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Viewpoint on Executive Compensation

Opinion Research **Alert**

IRS Issues Section 162(m) Guidance

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Background

Section 162(m) was added to the Internal Revenue Code (IRC) in 1994 in what was seen as a reaction to escalating executive pay. Commonly referred to as the "$1 million pay cap," Section 162(m) denied subject companies the corporate tax deduction for compensation paid to the CEO (referred to as the Principal Executive Officer or PEO) and other proxy-named executive officers (NEOs) that exceeded the $1 million statutory limitation. Exceptions to the amount of covered compensation pursuant to Section 162(m) were permitted if such compensation was deemed "performance-based" under shareholder-approved plans.

The Tax Cuts and Jobs Act of 2017 ("the Act") materially changed Section 162(m) effective January 1, 2018 in several respects:

- Extended the §162(m) deduction limitations to include companies with publicly traded debt and foreign private issuers;
- Expanded the definition of 'covered employee' subject to the deduction limits;
- Established that 'covered employee' designations, once received, are permanent; and
- Eliminated the exemption for performance-based compensation.

Key Takeaways

- *On August 21st, the IRS released its initial guidance on the application of Section 162(m) deduction limitations following the Section's amendment by the Tax Cut and Jobs Act of 2017.*
- *The Notice provides guidance on key provisions, including 'covered employee' designations, terms of a written binding contract, and material modifications.*
- *Importantly, the guidance clarified that amounts subject to negative discretion (common in shareholder-approved plans) disqualify payments from the grandfathering rules.*
- *In light of this guidance, we advise companies to:*
  - *Review procedures for identifying and tracking covered employees;*
  - *Evaluate outstanding plans and agreements to identify those which may qualify as a written binding contract; and*
  - *Exercise caution when considering adjustments to the amount or timing of payments payable pursuant to a written binding contract.*

The Act established transition rules that would allow for certain amounts, paid pursuant to written binding contracts in effect on November 2, 2017 and not materially modified thereafter, to remain deductible under grandfathering rules.

On August 21st, the IRS released Notice 2018-68, which provides initial guidance regarding the application of the §162(m) deduction limitations under the new law.

The Notice provides guidance in the following areas:

- Covered Employee – The Act revised the definition of a "covered employee" to include any individual acting as a Principal Executive Officer, Principal Financial Officer, one of the three mostly highly compensated officers for the taxable year (other than the PEO or PFO), and any individual designated as a covered employee for taxable years beginning after December 31, 2016. The Notice indicates that the determination of the three 'other' mostly highly compensated officers is not limited to individuals serving as executive officers at the end of the taxable year; this means some NEOs may not necessarily be "covered employees." The Notice also provides guidance on "covered employee" determinations when a company is no longer subject to public reporting requirements.

  As "covered employee" designations are no longer linked to proxy disclosures and are permanent, we advise companies to review their procedures for identifying and tracking "covered employees."

- Written Binding Contract – The amendments to Section 162(m) do not apply to compensation payable under a written binding contract that was in effect on November 2, 2017 and has not been materially modified after that date. The Notice establishes that contracts cancellable or renewable by the employer may qualify as written binding contracts, but only until the date the contract is next eligible for cancellation or renewal. Amounts qualifying for deductibility under these written binding contracts are limited to those amounts the company is obligated to pay as of November 2, 2017. Further, any amounts that may be reduced pursuant to negative discretion will not be considered written binding contracts (likely impacting payments under most shareholder approved plans).

  We advise companies to review the terms of outstanding employment agreements, incentive arrangements, deferred compensation, and other plans to determine whether they qualify as a written binding contract and the extent to which any payments under the plans may be subject to negative discretion (common in most shareholder-approved incentive plans).

- Material Modification – The amendments to Section 162(m) will apply to any written binding contracts that are materially modified after November 2, 2017. The guidance states that a material modification occurs when the contract is amended to increase the amount of compensation to be paid. Parallel or supplemental arrangements may trigger a material modification if payable on "substantially the same" basis as the written binding contract. The guidance indicates that material modifications affect deductibility of all payments made after the modification (prior payments are not affected). The guidance also allows for non-material modifications to provide cost-of-living adjustments, or to defer or accelerate payments (if adjusted to account for the time value of money).

  For individuals subject to written binding contracts, we advise companies to be cautious when considering adjustments to the amount or timing of payments.

The IRS has advised that companies may rely on Notice 2018-68 until such time as the Treasury Department issues proposed final regulations. Companies are permitted to file comments regarding the Notice up to the date of November 9, 2018.

It should be noted that Pay Governance LLC is a management consulting firm and is not permitted to render an official tax opinion or engage in the practice of law. Therefore, we recommend that you seek the advice of qualified tax counsel should you have detailed questions pertaining to the tax issues discussed herein.

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