SULLIVAN & CROMWELL LLP

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IRS Releases Initial Guidance on the 2017 Amendments to the Internal Revenue Code's Limitation on Deduction for Certain Executive Compensation

Notice 2018-68 Provides Guidance on the Application of the Internal Revenue Code Limitation on the Deduction for Certain Executive Compensation, Including Clarification of Definitions of "Covered Employee," "Publicly Held Corporation" and Grandfathered Arrangements

SUMMARY

The IRS released Notice 2018-68 (the "Notice") on August 21, 2018, which provides initial guidance on changes made to the Internal Revenue Code (the "Code") limitation on the deduction for certain executive compensation, including a transition rule with respect to arrangements that were grandfathered under the prior tax regime.

Section 162(m) of the Code generally imposes a $1 million deductibility limit on compensation paid to "covered employees" of a "publicly held corporation" for any taxable year, unless an exception applies.[1] Section 162(m) was significantly amended by the Tax Cuts and Jobs Act of 2017 (the "Act"),[2] which removed a long-standing exemption for certain performance-based compensation, expanded the definitions of "covered employee" and "publicly held corporation" and also provided a transition rule applicable to certain arrangements outstanding as of November 2, 2017, referred to as the "grandfather rule." The Notice provides guidance on the amended rules for identifying "covered employees" and a "publicly held corporation" and the operation of the grandfather rule.

BACKGROUND

Section 162(m)

A "publicly held corporation's" deduction for "applicable employee remuneration" is limited to $1 million in the case of "covered employees."[3] Prior to the changes imposed by the Act, the IRS had interpreted "covered employee" to mean the CEO of a publicly held corporation and its three highest-compensated officers, other than the CEO and CFO, on an annual determination that was applied on the last day of the applicable taxable year. The statute had provided a long-standing exception to this rule whereby commissions and certain performance-based compensation, including stock options, were excepted from the $1 million deductibility limit so long as certain conditions were met, including approval of performance-based compensation by a compensation committee of the board of directors consisting of two or more outside directors.[4]

The Act amended Section 162(m) significantly by (1) removing the performance-based pay exception, (2) broadening the definition of "covered employees" to include the CEO, CFO, the three other highest-compensated employees and any employee who was a covered employee for any taxable year beginning after 2016, and (3) expanding the definitions of "publicly held corporation" and "applicable employee remuneration."

The Act also provided that the changes would not apply to compensation paid pursuant to a written binding contract in effect on or prior to November 2, 2017, so long as the contract is not modified in any material respect or renewed.

GUIDANCE

"Covered Employees." The Act amended the definition of "covered employee" to provide that the deduction limitation applies to the CFO (in addition to the CEO and the top three highest-paid officers).[5] The Act also provides that any employee who was a covered employee of the taxpayer (or any predecessor) for any taxable year beginning after December 31, 2016 would be deemed to always be a covered employee and that the three highest-paid officers (other than the CEO and CFO) would be covered even if the officers' compensation is not required to be disclosed under SEC rules. Notice 2018-28 states that the language picking up the top three highest-paid officers, even if the officers' compensation was not required to be disclosed under SEC rules, was meant to apply broadly and would include, for example, a corporation that does not file a proxy statement for the year because the corporation delists its securities and the top three highest-paid officers of so-called "emerging growth companies" and "smaller reporting companies," which are permitted to disclose the compensation of fewer executive officers under SEC rules. As a result, certain executive officers of publicly held

corporations may be covered employees (and would remain covered employees in the future), and such executive officers' compensation would be subject to the deduction limitation, even when SEC rules do not require annual proxy disclosure.

The Notice provides several examples applying the new guidance with respect to the definition of covered employees. The examples make clear that, in addition to covering any CEO and CFO who served at any time during the taxable year, the next three highest-paid executive officers are covered employees, regardless of whether those next three executive officers are serving at the end of the applicable tax year and regardless of whether the executive officers' compensation is subject to SEC disclosure rules. In this respect, the definition of "covered employees" differs from SEC proxy disclosure requirements for larger reporting companies in that Item 402 of Regulation S-K requires that disclosure be provided for the three highest-paid executive officers (other than the CEO and CFO) serving at the end of the Company's fiscal year and up to two additional individuals who had served as executive officers during the fiscal year and would have been among the three highest-paid executive officers for the fiscal year except that those individuals were not serving in those positions at fiscal year-end. The Notice goes on to clarify that for purposes of determining a publicly held corporation's covered employees, it is irrelevant whether the corporation is an emerging growth company or smaller reporting company under SEC rules.

An additional example describes a publicly held corporation ("Corporation Y") of which 80% of its common stock is acquired by a non-publicly held corporation ("Corporation X"), resulting in short taxable years ending July 31, 2019 and December 31, 2019 but a single unchanged fiscal year for SEC reporting purposes. The example explains that even if individuals who were covered employees of Corporation Y ceased to serve as executive officers of Corporation Y for the taxable year ending December 31, 2019, these individuals would continue to be treated as covered employees of Corporation Y for purposes of the deduction. The Treasury Department and the IRS are requesting comments "on the application of the SEC executive compensation disclosure rules to determine 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," such as a short taxable year as a result of a corporate transaction. Until additional guidance is issued, the Notice states that taxpayers should base their determination of the three most highly compensated officers upon a "reasonable good faith interpretation of the statute, taking into account the guidance provided under [the Notice]."

"Publicly Held Corporation." Prior to the Act, "publicly held corporation" meant any corporate issuer of common equity securities required to be registered under section 12 of the Securities Exchange Act of 1934 (the "Exchange Act"), i.e., any company which lists its securities on a national securities exchange. The Act amended the definition of "publicly held corporation" to mean any corporation which is an issuer of securities required to be registered under section 12 of the Exchange Act or that is required to file

reports under section 15(d) of the Exchange Act, which potentially includes any company which registers a class of securities under the Securities Act of 1933 (the "Securities Act"), such as issuers of debt securities and foreign private issuers.

"Applicable Employee Remuneration." In addition to the removal of the performance-based compensation and commission exceptions, the Act revised the definition of "applicable employee remuneration" to add a special rule for beneficiaries, which the Notice reiterates: remuneration will not fail to be "applicable employee remuneration" merely because the remuneration is includible in the income of (or paid to) a person other than the covered employee, including after the covered employee's death.

"Grandfather Rule." Similar to the grandfathering rule contained in the pre-Act Section 162(m)(4)(D) for written binding contracts in effect on February 17, 1993, the Act provides for limited transition relief. Under the so-called "grandfather rule," the Act's amendments to Section 162(m) will not apply to "a written binding contract in effect on November 2, 2017, and which was not modified in any material respect on or after such date."

1. Written Binding Contract.

For purposes of determining if a contract is covered by the grandfather rule, the Notice clarifies that remuneration is payable "under a written binding contract" only to the extent applicable law (for example, state contract law) obligates the corporation to pay under the contract "if the employee performs services or satisfies the applicable vesting conditions." Accordingly, where a written binding contract exists, the Act's amendments to Section 162(m) would not apply to amounts the corporation is legally obligated to pay under the contract, but the amendments would apply to any amounts in excess of the amount the corporation is legally obligated to pay under the contract.

The Notice goes on to provide that the Act's amendments to Section 162(m) apply to a written binding contract that is renewed after November 2, 2017, and that written binding contracts that are terminable or cancelable by the corporation without the employee's consent after November 2, 2017 will be treated as "renewed" as of the date that the termination or cancellation would be effective, and therefore subject to the amended rules. Two examples are provided: (1) if a contract provides for automatic renewal or extension unless either party provides notice of termination before a specified date, the contract is treated as renewed as of the date that termination would be effective if notice were given; and (2) if a contract provides that it will be terminated or canceled as of a certain date unless either party elects to renew, the contract is treated as renewed as of that date, unless the contract is actually renewed prior to that date, in which case the contract is treated as renewed at that time. Alternatively, if a contract may be renewed or terminated beyond a certain date at the sole discretion of the employee, such a unilateral contract would

not be treated as renewed as of that date if the employee exercises discretion to continue the corporation's obligations under the contract. In addition:

- A contract that can be terminated or canceled only by termination of the employee's employment is not treated as "terminable or cancelable";
- If upon termination or cancelation of a contract, employment continues, then the contract is not treated as "renewed," however payments made after termination or cancelation are not grandfathered; and
- Binding compensation plans or arrangements that are required to be paid to an employee as of November 2, 2017 are treated as grandfathered even if the employee was not eligible to participate in the plan or arrangement as of November 2, 2017. However, the employee must be employed as of such date by the corporation that maintains the plan or arrangement (or must have had a right to participate in the plan or arrangement under a written binding contract as of that date).

2. Material Modification.

A "material modification" made after November 2, 2017 to any written binding contract will cause the contract to be treated as a new contract that is subject to the Act's amendments to Section 162(m) as of the date of the material modification. The Notice provides the following rules with respect to the occurrence of a material modification, including changes to a written binding contract that would be deemed to result in a material modification:

- Amendment of the contract to increase the compensation payable to the employee; and
- Modification of the contract that accelerates a payment, unless the amount of compensation paid is discounted to "reasonably reflect the time value of money."

The following rules are examples of changes that would not be deemed to result in a material modification:

- Modification of the contract that defers payment of compensation will not be treated as a material modification, however, any amount paid in excess of the amount that was originally payable will be treated as a material modification unless any such amount paid in excess is based on "either a reasonable rate of interest or a predetermined actual investment" (whether actually or notionally invested, so long as based on the actual rate of return, including any decrease as well as increase in the value of the investment);
- Adoption of a supplemental contract or agreement that provides for increased or additional compensation will not be treated as a material modification unless "the facts and circumstances demonstrate that the additional 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"; and
- The failure, in whole or part, to exercise negative discretion under a contract (to the extent permitted by the contract) does not result in a material modification. Note, however, that the example that follows below suggests that an arrangement might be considered binding under applicable law only to the extent that the amounts payable cannot be reduced.

The Notice provides several examples illustrating the application of the guidance with respect to material modifications to written binding contracts, including the following:

- The achievement of a performance-based bonus established on February 1, 2017 is certified by the compensation committee on March 1, 2018. Under applicable law taking into account the terms of the bonus plan, the performance-bonus may be reduced by the committee but not below $400,000, the committee exercises negative discretion to reduce the award to $500,000, and the payment otherwise satisfies the pre-Act requirements to constitute qualified performance-based compensation.[6] The IRS concludes that, because the bonus plan established on February 1, 2017 constitutes a written binding contract under applicable law to pay $400,000, the amendments to the Act do not apply to $400,000 of the $500,000 payment, and the exercise of negative discretion by the committee to reduce the award to $500,000 does not result in a material modification of the contract. The result is that $400,000 is not subject to the deduction limitation. However, the remaining $100,000 is subject to the deduction limitation regardless of whether the $100,000 would have otherwise qualified as performance-based compensation under Section 162(m) as in effect prior to the Act.
- Future credits made after November 2, 2017 to a CFO's nonqualified account balance deferred compensation arrangement that was entered into in 2016 will be subject to the deduction limitation if the plan provides that the corporation may amend the plan to stop or reduce future credits (i.e., only the portion of the deferral that was credited prior to November 2, 2017 will be grandfathered).
- Grants of stock options and stock appreciation rights that were granted to a corporation's CEO prior to November 2, 2017 pursuant to a written binding contract and that qualified as performance-based compensation will be grandfathered if there are no subsequent material modifications. Accordingly, compensation received pursuant to the subsequent exercise of these awards will not be subject to the deduction limitation. However, where the CEO's pre-November 2017 employment agreement provides that a specified number of stock options and stock appreciation rights will be granted on January 2, 2018, subject to the approval of the corporation's board of directors, and that such obligation does not constitute a written binding contract under applicable law, then the Act's amendments to 162(m) would apply to compensation paid pursuant to the subsequent exercise of options and stock appreciation rights.
- Salary paid to a corporation's CFO pursuant to a multi-year written binding contract entered into prior to November 2, 2017 will continue to be deductible until the contract is materially modified, for example, by increasing the salary. However, if instead of increasing the CFO's salary, the corporation grants the CFO a restricted stock award that vests provided the CFO remains employed through the remaining term of the contract, the restricted stock grant would not be considered a material modification of the contract because the restricted stock grant is not paid on the basis of substantially the same elements and conditions as the CFO's salary, but deductions related solely to restricted stock would be subject to the deduction limitation.

Effective Date and Request for Comment. The Act's amendments apply to tax years beginning on or after January 1, 2018, and the Treasury Department and the IRS anticipate that the guidance in the Notice will be incorporated into future regulations that will apply to tax years ending on or after September 10, 2018. The Notice indicates that any future guidance addressing the issues covered by the Notice in a manner that expands the definition of "covered employee" or that restricts the application of the definition of "written binding contract," in each case, as contemplated under the Notice, will apply prospectively only.

The Treasury Department and the IRS also anticipate issuing additional guidance on other aspects of Section 162(m), including the Act's amendments, and have specifically requested comment on "(1) 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 Securities Exchange Act of 1934, (2) the application of the definition of 'covered employee' to an employee who was a covered employee of a predecessor of the publicly held corporation, (3) the application of section 162(m) to corporations immediately after they become publicly held either through an initial public offering or a similar business transaction, and (4) 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."

The Notice provides instructions for the submission of comments, which will be accepted through November 9, 2018.

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ENDNOTES

1 26 U.S.C. § 162(m)(1).

2 See Section 13601 of Pub. L. 115-97, 131 Stat 2054 (2017).

3 26 U.S.C. § 162(m)(1).

4 26 U.S.C. § 162(m)(4)(C) [repealed].

5 See Section 13601(b) of Pub. L. 115-97; 26 U.S.C. § 162(m)(3).

6 See 26 C.F.R. § 1.162-27(e).

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