or an officer described in paragraph (c)(2)(i)(B) of this section is determined pursuant to the executive compensation disclosure rules under the Exchange Act.

16. 84 Fed. Reg. 70,359, 70,360.

17. 84 Fed. Reg. 70,360.

18. *Id.; See* Item 402 of Regulation S-K, 17 CFR 229.402(a)(3).

19. Notice 2018-68; 84 Fed. Reg. 70,360.

20. *See,* 17 CFR § 240.3b-7.

21. 84 Fed. Reg. 70,360, 70,361.

22. 84 Fed. Reg. 70,361.

23. Notice 2018-68; 84 Fed. Reg. 70,360.

24. 84 Fed. Reg. 70,360.

25. *Id.*

26. Notice 2018-68, 84 Fed. Reg. 70,360, 70,361; Prop. 26 C.F.R. § 1.162-33(c)(2)(i)(C).

27. *Id.*

28. IRC § 162(m)(3)(C).

29. *Id.*

30. 84 Fed. Reg. 70,361.

31. *Id.*

32. *Id.*

33. *Id.*

34. *Id.*

35. 84 Fed. Reg. 70,361, 70,362.

36. *Id.*

37. Prop. 26 C.F.R. § 1.162-33(c)(1)(ii)) 84 Fed. Reg. 70,362.

38. *Id.*

39. *Id.*

40. *Id.*

41. *Id.*

42. 84 Fed. Reg. 70,368.

43. Treas. Reg. § 1.409A-2(b)(7)(i).

44. *Id.*

45. *Id.*

46. 84 Fed. Reg. 70,369.

47. *Id. See also,* § 409A(a)(4)(C):" Changes in time and form of distribution. The requirements of this subparagraph are met if, in the case of a plan which permits under a subsequent election a delay in a payment or a change in the form of payment—(i) the plan requires that such election may not take effect until at least 12 months after the date on which the election is made, (ii) in the case of an election related to a payment not described in clause (ii), (iii), or (vi) of paragraph (2)(A), the plan requires that the payment with respect to which such election is made be deferred for a period of not less than 5 years from the date such payment would otherwise have been made, and (iii) the plan requires that any election related to a payment described in paragraph (2)(A)(iv) may not be made less than 12 months prior to the date of the first scheduled payment under such paragraph.

48. 84 Fed. Reg. 70,369.

49. *Id.*

50. *Id.*

51. *Id.*
52. *Id.*
53. *Id.*
54. 84 Fed. Reg. 70,369, 70,370.
55. 84 Fed. Reg. 70,369.
56. *Id.*
57. 84 Fed. Reg. 70,365.
58. *Id.*
59. *Id.*
60. 84 Fed. Reg. 70,366.
61. *Id.*
62. *Id.*
63. *Id.*
64. *Id.*
65. 84 Fed. Reg. 70,366, 70367.
66. 84 Fed. Reg. 70367.
67. *Id.*
68. 84 Fed. Reg. 70,367.
69. *Id.*
70. 84 Fed. Reg. 70,367.
71. 84 Fed. Reg. 70,367, 70368.
72. 84 Fed. Reg. 70,368.
73. 84 Fed. Reg. 70,368.
74. *Id.*
75. *Id.*

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Volume 33, Number 4, pages 97–120, with permission from
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