

October 29, 2018

One-Year Checkup for the New Section 162(m)

The Tax Cuts and Jobs Act eliminated the performance-based compensation exception to the \$1 million per-executive annual limitation on the deductibility of compensation paid to specified executives under Section 162(m) of the Internal Revenue Code, subject to a transition rule grandfathering certain written binding contracts that were in effect on November 2, 2017. On August 21, 2018, the IRS issued [Notice 2018-68](#), which includes initial guidance clarifying the scope of the transition rule (see our August 23, 2018 memorandum, [IRS Issues Initial Guidance on Section 162\(m\) Amendments](#)). As companies await formal regulations, they should take the following actions based on current IRS guidance:

- **Identify Grandfathered Arrangements.** Determine whether any compensatory arrangements that were in effect on November 2, 2017 are grandfathered under the transition rule based on current IRS guidance. All documentation relating to a compensation arrangement should be considered when evaluating the grandfathered status of an arrangement that includes negative discretion.
- **Do Not Inadvertently Degrandfather.** Avoid any non-essential “material modification” to grandfathered arrangements, which Notice 2018-68 defines as an amendment that increases, or accelerates (without a time-value discount) the payment of, compensation. Companies should understand when arrangements expire, renew or need to be extended and the impact on grandfathering.
- **Maintain Clear Records.** In order to identify grandfathered arrangements and protect their grandfathered status, companies should maintain clear records of the state of their compensation programs as of November 2, 2017, including accrued balances as of that date.
- **Make a List of Covered Employees.** The revisions to Section 162(m) provide that, if an individual becomes a covered employee during any taxable year beginning on or after January 1, 2017, he or she will remain a covered employee indefinitely. Since the covered employee population is backward-looking and continually expanding, companies should maintain a list of all covered employees and review it annually for updates.
- **Consider Which Employees Are Executive Officers.** Only an executive officer can become a covered employee under Section 162(m). As such, companies

should carefully assess the classification of individuals as “executive officers” under Rule 3b-7 of the Securities Exchange Act of 1934.

- **Structuring New Compensation Arrangements.** When structuring new compensation arrangements, consider whether payments can be spread out over multiple years (rather than paid in a lump sum) in order to avoid the recipient being classified as a covered employee or to keep payments to a covered employee below \$1 million per year.
- **Maintain a Committee of Outside Directors.** Maintain a committee composed solely of two or more individuals constituting “outside directors” under Section 162(m) for purposes of administering grandfathered arrangements. Accordingly, companies with grandfathered arrangements should not remove questions related to Section 162(m) from D&O questionnaires.
- **Review Proxy Disclosure.** Review annual proxy disclosure to determine whether it needs to be updated to reflect the changes to Section 162(m) or related changes to incentive plans.
- **Review New or Amended Equity Plans.** If seeking approval of a new or amended equity incentive plan, review the plan document to remove any references to the performance-based compensation exception that are no longer operative. At the same time, companies should consider whether certain provisions originally driven by Section 162(m) requirements, such as annual limits on awards to individuals and a list of performance goals, should be retained based on the expectations of stockholders.
- **Consider Treatment of Cash Incentive Plans.** It is no longer necessary for cash incentive plans to be approved by stockholders. Accordingly, companies should consider whether to maintain their existing stockholder-approved cash plans. Note that maintaining a filed plan should avoid the need for disclosure on Form 8-K when a bonus is granted to a named executive officer.
- **Update Deferred Compensation Plans.** Review and, if necessary, update deferred compensation plans under which payments are triggered based on deductibility not being disallowed by Section 162(m), taking into account compliance with Section 409A of the Internal Revenue Code.

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