Publications

IRS Clarifies Grandfather Rule and Other Code Section 162(m) Issues

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On August 21, 2018, the Internal Revenue Service ("IRS") issued Notice 2018-68 (the "Notice"), clarifying certain questions raised last year when Public Law 115-97 (the "Act") made changes to Section 162(m) of the Internal Revenue Code (the "Code"), including the grandfather rule, what constitutes a material modification, and certain aspects of who is a covered employee. This article focuses on the changes in the Notice. For more information on the Act, please refer to our January 12, 2018 article at https://www.groom.com/resources/tax-reform-series-iii-executive-compensation-provisions/.

Background

Code Section 162(m) restricts publicly held corporations' ability to take an income tax deduction for compensation paid to its "covered employees" in excess of $1 million.

Generally, the changes to Code Section 162(m) by the Act are applicable for tax years beginning after December 31, 2017. However, the Act provides a "grandfather rule" with respect to compensation provided under a written binding contract which was in effect on November 2, 2017, and which is not materially modified on or after such date. Such compensation would be subject to the Code Section 162(m) rules prior to the enactment of the Act (including the performance-based compensation exception). Thus, in certain cases, compensation that would otherwise become nondeductible under the new Code Section 162(m) rules may remain deductible if it meets the grandfather rule.

Application of Grandfather Rule

The Notice provides long-awaited guidance that addresses key questions regarding the scope of the grandfather rule:

- *What is a "written binding contract"?* The Notice clarifies that for purposes of the grandfather rule, compensation is considered payable under a "written binding contract" in effect on November 2, 2017 only if the employer is obligated under applicable law (e.g., state contract law) to pay compensation under the contract if the employee performs services or satisfies applicable vesting conditions.

- *What is the impact of "negative discretion"?* The Notice indicates that compensation will not be considered payable under a written binding contract if the employer is not obligated to pay it under applicable law. Thus, it appears that plans that provide the employer with discretion to reduce or eliminate an employee's compensation (i.e., negative discretion) will fail to satisfy the "written binding contract" standard to the extent the compensation can be reduced or eliminated.

This guidance is unfortunate for the many employers that included such "negative discretion" provisions in their incentive plans for top executives, many of which were designed to meet the performance-based compensation exception under the prior Code Section 162(m) rules. As a result, outstanding amounts as of November 2, 2017 subject to negative discretion will likely not be able to rely on the performance-based compensation exception to the $1 million deduction limit.

- *What if a written binding contract is renewed after November 2, 2017?* The Notice provides that a written binding contract is not grandfathered if it is renewed after November 2, 2017. The Notice adopts a broad interpretation of "renewal," and provides that if the employer can terminate the contract without the employee's consent after November 2, 2017, the contract is considered "renewed" as of the date such termination, if made, would be effective.

For example, if a deferred compensation plan (such as a SERP) provides an employer with discretion to cease future benefit accruals, benefits accrued under the plan after November 2, 2017 likely will not be grandfathered. Because deferred compensation plan records are typically maintained on a calendar year or fiscal year basis, differentiating between grandfathered and non-grandfathered amounts in 2017 may prove challenging to plan record keepers.

- *What is a "material modification"?* A written binding contract that is "materially modified" after November 2, 2017 is treated as a new contract entered into on the date of material modification, and compensation paid under the contract thereafter is not grandfathered. The Notice clarifies that a "material modification" occurs if the contract is amended to increase the amount of compensation payable thereunder.

This guidance suggests that employers may amend a plan's administrative provisions without jeopardizing the plan's grandfather status. However, employers should nevertheless carefully consider any amendment to a grandfathered plan to ensure that the change does not indirectly result in a material modification.

- *Are payment accelerations or payment deferrals material modifications?* The Notice provides that an acceleration of the payment timing of an amount is a material modification unless the amount is discounted to reasonably reflect the time value of money. Also, a deferral of an amount is not considered a material modification, so long as earnings on the deferred amount are based on either a reasonable rate of interest or a predetermined actual investment subject to gains and losses.
- *What about new compensation arrangements?* The Notice indicates that a supplemental contract or agreement that provides for additional or increased compensation is a material modification to a written binding contract if the additional compensation is "paid on the basis of substantially the same elements or conditions" as the compensation under the written binding contract. However, a supplemental payment that does not exceed a reasonable cost-of-living increase over the preceding year's payment is not considered a material modification.

Whether two amounts are paid on the basis of substantially the same elements or conditions is ultimately a facts and circumstances determination. However, the Notice suggests that the form of payment is relevant to the analysis. In particular, one example provided in the Notice suggests that an executive's employment agreement would be considered materially modified if an executive received a substantial increase in his base salary, but not if the executive received a comparable amount in the form of restricted stock.

Definition of Covered Employee

While the Notice is most significant for its detailed guidance on the application of the grandfather rule, it also provides important clarifications on determining who is a "covered employee" under the new Code Section 162(m) rules:

- *No "end-of-year" requirement*. The Notice clarifies that under the new Code Section 162(m) rules, an employee is a covered employee even if he or she is not serving as an executive officer at the end of the taxable year. For example, an employee who served as CEO for part of the year would be considered a covered employee under the new rules, even if he or she is not serving in that position at the end of the taxable year.

- *Disclosure under SEC rules not required*. The Notice also clarifies that an employee can be a covered employee even if his or her compensation is not required to be reported under Securities and Exchange Commission rules. For example, if an employer does not have to file a proxy statement for a taxable year because it delists its securities, employees of the employer who otherwise meet the definition of "covered employee" remain covered employees under the new Code Section 162(m) rules.
- *List of covered employees*. Remember, under the Act, once an individual is a covered employee, he or she is always a covered employee and subject to the $1 million deduction limitation. As a result, companies will need to keep an ongoing list of covered employees.

Next Steps

While the IRS has indicated that additional guidance on the new rules will be forthcoming, the Notice provides some much needed clarity on the new Code Section 162(m) rules, particularly with respect to application of the grandfather rule for written binding contracts. Any future guidance that addresses the issues covered in the Notice that would broaden the definition of "covered employee" or restrict the definition of "written binding contract" will apply only prospectively. Employers who are relying on the grandfather rule should carefully review their compensation arrangements in light of this new guidance. In addition, employers who have been waiting to see guidance on these issues before making changes to their compensation offerings may now consider moving forward. Please contact any of the attorneys listed here or your regular Groom Law Group attorney for further information or to discuss next steps.

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