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# LEGAL UPDATES AND NEWS

## IRS Issues Guidance on New Code Section 162(m)

On August 21, 2018, the Internal Revenue Service released Notice 2018-68 (the "Notice") which provides guidance regarding the changes made to Section 162(m) of the Internal Revenue Code by the Tax Cuts and Jobs Act of 2017 enacted in December 2017 (the "2017 Tax Act"). Section 162(m) ("162(m)"), originally enacted in 1993, limits the amount of tax-deductible compensation that "publicly held" corporations can pay certain executives to $1 million. Prior to the amendments, "qualified performance-based compensation" and commissioned income were exempt from this limit. In addition, compensation paid after termination of employment generally was exempt. All this has changed with the 2017 Tax Act, and the changes are significantly more burdensome than originally thought.

**Background**

Prior to the 2017 Tax Act, 162(m) generally limited the deductibility of compensation paid to certain "covered employees" of a publicly held corporation to $1.0 million per year. For these purposes, a "publicly held corporation" was defined as "any corporation issuing any class of common equity securities required to be registered under section 12 of the Securities Exchange Act (the "Exchange Act"). A "covered employee" was defined as (i) the chief executive officer ("CEO") or an individual acting in such capacity, or (ii) one of the four highest compensated officers (other than the CEO) whose total compensation is required to be reported to shareholders under the Exchange Act, excluding, in the case of accelerated filers, the chief financial officer ("CFO"). Exemptions from 162(m) existed for (1) "qualified performance-based compensation" such as stock options, cash incentive awards and performance shares that satisfied certain requirements; and (2) payments made to an executive after he or she was no longer considered a "covered employee," i.e., as a result of no longer being one of the most highly compensated officers or not being employed on the last day of the taxable year.

The 2017 Tax Act substantially modified 162(m) by, among other things: (i) expanding the definition of "covered employee"; (ii) eliminating the exemption from the 162(m) limitations for qualified performance-based compensation and commissioned compensation; and (iii) providing that once an executive becomes a "covered employee," that executive remains a covered employee forever, including after termination of employment or death.

These changes to 162(m) became effective for tax years beginning after December 31, 2017 for publicly held corporations but do not apply to certain compensation payable pursuant to a "written binding contract" that was in effect on November 2, 2017 and is not materially modified or renewed after that date (the "Grandfather Rule").

**New Definition of "Covered Employee"**

The 2017 Tax Act amended the definition of "covered employee," so that it now includes a publicly held corporation's principal financial officer ("PFO") and principal executive officer ("PEO," formerly referred to as "CEO") as well as the three additional highest compensated officers. The Notice clarifies that the "end of year" requirement (previously found in the regulations under 162(m)) for determining the three highest compensated executives has been eliminated, which means that covered executives will be subject to the 162(m) deduction limits even if their compensation is not disclosed in the Summary Compensation Table of the company's annual proxy statement or on the Form 10-K annual report. Similarly, the Notice refers to the legislative history of the 2017 Tax Act to confirm that an executive who is among the three highest compensated officers will be a covered employee even if a corporation is not required to file a proxy statement for the year in question.

The Notice also provides that the executive compensation disclosure rules under the federal securities laws for smaller reporting companies and emerging growth companies that limit compensation generally to the PEO and 2 other most highly compensated officers will be disregarded for 162(m) purposes. Smaller reporting companies and emerging growth companies that generally report only three executives in the summary compensation table, may nevertheless have five or more "covered employees" under the new 162(m) standards.

The 2017 Tax Act further expands the scope of covered employees under 162(m) by providing that once an executive is a covered employee for any taxable year beginning after December 31, 2016, the executive will always be a "covered employee," even after termination of employment or death, so long as the executive's employer is a publicly held corporation. The Notice confirms that a covered employee of a publicly held corporation would retain such covered employee status following the merger of the corporation with another publicly held corporation. However, we received informal guidance from the IRS that if an acquirer were a privately held corporation, the executive's covered employee status with the predecessor publicly held corporation would cease following the consummation of the merger. As a result, the private company would be able to deduct future compensation paid to the executive in excess of the 162(m) limit. While this is promising, it should be noted that informal guidance is not binding on the IRS. The IRS has indicated that it anticipates publishing proposed regulations.

The following examples demonstrate the impact of new Section 162(m) treatment of covered employees on merger and acquisition costs.

***Before 2017 Tax Act***: A publicly held corporation with a fiscal year ending December 31, is acquired by another publicly held corporation in May 2019 whereby the CEO of the acquired corporation receives a $3.0 million severance payment under an employment agreement. Under old 162(m) treatment, this payment was generally fully deductible (unless it included an excess parachute payment under Code Section 280G), as the CEO would cease to be a "covered employee" following his/her date of termination since he/ she would not be a covered employee at fiscal year end. Therefore, the full $3.0 million severance payment is deductible under old 162(m).

***After 2017 Tax Act***: Same facts as above except that the employment agreement was entered into or renewed after November 2, 2017. In this case, at least $2.0 million of the severance payment will be not deductible (the amount exceeding $1.0 million). Under revised 162(m), the fact that the executive is not employed at fiscal year end is irrelevant. For federal income tax purposes, new 162(m) would add at least $410,000 of expense ($2.0 million times 21% corporate tax rate) to a merger or acquisition. The loss of tax deduction could be greater because of other compensation paid to the executive during the same taxable year.

Note: for purposes of these examples, the potential loss of tax deduction due to having an excess parachute payment under Section 280G of the Internal Revenue Code ("Code") is ignored. A discussion of Code Section 280G is beyond the scope of this Alert.

The Notice provides that when a publicly held corporation's last completed fiscal year does not end on the same date as its tax year, such as when a corporation has a short tax year due to a merger or acquisition, the corporation's three most highly compensated executives for its short tax year will still be deemed to be "covered employees." The Treasury Department and the IRS have requested comments on how to determine a publicly held corporation's three most highly compensated executives for a short tax year, and the Notice states that corporations should base their determinations on a reasonable, good faith interpretation of the statute until such comments are received and further Notice is issued.

**Guidance on Written Binding Contracts and the Grandfather Rule**

The Notice confirms that compensation payable under a written, binding contract that was in effect on November 2, 2017, is exempt from the new 162(m) rules, only if applicable law (e.g., state contract law) obligates a corporation to pay the compensation if the employee performs the services or satisfies the applicable vesting conditions. Therefore, any amount paid to a "covered employee" that exceeds the amount a corporation is obligated to pay as of November 2, 2017, is subject to new162(m).

If, under a contract or arrangement in effect on November 2, 2017, an employer can exercise negative discretion to reduce the amount of a payment to a covered employee, the contract will not be treated as a written binding contract for the payment of any amount above the amount which cannot be reduced by the employer's exercise of negative discretion. An example in the Notice discusses a plan that would pay a cash bonus of $1,500,000 if certain performance goals are achieved, provided that the employer can reduce the bonus to $400,000 by exercising negative discretion. The goals are achieved but the employer reduces the bonus to $500,000. The Notice takes the position that only $400,000, the amount below which negative discretion cannot reduce the award, will be grandfathered and exempt from new 162(m). The additional $100,000 of the $500,000 bonus is subject to the deduction limits of new 162(m).

**Guidance on Material Modifications or Renewals and the Grandfather Rule**

The Notice provides that the Grandfather Rule will expire if any written, binding contract is materially modified or renewed after November 2, 2017. Under the Notice, a material modification is deemed to have occurred when a contract is amended to increase the amount of compensation payable to the employee, unless the increase in compensation is equal to or less than a reasonable cost of living increase over the payment made in the preceding year. It is possible that an employment agreement that provides a base salary and states that any increase in base salary is automatically the new base salary could be considered to have been materially modified upon an increase in base salary (if such increase exceeds a reasonable cost of living increase). If a written, binding contract is materially modified, it is treated as a new contract entered into as of the date of the material modification, and amounts received subsequent to the material modification are treated as paid under a new contract.

A modification that accelerates the payment of compensation is a material modification unless the amount of compensation is discounted to reasonably reflect the time value of money. If a contract is modified to defer the payment of compensation, any compensation paid or to be paid that is in excess of the amount that was originally payable will not be treated as a modification only if the additional amount is based on either a reasonable rate of interest or a predetermined actual investment such that the amount payable by the company is based on the actual rate of return or predetermined actual investment.

The Notice also clarifies that the Grandfather Rule will not apply to contracts that, although in effect on November 2, 2017, were renewed after that date. For example, if the terms of a contract, such as an employment agreement, provide that it will automatically renew as of a certain date unless the employer provides notice of termination of the contract at least 30 days before that date, the contract is treated as renewed as of the date that the termination of the agreement would be effective if that notice were given. Similarly, a written contract that is terminable or cancelable by a corporation without the employee's consent after November 2, 2017 is treated as renewed as of the date that any such termination or cancellation, if made, would be effective.

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The Notice makes clear that publicly held companies will have limited opportunities to preserve tax deductible treatment on compensation paid to covered employees. For the next few years, the Grandfather Rule may protect performance-based compensation, including non-statutory stock option exercises, if made pursuant to a plan or agreement that was a written binding contract entered into before November 2, 2017 that has not been materially modified on or after that date (and with respect to performance-based compensation, was not subject to the exercise of unlimited negative discretion). However, the impact of this change will soon be realized, initially, after year end when publicly traded companies prepare and file their federal tax returns. It could be felt earlier by companies that close an acquisition in 2018 and find that much of the severance payments paid to terminating senior executives who are covered employees are no longer deductible. Although beyond the scope of this Alert, it is clear that the changes to 162(m) may reduce, for publicly held company acquirers, the incentive to negotiate non-competes and other arrangements in lieu of change in control severance payments to preserve tax deductions and avoid "excess parachute payments." As a result of the 162(m) revisions, if severance payments in connection with a merger are nondeductible due to new 162(m), there will be less incentive for an acquirer to restructure an excess parachute payment under Code Section 280G.

If you have any questions regarding this alert or questions regarding deferral strategies for mitigating 162(m) exposure, please contact one of the attorneys listed below.

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