Alert Memorandum

Tax Reform: IRS Issues Guidance on Section 162(m)

August 27, 2018

On August 21, 2018, the Internal Revenue Service (“IRS”) issued Notice 2018-68 (the “Notice”), which provides initial guidance on the application of Section 162(m) of the Internal Revenue Code, as amended by the 2017 Tax Cuts and Jobs Act (“TCJA”). The guidance is limited to the definition of the term “covered employees” and the application of the transition rule accompanying the TCJA amendments. Certain aspects of the Notice will be of practical significance for many companies in connection with the potential deductibility of their executive compensation, even though the amount of the lost deductions may not be material to each company from a financial perspective. The Notice states that the IRS plans to issue further guidance in the form of proposed regulations and solicits comment on certain aspects of Section 162(m) as amended that are not addressed by the Notice.

In general, Section 162(m) limits the deductibility of compensation paid to certain senior executives of US public companies. Since Section 162(m) was enacted, it contained an exception for “qualified performance-based compensation.” The TCJA eliminated the qualified performance-based compensation exception and expanded the group of executives whose compensation is subject to its deductibility limitation (i.e., the “covered employees”). While the elimination of the performance-based compensation exception freed companies from the need to comply with the procedural requirements of the exception, companies will in the future need to determine, and keep track of, which of their employees are covered employees, because compensation paid to those employees may not be deductible under the Section as revised.

If you have any questions concerning this memorandum, please reach out to your regular firm contacts in the Executive Compensation group or the Tax group.

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Definition of “Covered Employees”

The TCJA expanded the group of covered employees to add the CFO back to the list, so that it includes anyone who served as CEO or CFO during the taxable year and the three other most highly compensated executive officers of the company. Additionally, under the new rule, once an employee qualifies as a covered employee, he or she continues to be treated as a covered employee indefinitely.

The Notice clarifies that there is no requirement that an employee serve as an executive officer or even as an employee at the end of a taxable year in order to qualify as a covered employee for that year. Further, executive officers can be covered employees under the new rule even when disclosure of their compensation is not required under the relevant Securities and Exchange Commission (“SEC”) proxy disclosure rules. For example, an employee who was an executive officer during a year, but who is no longer employed at the end of such year, would be a covered employee if he or she received compensation in the year that was (a) the third highest compensation of all of the company’s executive officers (other than anyone acting as the CEO or CFO during the year) who were no longer employed at the end of the year (meaning such person would not otherwise be a “named executive officer” for proxy reporting purposes), and (b) higher than the compensation of the three highest paid individuals (other than the CEO or CFO) who were executive officers at the end of the year, in each case as determined for purposes of proxy disclosure under Item 402 of Regulation S-K.

The misalignment of Section 162(m) with the SEC proxy disclosure rules means that, in practice, companies will be required to determine which of their executive officers (other than anyone who acted as CEO and CFO) are the three most highly compensated in each year, regardless of whether they are serving as executive officers at year-end and of whether those executive officers are included among the “named executive officers” in the proxy statement for that year.

The Notice also clarifies that covered employees identified for the tax year beginning during 2017 will continue to be covered employees for tax years beginning in 2018 and beyond.

Application of Transition Relief

The Notice contains important guidance on the TCJA transition rule, which grandfathers compensation paid after 2017 under written binding contracts in effect on November 2, 2017 and not materially modified thereafter.

In particular, the Notice states that compensation is payable pursuant to a written binding contract that was in effect on November 2, 2017 only to the extent the company is obligated under applicable law (e.g., state contract law) to pay the compensation if the employee performs services or satisfies applicable vesting conditions. As a result, Section 162(m) as amended will apply to any amount of compensation that exceeds the amount a company is required to pay under that written binding contract.

The Notice also states that a material modification occurs when a contract is amended to increase the amount of compensation payable thereunder. If materially modified, the contract will be treated as a new contract entered into as of the date of the modification such that amounts received by an employee subsequent to such modification will be treated as paid pursuant to a new contract and subject to the TCJA.

Finally, the Notice provides additional gloss, primarily through the use of examples, on whether a contract is a written binding contract and what may constitute a material modification of such contract. Some of the highlights include:

— **Renewals and Evergreen Provisions.** The Notice provides that a contract that is terminable or cancelable by the company without the employee’s consent after November 2, 2017 is treated as renewed, and therefore in effect materially modified, as of the date that any such termination or cancellation, if made, would be effective. For example, if an employment
agreement provides that its term will automatically renew as of a certain date unless the company or the employee provides 30 days’ prior notice, such agreement will be deemed to be materially modified as of the date that termination would be effective if that notice were given. The Notice also notes that a contract is not treated as terminable or cancelable if it can only be terminated or canceled by terminating the employment of the employee.

— Accelerations of Compensation. The Notice states that a modification of a contract to accelerate the payment of compensation will constitute a material modification unless the amount of compensation paid is discounted to reasonably reflect the time value of money. The potential impact of this concept on equity awards granted pursuant to a written binding contract prior to November 2, 2017 is not specifically addressed by the Notice. Any acceleration that is hard-wired into the written binding contract should not be a material modification. Whether the discretionary acceleration of vesting alone would constitute a material modification is not addressed by the Notice.

— Deferrals of Compensation. If a contract is modified to defer a payment, 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 a material modification if the additional amount is based on either a reasonable rate of interest or a predetermined actual investment (which may be notional) such that the amount payable by the employer at the later date will be based on the actual rate of return on such investment (i.e., reflective of any decrease or increase in value). Although the IRS’s intent is unclear, the reference to an “actual investment” could be read to suggest that deferred compensation notionally invested in an index would not qualify for this relief.

— Increases in Compensation. The Notice provides that increases in compensation, and supplemental agreements that provide for increased compensation “on the basis of substantially the same elements or conditions as the compensation that is otherwise [payable]” under a written binding contract, will generally constitute a material modification of such written binding contract unless the payment is equal to or less than a reasonable cost-of-living increase. Thus, if an employment agreement provides for a specified amount of base salary, and the base salary is increased in excess of a reasonable cost-of-living adjustment (a term which the Notice does not define), the employment agreement will be deemed to have been materially modified and the entire base salary amount will be subject to the deductibility limit. On the other hand, a new agreement to make an equity-based grant to the individual subject to vesting that requires the continued provision of services would not generally be a material modification to the existing base salary obligation since the new equity grant would not be considered “on the basis of substantially the same element or conditions” as the base salary.

— Negative Discretion. Common questions following the enactment of the TCJA included whether the right to exercise “negative discretion” under a contract meant that the contract could not qualify as a written binding contract for purposes of the transition relief or, if not so disqualified, whether a “material modification” would be deemed to occur as a result of a company exercising or not exercising that right. The right to exercise “negative discretion” under executive compensation arrangements was previously common because of a feature of the now-abandoned qualified performance-based compensation exception. The Notice states that a company’s refraining from exercising its right of negative discretion is not a material modification of the contract. The Notice also includes an example suggesting that a contract that gives the company the right to reduce compensation to zero would not qualify as a written binding contract for purposes of the
transition relief. However, if negative discretion may be used to reduce compensation to a specified floor amount greater than zero, the Notice suggests a written binding contract exists, and transition relief would be available, for up to the floor amount. If the company were to refrain from exercising negative discretion to reduce the amount payable to the floor, that would not disqualify the floor amount from transition relief, but the amount paid in excess of the floor would be subject to Section 162(m), as amended.

Given the prevalence of negative discretion clauses in many executive bonus arrangements, companies should review these arrangements carefully when determining whether or not transition relief is available.\(^3\)

The Notice also suggests that purely discretionary bonuses cannot qualify for the transition relief. This is relevant when reviewing the arrangements for individuals who were not previously covered employees subject to Section 162(m) but who become covered employees solely as a result of the TJCA (e.g., the CFO)\(^4\) and determining whether any compensation payable to them under existing arrangements may qualify for the transition relief.

— Plan Amendments. The Notice suggests that a plan may not constitute a written binding contract to the extent an employer has the unilateral right to amend or terminate the plan, even if the plan is not actually amended or terminated. If such right only applies on a prospective basis, meaning that an employee cannot be deprived of previously accrued rights, then any amounts accrued as of November 2, 2017 may still be eligible for transition relief.\(^5\)

— Contingent Approvals. The Notice indicates that equity grants that are subject to board or committee approval will not constitute written binding contracts until such approval is received and will therefore be ineligible for transition relief to the extent approval was not received prior to November 2, 2017.\(^6\)

Request for Comment

The IRS is also requesting comment on the following issues that were not addressed in the Notice:

— The application of the definition of “publicly held corporation” to foreign private issuers, including the reference to issuers required to file reports under Section 15(d) of the Securities Exchange Act of 1934.

— The application of the definition of “covered employee” to an employee who was a covered employee of a predecessor of the publicly-held company, which is an issue that is often raised in the acquisition context.

— The application of Section 162(m) to companies immediately after they become publicly-held either through an initial public offering or a similar business transaction.

— The application of SEC executive compensation disclosure rules for determining the three most highly compensated executive officers in cases where an issuer’s tax year does not end on the same date as the issuer’s last completed fiscal year. The Notice states that in cases in which a publicly held company’s last completed fiscal year

\(^2\) See Example 3 on page 16 of the Notice.

\(^3\) We note that although not expressly addressed in the Notice, the application of hard-wired provisions requiring a company to adjust performance goals as a result of certain enumerated non-routine events (such as a change in accounting standards), which are common in pre-amendment Section 162(m) bonus plans, should not be an exercise of discretion disqualifying grandfathered written binding contracts from transition relief.

\(^4\) The Notice is not clear as to whether someone who is amongst the three highest paid executive officers (other than the CEO and CFO) can be considered, depending on the facts and circumstances, as someone who is a covered employee solely as a result of the TJCA.

\(^5\) See Example 4 on page 17 of the Notice.

\(^6\) See Example 8 on page 19 of the Notice.
and the taxable year do not end on the same date (for example, due to a short taxable year as a result of a corporate transaction), the publicly held company will have three most highly compensated executive officers for the taxable year, which was not always the case under prior IRS guidance.

Key Takeaways

The Notice takes a broad view of the scope of covered employees and significantly limits situations in which companies may take advantage of the Section 162(m) transition relief. Companies should carefully review the compensation arrangements of all individuals who were at any time serving as executive officers during the year and any proposed changes thereto in light of the new guidance in order to determine when the Section 162(m) deductibility limit may apply.

In addition, when structuring compensation, including severance obligations, companies should take into account the effects of any outsized payments in the year of termination. A large severance payment in one year could potentially cause an executive officer who would not otherwise qualify as a covered employee to be caught by the new rule, and companies may therefore wish to consider structuring severance payments to be paid over time subject to compliance with a covenant not to compete rather than in a lump sum. Further, given that many executives with large deferred compensation balances are likely to have become covered employees under Section 162(m), as amended, during the course of their careers, companies should evaluate the structure of their non-qualified deferred compensation plans and consider how payments under such plans might be structured so as to maximize deductibility under the new rules. For example, payouts of non-qualified deferred compensation could be limited to $1 million in any year in order to preserve the deduction. Any changes in payout schedules should be reviewed for compliance under Section 409A of the Internal Revenue Code, including the special Section 409A rule relating to payments that would not be deductible by reason of Section 162(m).

If you have any questions or would like to discuss this further, please do not hesitate to contact your regular contacts in the Executive Compensation group or the Tax group.

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