

# IRS Issues Initial Guidance on Section 162(m) Amendments

## WHAT YOU NEED TO KNOW

On August 21, 2018, the Internal Revenue Service issued Notice 2018-68 which provides publicly-traded companies with initial guidance on certain changes made to Section 162(m) of the Internal Revenue Code as a result of the Tax Cuts and Jobs Act (TCJA). The Notice primarily focuses on (1) determining what is a written binding contract that may be grandfathered under the old rules, (2) explaining which actions constitute a material modification of a grandfathered contract, and (3) identifying covered employees who are subject to Section 162(m). The Notice has been generally viewed as unfavorable to employers as it narrowly interprets certain grandfathering provisions of the TCJA that were expected to be applied in a more employer-friendly manner.

### Background:

The TCJA made a number of significant changes to Section 162(m) effective for tax years beginning after December 31, 2017. Those changes included:

- Expanding the definition of a “publicly held corporation” to include companies with publicly-traded debt, certain large private corporations and foreign private issuers whose American Depository Receipts trade on a U.S. stock exchange.
- Expanding the definition of covered employee to include the CFO (in addition to the CEO and the top three other highest paid executive officers).
- Extending an individual’s covered employee status for all years after the individual first becomes a covered employee, regardless of whether the individual subsequently terminates employment or otherwise loses executive officer status (i.e. once a covered employee, always a covered employee).
- Eliminating exceptions to the Section 162(m) deduction limitation that result in the loss of tax deductions for stock options, severance benefits, performance stock units, nonqualified deferred compensation and death benefits.

The Section 162(m) changes, however, are generally not applicable to compensation provided pursuant to a “written binding contract” entered into on or before November 2, 2017, that has not been “materially modified” after that date. As discussed in greater detail below, the Notice provides much needed guidance on the grandfathering rules.

### Grandfathering of written binding contracts:

Remuneration payable under a written binding contract that was in effect on November 2, 2017, and not subsequently materially modified, where the employer is obligated under applicable law (including state contract law) to pay the remuneration under such contract (assuming continued employment and satisfaction of other vesting conditions) is not subject to the changes made to Section 162(m) by the TCJA. While the definition of a written binding contract may appear straightforward on its face, the Notice provides several circumstances where a contract that would seemingly be a written binding contract does not in fact obligate the employer to pay remuneration under such contract, and is thus not grandfathered under the prior Section 162(m) rules.

Negative discretion. The Notice provides that the portion of compensation in excess of which the employer has negative discretion to reduce or eliminate such compensation will not be deemed payable under a written binding contract because the employer has no obligation to pay the compensation. For example, if an employer has negative discretion over a \$1,500,000 cash bonus payable on the outcome of certain performance goals, and under the terms of the contract the bonus cannot be reduced to an amount less than \$400,000, then any amount paid in excess of \$400,000 is not grandfathered.

CONTINUED

*Contract renewals.* The Notice provides that a written binding contract is not considered grandfathered if it is renewed after November 2, 2017. Any written binding contract that is terminable or cancelable by an employer without the employee's consent is also treated as renewed as of the date such termination or cancellation, if made, would be effective. For example, if the terms of contract provide that it will be automatically renewed or extended as of a certain date unless the employer or employee provides notice of termination at least 30 days before that date, the contract is treated as renewed as of the date that the termination would have been effective if proper notice was given. Similarly, if the terms of a contract provide that it will automatically be terminated or cancelled as of a certain date unless the employer or employee elects to renew the contract within 30 days of that date, the contract is treated as renewed as of that date. Further, a contract will not be treated as renewed if upon termination or cancellation of the contract the employment relationship continues but would no longer be subject to the contract, though any future payments would not be considered to have been made pursuant to the contract (and thus not grandfathered).

#### **Material modification of a written binding contract:**

In addition to the above grandfathering rules, the Notice also provides guidance as to what constitutes a material modification to a written binding contract.

*Increase in compensation.* A material modification will generally be deemed to occur when the contract is amended to increase the amount of compensation payable to the employee. If a written binding contract is materially modified after November 2, 2017, it is treated as a new contract entered into as of the date of the material modification, and any compensation paid subsequent to such modification is not grandfathered under the prior 162(m) rules.

*Acceleration of payments.* A modification that accelerates payments under a pre-November 2, 2017, written binding contract will not be considered a material modification if the compensation paid is discounted to reflect the value of time.

*Deferral of payments.* If a contract is modified to defer the payment of compensation, then any compensation subsequently paid in excess of the amount originally payable will not be treated as a material modification if the additional amount is based on a reasonable rate of interest or a predetermined investment.

*Supplemental agreements.* The adoption of a supplemental contract or agreement that provides for increased compensation, or the payment of additional compensation, is a material modification of a written binding contract if the compensation is paid based on substantially the same elements or conditions as the compensation that is otherwise paid pursuant to the prior written binding contract.

#### **New covered employee guidance:**

The TCJA expanded the definition of "covered employee" to include CFOs in addition to the already covered CEO and the next three highest-paid executive officers. The TCJA also provided that any individual who was a covered employee at any time during the 2017 tax year or beyond will always be considered a covered employee in future years, though the Notice is clear that the identification of covered employees for the 2017 tax year should be made pursuant to the prior Section 162(m) rules and not the expanded TCJA definition. The Notice also confirms that unlike the SEC executive compensation disclosure requirements, there is no requirement that an individual be a named executive officer in the proxy or be employed on the last day of the year in order to be a covered employee. Any person who serves as a CEO or CFO at any time during a fiscal year, regardless of whether he or she is employed at the end of the year, will be considered a covered employee.

**WHAT YOU NEED  
TO DO**

Publicly-traded companies should:

- Identify all compensation arrangements that were expected to be grandfathered and review them in light of the new guidance provided by the Notice.
- Consult with their auditors on the need for any adjustment to deferred tax assets.
- Consider whether any past or planned changes to any compensation arrangements (including routine salary increases and extension of stock option exercise periods) could constitute a material modification under the Notice.
- Consider design changes to compensation arrangements to mitigate the loss of deductibility resulting from the Section 162(m) changes, such as qualified supplemental executive retirement plans and granting profits interests in subsidiaries formed as or converted to LLCs.
- Determine who may be a covered employee for tax purposes (now, or in the future) and track covered employee status beginning with the 2017 tax year.
- Watch for additional IRS guidance.

**FOR MORE INFORMATION**

If you have questions concerning the changes to Section 162(m) under the TCJA, the Notice or their applicability to your executive compensation arrangements, please contact your attorney at Choate, or one of the following Choate lawyers:

**Art Meyers**

617-248-4808 | ameyers@choate.com

**Wells Miller**

617-248-4838 | wmiller@choate.com

**Benjamin Gibbons**

617-248-5003 | bgibbons@choate.com