IRS Guidance on Navigating the $1 Million Executive Compensation Deduction Limitation under Section 162(m)

September 5, 2018

The Internal Revenue Service (the "IRS") recently issued guidance for determining employees covered by the $1 million compensation deduction limitation under Section 162(m), as amended by the Tax Cuts and Jobs Act (the "Act"), as well as the arrangements that qualify for grandfathered transition relief under the Act. As summarized in our previous client update, "How the Tax Reform's Changes to Section 162(m) Executive Compensation Rules Impact You," the Act eliminated the performance-based compensation exception and increased both the types of companies and the group of employees subject to the deduction limitation. It also included a transition rule for written binding contracts in effect on November 2, 2017, so long as those contracts were not materially modified on or after such date. As a reminder, the Act's amendments to Section 162(m) are applicable to a company for its first tax year that begins after December 31, 2017 and thus are currently applicable to companies whose tax year is the calendar year.

The Act left open a number of important questions about Section 162(m): How might the identification of covered employees differ from the group of executives for whom compensation is disclosed under the Securities and Exchange Commission's (the "SEC") proxy rules? What qualifies as a written binding contract for the transition rule? What constitutes a material modification that would disqualify a plan or agreement from the transition relief? The IRS answered some of these questions in its guidance. In particular, and as expected, the IRS clarified the grandfathering rule, although these clarifications effectively narrow the scope of its availability.

Who is a covered employee? Prior to the Act's amendments to Section 162(m), the determination of who was a covered employee tracked the SEC's proxy statement compensation disclosure rules. That is no longer the case. The Act also introduced a new rule to the effect that once a covered employee, always a covered employee. As a result, companies will need to take extra care to track the employees subject to SEC's disclosure rules separately from those who are subject to the Section 162(m) deduction limitation rules.

The IRS guidance emphasizes several points of divergence from the SEC's disclosure rules:

- There is no end-of-year service requirement. A covered employee for Section 162(m) purposes includes anyone who served as CEO or CFO at any time during the taxable year, plus the three most highly paid executives (other than the CEO and CFO) for the taxable year, regardless of whether they were serving as officers at the end of the year.

  Example: The IRS concluded that, if the three most highly paid executives for a taxable year retired before the end of the year, they are covered employees even though they would not all be subject to the SEC compensation disclosure rules for the year. Similarly, not every named executive officer (other than the CEO and CFO) will be a covered person (*i.e.*, an executive who departs can "bump" an executive who remains employed by having higher compensation than the remaining executive).

- The highest paid covered employees (other than the CEO and CFO) are determined based on the company's taxable year, which could be different from the company's fiscal year (the fiscal year forms the basis of a company's proxy compensation disclosure).

  Example: As a result of a transaction, a company may have a short taxable year ending June 30 even though it reports compensation based on the full fiscal year ending December 31. In that case, the covered employees for purposes of Section 162(m) would be determined based on compensation earned through the end of the June 30 tax year plus a second set of covered employees based on compensation for the second short tax year ending December 31.

- Even if a public company is not required under the SEC's rules to disclose its executive officers' compensation in a particular year (*e.g.*, if it had delisted its securities earlier in the year or it is a foreign private issuer), its executives could be Section 162(m) covered employees. In the context of smaller reporting companies and emerging growth companies, this also means an executive whose compensation the company would not be required to disclose under the SEC's rules (*e.g.*, a company's third most highly paid executive other than its CEO or CFO) could be a covered employee for Section 162(m).

Transition relief for grandfathered written binding contracts. Written binding contracts in effect on November 2, 2017 are grandfathered from the changes to Section 162(m) in the Act, so long as they are not materially modified after such date. The IRS guidance explains that, for a written contract to be considered binding, the company party to such contract must have a legal obligation (*e.g.*, under state law) to pay compensation if the employee performs his/her services or satisfies the specified vesting conditions. The IRS guidance clarifies some aspects of how this transition rule works:

- If a contract allows for the exercise of negative discretion (*i.e.*, the company can unilaterally reduce the payment amounts), then the contract is grandfathered only to the extent of any guaranteed or earned payment that cannot be reduced.

  Example: If a performance plan in place as of November 2, 2017 provided for a bonus of $1,000,000 if certain performance goals are satisfied, but the company may exercise negative discretion to reduce the bonus to $400,000, the agreement would be treated as a binding contract to pay $400,000, and only $400,000 of any bonus paid thereunder would qualify for grandfathered treatment. The implication of the IRS guidance is that if there were no limitation on the company's ability to exercise negative discretion—such as is typical under many Section 162(m) "umbrella plans"—there would be no binding contract, and the compensation payable under the arrangement would not qualify for grandfathered treatment.

- Once a contract becomes terminable by the company at its discretion, then it is not grandfathered. A contract that renews automatically unless the corporation or the employee provides 30 days' written notice is considered a new contract (and loses grandfathered status) as of the date that it could have been terminated and then loses grandfathered status. However, if a covered employee is required to be terminated from employment in connection with a nonrenewal of his/her contract, the contract will remain grandfathered.

Material modifications. A material modification to a written binding contract results in the contract being treated as a new agreement and losing its grandfathered status as of the date of the modification. The treatment of payments before the modification is not impacted. The IRS clarified that a "material modification" to a written binding contract means any amendment to increase the amount of compensation payable, with certain exceptions as summarized below:

- Increases not greater than a reasonable cost of living adjustment (although the amount of the cost of living adjustment would not be exempt from the Section 162(m) limitation).

- Acceleration of payment that is discounted to reflect the time value of money.

- The failure to exercise negative discretion is not a material modification.

- Any increase in connection with deferral of compensation is not a material modification, provided that the increased amount is based on either a reasonable rate of interest or the actual rate of return on a predetermined actual investment.

- The adoption of a supplemental contract that provides for increased compensation on ***substantially the same terms*** as an existing contract (based on the related facts and circumstances) is a material modification.

  Example: Providing a CFO (who was not covered by the pre-Act Section 162(m) rules) with a new one-time bonus of $50,000 on terms that are different from the CFO's annual bonus would not be a material modification of the CFO's annual bonus arrangement, and the CFO's annual bonus would continue to receive grandfathered treatment. However, giving the CFO a $50,000 salary increase would cause the salary provisions of the CFO's employment agreement to lose their grandfathered status (assuming the increase is more than a cost-of-living increase) and subject the CFO's entire salary to the Section 162(m) limitation.

In light of these nuances and the "facts-and-circumstances" nature of what constitutes a material modification, companies should take care when making any changes to grandfathered arrangements so as to not inadvertently lose grandfathered status for such arrangements, particularly in the case of contracts with executives who would not have been covered employees prior to the Act (such as the CFO or an executive who was not serving the company at year end). In addition, companies subject to Section 162(m) should review their existing compensation arrangements (especially those that allow the company to unilaterally decrease amounts payable under the arrangement, like annual bonus plans) and assess changes to its group of covered employees that arise from the Act and this IRS guidance to determine its ability to take related deductions.

* * *

Please do not hesitate to contact us with any questions.

NEW YORK

Lawrence K. Cagney
lkcagney@debevoise.com

Meir D. Katz
mdkatz@debevoise.com

Jonathan F. Lewis
jflewis@debevoise.com

Elizabeth Pagel Serebransky
epagelserebransky@debevoise.com

J. Michael Snypes, Jr.
jmsnypes@debevoise.com

Charles E. Wachsstock
cewachss@debevoise.com

Rosemary Chandler
rchandler@debevoise.com