Executive Compensation Bulletin

Initial IRS 162(m) guidance may make immediate company decisions possible

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The Internal Revenue Service (IRS) recently issued initial guidance in Notice 2018-68 that will allow publicly traded companies to make some immediate decisions on how to apply the amendments made to section 162(m) of the Internal Revenue Code by section 13601 of the Tax Cuts and Jobs Act of 2017 (TCJA). We've outlined the fundamental concepts addressed by the Notice that provide a framework to perform an analysis of existing compensation arrangements, and applied those concepts to the different elements of pay that are impacted by these changes. We've also provided more detail on definitions following our discussion of the pay elements.

For more background on the changes to section 162(m) and legislative history see "Making sense of the tax reform bill's confounding 162(m) transition rule – is action by year-end necessary to preserve deductions?", *Executive Pay Matters*, December 20, 2017.

This guidance addresses the availability of a tax deduction during a company's fiscal year, so at first blush it would appear public companies would have time to consider and act on it before the end of the 2018 fiscal year. However, the financial accounting rules may require more timely actions, so it's important to consult with your finance group to understand their views on timing.

We believe that in many cases, the guidance offers sufficient details to help companies decide what is and is not tax-deductible in future years for current covered employees. A review of the precise details underlying compensation grants will be required, including a close reading of plan documents and grant agreements. Counsel should weigh in on the enforceability of these provisions under applicable state laws. Keep in mind, however, this process is not limited to compensation arrangements for covered employees as of November 2, 2017. Other existing employees who later enter the cadre of covered employees will also need to be included.

Note, however, Notice 2018-68 should not be the driver of wholesale changes to your 162(m) plan documents. The Securities and Exchange Commission (SEC) must still opine on whether the disclosure regime that exists for "negative discretion" plans will change for future proxy disclosures to reflect modifications to 162(m). In addition, we continue to advise that companies perform shareholder outreach before they begin changing the framework under which current compensation grants are made so that existing notions of compensation with sufficient performance-based elements remain part of their plan documents.

Fundamental concepts

When the TCJA was signed into law by President Trump on December 22, 2017, it included three significant changes to the rules under section 162(m) that generally limits the tax deduction to the $1 million pay cap allowed for remuneration paid by any publicly held corporation with respect to a covered employee:

1. **"Once/Always" Rule**: Introduced the concept that starting in 2017, "once a covered employee, always a covered employee" while also clarifying how a covered employee is determined for a particular tax year
2. **Eliminated the performance-based exception**: Eliminated the concept that performance-based compensation would be considered an exception to the deduction limit rules (and could exceed the $1 million pay cap without causing the loss of a deduction)
3. **"Grandfathered" payments**: Provided a "grandfather rule" that permits remuneration pursuant to a written binding contract which was in effect on November 2, 2017, (the "grandfather date") and which was not modified in any material respect on or after such date, to remain deductible when paid.

The Notice focuses mainly on understanding how items one and two relate to the grandfather rule. Said differently, the grandfather rule can apply in two separate situations and raises the questions:

- Can compensation that formerly would have met the performance-based compensation exception paid under a written binding contract after the grandfather date continue to be deductible?
- Can compensation paid after the grandfather date to a previously uncovered employee under the prior 162(m) continue to be deducted because it is being paid under a written binding contract that has not been materially modified at the time payment is made?

It can be vexing to answer them.

The biggest issue with the first question is whether a promise after the end of a performance period (e.g., 2017 annual bonus paid in early 2018) would remain deductible if the compensation committee had the “negative discretion” to reduce or eliminate the payout value.

How to parse the amounts of post-retirement payments subject to “grandfathering” for employees caught by the “once/always” rule, is the biggest issue tied to the latter question.

How to apply the Notice to different types of compensation

Cash-based annual bonuses: As we’ve noted, there were questions about whether annual bonuses paid to covered employees under a typical “negative discretion” plan would remain deductible. Under the Notice, the IRS has determined that negative discretion is problematic and that a portion of a bonus that is subject to negative discretion will not be grandfathered. This is a better result than some anticipated, as simply having *the ability to exercise negative discretion* under a contract is not a material modification that would destroy grandfather treatment.

The Notice provides an example that seems to cover a real-world situation where a company used an “umbrella plan” and a “plan within-a-plan” concept to fund its bonus payouts. The example examines a bonus plan that could pay to a covered employee up to $1.5 million but no less than $400,000, pursuant to the compensation committee’s discretion if a specified performance goal is satisfied. The IRS concludes that the plan constitutes a written binding contract on November 2, 2017 to pay $400,000. As a result, when the committee awarded $500,000 in March of 2018, only $400,000 was exempt from the new 162(m) rules.

We interpret this to suggest that once the full-funding requirements of the “umbrella plan” are reached so that the maximum is funded, only the threshold amount of $400,000 would be grandfathered, regardless of whether $500,000 was paid (per the example) or if the full $1.5 million was paid. The remainder would be subject to the $1 million limit under the new rules, which do not recognize the performance-based compensation exception. Companies should review when the threshold was established and that it was communicated to the covered employee to confirm the existence of a written binding contract on the grandfather date.

Long-term, incentive-based compensation: There was no explicit guidance in the Notice on long-term cash or performance share plans, so we would apply the same rules as stated above for annual incentive plans. While compensation committees often make negative adjustments to payout amounts after the close of the LTIP cycle that are below the maximum, they should be careful to determine if the grant agreement actually sets forth a threshold payment level, as only that amount will remain deductible based on the Notice’s principles. This may be more problematic for equity grants if the notion of threshold performance is not clearly delineated.

Stock appreciation rights (SARs), stock options, restricted stock: The guidance regarding each of these equity grants before the grandfather date is relatively straightforward. Thus, SARs and stock options granted pursuant to a written binding contract before the grandfather date that are exercised in future years by a covered employee will continue to be considered performance-based compensation when exercised. In contrast, restricted stock that substantially vests in a later year will not be considered performance-based compensation, as it never was in the first place.

In another example, the facts are the same except that the covered employee has an employment agreement that provides grants of stock options, SARs and restricted stock in future years beginning after the grandfather date, subject to the approval of the board of directors. In this instance, the covered employee will not receive those grants under a written binding contract. This raises the question of whether an employment contract in place at the grandfather date that mandates future year grants of equity in certain amounts would be considered a written binding contract. It would seem to depend on whether the right to receive the grant is legally binding on the company on November 2, 2017 or whether it has discretion after that date to not make the grant.

Employment agreements: The rule states that amounts are grandfathered if payable under a written binding contact in effect on the grandfather date. But this is only to the extent that the corporation is obligated under applicable law (e.g., state contract law) to pay the remuneration under the contract if the employee performs services or satisfies applicable vesting conditions. (Note: this rule would be applied only where the employment contract exists as of the grandfather date, so there are no future planning opportunities.)

For example, a three-year employment agreement in place with the CFO on November 2, 2017 to pay $2 million in salary would be grandfathered. As a result, if the payments are made after that date and the employee remains the CFO, the payments would not be subject to the 162(m) deduction limit even though the employee becomes a covered employee due to the changes made by the TCJA.

In another example, an employment agreement in place for a CFO who starts work before the grandfather date grants the right to participate in a nonqualified deferred compensation plan available to all executive officers after the grandfather date and an accrued benefit credited on that date of $3 million. The CFO later becomes a covered employee due to the changes made by TCJA and ends up receiving a payment of $4.5 million in 2021. The Notice concludes that because he had a right to participate in the plan before the grandfather date, even though not yet a plan participant, the $3 million accrual will be deductible when paid. The fact that he was the CFO and a covered employee under TCJA at the time of payment does not cause the company to lose the deduction, because $3 million of it is pursuant to a written binding contract.

This example reflects the fundamental concept that grandfather protection is only available to employees who become covered employees due to the changes to 162(m) and have written binding contracts in place as of the grandfather date. So an employee who was a CFO before the law changed on January 1, 2018 can be grandfathered because the old 162(m) did not include CFOs as covered employees. Similarly, if one of the three highest paid employees was a covered employee, and later falls out of the top three group, that employee needs grandfather protection because he would remain a covered employee under the new law's "once/always" rule. Finally, as we discuss in the next section, every employee who is a covered employee at the date they receive post-termination payments needs grandfather protection because, under old 162(m), none of those employees would have been considered covered employees post-termination.

Nonqualified deferred compensation (NQDC) – defined contribution: Because of the "once/always" rule, payments that are made to covered employees will be subject to the 162(m) limitations even when paid post-retirement. Under prior law, a common approach to avoiding 162(m) was to make payments after retirement, when an executive would not be a covered employee listed on the proxy as the principal executive officer (PEO), principal financial officer (PFO) or one of the company's three most highly compensated employees.

As noted above, grandfather treatment for all or a portion of a NQDC account balance permits those payments made under a written binding contract in effect on the grandfather date to avoid application of 162(m) for amounts that a company never contemplated would be subject to the deduction limitation under prior law.

The Notice provides that a NQDC plan can meet the definition of a written binding contract and amounts accrued before the grandfather date will be grandfathered if the plan prohibits any benefits that have been accrued from being reduced or eliminated. An example in the Notice explicitly demonstrates that earnings on previously deferred grandfathered amounts in an account balance plan credited on or before the grandfather date would also be considered grandfathered. In the example, the employer retains the right, at any time, to amend the plan to either stop or reduce the amount of future credits to the account. As a result, earnings credited after November 2, 2017 are not grandfathered. Another example suggests that if a NQDC plan provides that a participant is entitled to receive earnings in a predetermined actual investment on deferred compensation through the date of payment, without the right for the company to reduce or eliminate that interest, the entire amount paid will be considered grandfathered.

The Notice also addresses instances where future grandfathered compensation payments are deferred into future years or accelerated to be paid early. If deferred into the future, the payment will remain grandfathered (i.e., the change will not be a material modification) if any amount of compensation paid excess of the amount that was originally payable is based on either a reasonable rate of interest or a predetermined actual investment. Similarly, accelerated payments will remain grandfathered if the amount of compensation paid is discounted to reasonably reflect the time value of money.

Nonqualified deferred compensation (NQDC) – defined benefit (DB) SERPs: The Notice omitted any explicit guidance or examples to address DB SERPs, so until the IRS issues regulations, companies should operate applying a reasonable good-faith interpretation of the law and any guidance they can glean from the Notice. Our experience is that most SERPs are drafted to allow the employer to amend, cease or reduce future accruals under the plan, but preserve the right to any employee accruals up to that date. For this reason, we would anticipate the accrued benefit as of November 2, 2017 will be grandfathered.

Employers with DB SERPs grandfathered from the 162(m) changes will need to pay careful attention to the material modification rules. For example, there is some troubling language in the Notice, discussed below, that indicates that a separate contract or agreement providing for increased compensation would result in 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 under the written binding contract*. Might this mean that increasing SERP benefits, even if done by adopting an entirely new and separate SERP agreement might cause a grandfathered SERP to lose grandfathered status since the payments from the new SERP are paid on substantially the same elements or conditions? The IRS will need to clear up this question in subsequent guidance.

Key definitions

Material modifications: This rule was mentioned above, but is key to understanding whether a grandfathered written binding contract will continue to maintain its status in future years. A material modification is one that amends a contract to increase the amount of compensation payable to the employee and means that the contract loses its grandfathered status and any future payments are subject to the TCJA revisions to 162(m).

The acceleration of future compensation payments are material modifications unless the amount of compensation paid is discounted to reasonably reflect the time value of money. Similarly deferrals of compensation will be considered material modifications unless the amounts paid in excess of the original compensation are based on either a reasonable rate of interest or a predetermined actual investment (real or notional).

A supplemental contract or agreement that provides for increased or 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 under the written binding contract. An exception exists if the supplemental payment 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. As we noted above, the failure, in whole or in part, to exercise negative discretion under a contract does not result in the material modification of that contract.

To illustrate how the grandfather rule interacts with salary increases, the Notice provides that 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 an example in the Notice, a PFO has a five-year contract starting on January 1, 2017 that provides for an annual salary of $1.8 million per year. Recall, under prior law, a PFO was not subject to 162(m), but now is a covered employee due to the change in the law. In 2019, the PFO receives a salary increase of $40,000 and for 2020 a salary increase to $2.4 million.

Because the $40,000, 2019 increase is less than or equal to a reasonable cost-of-living increase from 2017, there is no material modification. However, while this means the $40,000 increase would not be deductible if part of compensation is over the pay cap, it has no impact on the deductibility of the $1.8 million of salary for 2019.

Determining covered employees: The guidance reiterates the language of the statute, as amended by TCJA, and indicates that covered employees include any employee who is the PEO or PFO of the publicly held corporation at any time during the taxable year, or was an individual acting in such a capacity. Expansion of the statutory coverage to the PFO was a change from prior 162(m).

Covered employees also include any employee whose total compensation for the taxable year is required to be reported to shareholders under the Securities Exchange Act of 1934 because they are the three highest compensated officers for the taxable year (other than the PEO or PFO, or an individual acting in such capacity). The Notice indicates that there is no requirement for an employee to have been in service as an executive officer at the end of the taxable year. This was a change from prior 162(m), and from the existing SEC proxy disclosure rules, which determined the highest paid employees based on those in place at the end of the company fiscal year. The Notice also provides that executive officers can be 162(m) covered employees even if disclosure of their compensation is not reportable in the proxy under SEC rules.

The IRS is still investigating whether they will adopt this rule for determining the top three, as a regulatory matter, as well as how covered employee status should be determined if there is a corporate transaction and are seeking comments from the public. In the meantime, companies can apply a reasonable, good-faith standard to applying the statute, taking into account the guidance provided under the Notice.

Under a merger scenario outlined with a complicated example, there can end up being double the number of PEOs, PFOs and highest paid employees, depending on when the transaction takes place and whether the target company has a short tax year. The example illustrates that the determination of covered employee status is broader than that of the SEC proxy disclosure rules and should be consulted as similar situations arise.

For the 2020 salary increase, the example provides that the $560,000 increase in salary in 2020 is a material modification of the written binding contract that is greater than a reasonable, annual cost-of-living increase. This means that the entire contract was materially modified for 2020 and 2021, and that section 162(m) disallows any deduction for compensation to the PFO over $1 million.

There would not be a material modification, if instead of a salary increase, the company granted the PFO a restricted stock grant subject to his continued employment for the balance of the contract. This is because the grant is not considered as paid, as with a salary, because it is based both on the stock price and the PFO’s continued service. However, the restricted stock grant would be subject to 162(m).

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