Client Alert

IRS Issues Guidance on Application of Code Section 162(m) with Grandfathering Rules

Recently, the IRS issued Notice 2018-68, providing guidance under Section 162(m) of the Internal Revenue Code, as amended by the 2017 Tax Cuts and Jobs Act (the "2017 Act"). Section 162(m) disallows the deduction of compensation paid by public companies to covered employees to the extent such amounts exceed $1 million per year. The 2017 Act changed the definition of covered employees, expanded the entities subject to Section 162(m), and eliminated the exception for commission and performance based compensation. Application of the new rules commences in 2018, except that compensation paid pursuant to a binding written contract that was in effect on November 2, 2017, is grandfathered as long as such contract is not material modified after that date.

Old Rule	New Rule
Applies only to Publicly Traded Companies	Applies to any company with reporting requirements to the SEC
A covered employee is any individual serving as CEO or in a similar capacity AND any individual whose compensation was required to be reported in the company Proxy Statement, with the exception of the CFO	A covered employee is any individual serving as CEO or in a similar capacity, any individual serving as CFO or in a similar capacity AND the next 3 highest compensated executive officers (other than CEO and CFO)
A covered employee is only a covered employee if he/she was a covered employee on the last day of that tax year	Once a covered employee, always a covered employee, even in retirement or death
Commissions and performance based compensation is excluded from $1,000,000 cap	All compensation is subject to $1,000,000 cap

Changes to a Covered Employee

A covered employee is defined as including any employee who is (or is acting as) the principal executive officer (PEO) or principal financial officer (PFO) of the publicly held corporation at any time during the tax year. In addition, a covered employee includes any employee among the three highest-compensated officers for the tax year (other than the PEO or PFO) as computed under the Securities Exchange Act of 1934, even if his or her compensation is not required to be reported. The Notice specifically provides that a covered employee does not need to have qualified as such at the end of the tax year as long as he or she met the definition at any time during the tax year. The Notice also specifies that once an employee is considered a covered employee in any year beginning after December 31, 2017 he or she will always be a covered employee, regardless of employment status.

Binding Contract

The grandfather rule will only continue to exempt compensation if it is paid pursuant to a binding written contract that was in effect on November 2, 2017. Amounts will be grandfathered only if the employer is obligated under applicable law to pay such amounts if all applicable performance criteria and vesting conditions are met. If an award is subject to negative discretion, because the employer has the right to adjust the payment downward, the Notice provides that it will not be considered to be a binding right to the extent of such negative discretion. Thus, for example, if a contract provides that an award which is dictated by specified performance criteria is subject to a 20% downward adjustment at the discretion of a company's compensation committee, only 80% of the amount produced by the performance formula will be grandfathered. However, failure to exercise negative discretion will not be considered a material modification so that if the employer pays the full 100% produced by the award formula, 80% will still be grandfathered and the other 20% will be counted against the compensation limitation. Also, if the employer may cancel or terminate a binding written contract without the employee's consent, that contract is treated as renewed as of the date that any such cancellation or termination, if made, would be effective.

Material Modification

The Notice clarifies that a "material modification" will be deemed to occur only if a contract is amended to increase the amount of compensation paid to the employee. If a modification accelerates the timing of payment, it will be considered material unless the payment is discounted to reasonably reflect the time value of money. If the award is modified to defer payment, it will not be considered material unless the amount payable is increased by more than a reasonable rate of interest or crediting based on a predetermined actual investment. The adoption of a supplemental contract or agreement that provides increased compensation may also be considered a material modification of an existing right of facts and circumstance suggest that it is based on the same elements or conditions as the original award such that it constitutes a de facto increase in the original award.

Conclusion

Though the Tax Cuts and Jobs Act was passed at the end of 2017 and included new 162(m) provisions at that time, guidance from the IRS on how it will be administered is only now coming into focus. Several factors, including the position of the employee, whether compensation is performance based, and when the distribution occurs will determine whether or not compensation is deductible.

In the coming weeks, stay tuned for part two of this notice from Mullin Barens Sanford Financial. Part two will outline further the steps your company can take to understand potential grandfathering of executive deferred compensation.

Information provided by:

Marla Aspinwall, Partner
Loeb & Loeb, LLP

Kristin L. Barens, Principal
Mullin Barens Sanford Financial