IRS PROVIDES GUIDANCE ON AMENDED 162(M)

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Practices & Industries

Employee Benefits

On August 21, 2018, the IRS issued guidance regarding changes to Section 162(m) of the Internal Revenue Code made by the Tax Cuts and Jobs Act ("TCJA"). In particular, IRS Notice 2018-68 provides guidance regarding the determination of covered employees and what arrangements may qualify for grandfathered status under new Section 162(m).

Covered Employees

Under new Section 162(m), a covered employee includes any employee who serves as the CEO or CFO of a publicly held corporation at any time during a year. A covered employee also includes any employee whose total compensation for the taxable year is required to be reported to shareholders under the Securities Exchange Act of 1934 by reason of the employee being among the three highest compensated officers for the taxable year (other than the CEO or CFO). Further, any employee who was a covered employee in any preceding taxable year beginning after December 31, 2016 is a covered employee in any future taxable year.

The Notice addresses two aspects of covered employee status under new Section 162 (m):

- Certain commentators had asserted that an end-of-the-year requirement should apply to executive officers because SEC rules relating to executive compensation generally apply to the three most highly compensated executive officers (other than the CEO or CFO) who were serving as executive officers at the end of the fiscal year. The IRS responded that SEC rules can also require disclosure for individuals who were not serving as executive officers at the end of the fiscal year. For this purpose, the IRS specifically cited SEC rules requiring disclosure of the compensation of up to two additional individuals for whom disclosure would have been required but for the fact they were not executive officers on the last day of the fiscal year. As a result, the IRS concluded that there is no end of year requirement in order for an executive officer to be considered a covered employee.
- Commentators also questioned whether an individual for whom a publicly held corporation is not required to disclose compensation to shareholders under SEC rules could nevertheless be a covered employee. The IRS responded by pointing to the language in new Section 162(m) that a covered employee includes an employee who would otherwise be an executive officer (other than the CEO or CFO) for whom disclosure of compensation would be required if such disclosure

was required (e.g., executive officers of a corporation that does not file a proxy statement because the corporation becomes delisted). As a result, the IRS concluded that executive officers of a publicly held corporation can be covered employees even when disclosure of their compensation is not required under SEC rules.

The Notice includes an example where a publicly held corporation's three most highly compensated executive officers during a year (other than the CEO and CFO) each retire before the end of the fiscal year. Of these three retired executive officers, the corporation disclosed to shareholders the compensation of the two highest paid retired executive officers. The example concludes that all three retired executive officers are covered employees for the taxable year. The IRS' conclusion that the lowest paid retired executive officer is a covered employee for the taxable year appears to be at odds with the flush language of the statute, given the executive officer's compensation was not required to be reported to shareholders. However, the IRS position set forth in the Notice appears to be that any individual who is among the three highest compensated executive officers for a taxable year (other than the CEO or CFO) is a covered employee, even if such individual is not serving as an executive officer at the end of the fiscal year or even if such individual's compensation is not required to be disclosed to shareholders.

Grandfathered Arrangements

New Section 162(m) provides that its provisions will not apply to compensation that is provided pursuant to a written binding contract in effect on November 2, 2017, unless the contract is materially modified. The Notice provides guidance on what constitutes a written binding contract and a material modification.

Written Binding Contracts

- The Notice clarifies that compensation is considered payable pursuant to a written binding contract only to the extent the corporation is obligated under applicable law (e.g., state contract law) to pay the compensation if the employee performs the requisite services or satisfies the applicable vesting conditions.
- Many pre-TCJA arrangements permitted a corporation's compensation committee to exercise negative discretion to reduce the amount of compensation payable under an arrangement. The Notice suggests that arrangements permitting negative discretion will not qualify for grandfathered status because the arrangement may not constitute a written binding contract.
- Similarly, many deferred compensation plans provide that the corporation may amend or terminate the plan at any time, but in doing so may not reduce any benefits already earned under the plan. For plans including this type of language, an example in the Notice suggests that only amounts accrued under the plan as of November 2, 2017 may be viewed as being grandfathered under the same rationale that applies in the case of arrangements providing for negative discretion.
- In general, an arrangement that is renewed after November 2, 2017 will be viewed as a new written binding contract subject to new Section 162(m) as of the date the contract becomes terminable. Thus, for example, an employment agreement that is treated as being renewed unless either the corporation or the employee provides the other party with a non-renewal notice at least 60 days before the end of the current term of the agreement would be treated as a new written binding contract as of the renewal date. The Notice provides clarification on two additional points: (i) an arrangement is not treated as being terminable if it may only be terminated by terminating the employee's employment, and (ii) an arrangement that will be renewed unless the employee (but not the employer) decides to terminate the contract is not

treated as being terminable.

Material Modifications

- In general, a material modification will be considered to occur if an arrangement is amended to increase the amount of compensation payable to the employee. If an arrangement is materially modified, it is treated as a new contract as of the date of the material modification.
- If an arrangement is modified to accelerate the time of payment, the amendment constitutes a material modification unless there is reasonable adjustment to the amount of compensation payable to reflect the time value of money.
- If an arrangement is modified to defer the time of payment, the modification will not result in the loss of grandfathered status if any amounts payable under the modified arrangement that are in excess of the original amount payable are based on a reasonable rate of interest or a predetermined actual investment (whether or not any assets are actually being invested).
- Supplemental contracts that provide increased or additional compensation that, in substance, is based on the same elements or conditions as compensation that is otherwise payable under a grandfathered arrangement will be treated as resulting in a material modification. However, a modification of an arrangement to provide a reasonable cost of living adjustment will not be treated as a material modification.
- The failure to exercise negative discretion under a contract does not result in a material modification.

In view of the IRS' guidance, publicly held corporations are encouraged to examine (or re-examine) their current compensation arrangements to determine whether those arrangements may be grandfathered under new Section 162(m). In particular, an analysis may be necessary to determine whether a particular arrangement represents a written binding contract.