August 23, 2018

IRS Issues Initial Guidance on Section 162(m) Amendments

The IRS on August 21 issued Notice 2018-68, setting forth initial guidance on the provisions of the 2017 Tax Cuts and Jobs Act (the "Act") that significantly expanded the scope of the $1 million per-executive annual limitation on the deductibility of compensation paid to specified executives under §162(m) of the Internal Revenue Code. Most notably, the Notice provides useful transition rules on the provisions of the Act that grandfather written binding contracts in effect on November 2, 2017 that are not materially modified thereafter. Taxpayers may rely on the Notice until the Treasury Department issues proposed regulations. Highlights from the Notice are set forth below.

Scope of Covered Employees. The Notice clarifies that the determination of highly compensated employees whose compensation will be subject to the $1,000,000 deduction limitation, unlike the parallel determination for proxy statement purposes, disregards entirely whether an executive remains employed at the end of the year. In addition, the Notice confirms there are circumstances in which the deduction limitation will apply when a company is no longer subject to public reporting. The Notice also confirms that chief financial officers will become covered employees in taxable years beginning in 2018, and that compensation pursuant to grandfathered written binding contracts with chief financial officers will be excluded from the deduction limitation, regardless of whether performance-based. The rules are fairly technical, and companies should be careful to separately track their executives (both current and former) for proxy statement and §162(m) purposes.

Written Binding Contract. The Notice generally provides that the statutory amendments apply to remuneration in excess of the amount that applicable law would require the company to pay pursuant to a written binding contract in effect on November 2, 2017. Of particular note, an example in the Notice indicates that the existence of company discretion to reduce the amount payable under a performance-based arrangement limits the grandfathering to amounts, if any, that the company is legally obligated to pay under such arrangement - *i.e.*, the amount not subject to such negative discretion. Companies should review the terms of their § 162(m) performance-based incentive arrangements in effect on November 2, 2017 to determine the degree to which payouts are subject to negative discretion.

Definition of Material Modification. The Notice generally defines a "material modification" as an amendment that either increases compensation or accelerates the payment of compensation without a time-value discount. A deferral of grandfathered compensation will not constitute a material modification as long as any increases in value reflect a reasonable interest rate or a return on a predetermined actual investment. Even above-market increases upon a deferral will not taint the originally grandfathered amount, although the incremental amount will be subject to the deduction limitation. The Notice also includes anti-abuse rules under which new arrangements can be viewed as amendments of grandfathered arrangements, so companies should be mindful of these rules in designing new compensation programs for executives subject to grandfathered arrangements.

Renewable Agreements. The Notice also provides that agreements cease to be grandfathered as of the date that the company can contractually terminate the agreement – e.g., by notice of non-renewal. (However, a contract is not treated as terminable or cancelable if it can be terminated or canceled only by terminating the employment of the employee.) These rules may have significant implications for deductibility of severance payments under employment agreements, as the changes to §162(m) have eliminated the favorable treatment of payments made after termination of employment.

Deferred Compensation. The Notice confirms that payments following termination of employment under deferred compensation programs in effect on November 2, 2017 will generally be grandfathered, although in most cases the grandfathered portion will be limited to the accrued benefit as of November 2, 2017 and possibly the future earnings thereon.

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Comments regarding the Notice are due on November 9, 2018. If incorporated into final regulations, the guidance in the Notice will apply to any taxable year ending on or after September 10, 2018. Companies should carefully track §162(m) matters as preparation of the first post-§162(m) amendment tax returns draws near, continue to avoid non-essential amendments to grandfathered arrangements that could be viewed as material modifications, and watch for regulations in the coming months.

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