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August 30, 2018

IRS ISSUES INITIAL SELECTIVE GUIDANCE ON NEW SECTION 162(M) PROVISIONS, INCLUDING TRANSITION RULES

To Our Clients and Friends:

On August 21, 2018, the IRS released Notice 2018-68, which provides initial guidance regarding changes made to Section 162(m) of the Internal Revenue Code ("Section 162(m)") by last year's Tax Cuts and Jobs Act (the "Act"). Since 1993, Section 162(m) has imposed a limit on federal income tax deductibility by publicly traded corporations for compensation paid to certain senior executives—generally the same executives whose compensation is disclosed in the corporation's proxy statement, who are referred to under Section 162(m) as "covered employees". Section 162(m) has not imposed material increased tax costs on most publicly traded corporations since its enactment, probably mostly due to the exception for "performance-based compensation"—which includes cash bonuses, stock options, performance stock and similar awards— and the exclusion for amounts paid after termination of employment (such as deferred compensation and severance), at the same time that executive pay has increased significantly because of grants of cash and stock awards based on performance.

The Act amends Section 162(m) in a number of substantial ways to expand the scope of coverage and limit the exceptions for compensation subject to its deduction limit. The general view is that these amendments were part of a much broader effort to find ways to limit the federal government's revenue loss resulting from the Act's dramatic decrease in overall corporate income tax rates, with the maximum rate dropping from 35 to 21 percent. The Act, among other things, (1) includes a public corporation's Chief Financial Officer as a "covered employee" (which was the case prior to changes in the proxy reporting rules in 2009), (2) provides that once an executive becomes a "covered employee", that executive remains a "covered employee" in perpetuity, (3) eliminates the current exception from the $1 million deductibility limit for "performance-based compensation", and (4) applies the limit even for amounts paid after termination of employment.

The Act generally becomes effective for a public corporation's tax year beginning in 2018. As part of the transition to the new law, the Act contains an exemption from the new law for "written binding contracts" in effect on November 2, 2017 (the date that the bill was introduced in the House of Representatives). Specifically, the Act states that the changes to Section 162(m) "*shall not apply to remuneration which is provided pursuant to a written binding contract which was in effect on November 2, 2017, and which was not modified in any material respect on or after such date*." In other words, the pre-Act Section 162(m) rules generally continue to apply to these arrangements. Notice 2018-68 is intended to answer some of the many questions raised by taxpayers, particularly with respect to the changes in the definition of "covered employee" and the application of the transition rule (also referred to as the "grandfather rules").

Who is considered a "covered employee?"

Under the Act, a "covered employee" means any employee who is a principal executive officer (PEO) or principal financial officer (PFO) of a publicly held corporation or was an individual acting in that capacity at any time during the tax year . It also includes any additional employees whose total compensation for the applicable tax year places that employee among the three-highest compensated officers of the taxable year. At first glance, the definition looks like it covers the same group of executives whose compensation is subject to disclosure under federal securities laws in a publicly traded corporation's proxy statement. However, the Notice clarifies that there is no "end of year" requirement for determining the three highest compensated executives who did not serve during the year as PEO or PFO, which means that an executive officer can be a "covered employee" under Section 162(m) even if his or her compensation is not required to be disclosed in the corporation's Summary Compensation Table under the rules of the Securities and Exchange Commission ("SEC").

The Notice provides an example where a corporation's three most highly-compensated executives other than the PFO and PEO all terminated employment during the applicable taxable year. In that instance, even though one of those individuals would not be considered a "named executive officer" under SEC rules, all three are considered "covered employees" under the new rules.

Additionally, since the IRS will disregard the limited disclosure rules under the securities laws for smaller reporting companies and emerging growth companies for Section 162(m) purposes, those companies will find that they will need to calculate total compensation for more executives for purposes of Section 162(m) than is needed to satisfy the reporting requirements under the SEC's rules.

The Act also expands the definition of "covered employee" such that once an executive is a covered employee in any taxable year beginning after December 31, 2016, that status is retained forever and therefore covers all compensation paid to the executive for the remainder of his or her life, including compensation paid after the executive's termination of employment (and even if it is paid to a beneficiary or heir after the executive's death). Prior law provided that an executive would cease to be a "covered employee" after his or her departure from the corporation, and therefore compensation paid after the executive was no longer a "covered employee" was not subject to Section 162(m).

The IRS has provided a few examples to illustrate these changes. While the IRS has requested comments on how the rules should be applied to a corporation whose taxable year ends on a different date than its last completed fiscal year, the working principle that it has adopted in one of the examples is that if the corporation has a short tax year of less than 12 calendar months, the calculations to determine who is a "covered employee" will need to be completed independently for the short year.

What constitutes compensation paid under a written binding contract?

In general, compensation is considered as paid, or payable, under a written binding contract only to the extent that the corporation is obligated to pay the compensation under applicable law. Unless an agreement is renewed or modified, any compensatory payments made pursuant to such a written binding contract that was in effect on November 2, 2017, and that would have not been subject to the deduction limitation under Section 162(m) as it existed before the Act, are not subject to the deductibility limitation

under the new rules. The Notice emphasizes that in the case of executive employment agreements, even those with automatic renewal provisions, payments made under the agreement will generally be subject to the new law at the time that the contract is renewed or extended.

Under prior law, "performance-based compensation" did not lose its exemption if the compensation committee of the board of directors of the corporation decided to unilaterally reduce the amount, which was called "negative discretion". The Notice provides an example clarifying that to the extent an agreement or plan allows for a corporation to exercise this negative discretion with respect to performance-based compensation under a pre-November 3, 2017 written binding contract, the corporation may only deduct the amount that is not subject to such discretion. This example implies that where a corporation had a right to reduce performance-based compensation to zero regardless of actual performance, no portion of the compensation would be considered grandfathered for purposes of the Act. However, this example, and the underlying reasoning, should not apply to plans or agreements by which negative discretion is exercised by establishing the actual performance goals to be achieved, which have been referred to as "umbrella plans" or a "plan within a plan", so long as the actual goals were established on or before November 2, 2017. Of course, this arrangement will only be grandfathered for as long as those pre-established goals remain in effect. In addition, whether there was a right to reduce compensation payable presumably would have to be determined under applicable state law. For example, if a plan includes a negative discretion right that the company has never exercised, this practice may mean that there is no actual negative discretion for state contract law purposes.

The Notice also provides some examples clarifying that payments made pursuant to non-qualified deferred compensation programs in effect on November 2, 2017 will be grandfathered to the extent the corporation cannot unilaterally freeze or reduce future contributions. Since in our experience most non-qualified deferred compensation plans contain provisions that allow the plan sponsor to amend or terminate those plans with few restrictions, these examples send a signal that those public corporations with non-qualified deferred compensation arrangements may need to reach out to the plan administrators to make sure that benefits as of November 2, 2017 are being calculated for future use, since for those sorts of plans, that may well be the only eligible benefit not subject to the new rules.

What is considered a material modification?

An agreement will be considered materially modified (and thus no longer eligible for grandfather treatment under the Act) if the agreement is amended to (1) increase the amount of compensation paid (other than in an amount equal to or less than a cost-of-living increase), (2) accelerate the payment of compensation without a time-value discount, (3) defer the payment of compensation, except to the extent any increase in the value of the deferred amount is based on either a reasonable rate of interest or a predetermined actual investment, or (4) make payments on the basis of substantially the same elements or conditions as the compensation payable pursuant to such agreement.

The Notice contains an example in which a covered employee who has a grandfathered employment agreement providing for the payment of a fixed salary receives a restricted stock grant after November 2, 2017. The example states that the grant of restricted stock is not a material modification because the

stock grant is not paid on "substantially the same elements or conditions" as the salary. (However, any payments under the stock grant itself will be subject to the new law.)

To the extent an agreement is considered materially modified, all amounts received under the agreement after the effective date of such modification will be subject to the new rules, while the amounts received prior to the modification will remain protected under the grandfather rules.

Does the Act impact renewable agreements?

An agreement that is renewed after November 2, 2017 will be no longer be protected by the grandfather rules. An agreement is considered renewed on the date the agreement can be terminated by the corporation. An agreement is not considered renewable if it can only be terminated either (1) by the employee or (2) by having to terminate not only the agreement, but also the employee's employment with the corporation.

How should public corporations proceed?

The changes to Section 162(m) made by the Act will result in large losses of tax deductions for compensation paid to executives classified as "covered employees". Based on the guidance issued in the Notice, the IRS has indicated that it intends to interpret the statute and the transition rule in ways that are intended to maximize the amount of compensation that will be subject to the new rules. In particular, the Notice and its examples indicate that the IRS plans to interpret the "written binding contract" transition rule narrowly. When determining if an agreement is a "written binding contract," we recommend consulting with counsel since the assessment of whether an agreement is required to be paid under applicable law will require analysis of applicable state law.

We recommend that public corporations subject to Section 162(m) take careful inventory of all outstanding plans, agreements and arrangements that were in place on or before November 2, 2017 with one or more executives who are "covered employees". These arrangements should be reviewed to determine if and to what extent the grandfather rules can be relied upon. In the case of deferred compensation, corporations should determine the amounts attributable to each participant who is or may become a "covered employee" that were accrued on or before November 2, 2017. Such amounts will remain deductible when paid to the extent that they would have been deductible under the prior rules. In some cases, coordination with plan administrators will be necessary. Additionally, corporations should consider the potential tax impact of the new law and the IRS's interpretive guidance prior to making any changes to plans or agreements in effect as of November 2, 2017.

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This Client Alert necessarily only scratches the surface of this complex topic. Gibson, Dunn & Crutcher lawyers are available to assist in addressing any questions you may have regarding these issues. Please contact the Gibson Dunn lawyer with whom you usually work, or the following authors:

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