DrinkerBiddle

Client Alert

September 10, 2018

The IRS Breaks Its Silence on the 162(m) Grandfathering Rule but Companies May Not Like What the IRS Has to Say

By Mona Ghude, Christine M. Kong and Erik D. Vogt

The IRS has issued its much-anticipated initial guidance (Notice 2018-68) relating to the changes made to Internal Revenue Code Section 162(m) by H.R. 1, a congressional revenue act originally introduced in Congress as the Tax Cuts and Jobs Act (the "Act"). Notice 2018-68 provides detailed guidance regarding the application of the grandfathering rule and the covered employee determination. The IRS anticipates issuing further guidance regarding the changes to 162(m) in the form of proposed regulations.

Background

Code Section 162(m) prohibits a public company from deducting compensation paid to a covered employee in excess of $1 million per year. Prior to the Act, the $1 million deduction limit did not apply to performance-based compensation or to compensation payable on a commission basis. The Act, among other things, repealed these exceptions and expanded the definition of "covered employee" while providing that certain existing arrangements are "grandfathered" and not subject to the 162(m) changes. For more information regarding the 162(m) changes, please see our previous alert.

Grandfathering Rule

The Act contains a grandfathering rule under which the 162(m) changes will not apply to compensation provided pursuant to *written binding contracts* that were in effect on November 2, 2017, and which are not *materially modified* on or after that date.

Written Binding Contract. Compensation is payable under a "written binding contract" only to the extent that the company is obligated under applicable law (e.g., state contract law) to pay the compensation under the contract if the employee performs services or satisfies applicable vesting conditions.

Notice 2018-68 explains that the "written binding contract" requirement will (or will not) be satisfied in the following situations:

1. *Contract Renewable by Company and Employee Agreement*. The "written binding contract" requirement is not met for compensation payable under a contract that is renewed after November 2, 2017, where both the company and the employee must agree to the renewal. As a result, compensation payable under the renewed contract would not be grandfathered.

2. *Contract Terminable by Company Without Employee Consent*. A contract that can be terminated by the company after November 2, 2017, without the employee's consent, is treated as "renewed" on the date that such termination, if made, would be effective. Compensation payable under the renewed contract would not be grandfathered. However, a contract is not considered terminable if the contract can be terminated only by terminating the employee's employment.

3. *Contract Renewable Solely by Employee*. Compensation is payable under a "written binding contract" if it is payable under a contract that is renewed after November 2, 2017, where the employee is the only party with the power to renew.

   DBR Comment: A contract where the employee is the only party with the power to renew is unusual.

   DBR Comment: The above changes may affect the grandfathered status of compensation payable under employment agreements. For example, an employment agreement with a three-year term beginning on January 1, 2017, might provide for an automatic three-year renewal after the initial three-year term unless the company exercises its option to terminate the agreement within 30 days before the end of the initial three-year term. Unless the company exercises its option to terminate the agreement, the agreement is treated as "renewed" on January 1, 2020, and the Act's amendments to 162(m) would apply to any payments made under the agreement on or after January 1, 2020.

4. *Termination of Contract but Employment Continues*. A contract is not considered "renewed" if the contract is terminated or canceled but the employee's employment with the company continues. However, when an employee's employment continues after contract termination, compensation paid to the employee would not be made pursuant to the contract and, therefore, would not be grandfathered.

5. *Negative Discretion to Reduce Compensation to $0.* The "written binding contract" requirement is not met if the company has the discretion to reduce the amount of compensation payable under the contract to zero.

6. *Negative Discretion to Reduce Compensation to More Than $0*. The "written binding contract" requirement is not met to the extent the company has the discretion to reduce the compensation payable under the contract to something above $0.

   DBR Comment: Many performance-based plans provide companies with the ability to reduce amounts payable under those plans based on subjective factors. For example, if a company has the discretion to reduce a $1 million bonus to $200,000 based on subjective factors, only $200,000 is payable pursuant to a written binding contract and the remaining amount is not eligible for grandfathered status.

   DBR Comment: Example 7 of the Notice illustrates application of the "written binding contract" requirements to equity awards granted prior to November 2, 2017. In the Example, Corporation S and its principal executive officer (PEO) entered into a four-year employment agreement on January 2, 2017, under which the executive receives an annual salary of $1 million. Pursuant to the employment agreement, on January 2, 2017, Corporation S granted the executive nonstatutory stock options to purchase 1,000 shares of Corporation S stock, stock appreciation rights (SARs) on 1,000 shares, and 1,000 shares of Corporation S restricted stock. The options and the SARs vest on January 2, 2019. On January 2, 2019, the executive exercises the options and the SARs and the 1,000 shares of restricted stock vest. Compensation attributable to exercise of the options and the SARs satisfies the pre-Act requirements of 162(m) as performance-based compensation.

   The IRS explains that under the above example:

   - Because the January 2, 2017, grants of options, SARs, and restricted stock constitute a written binding contract in effect on November 2, 2017, the Act's amendments to 162(m) do not apply to compensation that the executive receives when the executive exercises the options and the SARs, or when the restricted stock vests.

   - Section 162(m) does not disallow Corporation S a deduction for compensation resulting from exercise of the options or the SARs, because the compensation satisfies the performance-based compensation requirements of the 162(m) regulations and the Act's elimination of the exception for performance-based compensation does not apply to these awards.

   - However, Corporation S's deduction for the compensation attributable to the restricted stock vesting is disallowed by 162(m) even though the Act's amendments do not apply to this compensation, because time-vesting restricted stock does not meet the requirements for performance-based compensation under the 162(m) regulations.

Material Modification: A "material modification" occurs when a contract is amended to increase the compensation payable to the employee. If a written contract is materially modified, it is treated as a new contract as of the date of the material modification. Thus, amounts received by the employee under the contract before the material modification are not affected, but amounts received after the material modification would not be grandfathered.

Notice 2018-68 explains that a "material modification" will (or will not) occur in the following situations:

1. *Acceleration*. A modification that accelerates payment is a material modification unless the amount of compensation paid is discounted to reasonably reflect the time value of money.

2. *Deferral*. If a contract is modified to defer the payment of compensation, any compensation paid (or to be paid) that exceeds the amount that was originally payable to the employee will not result in a material modification, if the additional amount is based on a reasonable interest rate or a predetermined actual investment (whether or not assets are actually invested in the investment).

3. *Supplemental Payments*. The adoption of a supplemental agreement that provides for additional compensation in excess of a reasonable cost-of-living increase is a material modification if the facts and circumstances indicate that the additional compensation is paid on substantially the same terms as the compensation to be paid pursuant to the written binding contract.

4. *Negative Discretion Not Exercised*. If a company has the discretion to reduce compensation payable under a written binding contract, the company's failure to exercise such negative discretion does not result in material modification of the contract.

   DBR Comment: The grandfathering rules may be relevant even in situations where the original payment is not considered performance-based compensation. For example, post-retirement payments to a company's former CEO under a SERP that was entered into before November 2, 2017, and is otherwise considered a written binding contract in effect on November 2, 2017, may be denied a deduction if the SERP is materially modified after that date.

Definition of Covered Employee

The Act expanded the definition of "covered employee" to include a company's principal financial officer and any employee who was a covered employee in any prior tax year beginning after December 31, 2016.

Notice 2018-68 clarifies that the covered employee determination is made without regard to whether the individual is employed at the end of the company's tax year, and without regard to whether the individual's compensation is subject to disclosure for the company's most recent fiscal year under the SEC disclosure rules.

> ***DBR Comment:*** Companies will need to maintain records to track covered employees for 162(m) purposes.

Employee Benefits and Executive Compensation Group

Primary Contacts

Mona Ghude
Partner
Philadelphia
(215) 988-1165
mona.ghude@dbr.com

Christine M. Kong
Partner
New York
(212) 248-3152
christine.kong@dbr.com

Erik D. Vogt
Associate
Chicago
(312) 569-1341
erik.vogt@dbr.com