WINSTON & STRAWN LLP

CLIENT ALERT

IRS Issues Key Guidance on Amended Code Section 162(m)

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On August 21, 2018, the Internal Revenue Service (IRS) released Notice 2018-68 (the Notice) containing much-anticipated guidance on the changes made to the deductibility of executive compensation under Section 162(m) of the Internal Revenue Code (Section 162(m)) by the 2017 Tax Cut and Jobs Act (the Tax Act).

The Notice clarifies two key points in particular: (1) the determination of Section 162(m) "covered employees," and (2) the transition rule for legally binding contracts in effect as of November 2, 2017, including what may constitute a "material modification" thereof. Each of these points is discussed in greater detail below.

DETERMINATION OF COVERED EMPLOYEES

Section 162(m) disallows deductions for applicable employee remuneration in excess of $1 million for the taxable year paid by a publicly held corporation to any covered employee. The Tax Act expanded the definition of "covered employee" to include a company's chief executive officer (CEO), chief financial officer (CFO), and the three other mostly highly compensated executive officers (other than the CEO and CFO). This expansion appeared to align the definition of "covered employee" with the Securities and Exchange Commission's (SEC) definition of "named executive officer" under the executive compensation disclosure rules.

The Notice clarifies two aspects of the "covered employee" determination:

- **No End-of-Year Employment Requirement.** The IRS clarifies that there is no requirement that an employee must have served as an executive officer at the end of the taxable year to be considered a "covered employee." If an employee (other than the CEO or CFO) is among the three most highly compensated executive officers for the taxable year, the employee will be a covered employee regardless of whether he or she is serving in such position at the end of the taxable year.
- **Potential Divergence from SEC Reporting Requirements.** The Notice indicates that executive officers of publicly held corporations can be covered employees even when disclosure of their compensation is not required under SEC executive compensation reporting rules. For example, the executive officers of a corporation whose securities are delisted or that undergoes a transaction resulting in the non-application of the proxy statement filing requirement, and which may not be required to disclose executive officer compensation for that year, will not

be exempt from being “covered employees.” The Notice also suggests that executive officers of smaller reporting companies and emerging growth companies may be considered covered employees notwithstanding that their compensation may not be required to be reported in proxy statements.

Winston Takeaway

The “covered employee” determination has become even more complex. Public companies must now carefully track any and all covered employees and those employees (and former employees) who may be determined to be covered employees at the end of the year, even if their employment terminates midyear, maintain a clear historical record, and retain that information until all payments of applicable remuneration have been made to the employee and his or her beneficiaries post-termination. In addition, companies should not assume that their “named executive officers” for SEC executive compensation disclosure purposes will entirely align with their Section 162(m) “covered employees.”

WRITTEN BINDING CONTRACTS AND MATERIAL MODIFICATIONS

As noted above, the transition rule provides that applicable employee remuneration paid to covered employees under a written binding contract in effect on November 2, 2017, and that is not modified in any material respect on or after such date, may continue to qualify for deductibility under the pre-Tax Act Section 162(m) rules.

The Notice specifies some of the items that a company must consider in evaluating whether an agreement constitutes a “written binding contract” for this purpose, including:

- **Enforceability Under Applicable Law.** A contract must obligate the corporation under applicable law (e.g., state contract law) to pay compensation if the employee performs the requisite services and otherwise satisfies the conditions set forth in the agreement, such that the employee can seek to enforce the payment obligation. Importantly, the Notice does not limit “applicable law” for this purpose solely to state law. In addition, the obligation will be considered binding solely to the extent of the amount stated in the contract. Any payment in excess of the legally obligatory amount (other than due to the application of a reasonable interest rate or investment returns) may not be grandfathered.
- **Impact of Discretion.** Many pre-Tax Act arrangements provide significant discretion for public companies to adjust executive compensation downward, including reducing compensation to zero, in light of changing circumstances, even where performance and service requirements were met. To the extent that compensation is subject to employer discretion, the transition rule is far less likely to apply unless the payment of such amounts is legally enforceable under applicable law.
- **Renewed Contracts Not Grandfathered.** Written binding contracts that are renewed on or after November 2, 2017 fall outside of the scope of the transition rule. For example, an employment agreement with an auto-renewal provision (e.g., the term of the agreement will automatically renew for an additional one-year period unless either party provides advance notice of non-renewal) will be treated as renewed, and no longer grandfathered, as of the date that termination would be effective if notice had been given.

The Notice goes on to describe certain types of modifications to written binding contracts that will result in the loss of grandfathered status:

- **Increased Compensation; Change in Time or Form of Payment.** A material modification is one that increases the amount of compensation payable to the employee. This includes the acceleration or deferral of payment, without a commensurate adjustment to the value of the payment to account for the economic impact of acceleration or deferral. Additional compensation paid due to the application of a reasonable interest rate or investment returns is not considered a material modification.

- **Timing of Modification.** A material modification causes the agreement to be treated as a new contract as of the date of the modification. Remuneration paid pursuant to the contract's terms prior to the modification would remain subject to the pre-Tax Act Section 162(m) rules, but remuneration paid after the date of the modification would not be grandfathered.
- **Supplemental Contract.** A supplemental contract that provides for increased or additional compensation (other than a reasonable cost-of-living adjustment) is a material modification if 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.
- **Failure to Exercise Discretion.** The Notice specifically provides that if a written binding contract provides the employer with the right to exercise discretion to reduce the amount of remuneration paid, the failure to exercise such discretion is not a material modification. However, as previously discussed, a discretionary amount, unless legally enforceable under applicable law, is not an amount paid under a written binding contract in any event. For example, if a contract provides for a maximum payment of $2,000,000 in remuneration, but a legally binding minimum payment of only $400,000, the failure by the employer to exercise complete negative discretion when it pays the employee $500,000 would not result in a material modification. The legally binding $400,000 payment would be grandfathered. The additional $100,000 would not be paid under a written binding contract, but is not a material modification to the contract, and does not affect the future deductibility of payments under the contract.

Winston Takeaway

The legal determination of whether an arrangement is a "written binding contract" in effect on November 2, 2017, and whether a subsequent modification of that arrangement is material, is critical to preserving the deduction for compensation payable thereunder pursuant to the Section 162(m) grandfather rule. Companies are encouraged to seek assistance from their counsel in undertaking a broad audit and analysis of all executive compensation arrangements currently in effect to ascertain whether those arrangements may be considered legally enforceable under any applicable laws for purposes of the Section 162(m) transition rules.

5 Min Read

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