

Under New IRS Section 162(m) Guidance, Many Common Arrangements will not Retain Grandfathered Status

by Michael J. Voves

On August 21, 2018, the Internal Revenue Service (“IRS”) released [Notice 2018-68](#) (the “Notice”), which clarifies a number of changes made to Section 162(m) of the Internal Revenue Code (the “Code”) by last year’s Public Law 115-97 (aka the Tax Cuts and Jobs Act). While the Notice is not comprehensive and promises additional guidance in forthcoming proposed regulations, companies should be aware of the restrictions placed on the ability to grandfather arrangements in place on or before November 2, 2017.

Background

Code Section 162(m) limits the deductibility of compensation paid by public companies to certain top executives to \$1 million per individual per year. Prior to last year’s amendment, companies could exempt qualified performance-based compensation paid to “covered employees” from Section 162(m)’s \$1 million annual limitation. The amendment removed the ability to exempt performance-based compensation prospectively and expanded the range of covered employees and types of public companies subject to the deduction limitation. Notably, compensation paid to principal financial officers is newly subject to limitation under Section 162(m) and individuals who become “covered employees” for purposes of Section 162(m) will now remain so for all future tax years. In a departure from SEC rules, executive officers of public companies may also become “covered employees” even if they are not employed at the end of the calendar year (for example, in the case of a public company that delists following its acquisition). The amendments also included transition rules stating that the modified Section 162(m) rules will not apply to compensation payable under a written binding contract in effect on November 2, 2017 (that is not later materially modified). The Notice gives important guidance on what constitutes a “written binding contract” and “materially modified” for purposes of these transition rules.

Written Binding Contract

The amendments to Code Section 162(m) do not apply to compensation payable under a

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written binding contract in effect on November 2, 2017 (which is not materially modified) where a company is *legally obligated* to pay such amount (for example, where *approval* for the grant of stock options or SARs (that constituted qualified performance-based compensation) was secured on or before November 2, 2017). Of course, the \$1 million limitation will still apply to the extent required under the previous rules, such as a binding right to salary paid to a CEO under an employment agreement executed on or before November 2, 2017.

Negative Discretion. As set forth in the Notice, where a company has reserved the right to reduce the amount of a bonus payment that would otherwise constitute qualified performance-based compensation, there is generally only a written binding contract in the amount of any guaranteed payment. The flexibility to apply full negative discretion is common in many public company annual and long-term incentive plans (*i.e.*, no guaranteed payment). Therefore, unless the terms of the plan place constraints on the exercise of negative discretion or the company can show another limitation under applicable state law if performance targets are achieved, then none of the payment will be grandfathered and all payments will be subject to Section 162(m)'s \$1 million limitation, even if the payment derives from a pre-November 2, 2017 arrangement.

Contract Renewal. Under the amended Section 162(m), grandfathered status for an arrangement ceases if it is renewed after November 2, 2017. For these purposes, an agreement will be treated as renewed after November 2, 2017 if its renewal is due to the action or inaction by the company (but not if the employee has the sole discretion to cancel an arrangement and declines to do so). For example, a written binding contract that is terminable or cancelable by a company without the employee's consent is treated as renewed as of the date that any such termination or cancellation, if made, would be effective. Therefore, if an employment agreement would renew on January 1, 2019 if 30 days' notice is not given by either party, the agreement will be considered renewed effective January 1, 2019 (and therefore, be removed from any grandfathered status), whether or not such notice is given.

"New" Covered Employees. Where a written binding contract was in place on or before November 2, 2017 with an individual who is considered a covered employee solely because of the recent amendments to Section 162(m), all compensation thereunder will be grandfathered and not subject to the \$1 million limitation. For example, unless materially modified or renewed (as discussed herein), a binding right to a CFO's salary under his or her employment agreement executed on or before November 2, 2017 will not be subject to Section 162(m)'s deduction limitation because a CFO was not considered a covered employee under Section 162(m) prior to last year's amendment.

Material Modification

A material modification occurs when an amended arrangement results in a higher amount of compensation to the covered employee (as opposed to an amendment to a plan's administrative provisions). However, the Notice provides for limited compensation benefits that will not be considered a material modification, including:

- the acceleration of payment timing where the payment amount is discounted to reflect the time value of money,
- the deferral of an amount if any earnings on the deferral are based on a reasonable rate of interest or a predetermined actual investment,
- a supplemental arrangement providing for additional compensation, so long as the additional right is not paid on the basis of substantially the same elements or conditions of the grandfathered arrangement (note that this is a facts and circumstances test), and
- notwithstanding the above, a supplemental payment that is no more than a reasonable cost-of-living increase over the original entitlement is not a material modification.

Note that while certain supplemental payments may not be considered a material modification, they will still be subject to the Section 162(m) \$1 million limitation.

Applying the material modification rules to an example account balance SERP arrangement with a CFO put into place prior to November 2, 2017 where (i) payment is contingent on continued service by the CFO and (ii) the company retains the discretion to discontinue additional deferrals at any time, but not the ability to reduce the amount of payment accrued at the time of an amendment:

- the CFO is a covered employee for Section 162(m) purposes only by virtue of the 2017 amendment to Section 162(m), therefore the SERP payments are grandfathered to the extent the arrangement is not materially modified or renewed, but only to the extent a legal obligation to pay existed as of November 2, 2017.
- if the company can discontinue accruals at any time, only the deferred balance (along with any credited earnings) as of November 2, 2017 is grandfathered and any additional accrued benefits will be subject to the \$1 million deduction limitation.
- if the company also retains the ability to accelerate payment at any time, such acceleration would require a reasonable discount to reflect the time value of money to avoid a material modification.
- any material modification will be treated as a new contract, meaning that grandfathered status will still apply to payments that predate any such modification.

Further Comments Requested

The Treasury Department and IRS request comments by November 9, 2018 on several open issues that may impact a number of Dorsey clients:

- whether a foreign private issuer fits within the definition of “publicly held corporation” for Section 162(m) purposes,
- whether an employee who was a covered employee with respect to a predecessor corporation must be considered a covered employee by the successor corporation,
- the application of Section 162(m) to newly publicly traded companies, and
- the method for determining the three most highly compensated executive officers in short tax years.

Conclusion

The Notice provides a number of examples of its interpretations of the amended Code Section 162(m) that are not always intuitive. We look forward to helping clients apply this guidance to their tracking and payment of existing arrangements as well as discussing how compensation paid to covered employees will be designed going forward. In addition, there are a number of areas that still require future guidance, including what modifications will be permitted with respect to deferred compensation plans that require a payment delay until such payment will be fully deductible by the company, as permitted under Section 409A of the Code. Please contact us with questions you may have, including on any of the areas where additional comments have been requested.