Clients&FriendsMemo

New IRS Guidance Regarding Section 162(m)'s Deduction Limitation for Executive Compensation – Increased Complexity and Reduced Availability of Grandfathering

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The Internal Revenue Service (the "**IRS**") recently issued Notice 2018-68 (the "**Notice**") that provides guidance regarding the application of Section 162(m) of the Internal Revenue Code of 1986, as amended ("**Section 162(m)**") following the amendments contained in the 2017 Tax Cuts and Jobs Act (the "**TCJA**"). While helpful in clarifying certain issues, the Notice narrowly interprets key aspects of the amended Section 162(m) in a manner that is likely to increase the complexity of compliance and greatly restrict eligibility for grandfathering of pre-TCJA compensation arrangements.

Section 162(m) – Background

Section 162(m) provides that the compensation of certain "covered employees" of public companies is not deductible over a limit of $1,000,000 for each covered employee per year. Prior to the TCJA, Section 162(m) contained an important – and widely utilized – exclusion to the deduction limitation for certain "qualified performance-based compensation." Except for certain compensation arrangements in effect on November 2, 2017 that qualify for grandfathering as discussed below, the TCJA eliminated this exclusion. Additionally, the TCJA expanded the definition of covered employees, further broadening the reach of the deduction limitation. Other changes to Section 162(m) introduced by the TCJA – including its expansion beyond corporations issuing common equity required to be registered under section 12 of the Securities Exchange Act of 1934 (the "**Exchange Act**") to corporations issuing other types of publicly traded securities – were not significantly addressed in the Notice.

Grandfathering Widely Unavailable

Under a grandfathering provision included in the TCJA, the amendments to Section 162(m), including the elimination of the performance-based compensation exclusion, do not apply to compensation payable under a "written binding contract" (generally determined under applicable state law) already in effect when the amendments were adopted on November 2, 2017, that has not been materially modified after such date. However, guidance contained in the Notice appears to make the possibility of grandfathering widely unavailable to public companies which historically designed short- and long-term compensation programs in an "umbrella plan" style intended to comply with the pre-TCJA performance-based compensation exclusion. Under umbrella plans, companies would establish maximum performance-based payments that could be made for an applicable performance period, but the actual amount payable was subject to "negative discretion" – that is, the ability to decrease the payout in the company's (frequently, its compensation committee's) discretion where performance goals were otherwise achieved.

Under an example included in the Notice, a bonus payment of $1,500,000 established prior to November 2, 2017, which the employer retains discretion to reduce to no less than $400,000, will only be grandfathered up to the $400,000 floor. Any payments made by the employer pursuant to the bonus plan in excess of the $400,000 floor are ineligible for grandfathering under the pre-TCJA qualified performance-based compensation exclusion, and therefore will be subject to Section 162(m)'s $1,000,000 deduction limitation. The Notice's reasoning is premised on the fact that, under applicable law, the bonus plan is a written binding contract to pay only $400,000, because the remainder of the $1,500,000 bonus was subject to reduction in the employer's discretion. Although the example did not address whether the employer's past practices regarding the use of such discretion would impact this analysis, it did clarify that the employer's failure to exercise negative discretion (or decision to exercise it only partially by reducing the $1,500,000 payment to $500,000, but not all the way to the $400,000 floor) did not constitute a material modification that would make the $400,000 payment ineligible for grandfathering.

In practice, many public company compensation arrangements intended to take advantage of the pre-TCJA qualified performance-based compensation exclusion were designed as umbrella plans in which employers retained the right to reduce bonus payments utilizing negative discretion. Additionally, unlike the bonus plan described in the IRS example, the vast majority of umbrella plans do not include a floor below which bonus payments cannot be reduced. Therefore, most compensation paid pursuant to pre-TCJA umbrella plans that broadly reserved negative discretion – most notably, under annual bonus programs for the 2017 calendar year that paid out in 2018 or performance-based equity awards (for example, performance stock units) that were granted prior to November 2, 2017, but settle after December 31, 2017 – will likely not be eligible for grandfathering under the pre-TCJA performance-based compensation exclusion and will therefore likely be subject to Section 162(m)'s $1,000,000 deduction limitation. This result, although a narrow interpretation under the Notice, is consistent with the intent of the TCJA's Section 162(m) changes to no longer permit the use of the performance-based compensation exclusion. Somewhat unexpectedly, umbrella plans historically designed to comply with the pre-TCJA performance-based compensation exclusion are now in a position of being ineligible for grandfathering because of the very same features that made performance-based compensation eligible for deduction in a pre-TCJA environment.

Expansive Interpretation of "Covered Employee"

Another important issue addressed by the Notice is the interpretation of the amendments made to the definition of "covered employee." Prior to the TCJA, covered employees included anyone who was an employer's CEO as of the close of the taxable year or whose compensation was required to be reported to shareholders under the Exchange Act because they were among the four highest compensated officers for the taxable year, other than the CEO and CFO (a company's CFO was not a covered employee under the pre-TCJA version of Section 162(m)). Under these rules, there was largely overlap between covered employees and employees whose compensation was required to be disclosed in a company's proxy statement (with the notable exception of a company's CFO, as referenced above), making the covered employee determination relatively simple and aligned with the company's analysis for purposes of its proxy disclosures.

The TCJA expanded the definition of covered employees to include: (A) any employee who was the principal executive officer or principal financial officer at any time during the taxable year, or was acting in such a capacity; (B) any employee whose compensation for the taxable year is required to be reported under the Exchange Act because they are among the three highest compensated officers for the taxable year (other than the CEO or CFO); or (C) any individual who was a covered employee for any preceding taxable year beginning after December 31, 2016. The amendments also provided that covered employees include anyone who would be described by clause (B) above if their compensation were to be required to be reported under the Exchange Act.

The Notice makes clear that officers can be considered covered employees even when disclosure of their compensation is not actually required in a filing under the Exchange Act, including officers of a company that does not file a proxy statement. Accordingly, unlike under the pre-TCJA version of Section 162(m), a company's proxy statement will no longer serve as a definitive guide to who is a covered employee.

Further, the Notice emphasized the TCJA's expansion of the definition of "covered employees" to cover any individual who was a covered employee after December 31, 2016. On this point, the Notice clarified that covered employee determinations for years beginning prior to January 1, 2018 (including for calendar year 2017), should be made pursuant to Section 162(m) as in effect prior to the TCJA.

Increased Complexity of Compliance

On the whole, the guidance provided by the IRS was helpful to clarify uncertainty surrounding the TCJA's application to Section 162(m) with respect to several points. However, the interpretations contained in the IRS guidance also place an increased compliance burden on companies and their advisers. With the definition of "covered employee" expanded to include any individual who was ever previously a covered employee after December 31, 2016, companies will need to keep a running list of anyone who they have ever determined to be a covered employee after

December 31, 2016, and track their annual compensation accordingly. Additionally, it will now be necessary to engage in a fact-intensive analysis of each executive compensation arrangement entered into before the TCJA's adoption in order to determine the extent to which it may constitute a written binding contract eligible for grandfathering under the pre-TCJA exceptions to Section 162(m)'s deduction limitations.

Remaining Issues

While the Notice clarified many questions surrounding the application of the amendments made by the TCJA to Section 162(m) that had been debated by commentators, many issues still remain open. In particular, in the Notice the IRS requested comment on how to apply the definition of "publicly held corporation" to foreign private issuers; whether an employee who was a covered employee of a predecessor of the employer constitutes a covered employee; how Section 162(m) applies to companies immediately after they go public through an initial public offering (or similar transaction); and how to determine the three most highly compensated officers for a taxable year that does not end on the same date as the last completed fiscal year (such that the time periods for the determination of who is a covered employee and who is subject to SEC disclosure rules are not the same).

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