Compensation
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IRS issues Guidance on the Application of Section 162(m)

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On August 21, 2018, the IRS issued long-awaited guidance on the amendment of Section 162(m) made in the Tax Cuts and Jobs Act (TCJA).

This initial guidance is limited in scope and intended to respond to comments requesting clarification on the amended rules for identifying covered employees and the operation of the grandfather rule applicable to written binding contracts in effect before November 2, 2017. The initial guidance contains commentary, as well as numerous examples, on:

- The definition of publicly held corporations covered by Section 162(m);
- The definition of covered employees;
- The definition of applicable employee remuneration;
- The grandfather rule for compensation arrangements made under a written binding contract; and
- Material modification of written binding contracts.

Highlights

The most important highlights include:

1. The definition of publicly held corporations covered by Section 162(m) is broadened.
2. The definition of covered employees is modified to better align with current proxy disclosure rules, although differences continue to exist primarily because the “end-of-year” requirement is eliminated for purposes of Section 162(m).
3. The definition of covered employees is expanded to include chief financial officers, former covered employees and payments to a covered employee’s heirs and estate.
4. The tax deductibility of compensation is preserved if the compensation is paid under a written binding contract in effect on November 2, 2017 and not materially modified after that date.
5. The ability to use negative discretion to reduce compensation under such an arrangement is likely sufficient to limit tax deductibility, since the contract is not binding. We expect companies to test this concept in the courts over time.
6. A material modification increases compensation, or provides additional compensation, on substantially the same elements or conditions.
7. Additional payments equal to or less than reasonable cost of living adjustments do not result in a material modification.

Amendments to the Definition of Publicly Held Corporation

The TCJA amendment broadened the definition of publicly held corporations covered by Section 162(m). Rather than limiting the scope to companies issuing common equity securities, the new definition includes “any corporation:

(a). Which is an issuer the Securities of which are required to be registered under section 12 of the Securities Exchange Act of 1934 (the 1934 Act), or

(b). That is required to file reports under section 15(d) of the 1934 Act.”

The new definition expands coverage to companies issuing various equity securities and publicly traded debt, as well as companies that may be otherwise exempt from filing a proxy statement. For example, the executive officers of a public company that delists its securities, thus eliminating the requirement to file a proxy statement and disclose executive compensation, would be covered employees for tax purposes and subject to the amendment's limits on tax deductibility.

Amendments to the Definition of Covered Employee

Under the TCJA, the definition of covered employees is modified to better align with current proxy disclosure rules. Under the new definition, a covered employee means "any employee if:

a. Such employee is the principal executive officer (PEO) or principal financial officer (PFO) of the taxpayer *at any time during the taxable year*, or was an individual acting in such a capacity,

b. The total compensation of such employee for the taxable year is required to be reported to shareholders under the 1934 Act by reason of such employee being among the three highest compensated officers for the taxable year other than any individual described in (a), or

c. Such employee was a covered employee of the taxpayer (or any predecessor) for any preceding taxable year beginning after December 31, 2016."

Importantly, the initial guidance clarifies that a covered employee is not limited to only those serving in their role at the end of the year. By eliminating the end-of-year requirement, disconnects between the individuals reported in the proxy statement and actual covered employees may occur. The IRS notes that SEC rules do not constitute the sole basis for interpreting Section 162(m).

By including covered employees for any preceding taxable year beginning after December 31, 2016, the initial guidance clarifies that the pre-amendment rules for identifying covered employees will apply for taxable years beginning during 2017. These employees will be wrapped in under the amendment, with tax deductibility strictly limited beginning in taxable years beginning in 2018 and beyond.

Amendment to the Definition of Applicable Employee Remuneration

Applicable employee remuneration was defined, under Section 162(m), as the total amount allowed to be deducted for the tax year. Prior to the amendment to Section 162(m), applicable employee remuneration excluded commission-based and qualified performance-based compensation. The amendments to Section 162(m) removed these exclusions from the definition. The Act also added a rule that limits the deductibility of applicable employee remuneration even if the compensation is paid to a beneficiary in the event of the death of a covered employee.

Application of the Grandfather Rule

The amendment to Section 162(m) allows for the tax deductibility of compensation to be preserved (in other words "grandfathered") if the compensation is paid under a written binding contract in effect on November 2, 2017 and not materially modified after that date. The initial guidance preserves the pre-amendment definitions of "written binding contract" and "material modification" as first detailed in the original 1993 grandfather rules included when Section 162(m) was added to the Internal Revenue Code.

Written Binding Contract

The initial guidance defines a written binding contract as a contract that requires the company under applicable law (for example, under state law) to pay compensation if the employee performs services or satisfies the vesting conditions attached to the compensation. If a contract contains elements that are binding and other elements that are discretionary, the amounts that are binding will continue to be deductible under the grandfather rule, absent a material modification, and the discretionary amounts will be subject to the amendment's limits on tax deductibility and not grandfathered.

Grandfathering is not available to contracts that are renewed after November 2, 2017. Instead, these are treated as new contracts. If a company has the right to cancel or terminate a contract without the executive's consent after November 2, 2017, the loss of grandfathering occurs as of that date and the amendment's limits on tax deductibility apply at that point and going forward. One common scenario plays out when a contract contains a notice period. For example, if a company can give notice of non-renewal after a defined initial term ends, or annually thereafter, the contract is treated as a new contract when the notice period ends or upon renewal, if earlier.

There are important caveats to this rule to keep in mind. If a contract can only be cancelled or terminated by ending the employment of the executive, the contract does not lose grandfathered status. Similarly, if the executive has the unilateral right to cancel the contract after a certain date but chooses not to do so, the contract does not lose grandfathered status after this date.

Consensus has developed that the ability of the board or compensation committee to exercise negative discretion and adjust payments down to zero makes a compensation plan or arrangement non-binding. This results in a loss of grandfathering and limits on tax deductibility under the amendment to Section 162(m). We expect this position to be tested by issuers in tax court and/or state court. For example, if performance metrics and targets are clearly articulated in a contract or award agreement and the company has no history of actually applying negative discretion, a case could be made that the executive has a valid claim to receive that compensation. We will monitor developments on this point, since negative discretion is built into the majority of executive incentive plans.

Finally, if a compensation plan or arrangement is binding, the amount that is required to be paid as of November 2, 2017, will be grandfathered with no loss of tax deductibility, provided the executive was employed on that date by the corporate sponsor or the employee had a written binding contract as of that date. Supplemental executive retirement plan (SERP) benefits are a good example of this. If an executive has a binding right to receive SERP benefits, the accrued benefit as of November 2, 2017 will continue to be deductible when paid in the future, while amounts accrued for service after that date will be subject to the amendment's limits on tax deductibility.

Material Modification

The IRS defines a material modification as an amendment that increases the amount of compensation payable to the executive, or provides additional compensation, on substantially the same elements or conditions. If a material modification occurs, amounts received prior to the date of the modification are grandfathered and amounts received after that are not grandfathered, but rather subject to the amendment's limits on tax deductibility.

Another aspect identified by the IRS as a material modification to a written binding contract includes the acceleration of the timing of a payment unless the payment is discounted to reasonably account for receiving the compensation early. The IRS notes that modifying a contract to defer a payment does not constitute a material modification as long as the excess amount payable is based on a reasonable rate of interest or the rate of return of a predetermined investment.

The adoption of a supplemental contract that increases compensation or provides for an additional payment is a material modification, when the facts and circumstances demonstrate that the "compensation is paid on the basis of substantially the same elements or conditions as the compensation that is otherwise paid pursuant to the written binding contract."

On the other hand, companies may increase compensation to offset the impact of cost-of-living without loss of grandfathering. The guidance clarifies that an additional payment that is less than or equal to a reasonable cost-of-living increase (for example, a modest salary increase) would not be a material modification.

Effective Date

According to the guidance, the amendment to Section 162(m) applies to taxable years beginning on or after January 1, 2018. The regulators anticipate that the guidance will be incorporated in future regulations and will apply to taxable years ending on or after September 10, 2018. The IRS also notes that any future guidance or regulations that address issues covered in the guidance that would broaden the definition of covered employee or limit the definition of written binding contract would apply prospectively only.

IRS Request for Comments

Treasury and the IRS expect to issue additional guidance on Section 162(m) and is requesting comments on other aspects of the amendments to Section 162(m) that should be addressed. These include a number of highly technical points, such as:

- The definition of "publicly held corporation" applicable to foreign private issuers,
- 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 an initial public offering or a similar business transaction, and
- 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.

Written comments are being requested through November 9, 2018.

Conclusion

The IRS has provided initial guidance on key questions from practitioner after the TCJA passed. Plenty of examples as to how the new rules would be applied going forward are provided. However, the guidance is complex. Companies should evaluate how the rules apply by consulting internal and external subject matter expert that understand compensation, as well as the tax and legal perspectives. We will keep clients informed as consensus develops on various aspects of the guidance and as the IRS issues further guidance on Section 162(m).