

IRS Guidance Clarifies Some TCJA Changes to the \$1 Million Deduction Limit for Executive Compensation under Code Section 162(m)

Section 162(m) of the Internal Revenue Code of 1986, as amended (the “Code”), limits a publicly held corporation’s ability to take a corporate income tax deduction for compensation in excess of \$1 million paid to “covered employees.” Section 13601 of the Tax Cuts and Jobs Act, P.L. 115-97 (“TCJA”), made a number of changes to Code section 162(m) for tax years beginning after December 31, 2017. These changes revised the definitions of “publicly held corporation,”¹ “covered employee,” and “applicable employee remuneration,”² and provided a grandfather rule pursuant to which the TCJA amendments to Code section 162(m) do not apply to remuneration payable under a written binding contract in effect on November 2, 2017, that is not thereafter materially modified.

On August 21, 2018, the IRS released Notice 2018-68, IRB 2018-36 (September 10, 2018)³ (the “Notice”), which provides some clarifying guidance for identifying covered employees under the amended definition and explaining the operation of the grandfather rule. This guidance is summarized below. This guidance applies to any taxable year ending on or after September 10, 2018.

We note that this guidance is relevant even to publicly held corporations that historically have not been concerned about paying non-deductible compensation in excess of the \$1 million limitation. Without properly identifying the covered employees to whom the deduction limitation applies, a corporation cannot identify the employees to whom the deduction limitation does not apply and for whom compensation in excess of the \$1 million is deductible. This is even more relevant now given the recent tax law changes that have expanded the list of covered employees and removed the commission and performance-based compensation exceptions for compensation subject to the \$1 million deduction limitation.

Clarifications on Definition of Covered Employee

A “covered employee” is one of the employees whose compensation may be nondeductible by the corporation under Code section 162(m). As amended by section 13601(b) of the TCJA, the term “covered employee” now includes, for any taxable year, the publicly held corporation’s principal executive officer (“PEO”), the principal financial officer (“PFO”), or any individual who had acted in the capacity as the PEO or PFO, and the three highest compensated officers (other than the PEO or PFO). The Notice provides the following clarifications on determining who is a “covered employee”:

- **No “End-of-Year” Requirement.** The Notice states that the determination of who is a covered employee is made regardless of whether the executive officer is serving at the end of the publicly held corporation’s tax year. For example, if an employee served as PFO of a calendar tax year corporation only until June, that employee nevertheless must be considered a covered employee for purposes of Code section 162(m). Thus, a corporation could have more than one PEO or PFO as a covered employee in any year.
- **No Disclosure under SEC Rules Required.** The Notice states that executive officers of publicly held corporations can be covered employees for a taxable year regardless of whether disclosure of their

compensation is required under the Securities and Exchange Commission (“SEC”) rules.

- **Covered Employees from Prior Years.** Under the TCJA amendment, any individual who was identified as a covered employee for any tax year after December 31, 2016, remains a covered employee for all future years, even if that person no longer is employed by the corporation (or any predecessor). The Notice clarifies that covered employees identified for the tax year beginning during 2017 (in accordance with the pre-amendment rules for identifying covered employees) will continue to be covered employees for the tax year beginning in 2018 and beyond.

Clarifications on Application of the Grandfather Rule under Code Section 162(m)

Under the grandfather rule, the TCJA amendments to Code section 162(m) do not apply to remuneration payable under a written binding contract that is in effect on November 2, 2017, and that is not thereafter materially modified. The Notice provides clarifications on what is (i) a written binding contract and (ii) a material modification.

- **Written Binding Contract.** For purposes of the grandfather rule, the Notice clarifies that remuneration is considered payable under a “written binding contract” in effect on November 2, 2017, only if the corporation is obligated under applicable law (e.g., state contract law) to pay the remuneration under the contract if the employee performs services or satisfies applicable vesting conditions. “Written binding contracts” can include not only employment agreements but also equity grants (such as stock options, stock appreciation rights, and restricted stock awards) and compensation arrangements such as bonus plans, subject to the limitations and requirements discussed below. **Brownstein Comment:** To determine whether a contract is binding, corporations will need to look beyond federal law to state law. This conceivably could cause different conclusions about whether a contract is a written binding “contract” depending on which state law applies; for example, in the case of contracts that have identical provisions other than with regard to what state law governs the contract.

Remuneration Exceeding the Binding Contract Amount. The Notice provides that the grandfather rule does not apply (and thus Code section 162(m) does apply) to remuneration in excess of the remuneration that applicable law obligates the corporation to pay if the employee performs the services or satisfies applicable vesting conditions, even under a written binding contract in effect on November 2, 2017. **Brownstein Comment:** Under this rule, it appears that a contract with “negative discretion” provisions cannot be grandfathered to the extent that the negative discretion applies because the contract does not legally obligate the corporation to make any payment to the extent that the negative discretion applies. Many existing contracts utilized “negative discretion” provisions as a way to meet the performance-based exception under Code section 162(m) as in effect before amendment by the TCJA. The result is that these contracts, which previously had been excluded from Code section 162(m) before the TCJA, would now be subject to Code section 162(m) to the extent the negative discretion is applicable. For example, if negative discretion could be applied to reduce a bonus, but not below \$50,000, then the contract is only grandfathered up to the \$50,000, and any amount paid in excess of \$50,000 would be subject to Code section 162(m) as amended by the TCJA.

Contract Renewals. The grandfather rule does not apply to any written binding contract that is renewed after November 2, 2017. The Notice explains when a contract is considered to be renewed and provides examples.

- *Corporation's unilateral right to terminate.* A written binding contract, which is unilaterally terminable or cancellable after November 2, 2017, by the corporation without the employee's consent, is treated as renewed as of the date of any such termination or cancellation, if made, would be effective. The effect of this rule is as follows:
 - *Automatic renewal.* If a contract by its terms will be automatically renewed or extended as of a certain date unless either the corporation or the employee provides notice of contract termination no less than a specified number of days (e.g., at least 30 days) before that certain date, the contract is treated as renewed as of the date that the termination would be effective if notice were given.
 - *Renewal election required.* If a contract by its terms will be terminated or cancelled as of a certain date unless either the corporation or employee elects to renew within a specified time of that certain date (e.g., within 30 days of the termination date), the contract is treated as renewed by the corporation as of that date (unless the contract is renewed before that date, in which case, the contract is treated as renewed on that earlier date).
- *Employee discretion.* In contrast, if the corporation remains legally obligated by the terms of a contract beyond a certain date at the sole discretion of the employee, the contract will not be treated as renewed as of that date if the employee exercises the discretion to keep the corporation bound to the contract.
- *Contract terminated on employment termination.* A contract is not treated as terminable or cancellable if the only way it can be terminated or cancelled is by termination of the employment relationship.
- *Employment continues after contract termination.* A contract is not treated as renewed if, upon a contract's termination or cancellation, the employment relationship continues but would no longer be covered by the contract. However, any remuneration paid during ongoing employment after such contract termination or cancellation is not grandfathered and therefore would be subject to Code section 162(m) as amended by the TCJA.

Compensation Arrangements and Plans. The grandfather rule applies to an amount required to be paid as of November 2, 2017, under a binding compensation arrangement or plan. The grandfather rule applies to an employee even if the employee was not eligible to participate in the compensation arrangement or plan as of November 2, 2017, but only if on November 2, 2017, (i) the employee was employed by the corporation maintaining the compensation arrangement or plan or (ii) the employee had a written binding contract providing the employee the right to participate in the compensation arrangement or plan.

Brownstein Comment: As a result of this guidance, compensation from a covered employee's exercise of stock options outstanding as of November 2, 2017, is grandfathered, even if vesting and exercise occur after November 2, 2017.

- **Material Modification.** The Notice provides that a material modification occurs when a contract is amended to increase the amount of compensation payable to the employee. A written binding contract is treated as a new contract entered into as of the date the contract has been materially modified. Amounts received by an

August 30, 2018

employee under the contract before its material modification are grandfathered; however, all amounts received after the material modification are treated as paid pursuant to a new contract, are not grandfathered, and are subject to Code section 162(m) as amended by the TCJA.

- *Acceleration of payment.* A modification that accelerates the payment of compensation is a material modification unless the amount of compensation to be paid under the modification is discounted to reasonably reflect the time value of money.
- *Deferral of payment.* A modification that defers the payment of compensation is a material modification unless the additional amount that becomes payable due to the deferral is based on (i) a reasonable rate of interest or (ii) a predetermined actual investment (whether or not assets associated with the amount originally owed are actually invested therein) and is adjusted for gains or losses.
- *Supplemental contracts.* A supplemental contract, which provides for additional or increased compensation, is a material modification 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 payable under the original contract. However, a supplemental payment, which is not more than a reasonable cost-of-living increase over the preceding year's payment, is not a material modification.
- *Failure to exercise negative discretion.* The failure, in whole or in part, to exercise negative discretion under a contract does not result in the material modification of that contract.

Brownstein Comment: It is unclear whether an extension of a stock option exercise period would be a material modification that causes the option to fail to be grandfathered, or whether the extension is a “deferral of payment” where the additional amount is based on a predetermined actual investment and thus would be grandfathered.

IRS Seeks More Comments by November 9, 2018

The Notice indicates that both the U.S. Department of the Treasury (“Treasury”) and the Internal Revenue Service (“IRS”) anticipate issuing more guidance in the form of proposed regulations. To help them prepare future guidance, Treasury and the IRS seek comments on the following:

- The application of the definition of “publicly held corporation” to foreign private issuers, including the reference to issuers that are required to file reports under section 15(d) of the Exchange Act.
- The application of the definition of “covered employee” to an employee who was a covered employee of a predecessor of the publicly held corporation. **Brownstein Comment:** We note that guidance addressing what transactions (asset acquisition, stock purchase, merger) will create predecessors would be helpful.
- The application of Code section 162(m) to corporations immediately after they become publicly held either through an initial public offering or a similar business transaction.

August 30, 2018

- The application of the SEC executive compensation 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 must be submitted by November 9, 2018.

Recommended Actions

Based on the guidance in the Notice, publicly held corporations should consider the following actions at this time:

- Determine if your corporation has any comments it would like to provide the IRS and provide them by November 9, 2018.
- Compile a list of employees who have been identified as covered employees for the tax year beginning in 2017.
- Identify and obtain copies of all contracts, equity-based compensation plans and grants, and compensation arrangements and plans under which the covered employees are entitled to remuneration.
- Review the terms of those contracts, plans and arrangements to determine which, if any, may be treated as grandfathered. Create a record that contains an explanation as to why the contract is or is not grandfathered.
- With respect to grandfathered contracts, plans and arrangements, establish a procedure to determine, before the effective date of an amendment to a grandfathered contract, plan or arrangement, whether the amendment will have an adverse effect on the grandfathered status of that contract, plan or arrangement.
- Establish a procedure to maintain the permanent and ongoing list of covered employees and the contracts, plans and arrangements related to those covered employees and determine who in the corporation will be responsible for maintaining that list.
- If involved in corporate transactions with other publicly held corporations, consider whether you are acquiring a “predecessor” corporation and how to reasonably determine the predecessor’s covered employees until more guidance is used.
- Be on the lookout for more guidance and be ready to make further adjustments.

Please let us know if you have any questions.

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August 30, 2018

¹Section 13601(c) of the TCJA amended the definition of “publicly held corporation” in Code section 162(m)(2) to mean not only any corporation issuing any class of common equity securities required to be registered under section 12 of the Securities Exchange Act of 1934 (the “Exchange Act”), but also entities required to file reports under section 15(d) of the Exchange Act.

²As amended by Section 13601(a) of the TCJA, “applicable employee remuneration” in Code section 162(m)(4) now includes remuneration payable on a commission basis and performance-based compensation (both of which had been excluded from the definition prior to the TCJA). Also, payments to the covered employee’s beneficiary remain subject to the \$1 million deductibility limit each year.

³See, <https://www.irs.gov/pub/irs-drop/n-18-68.pdf>.

This document is intended to provide you with general information regarding TCJA changes to the deduction limit for Executive Compensation under Code Section 162(m). The contents of this document are not intended to provide specific legal advice. If you have any questions about the contents of this document or if you need legal advice as to an issue, please contact the attorneys listed or your regular Brownstein Hyatt Farber Schreck, LLP attorney. This communication may be considered advertising in some jurisdictions.