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Executive Compensation

INSIGHT: Not Quite as Bad as It Seems But Almost: IRS Notice 2018-68 Provides Tax Act Section 162(m) Change Guidance



By RUTH WIMER

Thoroughly addressing the changes made by the 2017 Tax Cut and Jobs Act (2017 tax act), the IRS has at long last released its much-anticipated guidance with respect to the significant and unfavorable amendments related to the deductibility of executive compensation under tax code Section 162(m). The 2017 tax act eliminated the exceptions for compensation over \$1 million per year for performance and commission-based pay and also expanded the definition of covered employee dramatically. The Internal Revenue Service Notice

2018-68 initially appears very harsh on several interpretations of this new law, but careful analysis, strategizing, and solid record-keeping, will allow affected companies to obtain deductions to the maximum extent possible on a go-forward basis.

This article explains how that goal can be achieved in full compliance with Notice 2018-68. Each section of the article is titled descriptively so that the reader may skip to the “juicy” parts.

INTRODUCTION: SECTION 162(m)

Post Tax Act Section 162(m) Deduction Flowchart

| | | | |
|---|---|-------------|----|
| 1. Employee of Public Company under new expanded definition including reporting companies? | 1 | Yes | No |
| 2. Covered employee under new law, e.g. PFO, or formerly Covered Employee under old law in 2017, or new law in 2018, or thereafter? | 2 | Yes | No |
| 3. Amount paid pursuant to written binding contract terms as of November 2, 2017 and not pursuant to the amounts paid attributable to <i>services</i> after the date of any renewal or termination effective date, automatic or otherwise, other than that attributable solely to employee? | 3 | Yes | |
| 4. Amounts paid pursuant to written binding contract as above and not after the date of a material modification? | 4 | Yes | |
| 5. Would Pre-Tax Act rules have allowed deduction due to employee: 1. not being a covered employee, 2. no longer being a covered employee, 3. not being an employee of a public company under old law, or 4. or the compensation being performance or commission based? | 5 | Yes | |
| 6. Add Post-Tax Act ongoing exclusions of qualified plan contributions and tax free fringe benefits. | 6 | \$ _____ | |
| 7. Add \$1,000,000 | 7 | \$1,000,000 | |
| 8. Add all amounts paid to employees not covered in Box 1 and 2 | 8 | \$ _____ | |
| 9. AMOUNT DEDUCTIBLE POST TAX-ACT | 9 | \$ _____ | |

SUMMARY OF THE NEW SECTION 162(m)

Historically, Section 162(m) has disallowed the deductibility of executive compensation paid by a publicly held corporation employer to a “covered employee” in excess of \$1 million for the taxable year. Note that the limit to the \$1 million deduction is basically on a cash basis with respect to amounts paid per covered employee per year plus certain amounts accrued during the year, paid within 2.5 months of the year, so generally compensation being deferred for later payment does not count toward the limit. Unfortunately, the 2017 tax act removed the popular and longstanding exceptions to this rule for performance-based compensation and commission-based compensation, applicable for tax years that start Jan. 1, 2018, or later. The 2017 tax act also made major changes to the definition of covered employee to now also include the principal financial officer (PFO) and to include as a covered employee any individual that had ever been a covered employee in a year beginning after 2016. Finally, the definition of the companies which are subject to Section 162(m) was expanded from “public companies” issuing securities required to be registered under Section 12 of the Securities Exchange Act of 1934, to also include those required to file reports under Section 15(d) as well.

The 2017 tax act provided an important exception referred to as the “grandfather rule” or transition rule, to the application of these Section 162(m) amendments concerning covered employees and performance based and commission based pay: The old, more favorable Section 162(m) rules on deductibility continue to apply for remuneration provided pursuant to a “written binding contract” that was in effect on Nov. 2, 2017, without subsequent modification in any material respect.

OVERVIEW OF NOTICE 2018-68

Notice 2018-68 provides nicely thorough guidance on limited but key issues concerning the 2017 tax act changes to Section 162(m). Very little is left uncovered. Most of the guidance is a straightforward interpretation of the new statutory provisions, with the most notable exception being that the interpretation of amounts paid under a “written binding contract,” the transition rule which allows application of the pre-2017 tax act changes, is unexpectedly harsh. The Treasury Department and IRS anticipate that further guidance on the amendments made by the 2017 tax act will be issued in the form of proposed regulations which will also incorporate the guidance provided in the notice, hinting that proposed regulations may be even less favorable. The notice provides that reliance on the notice is permitted until proposed regulations are published.

The notice principally addresses the following:

- Who is a covered employee?
- What is a written binding contract?
- What is a renewal of a written binding contract?
- What is a material modification?

DEFINITION OF PUBLICLY HELD CORPORATION

The tax act amended the definition of “publicly held corporation” in Section 162(m)(2) to mean any corpo-

ration that is an issuer (as defined in Section 3 of the Exchange Act) (A) the securities of which are required to be registered under Section 12 of the Exchange Act, or (B) that is *required to file reports* under Section 15(d) of the Exchange Act. The notice does not provide any real additional guidance on this new definition. The flowchart above illustrates how this addition will affect those companies in the future.

DEFINITION OF COVERED EMPLOYEE

The first of the two draconian changes to Section 162(m) made by the 2017 tax act is the multi-faceted expansion of the definition of “covered employee” in Section 162(m)(3). Prior to amendment, and due to prior interpretation, covered employee encompassed only the principal executive officer or the three highest compensated officers for the taxable year (other than the chief executive officer) the compensation of which is required to be reported under the Exchange Act, and which were still employed as such at the end of the taxable year. The principal financial officer was not included. After the 2017 tax act, covered employee is defined as:

- the principal executive officer (PEO) of the taxpayer at any time during the taxable year, or an individual acting in such a capacity,
- the principal financial officer (PFO) of the taxpayer at any time during the taxable year, or an individual acting in such a capacity,
- an employee whose total compensation for the taxable year is required to be reported to shareholders under the Exchange Act by reason of such employee being among the three highest compensated officers for the taxable year (other than any individual described previously) and any employee *who would be included in such definition* if the reporting described in such subparagraph were required. The notice provides that the determination of the amount of compensation used to identify the three most highly compensated executive officers for purposes of Section 162(m)(3)(B) is made consistent with the Instructions to Item 402(a)(3) of Regulation S-K and the Instructions to Item 402(m)(2), or
- an employee who was a covered employee of the taxpayer (or any predecessor) for any preceding taxable year beginning after Dec. 31, 2016.

Additionally, amounts paid to a beneficiary or estate of a covered employee are treated as paid to a covered employee.

Reflected in the above list, Notice 2018-68 clarified the meaning of covered employee in the statute as amended to resolve several issues:

- identification of any of the definitions above is not dependent upon employment by the employee at the end of the year, and
- identification of any of the definitions above is not dependent upon whether the reporting was required under the Securities and Exchange Commission rules. The notice provides several reasons for supporting these two interpretations, but again, there was an element of surprise on behalf of some practitioners. With respect to the notice’s interpretation regarding employment on the last day, there is not much effect. It is only the IRS interpretation with respect to the judgment of the “three most highly paid” in the current year bearing in mind that the literal statutory language would

pick up an unlimited number of PEOs and PFOs in the current year in any regard, and any covered employees, including the three most highly paid from prior years, continue as covered employees for evermore. The fact that the covered employee is designated as such regardless of whether the reporting is required was also unexpected because some thought the flush language that provided the point applied only to Section 15(d) reporting companies and not those that did not have a reporting requirement for other reasons such as becoming delisted or a short year.

Unknowns include the interpretation of “predecessor” and taxable years that do not coincide with the fiscal year. Smaller reporting companies and emerging growth companies typically only have three named executive officers but the new Section 162(m) definition would require additional covered employees. Public companies now can have many “new” covered employees in one year, e.g. multiple PEOs and PFOs, as well as the “carry over” covered employees from prior years.

Notice 2018-68 provides three long, detailed examples, summarized here, to illustrate these new rules and lay to rest any uncertainty as to how the new statutory provisions work:

1. A public company, as now defined by the 2017 tax act, is not bound by the disclosure of the most highly compensated officers on its Form 10-K. Officers so disclosed may or may not be covered employees depending solely upon current or former status for years beginning after Dec. 31, 2016. For example, where Employee A served as the sole PEO of Corporation Z, Employees B and C both served as the PFO of Corporation Z at different times during the year, and Employees D, E, F, G, H, and I were, respectively, the first through sixth most highly compensated executive officers other than the PEO and PFO, all but Employees G, H, and I are covered employees, despite the fact that Employees D, E, and F, were not employed at the end of the year, despite the fact there were two PFOs during the year, and despite the fact that more highly compensated officers were reported on the Form 10-K. **See Example 1.** In addition, for purposes of identifying a covered employee, it is not relevant whether the SEC rules for smaller reporting companies or emerging growth companies apply, nor whether the specific officers’ compensation must be disclosed under the SEC rules. **See Example 2.**

2. Where a non-public company acquires all the stock of a public company and files a consolidated return creating a short taxable year for the public company, and the public company remains public for the first and second short taxable years, the PEO, PFO, and three most highly compensated employees for the short taxable year with the acquisition are covered employees for that year and for the subsequent short taxable year ending December 31. The fact that the officers’ compensation was not required to be disclosed in all these instances for the first short taxable year was not relevant in the identification of covered employees. Another officer which was PEO only during the second short calendar year is a covered employee for that year, but not the first taxable year. **See Example 3.**

TRANSITION: THE GRANDFATHER RULE

Definition of ‘written binding contract’

To cut to the chase, the most significant upset brought on by the notice is that it clearly articulated that to be grandfathered from the new 2017 tax act changes and thus potentially still deductible, not only does there need to be a “written binding contract,” but every dollar paid thereunder must also be analyzed to determine if it is contractually legally obligated to be paid. The result is that some or no amounts under a written binding contract may remain deductible under old law. The “excess” so determined is dependent upon the exact language of the contract, expectations of the parties, past practices, and applicable law.

Treasury and the IRS observe in the notice that the 2017 tax act grandfather rule is almost identical to the written binding contract rule of Feb. 17, 1993, that took effect with respect to prior Section 162(m) transition provisions. Thus the notice closely follows Treasury Regulation Section 1.162-27(h)(1) of the regulations relating to the grandfather rule but providing far more detail as well as the “excess rule” as noted.

The notice provides many examples on the grandfather rule application, but not on the definition of written binding contract. However, there definitely are indications in the notice that discretion can be fatal.

Notice 2018-68 concludes that remuneration is payable under a written binding contract that was in effect on Nov. 2, 2017, only to the extent that the corporation is obligated under applicable law (for example, state contract law) to pay the remuneration under such contract if the employee performs services or satisfies the applicable vesting conditions. Unfortunately, the guidance makes clear that any amount that *exceeds* such amount is not deductible under the old rules. In other words, if the contract itself is binding but only a minimal amount is not discretionary *and* enforceable under applicable law, then only the minimal amount is considered an amount paid under a written binding contract.

On a favorable note, as compared to the prior transitional rule regulations, the notice refers to “applicable law” rather than simply “state law” thus leading to the possibility of other law to render amounts paid as legally binding. This certainly means some challenging work for attorneys to hark back to law school days and decipher when an executive could legally enforce a payment under a contract.

On another favorable note, it is clear that the employee need not have been vested in the compensation for the grandfather rule to apply. For example, if restricted stock or restricted stock units were granted subject to a three-year cliff, non-discretionary vesting schedule based on services or performance, the amounts included in income by the employee pursuant to the grant would constitute a written binding contract and be grandfathered.

On a third favorable note, if a compensation plan or arrangement is binding, the amount that is required to be paid as of Nov. 2, 2017, will be grandfathered even though the employee was not eligible to participate in the plan or arrangement as of Nov. 2, 2017. However, the Act’s amendments to Section 162(m) will apply to

such compensation plan or arrangement unless the employee was either employed on Nov. 2, 2017, by the corporation that maintained the plan or arrangement, or the employee had the right to participate in the plan or arrangement under a written binding contract as of that date. This rule follows the example in the committee report that provided an illustration of an employee employed on Nov. 2, 2017, and who would eventually participate in a non-discretionary deferred compensation plan.

Public company accountants are currently attempting to determine what payments to covered employees under the new expanded definition are “more likely than not” grandfathered under a written binding contract and remain deductible.

Referring to guidance under the old similar transition rule, Chief Counsel Advice 199926030, discussed two plans and the awards issued thereunder sometime prior to Feb. 17, 1999, the prior written binding contract rule cut-off date. Although there was discretion to allow both upward and downward adjustment to the amounts paid under the plans, the units, awards, and bonuses, all amounts were determined to be paid under the written binding contract exception to the Section 162(m) deduction limitation and thus fully deductible. The IRS conclusion stated that the awards and grants were made prior to Feb. 17, 1999, but did not make the same statement with respect to the actual payment of the bonuses. The CCA noted that under New York law, in an “at will” employment situation, if an employer’s plan promises the employee compensation and the employee relied on the promise, the plan is binding on the corporation citing *DePetris v. Union Settlement Assn.* Although not entirely clear, it appears that this CCA stood for the proposition that if a written binding contract exists for some amounts, then all amounts even though discretionary, would be fully grandfathered. However, the notice would indicate that the CCA former position cannot be followed with respect to the current transition rule.

According to Black’s Law Dictionary, an enforceable contract is “an agreement between two or more parties creating obligations that are enforceable or otherwise recognizable at law. The four elements of a legally binding contract are: offer, acceptance, an intention to create a legal relationship, and consideration. In the typical public company employment context, any equity plan documents, omnibus plans, non-qualified deferred compensation, employment contracts and supplements thereto, that are in writing, would presumably meet the written binding contract requirement with respect to any amounts that were legally enforceable as of Nov. 2, 2017, as these elements would be met through the services of the employee and the payments thereunder as the consideration by the parties.

The real problem with the notice’s definition of written binding contract is the fact that the actual dollars ultimately paid must have been subject to the employee’s ability to enforce the payment. This raises the issue of how discretion retained by the employer to pay a lesser amount will affect the amount that is grandfathered. The contract language regarding discretion may range from affirmative complete negative discretion to negative discretion limited to a stated small percentage of the maximum that might be paid. The history of exercising or not exercising the discretion would be a factor

to consider coupled with applicable law, including state law.

For example, with respect to one extreme, if a shareholder-approved omnibus plan that enables the company to issue various types of incentive pay including cash and equity grants, clearly states that the company may issue nothing at all if it so chooses, and in fact does not issue any grants or has a sporadic history of issuing grants, it is clear that there is not a legally enforceable amount to be grandfathered. On the other hand, if a covered employee has an employment contract entitling the employee to performance-based bonuses in line with prior practices, and the employee received bonuses of three times base pay for the last several years, there is a solid position to state the amount is grandfathered, based on the implied doctrine of good faith and fair dealing.

Every contract includes an implied obligation of good faith performance. See *Perkins v. Standard Oil Co.* Many states apply the “covenants of good faith and fair dealing” in interpreting the terms of a contract or the amount which must be paid under a contract. So called “at will” employment appears to not be as protected, but that is a different issue than enforceability of the payment of compensation. Contract law is almost exclusively state common and statutory law, but the states tend to follow common principles and the best state cases and practices. There are numerous state cases which address the issue of good faith and fair dealing in the employment context.

Years ago, in *Wyss v. Inskeep*, a court held in favor of the plaintiff employee, based on the requirement to exercise good faith in allocating a bonus pool amongst employees where the employee had consistently received allocations for all prior bonus pools other than the last one. This court looked at past allocations, which were between 9 percent and 12 percent of the bonus pool and used that as a basis for its award. It is noteworthy that the plan under which the awards were made did not provide any minimum at all as an allocation to the plaintiff with the amounts allocated at the complete discretion of two shareholders.

By way of other relevant examples, in *Wilson v. Career Educ. Corp.*, the U.S. Court of Appeals for the Seventh Circuit held that the implied covenants and the reasonable expectations of the parties under Illinois law could limit the employer’s discretion even where the employer retained sole discretion to terminate or amend the plan for any reason that it determined. The court there referred to other cases and stated “The covenant of good faith and fair dealing requires only that discretion be exercised reasonably with proper motive rather than arbitrarily or capriciously or in a manner inconsistent with reasonable expectations. *McCleary v. Wells Fargo Sec., LLC; Resolution Trust Corp. v. Holtzman*” (citations omitted). The case was ultimately unfavorable to the plaintiff because he could not prove the termination of the bonus arrangement was not made in good faith. In Florida, the court observed that in every contract there is an implied covenant of good faith and fair dealing—this requires the parties to the contract to “follow standards of good faith and fair dealing designed to protect the parties’ reasonable contractual expectations.” *Centurion Air Cargo, Inc. v. United Parcel Serv. Co.*

In summary, although in reviewing the case addressing the doctrine of good faith and fair dealing, it is clear

that it does not mean that the employer must be a “nice guy” or act in the interest of the employee as if it were its’ own interest, were contractual language is at all ambiguous including the ability to exercise discretion, the doctrine requires interpretation in a manner that protects the parties’ reasonable contractual expectations.

Definition of ‘Renewal’

A written binding contract that is not renewed or extended, or is terminable or cancelable by the corporation *without the employee’s consent* after Nov. 2, 2017, is treated as renewed *as of the date* that any such termination or cancellation, if made, *would be effective* and is not grandfathered. This includes automatic renewals or extensions as of a certain date, so-called “evergreen contracts” unless either the corporation or the employee provides notice of termination of the contract at least 30 days before that date, and similarly with respect to terminations or cancellations, the contract is treated as renewed as of the date that termination would be effective if that notice was given (unless the contract is renewed before that date, in which case, it is treated as renewed on that earlier date).

There are three exceptions to the preceding renewal rules.

- If the employer remains legally obligated by the terms of the contract at the sole discretion of the employee, the contract remains grandfathered. This type of contract language is rare so not particularly useful.

- Secondly, if the contract may only be terminated dependent upon the employee no longer being employed, then the contract is not considered renewed and remains grandfathered. Like the first exception, this will not help in many cases as not the typical contract language.

- Finally, a contract is not treated as renewed if upon termination or cancelation of the contract the employment relationship continues but is no longer covered by the contract; in that instance amounts paid for the services performed after that date are not grandfathered but the payments for services prior pursuant to the former contract remain grandfathered.

The third exception, if it can be called that, addresses the most common situation and is why public companies will need to diligently track old contracts and continue all the administration surrounding the old performance-based pay requirements in some situations. By way of a simple example, performance-based cash awards granted to a covered employee as determined by both new and old law, for the 2019 performance period, provided under a written binding contract that extended through the end of 2019, would be grandfathered, but to also be deductible for 2019, the compensation committee would need to certify that the goals were met at the end of the performance period as well as any other old performance based pay requirements. On the other hand, if the employee in this instance separated from service prior to year-end and thus was no longer a covered employee under old law, performance-based pay requirements would not need to be met because all payments under the grandfathered written binding contract would have been deductible under the old law even without meeting the performance based-pay requirement.

A challenge with respect to renewed or terminated contracts wherein the renewal or termination date falls

other than neatly at the end of a service period for which compensation is provided, is to bifurcate the amounts under the old contract terms versus the new compensation arrangement. For example, a public company with a covered employee with a bonus period coinciding with a single calendar year with an evergreen contract renewing every June 1, would need to determine how much of the bonus related to the old contract. The same issue would occur if the bonus period covered three years.

Definition of Material Modification

The notice provides the rules for actions that will constitute a material modification and thus cause the amounts under the written binding contract to then be subject to the new rules eliminating the deductions. The occurrence of a material modification is worse than the renewal or terminations previously discussed because with the former, any amounts after the date of the material modification even if pursuant to the contract prior to the material modification, are no longer grandfathered but with the latter, amounts paid under the contract as it existed prior to the renewal continue to be grandfathered even indefinitely.

A material modification occurs only when the contract is amended to *increase the amount of compensation payable* to the employee. The amounts actually received by an employee under the contract before a material modification are not affected, but amounts received *subsequent* to the material modification are treated as paid pursuant to a new contract, rather than as paid pursuant to a written binding contract in effect on Nov. 2, 2017. Acceleration or deferral of amounts under the contract are “OK” as long as adjusted for the time value of money or adjusted based on a predetermined actual investment.

The adoption of a supplemental contract or agreement that provides for increased compensation, or the payment of additional compensation, is a material modification of a written binding contract if the facts and circumstances demonstrate that the additional compensation is paid on the basis of substantially the same elements or conditions as the compensation that is otherwise paid pursuant to the written binding contract. For this purpose, cost-of-living adjustments are ignored, as is the failure to exercise negative discretion under a contract.

Notice 2018-68 Grandfather Examples

The notice helpfully provides numerous examples of the above conclusions renewals or terminations of written binding contract, material modification, and how this can allow continued deduction which can be tricky because simply being an amount paid under a written binding contract is not enough. The examples do not address inherently what is a written binding contract, other than intimating discretion may cause the contract amount to not be binding.

1. A multi-year contract with automatic extensions unless notice is given 30 days prior to the three-year anniversary date is grandfathered but only for the three-year period. **See example 1.** A multi-year employment contract, e.g. five years, in place on Nov. 2, 2018, for a specified salary, *plus an annual increase equal to cost of living amounts* is grandfathered. When a cash

amount above a cost of living increase is also provided, the entire contract payments, even the original base pay is no longer grandfathered because the additional payment on “substantially the same terms” is a material modification. Favorably, where instead of a cash payment, restricted stock is provided, the base pay under the multi-year contract is preserved as deductible. **See examples 10 and 11.** Note that both the cost of living payments and the restricted stock remain non-deductible under the new rules.

2. A performance based plan that provides a maximum amount of compensation, e.g. \$2 million, but which under state law is only binding with respect to a minimum, e.g. \$400,000, only provides for deduction under the old rules of that minimum, e.g. only the \$400,000 remains deductible. **See example 3.** The example also concludes that the exercise of the negative discretion is not a material modification and therefore does not cause all payments to be subject to the new rules.

3. A deferred compensation plan that, as is typical, allows an employer to cease future accruals at any time only allows for deduction under the old rules of amounts actually accrued and credited to the employee’s account prior to Nov. 2, 2017. **See example 4 and 5.** The examples illustrate the grandfathering of an account balance plan, including the different effect of the crediting of earnings, as applied to an employee that was not a covered employee under the old rules.

4. Grants under an employment contract of stock options and stock appreciation rights (SARs) already made prior to Nov. 2, 2017, and which vest after that date which satisfy the old rules for performance based pay remain deductible, but grants made after Nov. 2, 2017, at the discretion of the employer do not. **See examples 7 and 8.** Note that the IRS basis its conclusion on the fact that the discretionary grants are not written binding contracts under applicable law leaving open the question of whether all state law treats discretionary grants as non-binding under all circumstances.

5. An employee employed on Nov. 2, 2017, promised a deferred compensation credit after such date should he remain employed, receives that amount as under a binding written contract even though participation did not occur in the plan until after Nov. 2, 2017. **See example 9.**

PRESERVING GRANDFATHER TREATMENT FOR WRITTEN BINDING CONTRACTS

Amounts paid under written binding contracts may be fully deductible despite 2017 tax act changes depending upon whether pre-2017 tax act changes would have exempted the amounts. To best be able to preserve the grandfather treatment, the public company would be well served to set up a process requiring it to:

- Exercise caution in making any material modifications or introducing any supplemental arrangements without input of counsel.

- Inventory and maintain a list of all covered employees beginning in 2017 by applying pre-2017 tax act law to determine covered employees for 2017 and post-2017 tax act law to determine covered employees after 2017 (e.g., include PFO).

- Inventory all compensation plans, policies, and agreements that were in existence as of Nov. 2, 2017,

and could be grandfathered, including employment agreements, equity award plans, agreements, and grants, non-qualified deferred compensation plans or SERPs, short-term incentive/annual bonus plans, offer letters, retention agreements, change in control plans and agreements, severance plans and agreements, compensation committee meeting minutes for the past few years, fringe benefits or special one-time bonus arrangements, e.g., relocation bonus or reimbursement.

- List employees in each identified arrangement above that were or could potentially become covered employees.

- Review each existing plan and agreement for:

- enforceability,

- fixed promises,

- discretion,

- expiration, automatic renewal, or termination, other than solely by employee, and

- any amendments or supplements

- Review past practices such as size of grants or bonuses, and actual exercise of discretion.

OTHER STRATEGIES TO OBTAIN A DEDUCTION

Carefully documenting the status of employees as covered employees under new law, as well as covered employees under old law, and whether amounts exist under a Nov. 2, 2017, written binding contract as described above, is the first strategy for preserving deductibility. Others include:

- Not over-including individuals as “officers” and thus potentially covered employees where the individual does not truly fit the definition, e.g., does not have policy making responsibilities even though very highly compensated.

- Exploring all kinds of deferred compensation strategies. To describe a few, Section 409A has some forgiveness for deferring amounts that were believed to be deductible under Section 162(m) even if under normal circumstances it is “too late” to defer the amounts. More importantly, for new accruals of bonuses, amounts can be prospectively deferred until after separation from service and to the extent the annual amounts paid by the company are “only” \$1 million or less, such amounts will be fully deductible.

- Explore alternative types of payments that previously and now remain exempt from Section 162(m) limits. For example, payments made by a partnership as employee wage payments in recognition of services provided by the employee that benefit the partnership. Even more interesting is to grant an actual partnership profits interest to the employee that would both allow an exclusion of that income from taxation to the public company to the extent it had income from that interest, and may under the right circumstances allow for a 20 percent deduction to the recipient employee under the new favorable provisions of Section 199A applicable to pass-throughs.

- Increase benefits under qualified plans such as qualified defined benefits.

In addition, while not a method to maximize deductions, providing incentive stock options provides the employee very favorable tax treatment, e.g., potential capital gain and deferral, and the fact that for that kind of arrangement there is an inherent denial of some de-

duction to the employer is not relevant as there would be no deduction in any regard due to Section 162(m). In other words, nothing to lose and only a gain of favorable tax treatment to the employee.

CONCLUSION

The notice is considerably more restrictive than had been hoped with respect to the grandfather rule and more expansive with respect to the definition of covered employee. The notice explains that the proposed regulations will follow the notice for years ending after Sept. 10, 2018, although any rules that are even harsher

with respect to the definition of covered employee or written binding contract will apply prospectively only. Because the guidance is expected to be effective for tax years ending after Sept. 10, 2018, affected employers are well advised to establish systems to document the status of executives as covered employees as well as the status of any and all written documents as providing for compensation grandfathered from the new more restrictive deduction rules as clarified in the IRS guidance. Furthermore, the unfavorable aspects of the guidance may provide a wake-up call to explore other opportunities for providing more tax favored compensation to executives.