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Introduction

Internal Revenue Code section 162(m) (“section 162(m)”) generally imposes a \$1 million limit on the deduction allowed to be taken by a “publicly held corporation” for remuneration paid to covered employees. Tax legislation (P.L. 115-97, “the Act”) signed into law by President Trump on December 22, 2017, made significant amendments to section 162(m), including amending the definition of applicable employer remuneration to eliminate exceptions for qualified performance-based compensation and commissions, expanding the definitions of covered employee and publicly held corporation, and adding a transition rule to allow for grandfathering certain payments. These rules impact any corporation which is an issuer of securities that is required to be registered under section 12 or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (the “Exchange Act”) paying certain executives remuneration that exceeds \$1 million for tax years beginning after December 31, 2017.

On August 21, 2018, the Internal Revenue Service (IRS) issued Notice 2018-68 (“the Notice”) to provide initial guidance on certain aspects of the amendments made by the Act. In particular, the Notice addresses the amended rules for identifying covered employees and the operation of the grandfather rule, including when a material modification to a written binding contract has occurred rendering the contract ineligible for grandfathering.

URL: <https://www.irs.gov/pub/irs-drop/n-18-68.pdf>

The Department of Treasury and the IRS anticipate further guidance will be issued in the form of proposed regulations and that the proposed regulations will incorporate guidance addressed in the Notice.

Background

Section 162(m) was enacted in 1993 and limits the deductibility of compensation paid by publicly traded corporate employers to covered employees. The otherwise allowable deduction for compensation with respect to a covered employee of a publicly held corporation is limited to no more than \$1 million per year.

Prior to passage of the Act, the \$1 million dollar limitation extended to all types of compensation, but with certain exceptions. Most notably, the \$1 million dollar exception did not apply to certain performance-based compensation and commissions.

The Act amended the following definitions under section 162(m):

Applicable Employee Remuneration: Effective for tax years beginning after December 31, 2017, the Act amended section 162(m) to repeal the performance-based compensation and commission exceptions to the section 162(m) \$1 million deduction limitation. The Act also added a rule for remuneration paid to beneficiaries, providing that applicable employee remuneration includes remuneration includible in the income of, or paid to, a person other than the covered employee.

Publicly Held Corporation: Prior to the passage of the Act, section 162(m) defined the term “publicly held corporation” as any corporation issuing any class of common equity securities required to be registered under section 12 of the Exchange Act. The Act amended the definition to include both a corporation that is an issuer of securities required to be registered under section 12 of the Exchange Act as well as a corporation that is required to file reports under section 15(d) of the Exchange Act.

Covered Employee: When section 162(m) was initially passed, the term “covered employee” was defined to include any employee of the taxpayer if, as of the close of the taxable year, such employee was the chief executive officer (or an individual acting in that capacity), or the total compensation of the employee for the taxable year was required to be reported to the shareholders under the Exchange Act by reason of the employee being among the four highest compensated officers for the tax year (other than the CEO). Notice 2007-49 reconciled this definition with changes made to the SEC disclosure requirements such that the Principal Financial Officer (PFO) was no longer a covered employee. To be a covered employee, the officer had to be serving as an officer on the last day of the year.

URL: <https://www.irs.gov/pub/irs-drop/n-07-49.pdf>

The Act amends the definition of “covered employee” to include any employee who is the Principal Executive Officer (PEO) or PFO of the corporation (or any individual acting in such capacity) at any time during the tax year, or the total compensation of the employee is required to be disclosed to shareholders under the Exchange Act by reason of being amongst the three highest compensated officers (other than the PEO or PFO or any individual acting in such capacity). If the corporation does not have a disclosure requirement under the Exchange Act, then the determination of top three highest compensated officers should be made as if the disclosure requirements apply.

Additionally, for tax years beginning after December 31, 2017, an individual who is a covered employee for any taxable year beginning after December 31, 2016, will continue to be a covered employee for all subsequent taxable years, including years after the death of the individual, even if the individual would not otherwise meet the definition of “covered employee” for that year.

Grandfather Rule: The Act also added a grandfather rule providing that the amendments to section 162(m) will not apply to remuneration provided pursuant to a written binding contract in effect on November 2, 2017, and not materially modified on that date or thereafter.

Initial guidance in Notice 2018-68

Operation of the grandfather rule

Written binding contract: Section 162(m) as amended by the Act will not apply to payments made pursuant to a written binding contract in effect on November 2, 2017, and not materially modified on that date or thereafter. The

Notice provides that a contract is considered to be written and binding only when the corporation is obligated under applicable law (for example, state contract law) to make a payment to an employee once all services have been performed or vesting conditions have been satisfied as required by the terms of the contract.

Therefore, even if there is a written binding contract in place on November 2, 2017, if the remuneration paid exceeds the amount the corporation is obligated by applicable law (for example, state contract law) to pay under the contract upon completion of performance of services or satisfaction of vesting conditions, the grandfather rule would not apply to those excess payment amounts.

To the extent a written binding contract is renewed after November 2, 2017, the grandfather rule would not apply to payments made on or after the date of renewal. Further, if a corporation has the right to cancel or terminate a contract without the employee's consent after November 2, 2017, then the grandfather rule would cease to apply on the date that termination or cancellation would be effective (even if the contract is not in fact cancelled or terminated on that date).

The Notice provides a number of examples to illustrate when a contract is considered terminated, cancelled or renewed.

Negative Discretion: Based on final regulations under pre-amendment section 162(m), many publicly held corporations had performance bonus programs that permitted the corporation to exercise "negative discretion", allowing them to pay a lesser amount of compensation (including zero) even if the goals had been attained, and to do so for any reason, or even no reason.

The written binding contract grandfather rule raises the question of whether programs with negative discretion would qualify for grandfathering, even though the particular performance period for the bonus commenced prior to the enactment of the Act, and was still underway at the time of passage. It has been suggested that negative discretion does not render a contract ineligible for grandfathering, in particular if the negative discretion was never actually exercised. However, the Notice provides that a contract will not meet the written binding contract requirement to the extent that the corporation has an enforceable ability to exercise negative discretion.

The Notice provides that to the extent a corporation has the right to exercise negative discretion with respect to a payment or a portion of a payment that, but for the discretion, would be due under the terms of an agreement, the amount of the payment to which negative discretion may be exercised (whether or not actually exercised) will not be eligible for grandfathering. An example in the Notice illustrates this principle: if a written binding contract establishes a maximum bonus payment of \$1.5 million if performance targets are satisfied, but reserves the right of the compensation committee to adjust a performance-based compensation payment downward to \$400,000, only \$400,000 is eligible for grandfathering, even if a higher amount – \$500,000 in the example – is in fact paid. For many plans, discretion allows for reduction to zero, in which case no amount of the performance-based payment will be eligible for grandfathering.

As a result of the IRS position, many performance-based payments with performance periods that ended in 2017 (or were multi-year programs where the period is still underway) subject to negative discretion are unlikely to be eligible for the grandfather rule. As a result, payments made under these programs upon the satisfaction of performance goals to covered employees would be subject to deduction limitations.

Material modifications: Section 162(m) as amended by the Act will apply to any contract materially modified after November 2, 2017. If a contract is materially modified, it is treated as a new contract as of the date of the modification. Amounts payable under a contract prior to material modification may still be eligible for grandfathering while amounts payable after the material modification may not be eligible.

The Notice provides a number of examples illustrating situations where a contract is or is not materially modified.

Identification of Covered Employees

Covered employees for purposes of amended section 162(m) (in addition to the PEO and PFO) are limited to the top three highest paid executives. Under pre-amendment section 162(m), a corporation relied on disclosure of the three individuals in the Summary Compensation Table following the PEO and the PFO. The Notice, however, indicates that pursuant to amended section 162(m), there is no disclosure requirement and no last day of the year employment

requirement (as discussed further below) rendering reliance on the Summary Compensation Table potentially ineffective for purposes of identifying the top three highest compensated executives for purposes of section 162(m).

No shareholder disclosure requirement: The Notice provides an expansive interpretation of “covered employee.” As amended, section 162(m) provides that a covered employee is determined as if the reporting disclosure requirements applied. Thus, entities in the expanded definition of “publicly traded company” that may not be subject to reporting requirements under the Exchange Act will still have covered employees for purposes of section 162(m), determined as if the disclosure requirements applied. Additionally, a publicly held corporation will also have covered employees for a period for which there is no required disclosure under section 12 of the Exchange Act, such as a short year because of a transaction or due to delisting of securities after the end of the period.

To the extent the corporation’s last completed fiscal year and the taxable year do not end on the same date, and until additional guidance is issued, corporations should use a reasonable good faith interpretation of the statute in conjunction with the guidance provided in the Notice to determine the three most highly compensated employees for purposes of section 162(m).

No “end-of-year” requirement for top three highest paid executives: The statute explicitly eliminates the requirement that the PEO and PFO must be employed on the last day of the taxable year to be considered a covered employee. Instead, anyone serving in one of these roles at any point during the year is a covered employee and subject to the deduction limitation. The Notice further expands this rule to provide that there is no requirement that any officer be active on the last day of the taxable year to be considered a covered employee if that officer is one of the top three highly compensated officers for the year.

The SEC rules related to executive compensation disclosures under the Exchange Act do not limit disclosure only to executive officers who serve at the end of the last completed fiscal year. Rather, the rules require reporting of up to two additional individuals that otherwise would have been reported had they been serving on the last day of the year. The Notice extends the analysis for executives not reported under SEC rules even further, providing that even if an officer is not required to be disclosed under SEC rules, the officer will be a covered employee if, based on his or her compensation, the officer is amongst the top three highest paid.

Thus, the definition of covered employee includes any employee who is among the top three highest compensated executive officers for the taxable year (other than the PEO or PFO, or an individual acting in such capacity), regardless of whether they are serving in such capacity at the end of the corporation’s taxable year and regardless of whether the executive’s compensation is required to be disclosed under SEC rules for the last completed fiscal year, even if there is a table required for that period.

This aspect of the Notice, that an officer could be limited even if not required to be disclosed during a period for which the SEC disclosure rules apply, is broader than generally anticipated. While it may require an expanded analysis of who is a covered employee, it may not, as a practical matter, result in an actual expansion of who is covered, since an officer who is not active at the end of the year but is still among the top three most highly compensated is likely to already be considered a covered employee due to qualifying as a covered employee in a prior period. This aspect of the rule is discussed in more detail below in the discussion of “Permanent” Covered Employee status.

It will be important for counsel to evaluate compensation paid to executives under the relevant SEC rules for determining the three highest paid officers independent of who is required to be reported on the Summary Compensation Table at the end of the last completed fiscal year.

“Permanent” Covered Employee status: The definition of covered employee includes any individual who was a covered employee of the publicly held corporation (or its predecessors) for taxable years beginning after December 31, 2016.

Deloitte views

As a next step, employers should:

- Continue to watch for additional guidance from the Department of Treasury and IRS. Proposed regulations are anticipated and will incorporate the guidance in this Notice;

- Consider how initial guidance under this Notice might impact the covered employee analysis for tax years beginning after December 31, 2017; and
- Review written binding contracts for material modifications and negative discretion to determine if the grandfather rule applies to current and future payments made to covered employees.

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