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Initial Guidance on Recent Changes to Section 162(m): Covered Employees and Grandfather Rule

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On August 21, 2018, the Treasury Department and the Internal Revenue Service (the "IRS") released Notice 2018-68, which provided initial limited guidance on recent changes to the application of the limitation on the deduction of compensation paid to certain "covered employees" under §162(m) of the Internal Revenue Code. Additional IRS guidance on §162(m) is still expected in the future.

Background and Related Considerations

Overview of §162(m). §162(m) limits the deductibility of annual compensation paid to certain "covered employees" of a publicly held corporation to $1 million per executive. Prior to amendments under the Tax Cuts and Jobs Act (the "Act") which was enacted in 2017, "covered employees" included the CEO and the next three highest paid executive officers (excluding the CFO), determined as of the end of a taxable year, and the limit applied with respect to covered employees of a corporation with publicly traded equity. In addition, §162(m) previously provided that certain qualifying performance-based compensation (which generally included stock options and other performance-based equity awards) and commissions were not subject to this deduction limit.

Changes to §162(m) under the Act. As described in our prior memorandum, *Compensation Season 2018: Section 162(m) and Related Considerations Post-Tax Reform*[1] (the "Prior Memo"), the Act modified §162(m) in a number of material ways. First, it eliminated the performance-based exception to the $1 million per executive annual deduction limit under §162(m) and broadened the definition of "covered employees." Second, the Act expanded the number of companies that are subject to §162(m). Finally, the Act provided for a transition rule, or more commonly known as the grandfather rule, to protect certain outstanding arrangements which were in effect as of November 2, 2017. These changes are discussed in detail in our Prior Memo.

Initial Guidance

Limited Scope and Effective Date. The Treasury Department and the IRS issued Notice 2018-68[2] (the "Notice") to clarify certain aspects of the Act, in particular, the amended rules for classifying "covered employees" and the

[1] https://www.whitecase.com/publications/alert/compensation-season-2018-section-162m-and-related-considerations-post-tax-reform

[2] https://www.irs.gov/pub/irs-drop/n-18-68.pdf

operation of the grandfather rule. The Act's amendments apply to taxable years beginning on or after January 1, 2018 and the guidance in the Notice will apply to any taxable year ending on or after September 10, 2018. Any future guidance on the rules addressed by the Notice will only apply prospectively. The Notice also indicated that the Treasury Department and the IRS anticipate issuing additional guidance on other aspects of §162(m), including the Act's other amendments of §162(m).

Covered Employee. As described in the Prior Memo, the Act expanded the definition of "covered employees" for purposes of §162(m) to include (1) the CFO; (2) any employee whose total compensation is among the three highest compensated officers for the taxable year (excluding the CEO and CFO); and (3) any executive who was a "covered employee" for any tax year beginning after December 31, 2016. The Notice clarifies that the term "covered employee" is anyone who meets the definition of a "covered employee" at any time during the year (i.e., employment at the end of the year is no longer required) and also includes executives who are the top three highest paid officers (excluding anyone who served as CEO or CFO during the year) even if their compensation is not required to be disclosed under existing SEC rules. This means that a company's status as a smaller reporting company or an emerging growth company (which are allowed to disclose the compensation for a smaller number of executive officers than other public companies) is not relevant for determining whether an employee is a "covered employee." In addition, the Notice confirms that if a public corporation is acquired by a private corporation, the covered employees' compensation for the short taxable year which ends on the date of the corporate transaction (including compensation from acceleration of equity vesting or bonuses paid at the time of the closing of the transaction) will continue to be subject to the §162(m) deduction limitation.

Grandfather Rule. As described in our Prior Memo, the Act's changes to §162(m) do not apply to compensation under *written binding contracts* in effect as of November 2, 2017, so long as the contracts are not *materially modified* thereafter. Companies are allowed to deduct compensation (i) under performance-based arrangements in effect on November 2, 2017, including existing stock options and other performance-based equity awards, (ii) for amounts earned and deferred under deferred compensation arrangements as of November 2, 2017 and (iii) under arrangements in effect on November 2, 2017 with CFOs and any individual who would first be covered by §162(m) solely due to the changes to §162(m) under the Act.

> *Written Binding Contracts*. The Notice provides additional guidance as to whether certain contracts that are renewed are protected under the grandfather rule. A contract in effect as of November 2, 2017 is a written binding contract only to the extent the corporation is obligated under applicable law to pay the employee under the contract. Even if there is a written binding contract protected under the grandfather rule, the amendments to §162(m) will apply to any amounts that exceed the remuneration that applicable law obligates the corporation to pay pursuant to the written binding contract. However, a contract that is renewed after November 2, 2017 is treated as a new contract and will not qualify for the grandfather status of §162(m).[3]
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> Even if an employee was not eligible to participate in a binding plan or arrangement as of November 2, 2017, the grandfather rule will still apply to his or her participation in the plan or arrangement after that date pursuant to a written binding contract as long as the individual was employed by the corporation on November 2, 2017 or otherwise had a right to participate in such plan or arrangement as of that date.[4]

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[3] For example, a contract with an automatic renewal provision is treated as renewed if the corporation may cancel or terminate the contract without the employee's consent. However, if the corporation will remain legally obligated by the contract and the contract can only be terminated at the sole discretion of the employee, the contract will not be considered renewed if the employee elects to keep such contract in effect and the contract will continue to be covered under the grandfather rule.

[4] The Notice provides the following example: an individual entered into a contract with a publicly traded corporation on October 2, 2017 to serve as the CFO of the corporation, which provides that on April 1, 2018, the executive will participate in a nonqualified deferred compensation plan and that the benefit accrued on that date will be $3,000,000. On April 21, 2021, the individual receives a payment of $4,500,000, which is the entire benefit under the plan. According to the Notice, $3,000,000 (the amount required to be paid pursuant to the contract) will be grandfathered even though the individual was not eligible to participate in the nonqualified deferred compensation plan until April 1, 2018. The remaining $1,500,000 will be subject to the deduction limitation.

Material Modification. Generally, a material modification occurs when a contract is amended to increase the amount of compensation payable to an employee. The Notice provides specific instances of material modifications. These include but are not limited to the following:

- Cost-of-living increases are generally not considered a material modification. However, any increases in compensation beyond a cost-of-living adjustment would be considered a material modification and a loss of the grandfathering status to the entire contract.
- An exercise of negative discretion under existing plans is not considered a material modification. However, if a compensation floor is set, the grandfather rule will only apply to the floor during an exercise of negative discretion and any amounts above the floor will not be protected by the grandfather rule (and such amounts will therefore be subject to the §162(m) deduction limitation). The failure, in whole or part, to exercise negative discretion is also not considered a material modification.
- An acceleration of compensation is considered a material modification, unless the additional amount is discounted for the time value of money.
- A deferral of payment will not be considered a material modification, if the amount to be paid or the additional amount that exceeds the amount that was originally payable to the employee is based on a reasonable rate of interest or an actual rate of return on a predetermined actual investment.

Practical Considerations. Going forward, companies should continue to review their existing incentive plans and agreements to determine whether any changes should be made to such arrangements as a result of the guidance in the Notice. In particular, companies should implement procedures to (i) identify and monitor the arrangements which may be grandfathered for purposes of §162(m), (ii) determine whether subsequent renewals or modifications will affect this status and (iii) consider deferral or acceleration of compensation in light of the new guidance. In addition, smaller reporting companies and emerging growth companies should consult with their advisers to ensure that all "covered employees" are accurately identified even though such individuals will not be subject to the SEC executive compensation disclosure rules and all companies should ensure that the determination of covered employees includes all officers who served at any time during the year, even if such individuals are not employed at year end.

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