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Considerations and Challenges Under New IRS Guidance on Section 162(m)

On August 21, the IRS issued Notice 2018-68, Guidance on the Application of Section 162(m) ("Notice"). Internal Revenue Code ("Code") Section 162(m) places a limitation on the amount publicly traded companies are permitted to deduct for compensation paid to "covered employees." The Tax Cuts and Jobs Act, effective as of December 2017 ("TCJA"), amended Section 162(m), by, among other things, broadening the definition of "covered employee," expanding the universe of entities subject to the deductibility limitation, and repealing the "performance-based compensation exemption."

Katten discussed the key changes to Section 162(m) and noted potential issues associated under the new rules in a prior advisory, "Issues for Compensation Committees to Consider When Grappling With Changes to 162(m) and the Death of the Performance-Based Compensation Exemption." This advisory highlights certain considerations and challenges presented under the Notice, including with respect to identifying covered employees, grandfathering requirements and issues related to corporate transactions. The IRS also indicated that it would be issuing further guidance on the new Section 162(m) rules.

Covered Employees

Section 162(m) generally limits the amount a publicly held corporation can deduct for compensation paid to "covered employees" to $1 million. Under the new Section 162(m) rules, the term "covered employee" includes any employee of the company:

- who is the principal executive officer or principal financial officer at any time during the tax year;
- any employee who is one of the top three highest compensated officers for the tax year; or
- any employee who was a covered employee for any preceding taxable year beginning after December 31, 2016.

The Notice clarifies that, under the new Section 162(m) rules, if an individual is a covered employee at any time during the tax year, rather than at the end of the year, Section 162(m) limits the deduction an employer may take for compensation paid to the covered employee. Further, the limitation applies regardless of whether disclosure is required under Item 402 of Regulation S-K, the SEC's rules regarding executive compensation disclosure, (the "Disclosure Rules") or the corporation has a short tax year. The Notice contains the following illustrative example:

> If during the 2018 tax year, Employee A served as the Company's CEO, Employee B and Employee C both served as the CFO (at different times during the tax year), and Employees D, E, and F were the three highest

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> compensated employees (other than the CEO and CFO), all would be covered employees for the 2018 tax year for purposes of Section 162(m). If Employees D, E, and F were to retire prior to the end of 2018 and Employees G, H, and I were the corporation's fourth, fifth, and sixth highest compensated employees, D, E, and F would still each be considered covered employees for Section 162(m) purposes, even if G, H, and I were subject to the Disclosure Rules. Note that G, H and I would not be treated as covered employees for the 2018 tax year under this example.

The Notice also clarifies that the covered employees of smaller reporting companies and emerging growth companies are not limited by the Disclosure Rules, which generally limit compensation disclosure to the CEO and the two most highly compensated executive officers other than the CEO who were serving in such roles at the end of the last completed fiscal year. Thus, although the TCJA provided new rules for identifying "covered employees," the Notice clarifies the importance of determining the covered employees during a particular tax year, regardless of whether the compensation for such individuals is required to be disclosed under the Disclosure Rules.

Additionally, in reversing prior IRS guidance, the Notice clarifies that, in the context of a corporate transaction, employees of the target company will be covered employees for the short tax year (i.e., the date of the transaction), even though their compensation is not required to be reported under the Disclosure Rules for the year in which the transaction occurs. Determining the three most highly compensated employees of the target corporation in this context may be more difficult due to the fact that the tax year ends on a different date (i.e., the date the transaction closes) than the previously completed fiscal year. The IRS has deferred guidance on this issue, requiring the parties to the transaction to make a good faith determination when identifying the target company's three most highly compensated individuals.

Another identified complexity in a merger or stock acquisition is that the covered employees of the acquired or merged corporation will need to be tracked by the surviving company, as amounts paid to such covered employees will still be subject to the 162(m) deductibility limitation at the surviving company. Acquirers should be highlighting this in their due diligence process.

Grandfather Rule

The TCJA includes certain grandfather rules for written binding contracts in effect on November 2, 2017, as long as no material modifications have been made to such contracts. The terms "binding contract" and "material modification" have significant consequences for purposes of this grandfathering rule.

Written Binding Contract

The Notice provides that remuneration is payable under a written binding contract that was in effect on November 2, 2017, only to the extent that the corporation is obligated under applicable state law to pay the remuneration under such contract if the employee satisfies his or her obligations under the agreement.

Importantly, the Notice requires the company determine whether state contract law would treat a performance-based award that was granted prior to November 2, 2017 (but provided the company with discretion to reduce the award payout, even if the performance goals were satisfied (i.e., negative discretion)) as grandfathered under the old Section 162(m) performance-based compensation rules (and otherwise exempt from the $1 million deduction limitation under Section 162(m)). Prior the Notice, the IRS received comments requesting bright line rules or grandfathering for awards that contained negative discretion. Unfortunately, the IRS did not provide any bright line rules or explicit extension of grandfathering treatment to performance-based awards that permit negative discretion. The Notice, however, provides the following example:

> **(i) Facts.** Employee P serves as the PEO of Corporation U for the 2017 and 2018 taxable years. On February 1, 2017, Corporation U establishes a bonus plan, under which Employee P will receive a cash bonus of $1,500,000 if a specified performance goal is satisfied; the outcome of the performance goal is uncertain on February 1, 2017. The compensation committee retains the right, if the performance goal is met, to reduce the bonus payment to no less than $400,000 if, in its judgment, other subjective factors warrant a reduction. On November 2, 2017, *under applicable law, which takes into account the employer's ability to exercise negative discretion*, the bonus plan established

on February 1, 2017 constitutes a written binding contract to pay $400,000. On March 1, 2018, the compensation committee certifies that the performance goal was satisfied. However, the compensation committee reduces the award to $500,000 due to the sale of certain corporate assets that resulted in the lowering of the fair market value of Corporation U's goodwill. On April 1, 2018, Corporation U pays $500,000 to Employee P. The payment satisfies the requirements of §1.162-27(e) as qualified performance-based compensation.

(ii) Conclusion. Employee P is a covered employee for Corporation U's 2018 taxable year. Prior to the Act's amendment to section 162(m)(4), section 162(m) did not apply to qualified performance-based compensation because such compensation was excluded from the definition of applicable employee remuneration. Thus, the $500,000 payment constitutes applicable employee remuneration solely as a result of the amendment to section 162(m)(4). Because, *under applicable law*, as of November 2, 2017, the bonus plan established on February 1, 2017, constitutes a written binding contract to pay $400,000, the Act's amendments to section 162(m) do not apply to $400,000 of the $500,000 payment to Employee P. Furthermore, the failure of the compensation committee to exercise negative discretion to reduce the award to $400,000, instead of $500,000, does not result in a material modification of the contract. Accordingly, the $400,000 is not subject to the deduction limitation under section 162(m). The remaining $100,000 of the $500,000 payment is subject to the deduction limitation under section 162(m) regardless of whether the payment satisfies the requirements of §1.162-27(e) as qualified performance-based compensation. (emphasis added)

Although this example calls into question the ability to grandfather awards as written binding contracts when the company retains discretion to reduce the award, companies and compensation committees should analyze state contract law with their counsel to determine whether, notwithstanding the presence of negative discretion, a court in the applicable jurisdiction would consider the award as a binding written contract between the employee and company that allows for grandfathering.

Material Modifications

As noted above, to retain grandfathered status for a written binding contract that was in effect on or before November 2, 2017, the contract must not be materially modified after such date. The Notice provides that material modifications include:

- amendments that increase the amount of compensation payable under the contract's terms (excluding reasonable cost-of-living increases);
- amendments that accelerate the payment of compensation, unless the accelerated amount is discounted to reasonably reflect the time value of money;
- adoption of supplemental contracts that provide for payments of increased or additional compensation if the payments are based on substantially the same elements or conditions as the original agreement; and
- amendments that defer compensation if any amount paid exceeds the original amount payable to the covered employee, unless the additional amount is based on either a reasonable interest rate or a predetermined actual investment.

Contracts renewed after November 2, 2017 will be subject to the post-TCJA Section 162(m) rules. Additionally, contracts with evergreen provisions will be treated as renewed as of the date that a termination otherwise would be effective had a notice to terminate been given. The Notice also clarifies that a failure, in whole or in part, to exercise negative discretion under a contract does not result in a material modification of that contract.

Importantly, if a written contract is materially modified, it is treated as a new contract entered into as of the date of the material modification and any amounts received by the employee before the material modification are not affected (i.e., remain grandfathered), but amounts received after the material modification are no longer grandfathered.

Request for Comments

The US Treasury Department has requested comments on the application of the definition of "publicly held corporation" to foreign private issuers, including reference to issuers that are required to file reports under Section 15(d) of the Securities Exchange Act of 1934; the application of the definition of "covered employee" to an employee who was a covered employee of a

predecessor of the publicly held corporation; the application of Section 162(m) to corporations immediately after they become publicly held either through an IPO or a similar business transaction; and the application of the Disclosure Rules for determining the three most highly compensated executive officers for a taxable year that does not end on the same date as the last completed fiscal year. Comments will be accepted through November 9.

Action Items

The Notice provides additional considerations for companies designing awards under the new Section 162(m) rules or analyzing existing arrangements under the grandfathered rule guidance. Items to consider include:

- carefully review compensation arrangements if planning to rely on the grandfather rule and whether any changes will result in a material modification;
- determine who are "covered employees" and maintain a database to keep track of all covered employees for tax years beginning after December 31, 2016, especially in connection with corporate transactions;
- consider consulting legal counsel to determine whether compensation arrangements should be amended and the impact of such amendments;
- consider revisions to equity plans and other arrangements with the repeal of the performance-based compensation exemption; and
- review employment agreements and other compensation arrangements with covered employees and consider Section 162(m)'s impact on compensation arrangements.

Katten will continue to monitor developments regarding Section 162(m) and provide updates as they occur.

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