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THE 162(M) GRANDFATHER REVEAL PARTY: IRS RELEASES LIMITED GUIDANCE ON INTERNAL REVENUE CODE SECTION 162(M)

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It took roughly nine months, but you may now be in a position to identify and reveal the status of contracts as 162(m) grandfathered – or not. Last week, in IRS Notice 2018-68, the IRS provided long-awaited, albeit limited, guidance concerning the changes made to Internal Revenue Code Section 162(m) by the Tax Cuts and Jobs Act. Specifically, the notice includes additional information about the new definition of "covered employee" (i.e., an employee with respect to whom the compensation deduction is capped at $1 million) and…drum-roll please…. the meaning of "written binding contract" for purposes of determining whether a contract is grandfathered under Section 162(m).

Notice 2018-68 anticipates that future regulations will incorporate its contents, but that any such regulations will only apply to taxable years ending on or after September 10, 2018. The notice further specifies that any future guidance, including regulations, addressing the issues covered by Notice 2018-68 in a manner that would broaden the definition of "covered employee" will apply prospectively only.

Read on for a brief summary of the guidance provided by the notice – and stay tuned for our next post which will explore the most common questions companies are asking about the guidance, including questions about equity and deferred compensation arrangements, and steps companies can take in response to it.

Covered Employees

<u>End of Year Requirement:</u> Before we address the grandfather guidance, we want to explore the expanded the definition of covered employee as this may impact the employees with respect to whom the question of grandfathering is relevant. Notice 2018-68 clarifies that despite other suggestions by certain commentators relying on SEC rules, there is no end-of year requirement under the section of the definition of "covered employee" that refers to individuals who are the PEO or PFO of a publicly held corporation at any time during the taxable year. Instead, an individual who acted as the PEO or PFO of a publicly held corporation at any point during the year qualifies as a

"covered employee" even if the individual was not the PEO or PFO at the end of the year. In the notice, the IRS further explains that the text of Section 162 and its legislative history do not impose an end-of-year requirement, and the SEC rules are not the sole basis for interpreting Section 162(m).

<u>Companies Not Required to File Proxy:</u> The IRS also clarifies the new language added to the definition of "covered employee," providing that for purposes of the section of the definition linked to SEC reporting, a "covered employee" includes officers of a corporation that is not required to file a proxy statement but which otherwise falls within the revised definition of a publicly traded corporation that would have been required to file a proxy statement for the year. For example, this definition encompasses a corporation otherwise required to file a proxy statement but for the fact that it delisted its securities or underwent a transaction that resulted in the non-application of the proxy statement requirement.

<u>Covered Employee Status Forever – Transition Rule:</u> The IRS confirmed how the "once a covered employee always a covered employee" rule works during the transition to the new 162(m) rules. This rule was effective for tax years after December 31, 2016. An employee who was not a covered employee in 2017, will not be a covered employee in 2018 or future years based on the employee's 2017 status (although the employee could satisfy the covered employee requirements based on compensation or officer status after 2017). Conversely, an employee who was a covered employee in 2017 will always be a covered employee regardless of changes in officer status, compensation, employment or death.

<u>Fiscal Year:</u> This section of Notice 2018-68 concludes by offering the less-than-clear advice that until further guidance is issued, publicly held corporations should use a reasonable good faith interpretation of the statute to determine the three most highly compensated employees for the year where the corporation's fiscal year and tax year do not end on the same date.

Grandfather Relief for Written Binding Contracts

And now…what we have all been waiting for … the grandfather status reveal. Is a particular compensation arrangement grandfathered and therefore exempt from the new 162(m) provisions, particularly those new provisions which subject performance based compensation to the $1 million deduction limit? Read on my friends for a summary of the new guidance on this issue.

<u>Written Binding Contract:</u> Generally, compensation which is paid pursuant to an arrangement which was a written binding contract as of November 2, 2017, is grandfathered. Notice 2018-68 provides that for Section 162(m) purposes, a "written binding contract" is a contract under which the employer is required to pay the executive by law. For example, and most commonly, a written binding contract is one in which state contract law requires an employer to pay an executive under a contract provided that the executive remains employed and satisfies any other vesting conditions.

One of the most compelling questions has to do with the effect of negative discretion on the grandfather status of a contract. The guidance indicates that payment of any compensation that is

subject to discretion is not payable pursuant to a written binding contract (although if payment of the purportedly discretionary compensation was binding under state law, it arguably would satisfy the written binding contract exception - more on this in subsequent posts.)

The new guidance acknowledges the similarity between this grandfather provision and the grandfathered provision provided when 162(m) was initially enacted (which guidance is set forth in regulations), implying, without explicitly endorsing, the value of the earlier guidance in interpreting the current grandfather provision.

Material Modification: At the end of the guidance section of the notice, the IRS arguably provides the most useful information by explaining the meaning of "material modification." Generally speaking, Notice 2018-68 provides two categories of events through which a material modification to a contract might occur. First, a material modification might occur when an employer and an executive enter into a supplemental contract that increases compensation where the executive receives the increased compensation under substantially the same terms and conditions of the original contract. Second, a material modification might occur upon a contract's renewal.

Supplemental Contract: Where a supplemental contract increases the amount of compensation that an executive receives without adding additional duties or responsibilities to the executive's job description, it follows that a material modification has occurred. This type of arrangement falls into the classic IRS tenet of "substance over form," because where a supplemental contract simply increases compensation without changing any other terms or conditions of employment, in substance, the underlying contract itself has been altered (more on this guidance and its nuances in subsequent posts). Similarly, a material modification occurs where the timing of payment of an executive's compensation is accelerated or deferred, unless the acceleration or deferral of payment of such compensation is adjusted to reasonably reflect the time value of money. For example, where an employer and an executive agree to defer the payment of compensation, in order to avoid materially modifying the underlying contract, the deferred compensation must be subject to a fair market rate of return, or be payable based on the actual performance of its investment in a specified investment fund.

Renewal (evergreen Provisions): As mentioned above, a contract in place prior to November 2, 2017 but renewed after that date does not lose grandfather status (i.e., is not treated as a new contract) if the employee renews the contract pursuant to the employee's unilateral right to require renewal. If the employer could avoid renewal (e.g., by providing notice of intent not to renew), the renewal is not grandfathered.

Newly Eligible Employees: If a compensation plan or arrangement is binding, it is grandfathered with respect to any participating executives, even if the executives do not become eligible to participate in the plan or arrangement until after November 2, 2017. However, in order for this exception to apply, the executives in question must have been either employed on November 2,

2017 by the corporation maintaining the plan or arrangement or given the right to participate in the plan or arrangement under a written binding contract (as defined above) as of November 2, 2017.

Questions? Comments? Concerns? Talk to the IRS—it will accept comments and questions regarding Notice 2018-68 through November 9, 2018.

RELATED PRACTICE AREAS

- Employee Benefits & Executive Compensation

MEET THE TEAM

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