



Executive Compensation and Benefits Alert

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IRS Issues Anticipated Guidance on Covered Employees and Grandfathering Rules Under Code Section 162(m)

On August 21, 2018, the Treasury Department and the Internal Revenue Service (IRS) issued Notice 2018-68, which provides eagerly awaited guidance for changes that were made to Section 162(m) of the Internal Revenue Code (Code) by the Tax Cuts and Jobs Act (the Act) with respect to identifying covered employees and applying the transition rule under Code Section 162(m).

Overview of Changes to Code Section 162(m) Under the Act

Code Section 162(m) generally limits the deductibility of compensation paid to certain “covered employees” of a publicly held corporation to \$1 million per year. Prior to the implementation of the Act, payments of qualified performance-based compensation made to such covered employees were exempt from the \$1 million annual limitation. The Act substantially modified Code Section 162(m) by eliminating the exemption for qualified performance-based compensation and expanding the scope of individuals who may qualify as covered employees subject to the \$1 million annual limitation. The Act does, however, include an important transition rule under which the changes made to Code Section 162(m) will not apply to compensation payable pursuant to a written binding contract that was in effect on November 2, 2017, that is not materially modified after that date.

The changes made to Code Section 162(m) by the Act became effective on January 1, 2018, for calendar year companies, or for tax years beginning after December 31, 2017, for noncalendar year companies.

For a more detailed overview of the changes made to Code Section 162(m) by the Act, see our January 4, 2018, client alert, “[Section 162\(m\) After the Tax Cuts and Jobs Act: What to Do Now.](#)”

Guidance Regarding Covered Employees

The Act expanded the scope of covered employees under Code Section 162(m) to include any individual who served as the CEO or chief financial officer at any time during the taxable year and the three other most highly compensated officers (other than the CEO and CFO) for the taxable year. Notice 2018-68 clarifies that any such individual for

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a taxable year qualifies as a covered employee, regardless of whether the individual is an executive officer at the end of that year and regardless of whether the individual's compensation is required to be disclosed for the last completed fiscal year under the rules of the Securities and Exchange Commission. Importantly, this may result in Code Section 162(m) applying to the compensation of individuals who never appear in the company's annual proxy statement. In the context of a merger, Code Section 162(m) may apply for a taxable year to individuals who are covered employees for the short tax year ending with the merger.

The Act further expanded the scope of covered employees under Code Section 162(m) by providing that any individual who is or was a covered employee for any taxable year beginning after December 31, 2016, will remain a covered employee for all future taxable years. As a result, covered employees identified for the taxable year beginning in 2017 based on the pre-Act rules for determining covered employees will continue to be covered employees for all taxable years beginning in 2018 and beyond.

Guidance for Applying the Transition Rule

Under the transition rule, the Act's changes to Code Section 162(m) do not apply to compensation payable pursuant to a written binding contract that was in effect on November 2, 2017, that is not materially modified after that date. Unless a contract is materially modified on an earlier date, grandfathered status may generally last until the date on which the contract may be terminated by the employer (for example, by giving notice of contract nonrenewal). Notice 2018-68 provides guidance as to what constitutes a written binding contract and a material modification to a written binding contract for this purpose.

Negative Discretion. Compensation is payable pursuant to a written binding contract that was in effect on November 2, 2017, only if the company is legally obligated to pay the compensation under the contract pursuant to applicable law (for example, state contract law) in the event that the employee performs services or satisfies any applicable vesting conditions. Notice 2018-68 clarifies that a company is not considered to be legally obligated to pay an amount for purposes of Code Section 162(m) to the extent that, under applicable state law, the amount may be reduced upon the company's exercise of negative discretion, regardless of whether that discretion is actually exercised. One key takeaway is that annual bonuses, performance stock units or other performance-based incentives with payments that are

subject to negative discretion will not be grandfathered unless there may be an entitlement to a payment under applicable state law. Generally, the elimination of the exception for qualified performance-based compensation does not apply to stock options and stock appreciation rights that were granted pursuant to legally binding contracts on or prior to November 2, 2017, and that satisfied the requirements of the qualified performance-based compensation rules under Code Section 162(m) prior to the implementation of the Act.

First-Time Covered Employees. In addition, Notice 2018-68 provides that if an individual becomes a covered employee solely as a result of the amendments to Code Section 162(m) under the Act, then any payments that are made to the individual under a written binding contract that was in effect on November 2, 2017, will not be subject to Code Section 162(m). For example, if a CFO of a publicly traded company is entitled to payment of a specified amount of salary under a binding written employment agreement that was in effect as of November 2, 2017, and first becomes a covered employee for the taxable year beginning January 1, 2018, as a result of the changes to Code Section 162(m) made by the Act, the salary payable to the CFO under the employment agreement after implementation of the Act will not be subject to Code Section 162(m).

Material Modifications. If a written binding contract that was in effect on November 2, 2017, is materially modified after that date, it is treated as a new contract entered into as of the date of the material modification. Any amounts an employee received under the contract before the material modification remain grandfathered, but any amounts received after the material modification are treated as paid pursuant to a new, nongrandfathered contract rather than pursuant to a grandfathered contract. A "material modification" occurs when a written binding contract is amended or modified to:

- increase the amount of compensation payable to the employee,
- accelerate the payment of compensation, unless the amount paid is discounted to reasonably reflect the time value of money, or
- defer the payment of compensation, unless the amount of compensation paid or to be paid at a later date that is in excess of the amount originally payable to the employee is based on either a reasonable rate of interest or the actual rate of return on a predetermined actual investment.

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In addition, a material modification to a written binding contract that was in effect on November 2, 2017, will be deemed to occur if a supplemental contract or agreement providing for increased compensation or the payment of additional compensation is adopted after November 2, 2017, and the facts and circumstances demonstrate that the additional compensation is paid based on substantially the same elements or conditions as the compensation that is otherwise paid pursuant to the existing contract. However, a material modification will not occur under these circumstances if either the amount of the additional payment is equal to or less than a reasonable cost-of-living increase over the payment made in the preceding year under that contract or there has been a failure to exercise negative discretion under that contract.

Forthcoming Proposed Regulations

The Department of the Treasury and the IRS anticipate issuing proposed regulations under Code Section 162(m) that will incorporate the guidance under Notice 2018-68.

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Next Steps

The rules for determining which agreements and arrangements are grandfathered, and which employees are covered employees, under the guidance are complex. Companies should reach out to their legal advisers to review the terms of their existing incentive compensation plans and arrangements and discuss the extent to which they may be grandfathered as well as how to avoid inadvertent material modifications that could jeopardize the deductibility of compensation paid to covered employees for current and future taxable years. Companies should also develop a protocol for keeping track of covered employees going forward.