

IRS Releases Guidance Concerning Changes to Section 162(m) of the Internal Revenue Code

New guidance from the IRS on the tax bill's treatment of 162(m) delves into the identification of covered employees, operation of the grandfather rule and modification of a written contract.

One of the more noteworthy provisions within the giant corporate tax bill that passed at the end of 2017 for executive compensation professionals was the elimination of a provision under Section 162(m), which allowed companies to deduct performance-based pay above \$1 million. Now, we're getting more clarification on how that change in tax law will play out in practice.

The Internal Revenue Service (IRS) released [Notice 2018-68](#) in August, which provides initial guidance on applying the new rules under Section 162(m) of the Internal Revenue Code — concerning recent changes to the \$1 million deduction limit — as amended by the Tax Cuts and Jobs Act of 2017, P.L. 115-97 (the Act).

Section 162(m)(1) generally limits the permissible deduction for a taxable year for compensation paid by any publicly held corporation with respect to a “covered employee.” The Act made significant amendments to Section 162(m), providing a transition rule (known as the grandfather rule) that could be applied to certain outstanding arrangements that were subject to a written binding contract in effect on November 2, 2017.

In this article, we focus on three key areas of guidance:

1. Identification of covered employees, with particular attention to the three most highly compensated individuals other than the CEO and CFO
2. Operation of the grandfather rule
3. Material modification of a written binding contract

Identification and Definition of Covered Employees

Prior to amendment, the application of Section 162(m) was limited to five individuals for any given tax year:

- The individual serving as the CEO at the end of the fiscal year
- Up to four individuals serving as executive officers, whose compensation required disclosure to shareholders under the Securities Exchange Act of 1934 (the Exchange Act) by reason of such employee being among the four highest compensated executive officers for the taxable year (other than the CEO).

As amended, Section 162(m) now applies to any individual who, at any time during the taxable year, served in the capacity of:

- Principal executive officer (PEO),
- Principal financial officer (PFO), or
- Was among the three highest compensated executive officers for the taxable year— other than those who served as a PEO or PFO— regardless of whether the person’s compensation requires disclosure under the Exchange Act rules.

Finally, if an individual is a covered employee in any taxable year beginning after December 31, 2016, he or she remains covered for all future taxable years.

When determining if an individual qualified as a covered employee for the 2017 tax year, you should use the rules under Section 162(m) that applied prior to the amendment. For example, if an individual was the CFO for any portion of that tax year, then by definition, the CFO would *not* be considered a covered employee under Section 162(m) for that tax year. This is particularly important for the operation of the grandfather rule, as explained below.

Tax Guidance and Regulations vs. SEC Regulations

The Notice states that “[w]hile certain aspects of section 162(m) are interpreted consistent with the SEC rules, the SEC rules do not serve as the sole basis for interpreting 162(m).” In other words, the IRS has analyzed certain aspects of Section 162(m) differently from the SEC’s analysis under Item 402 of Regulation S-K, which governs who is a “named executive officer” for SEC executive compensation reporting purposes. Notably, the Notice points out that “the Treasury Department and the IRS have determined that there is no end-of-year requirement [to continue to be employed at year-end] under Section 162(m)(3)(B) [as amended].” Thus, the question of who are the three highest compensated executive officers for the taxable year is determined regardless of whether the individual was active on the last day of the year. This means that one of these individuals may not have had his or her compensation reported in the company’s proxy statement. (SEC rules only require disclosure of compensation for up to two executive officers who were no longer serving at year-end.) Additionally, the Notice provides that a company’s status as a smaller reporting company or emerging growth company (with fewer required named executive officers) does not decrease the number of covered employees.

For example, if the three highest compensated executive officers for the fiscal year (other than the PEO and PFO) all happen to retire during the year, they would be subject to Section 162(m) even though only two of them would have been deemed “named executive officers,” with their compensation disclosed to shareholders. Furthermore, none of the other executive officers who are actually designated as named executive officers and listed in the proxy statement because they were the three highest paid executive officers in this role on the last day of the fiscal year, would be considered a covered employee under Section 162(m) for that taxable year. The only exception would be if they happened to be a covered employee in some other year beginning after December 31, 2016.

This IRS guidance underscores the need to carefully identify the three most highly compensated executive officers (other than those serving as a PEO or PFO). Maintaining an accurate, cumulative list of covered employees for any year beginning after December 31, 2016, will be essential to determine if those individuals have, in any future year, otherwise deductible compensation that might exceed \$1 million. One specific situation

that warrants this level of vigilance is if you have an individual acting as PEO or PFO for a short period of time who may, down the road, be eligible for compensation that exceeds \$1 million in tax year.

Operation of the Grandfather Rule

The Notice provides critical guidance with respect to compensation that is subject to a binding written contract in effect as of November 2, 2017. State contract law, as well as other laws relating to the enforcement of a contract, must be considered when determining if the grandfather rules apply to future compensation payments.

As noted above, this is important because grandfathered compensation is subject to the rules under Section 162(m), as they existed prior to enactment of the Act (that is, the compensation may be eligible for deduction). In many instances, this will mean that the compensation is not subject to the \$1 million limitation and is generally fully deductible. For example:

- The compensation paid to an individual who would not be a covered employee under the former rules at the time the grandfathered compensation becomes otherwise deductible in the future (i.e. the CFO or an individual who terminates during the year)
- The compensation arises from a written binding contract that was considered performance-based under the former Section 162(m) rules

The grandfather rule is not available after a written binding contract is renewed, and a contract that is terminable or cancelable by the corporation without the employee's consent is deemed renewed as of the earliest date (after November 2, 2017) that such termination or cancellation could occur. However, if termination or cancellation can only occur in conjunction with termination of employment, then this special rule would not apply.

For example, as is common in many employment contracts, an agreement that is automatically renewed or extended as of a certain date, unless either the company or the employee provides notice of nonrenewal prior to that date, will be treated as renewed and no longer grandfathered as of the date the termination would have been effective.

Impact of Negative Discretion Provision on Grandfather Rule

As explained in the Notice, an arrangement will not be considered a binding written contract to the extent that the compensation may be reduced through negative discretion. Such provisions are commonly found in so-called 162(m) bonus pool arrangements and other incentive arrangements designed to qualify as performance-based compensation. As a result, many incentive arrangements will not be eligible for grandfathering.

Another area of concern involves amendment provisions that are typically included in nonqualified deferred compensation arrangements (e.g., the nonqualified arrangement can be amended on a prospective basis). In such situations, only a portion— or, in some rarer cases, none— of the future compensation payment will be considered grandfathered.

To illustrate the points mentioned above, the Notice provides nine examples of how the grandfather rule would operate under various facts and circumstances.

When the grandfather rule provides a material tax benefit to the corporation, it may be appropriate to confirm with legal counsel the enforceability of the contract prior to deducting the grandfathered compensation. In addition, it's important to carefully consider provisions of a contract where the company reserves the right to curtail the accrual of future benefits or even the final amount payable. In such situations, corporations should carefully document the amount that remains protected each year under the terms that existed as of November 2, 2017, so that the appropriate deduction can be sustained in the future.

Material Modification of a Written Binding Contract

If a written binding contract is materially modified, the compensation provided under the contract after the modification date is no longer grandfathered. The Notice explains that a material modification occurs when the contract is amended to increase the amount of compensation payable to the employee. This is true even if it is increased through the adoption of a supplemental contract or through the payment of additional compensation, given the facts and circumstances demonstrate that the additional incremental amount is to be paid on the basis of substantially the same elements or conditions as the grandfathered compensation. However, an increase that does not exceed a "reasonable cost-of-living increase" would not be considered a material modification. The Notice provides an example of a supplemental payment that is less than or equal to a reasonable cost-of-living increase, but it does not explain how to determine what a reasonable cost-of-living increase might be.

If a material modification occurs, the grandfather status is lost as of the modification date with respect to both the original grandfathered amount and the additional amount. The Notice contains an example in which a written binding contract provides annual salary payments of \$1,800,000, with the salary subsequently increasing to \$2,400,000. As a result, the entire amount of salary paid after the increase is subject to the new rules under Section 162(m).

Another example provided in the Notice illustrates the impact of adding a new element of compensation under an existing contract, such as the addition of a new right to equity. The Notice explains that providing for a completely new element of pay would not materially modify an existing contract because the new pay element would not be paid based on substantially the same elements or conditions as the grandfathered compensation. The Notice also explains that accelerating a payment under a written binding contract is not a material modification, provided the amount of payment is appropriately discounted to reflect the time value of money.

There are additional instances in which further guidance may be required. For example:

- If an individual's compensation does not increase, but his or her duties under the contract are reduced — or the work schedule is reduced without a commensurate reduction in pay — would the contract be considered materially modified?
- If, under a separate, supplemental contract the employee receives additional salary solely because additional duties are required, would such a separately structured salary increase still be treated as a material modification of the salary that would otherwise be grandfathered?

Looking Ahead

The Department of the Treasury and IRS anticipate the guidance in the Notice will be incorporated in future regulations that will also address other aspects of Section 162(m). Additionally, they have requested comments

by November 9, 2018, on other issues under Section 162(m) that future guidance, including regulations, should address.

The Notice lists four items of special interest:

- Treatment of foreign private issuers as publicly held corporations
- Treatment of individuals who were covered employees of the predecessor of a publicly held corporation
- Treatment of corporations immediately after they become publicly held through an IPO or similar business transaction
- Application of SEC 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 (for example, due to a short taxable year as a result of a corporate transaction)

You can read [the Notice](#) in its entirety here. If you have any questions about these changes or other matters related to corporate governance, please [contact our team](#). In the meantime, we will continue to follow future guidance and will provide updates when new information is available.

About Radford

Radford partners with technology and life sciences companies to reimagine their approach to rewards, empowering them to achieve superior levels of people and business performance. Radford is part of Aon plc (NYSE: AON). For more information, please visit radford.aon.com.

About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance. For further information, please visit aon.com.

This article provides general information for reference purposes only. Readers should not use this article as a replacement for legal, tax, accounting or consulting advice that is specific to the facts and circumstances of their business. We encourage readers to consult with appropriate advisors before acting on any of the information contained in this article.

The contents of this article may not be reused, reprinted or redistributed without the expressed written consent of Radford. To use information in this article, please [write to our team](#).

© 2018 Aon plc. All rights reserved