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Initial Post-Tax Reform 162(m) Guidance Issued – A Reasonable Grandfather and a Covered Employee Surprise

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On August 21, 2018, Treasury and IRS released Notice 2018-68, their initial guidance on the application of Code section 162(m) after Tax Reform (including the operation of the grandfather provision for compensation required under certain written binding contracts). The notice includes useful examples that clarify the new rules and a grandfather provision that, as expected, follows section 162(m)'s original 1993 grandfather. However, the guidance also includes a surprise in its definition of covered employees. Here are the highlights. Our next post will share thoughts on next steps for companies in response to the guidance.

Covered Employees

What the Notice Provides. The definition of covered employees (the group for whom compensation deductions are capped at $1 million) has always been closely tied to the group of named executive officers who are reported in the proxy under SEC rules. Notice 2018-68 partly changes this.

Notice 2018-68 is aligned with SEC rules with respect to covering CEOs and CFOs, and the notice picks up all who served as the SEC Principal Executive Officer (PEO) or SEC Principal Financial Officer (PFO) at any time during the year. However, alignment breaks down when identifying the three covered employees who are identified based on compensation as one of the three highest paid officers for the year. Under Notice 2018-68, these three are identified as follows:

- Compensation is determined in accordance with SEC proxy rules.
- That compensation is then used to identify the three top-paid executive officers for the year (other than any PEO/PFO covered employees).
- Employment as an executive officer at year end is irrelevant.
- However, and here is the surprise, the three selected above are covered employees regardless of whether each would be reportable in the proxy under SEC rules.

Why This Is Surprising. This is surprising because the key statutory language expressly requires that the three identified based on top compensation be reportable in the proxy under SEC rules. Code Section 162(m)(3)(B) describes a member of this top-paid group as follows:

- the total compensation of such employee for the taxable year *is required to be reported to*

> *shareholders under the Securities Exchange Act of 1934* by reason of such employee being among the 3 highest compensated officers for the taxable year (other than any individual described in subparagraph (A) [which covers CEOs and CFOs])… [Emphasis added.]

Under SEC rules, up to five executive officers can be reported in the proxy based on compensation: the three top paid executive officers employed at year end and up to two more whose compensation for the year is higher but who are not employed as executive officers at year end. It would have been less surprising if Notice 2018-68 had picked the three top paid out of these five. However, Example 1 in Notice 2018-68 clarifies that the three covered employees identified based on compensation can be three who were top-paid during the year but are no longer employed as executive officers at year end. Under SEC rules, only two of these will be in the proxy (the two with the highest compensation). Therefore, one of the covered employees in Example 1 of the notice will not be reportable in the proxy.

The cited rationale for this deviation from the SEC proxy rules is certain statutory language (which was newly added to the definition of covered employee) that says the term covered employee "shall include any employee who would be described in [Section 162(m)(3)(B), as quoted above] if the reporting described in such subparagraph were required as so described."

This was a conforming change that addressed the fact that the new definition of a publicly held corporation subject to 162(m) included some corporations that were not required to file a proxy. On its face, the newly added language seems to provide for *applying* the SEC proxy rules when they otherwise would not apply – but still applying the SEC rules. Notice 2018-68 goes further, however, and interprets this newly added language to disregard the SEC rules.

Why Did Treasury and IRS Take This Approach? Notice 2018-68 does not say. However, recall the disruption in the operation of 162(m) that occurred when the SEC changed its proxy rules to include the CFO in the proxy without regard to compensation. The mismatch at the time between section 162(m) and the SEC proxy rules caused the CFO to fall out of 162(m) coverage and reduced the covered employee group from five to four. That experience may have caused Treasury and IRS to think that a little less reliance on SEC rules would be a good thing.

In addition, reportedly Capitol Hill staff had indicated that tax reform's 162(m) changes were intended to change the old 162(m) rule that picked up the three highest paid who were employed as executive officers at year end. Not picking up just those who are executive officers at year end will sometimes increase tax revenue, when someone is identified as a covered employee who has higher SEC compensation in place of someone employed at year end with lesser compensation. The Notice "goes all in" on covering those with the highest SEC compensation by picking up not just two (as the SEC rules do) but as many as three who are not executive officers at year end.

Will the Notice's Position Be Challenged ? There may be objections to the position as part of the process of moving to proposed and then final regulations. Whether there will be litigation probably depends on how much tax is involved. The difference with SEC rules affects the identity of just one covered

employee, and thus generally the tax difference may not be worth litigating. In addition, the officer who it brings into the top-three based on compensation will often already be a covered employee under the "always rule" discussed just below. When this happens, it may actually reduce the bite of the 162(m) compensation cap (by preventing another officer with compensation above $1 million from newly becoming a covered employee for the year).

Once a Covered Employee Always a Covered Employee. Tax reform adopted a rule that causes an individual who is a covered employee in a year to remain a covered employee in all future years (even, for example, with respect to post-death payments to a beneficiary). While post-tax reform 162(m) is generally effective for tax years after December 31, 2017, this "always rule" was made effective for tax years beginning after December 31, 2016.

Notice 2018-68 confirms that the pre-tax reform rules for identifying covered employees apply when doing the lookback to 2017 under the "always rule." Thus, an officer who was not a covered employee for 2017, *e.g.*, because of a termination from executive officer employment prior to the end of 2017, will not be a covered employee in future years based on 2017 status. On the other hand, an individual who was a covered employee in 2017 under pre-tax reform rules will remain a covered employee for tax years beginning after 2017 regardless of employment or compensation in later years. Still, no executive will be a covered employee for the 2017 year as a specific result of the "always rule."

Tax Reform's Section 162(m) Grandfather Provision

A comparison of tax reform's 162(m) grandfather (the "2017 Grandfather") with the original grandfather that dates back to 162(m)'s enactment in 1993 (the "1993 Grandfather") reveals statutory language and legislative history for both that are essentially identical. This replication suggests that both should operate the same way and, more specifically, that the 2017 Grandfather should follow the existing regulations for the 1993 Grandfather (Treas. Reg. § 1.162-27(h)).

Notice 2018-68 acknowledges the two grandfather provisions are "almost identical," and its guidance on the 2017 Grandfather follows the 1993 Grandfather regulations on points that the notice covers. At the same time, Notice 2018-68 stops short of stating that taxpayers can look to the 1993 Grandfather regulations for guidance on points not addressed in the notice. However, in practice, doing this should generally be valid.

The following summarizes (and comments on) key guidance from Notice 2018-68's explanation and 11 separate examples regarding the 2017 Grandfather.

Negative Discretion. A pre-November 3, 2017 bonus plan that meets the requirements for the performance-based compensation exception, provides for a $1,500,000 bonus, but the compensation committee discretionarily may pay as little as $400,000 even if the goal is met. As a result, only $400,000 is grandfathered and exempt from the compensation cap. If the Committee pays $500,000, $100,000 is subject to the compensation cap. However, Notice 2018-48 expressly clarifies that paying more than the minimum required is not a "material modification" that would terminate the grandfather.

- COMMENT. The example assumes an unambiguous right to reduce the payment to only $400,000. Thus it avoids nuanced facts of the type that under Code section 409A's legally binding right guidance might cause the negative discretion to lack "substantive significance." However, ultimately the standard under the notice is whether there is a binding obligation "under applicable law (for example, state contract law) to pay the remuneration under such contract if the employee performs services or satisfies the applicable vesting conditions." This standard should justify considering all of the facts and legal nuances (including, *e.g.*, state law contract principles such as estoppel).
- COMMENT. It is noteworthy that this standard also rules out state law unilateral contract requirements that necessitate a certain level of completed performance to create a binding contract. Under the notice, a unilateral contract can be binding in advance of services by the executive. Similarly, the notice also treats a contract as binding before it is vested.
- COMMENT. The point that paying $100,000 more than the minimum is not a material modification is a helpful clarification that goes beyond the guidance in the 1993 Grandfather regulations. Based on the principle behind this conclusion, paying up to the full $1,500,000 would also not be a material modification.

Grandfathered Employment Agreement. An employment agreement for ongoing services as a PFO at a set salary that was signed by November 2, 2017 and commenced January 1, 2018 is grandfathered. Therefore, because PFOs were not covered employees under prior law, the fixed salary for services that is paid during the term of the agreement is not subject to 162(m)'s deduction limitation.

- COMMENT. The example regarding a PFO's salary assumes that the executive remains in the PFO position, and thus never becomes a covered employee based on the pre-tax reform definition. However, if the PFO became the PEO and was PEO at year end, salary for that year would be subject to the compensation cap (even if the agreement was not modified).

Evergreen Clauses. Automatic renewals of a grandfathered employment agreement through an evergreen clause (or otherwise) do not extend the period of grandfathering when the employing corporation could avoid the renewal, *e.g.*, by providing advance notice. However, if the agreement gives the employee the right to require the renewal unilaterally and the employee does so, grandfathering is extended.

Stock Options, SARs and Other Equity Grants. A January 2, 2017 grant of options, SARs and restricted stock to the PEO vests on January 2, 2019, and the options and SARs are immediately exercised by the PEO. Here all of the equity is grandfathered (vesting by November 2, 2017 is not required for grandfathering) and the options and SARs are not subject to the compensation cap because they qualify as performance-based compensation under pre-tax reform 162(m). The restricted stock is grandfathered, but it is subject to the cap. However, if the equity grants were made after November 2,

2017 and a pre-November 2, 2017 employment agreement provided for equity grants that are "subject to approval of the Board of Directors," this approval condition is inconsistent with the corporation having a binding obligation and so none of the equity grants would be grandfathered.

- COMMENT: The grandfathered restricted stock is subject to the cap because it is not performance-based compensation and the executive remains PEO through the end of the 2019. Thus, under pre-tax reform act law, the 162(m) compensation cap applies to the restricted stock.

Deferred Compensation Arrangements. An officer is credited with an account balance under a deferred compensation plan by November 2, 2017. The plan permits amendments at any time that would cut off both additional deferral credits as well as additional phantom earnings credits. On these facts, the deferrals and earnings that are credited as of November 2, 2017 are grandfathered (but any later earnings on these amounts are not). If instead the plan permitted amendments to cut off deferral credits but preserved rights to future earnings credits, then both the November 2, 2017 account balance and future earnings on that account balance would be grandfathered.

- COMMENT: Many account balance deferred compensation plans are drafted to permit eliminating both future deferral credits and future earnings credits, and these are addressed by the Notice 2018-68. The notice does not address a plan with more limited amendment rights that allow *changing* earnings credits but not *eliminating* them altogether. Perhaps this could be analyzed as a form of negative discretion, and the question would be to what extent there is a determinable limit on the negative discretion.
- COMMENT. In the case of nonaccount balance deferred compensation plans (*e.g.*, a nonqualified defined benefit make-up plan), typically the "implicit earnings" that are part of the plan's benefit are not subject to elimination, and thus they should be grandfathered. The section 409A grandfather rules addressed how to determine such a plan's grandfathered benefit when service continues beyond the grandfather date (taking into account actuarial complexities). Notice 2018-68 does not address this, but implicit earnings should be grandfathered and the 409A rules may provide a starting point for good faith compliance.
- COMMENT: Like any other grandfathered arrangement, the applicability of the compensation cap to a grandfathered deferred compensation plan turns on the rules of pre-tax reform 162(m). Especially important in this respect with deferred compensation plans is the part of the pre-tax reform definition of covered employee that required executive officer status on the last day of a year to be a covered employee for the year. Thus, grandfathered deferred compensation that is paid after termination of employment can avoid the 162(m) compensation cap.

Material Modification – Increased Compensation. A binding five-year employment agreement is executed on January 1, 2017 and provides a salary of $1,800,000 to the PFO. In 2019, the corporation

provides a supplemental payment of $40,000. This is not a material modification that would cancel the grandfathered status of the contract because it qualifies as a reasonable cost-of-living increase from 2017 (but the $40,000 supplement is not grandfathered). In 2020, the corporation increases the PFO's salary to $2,400,000. This is a material modification, and all compensation paid to the PFO in 2020 and later is no longer grandfathered. However, if instead of increasing the PFO's salary in 2020 the PFO was given a restricted stock grant requiring service through 2021, the grant would not be a material modification of the right to salary under the employment agreement.

- COMMENT. The restricted stock grant is not a material modification because this compensation "is not paid on the basis of substantially the same elements and conditions as [the PFO's] salary because it is based both on the stock price and [the PFO's] continued service."
- COMMENT. As with other issues, Notice 2018-68's guidance on material modifications follows the corresponding guidance in the 1993 Grandfather regulations. Therefore, the private letter rulings on material modifications that applied those regulations should help inform the same issues under the 2017 Grandfather. See, *e.g.,* PLRs 9551024, 9649014, 9712002 and 9810024.

Material Modification – Deferral and Acceleration. If the payment of grandfathered compensation is deferred, there is no material modification if any increase in the amount payable (*e.g.*, through a deferral plan earnings adjustment) is based on either a reasonable interest rate or the results of a pre-determined actual investment. Similarly, if payment of grandfathered compensation is accelerated, there is no material modification if the amount paid is reasonably discounted to reflect the time value of money.

- COMMENT. Deferring grandfathered compensation can convert it from being subject to the 162(m) cap to being exempt from the cap (by pushing the compensation's payment beyond an executive's termination of employment). Earnings must be restricted as noted above for the deferred compensation to retain its grandfathered status. However, nothing in the notice suggests that the ability to defer the compensation had to be baked into the compensation's binding contract by November 2, 2017. Therefore, this apparent ability to add a deferral feature to grandfathered compensation, without triggering a material modification, is an especially important planning opportunity under post-tax reform 162(m).
- COMMENT. Even when deferring grandfathered compensation is not a material modification, any additional amount paid (typically the phantom earnings on the deferral) probably will not be grandfathered *unless* the deferral opportunity and the right to related earnings were set forth in a binding contracts as of November 2, 2017, and the right to future earnings on the deferral could not be taken away (either retroactively or prospectively) by a plan amendment.
- COMMENT. Note that earnings can be based on *either* a reasonable interest rate *or* the results of a pre-determined actual investment, but not the higher of these two. At the same time, this should not

preclude using the results on an actual investment that includes a value preservation feature. In addition, the guidance should allow the approach of emulating (on a phantom basis) the kind of self-directed investment that is typical under 401(k) plans.

Effective Date

The tax reform changes to section 162(m) apply to years beginning on or after January 1, 2018. Notice 2018-68 notes that its guidance is expected to be incorporated into regulations, and the portion of the regulations that reflects guidance from the notice will "apply to any taxable year ending on or after September 10, 2018. (Given the statutory effective date, this should be 99.99% of the 2018 tax years of public companies.) The notice then goes on to say that any regulatory guidance that would define covered employees more broadly or define the grandfather more narrowly will be prospective only, so public companies may rely on Notice 2018-68's guidance – at least for now.