KPMG

GMS Flash Alert

Global Compensation Edition

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United States - IRS Notice Provides Initial 162(m) Guidance, Narrows Grandfathering Provision

U.S. Internal Revenue Service (IRS) Notice 2018-68 provides initial guidance on the tax law changes to the U.S. Internal Revenue Code (I.R.C.) section 162(m) deduction limitation for compensation paid to certain executive officers of publicly-held corporations.[1] The Notice provides guidance on a variety of issues including (i) the definition of a covered employee, (ii) grandfathering under the prior section 162(m) rules, and (iii) material modifications.

This GMS *Flash Alert* updates our prior report on the same subject by summarizing those changes, but also expanding upon them in light of recent developments. (For prior coverage, see GMS *Flash Alert* 2018-013 (January 18, 2018).)

WHY THIS MATTERS

Notice 2018-68 provides much needed initial guidance on an array of areas impacting section 162(m), including the applicable employer, covered employees, and transition or grandfathering rules.

For instance, the grandfathering provisions do not apply if a contract is materially modified after November 2, 2017. The Notice clarifies that a material modification occurs, for example, when the contract is amended to increase the amount of compensation payable to the employee. If a contract is materially modified, it is treated as a new contract.

The rules are complex and it is important that reasonable interpretations are made consistent with H.R. 1 and recent guidance as these will impact a company's effective tax deductions and tax rate, as well as the adjustment to deferred tax assets.

Employers and other interested parties are welcome to provide comments to the IRS through November 9, 2018.

In Brief: Significant Provisions

The recently-enacted tax reform law, H.R. 1, includes several significant provisions amending the section 162(m) deduction limitation for compensation paid to named executives of publicly-traded companies, including, but not limited to, amendments:

- expanding the definition of companies subject to section 162(m) beyond those with publicly-traded stock to include certain companies with publicly-traded debt as well certain companies with American depository receipts (ADRs);

- expanding the definition of covered employee to include anyone serving as the CEO or CFO during the year (beyond the individuals serving in those roles at the end of the year) as well as extending the definition of covered employee to include anyone identified as a covered employee from 2017 forward;

- no longer exempting performance-based compensation, including stock options and performance-based bonuses/equity awards;

- providing a transition rule (grandfathering rule) for compensation paid pursuant to a written binding contract in effect as of November 2, 2017, if not materially modified after that date.

Expansion of Applicable Employer

H.R. 1 expanded the types of companies subject to section 162(m) to include any corporation which is an issuer (as defined in section 3 of the Securities Exchange Act of 1934) (A) the securities of which are required to be registered under section 12 of the Securities Exchange Act of 1934, or (B) that is required to file reports under section 15(d) of the Securities Exchange Act of 1934, which would include those with publicly-traded debt or ADRs traded in the United States.

Notice 2018-68 did not shed additional light on this definition, but made a request for comments on the application of the definition to foreign private issuers. The Notice did provide additional clarification on the related definition of covered employees.

Covered Employees

H.R. 1 expanded the list of employees who will be subject to the section 162(m) limits. For the 2017 taxable year, the "covered employee" group remains the CEO and the three highest paid officers other than the CFO. For the 2018 taxable year, the covered employee group expands to anyone who serves as the CEO and/or CFO at any point during the year as well as the highest three paid employees (the "High Three"). The law also provides that once an individual is identified as a covered employee after 2016, the individual is forever, going forward, a covered employee, even in years where the individual would not otherwise meet the definition.

The rule provides that the covered employee treatment applies even after termination or death (e.g., with respect to amounts paid to a beneficiary), and that the designation could follow the covered individuals even if the individual was a covered employee at a predecessor company. The application of the definition to an employee who was a covered employee at a predecessor company is expected in future guidance. The Notice requested comments on this specific issue.

The new law provides that the group of employees who were covered employees in 2017 (under the pre-H.R. 1 rules) will be in the covered group for 2018. However, it appears that for employees who were not in the covered group in 2017 (such as a person who retired during 2017 and was not an officer on the last day of the company's year), that person is not likely to be a covered employee in 2018 even if the employee has significant compensation paid in 2018 (e.g., paid to the individual as a former or retired employee).

Notice 2018-68 clarifies that the term covered employee includes the following:

- **Officers of a corporation not required to file a proxy statement but that corporation otherwise falls within the revised definition of a publicly-held corporation**. For example, if a corporation de-listed its securities or underwent a transaction that resulted in the non-application of the proxy statement requirement, it would still have "covered employee" as defined under section 162(m). Furthermore, the High Three for purposes of section 162(m)(3)(B) in such instances should be based upon a reasonable good faith interpretation of the statute, taking into account the guidance provided under the Notice.

- **Certain individuals not employed at the tax-year end even though SEC disclosure rules may not be in alignment**.

The guidance provided in the Notice was clear that the High Three are determined regardless of whether the individuals are employed with the corporation at the end of the tax year and regardless of whether their compensation is subject to SEC disclosure. However, the determination of the amount of compensation used to identify the highest-compensated executive officers must be consistent with applicable SEC instructions. Additional covered employees that are different than the individuals disclosed on the SEC filing could occur due to termination or retirement of executive officers during the year, and also when smaller reporting companies or emerging growth companies may file disclosures for a more limited group of officers.

Transition Rule – Grandfathering

The performance-based compensation exemptions have been commonly utilized by companies to exempt payments from the section 162(m) deduction limit. Often, payments of commissions, bonuses, performance-based restricted stock units, and stock options were exempt from section 162(m) under the performance-based exemption. For deductions taken in 2018 and forward, the performance-based exemption was eliminated.

Although the performance-based exemption has been eliminated, H.R. 1 provides a limited transition rule for companies affected by the changes in section 162(m). The transition rule provides that to the extent a benefit was already subject to a written, binding contract on November 2, 2017, and is not materially modified after that date, the benefit provided is protected from the changes in section 162(m).

KPMG NOTE

The explanatory provision from the Joint Committee on Taxation was clear that merely having a live plan on November 2, 2017, is not enough to protect the benefits under that plan. The issue regarding to what extent a particular grant for a particular employee is under a written *binding* contract as of November 2, 2017, was not entirely clear with many executive arrangements because the board often retains negative discretion to reduce payments under the terms of the plan. Such discretionary language *may* result in the arrangement (in whole or in part) not being respected as a binding contract depending on applicable law.

Further, the transition rule only protects a company against the *changes* made in section 162(m). Thus, if the award would not have been exempt under section 162(m) previously, it is not protected by the transition rule.

Written Binding Contract

Notice 2018-68 clarifies that amendments to section 162(m) under H.R. 1 do not apply to remuneration payable under a written binding contract which was in effect on November 2, 2017, and which is not modified in any material respect on or after such date. However, remuneration is payable under a written binding contract that was in effect on November 2, 2017, only to the extent that the corporation is obligated 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.

Furthermore, the Notice indicates that the transition period ends and the new law applies as soon as a written binding contract is terminable or cancelable by the corporation without the employee's consent after November 2, 2017. However, such contracts are not treated as subject to the new rules if:

- employee consent is required,
- the contract is terminated or canceled only by terminating the employment relationship of the employee, or
- the amount is required to be paid under an arrangement in place as of November 2, 2017, even though the employee was not eligible to participate in the plan or arrangement as of November 2, 2017, as long as the employee had the right to participate in the plan or arrangement under a written binding contract as of that date.

Particularly instructive is Example 3 in the Notice under the "written binding contract" discussion. In Example 3, Employee P serves as the CEO of Corporation U for the 2017 and 2018 taxable years. On February 1, 2017, Corporation U establishes a bonus plan, under which Employee P will receive a performance-based cash bonus (that otherwise satisfies the old 162(m) rules for performance-based compensation) of $1.5 million. The compensation committee retains the right, even if the performance goal is met, to reduce the bonus payment to no less than $400,000. According to the Notice, on November 2, 2017, under applicable law, which takes into account the employer's ability to exercise negative discretion, the bonus plan established on February 1, 2017, constitutes a written binding contract to pay $400,000. Thus, only $400,000 is considered grandfathered in the example.

Interestingly, within the details of the example in the Notice, the corporation does utilize negative discretion. Where a corporation has not utilized negative discretion, there may nonetheless be a written binding contract "under applicable law" as noted in the Notice. The Notice also provides examples in which the corporation retains a right to terminate or amend contribution or accrual of payments on a go-forward basis and clarifies that a portion of the total future payments may be considered binding under applicable law as of November 2, 2017 (e.g., the non-forfeitable amount accrued as of that date) and therefore only a portion of the total payments may be considered grandfathered while the remainder is not.

Material Modification

The grandfathering provisions do not apply if the contract is materially modified after November 2, 2017. The Notice provides that a material modification occurs when the contract is amended to increase the amount of compensation payable to the employee. If a contract is materially modified, it is treated as a new contract.

Notice 2018-68 clarifies that the following do not constitute a material modification:

- Acceleration of a payment if the compensation paid is discounted to reasonably reflect the time value of money;
- The failure (in whole or in part) to exercise negative discretion;
- A modification for deferral of compensation where the additional amount paid (amount in excess of the original payment amount) is based on a reasonable rate of return or a predetermined actual investment; and
- A supplemental payment that is equal to or less than a reasonable cost-of-living increase over the payment made in the preceding year under the written binding contract.

In addition, the following are examples of a material modification:

- A supplemental contract or agreement that provides for increased compensation or a payment of additional compensation (greater than a cost of living adjustment), if the additional compensation is paid on the basis of substantially the same elements as the compensation pursuant to the written, binding contract;
- An accelerated payment of compensation that is not discounted for the time value of money; and
- A modification for deferral of compensation where the additional amount paid (amount in excess of original deferral amount) is not based on a reasonable rate of interest or a predetermined actual investment.

KPMG NOTE: Deferred Tax Asset ("DTA") Considerations and Other Items

DTAs related to covered employee compensation (bonuses, deferred compensation expense, and share-based compensation expense, etc.) should be evaluated to determine if the new section 162(m) rules will impact the ability to claim a deduction in the future and adjusted accordingly. At the very least, the change in tax rates have already impacted the DTA.

Going forward, a DTA should only be recognized for future compensation expense if a tax deduction is expected under the new rules or the arrangement is grandfathered under the transition rules.

In some cases, the application of the transition rule will depend on each grant or grant type. While the determination of whether a given grant is protected by the transition rule is very fact-based, there are some steps to help sort through the types of plans that may or may not be protected. Preliminary considerations include, but are not limited to the following:

1. Check the actual plan document(s) to determine whether the compensation committee has discretion to change and reduce the benefits granted. This language is fairly typical in a lot of plans, but it is not in all plans.
2. Check the "choice of law" statement that is in the back of many plan documents. If the plan provides the compensation committee with a level of discretion, the choice of law provision may set forth the state laws controlling the "binding contract" determination. A state with laws leaning toward employee rights might lead to a different conclusion than a state that leans towards protecting employer rights.
3. Check the actual grant to see whether the company has given up the right to eliminate the benefit or provides a minimum benefit. As an example, a typical stock option or stock appreciation right may have language in the grant requiring an employer to make the employee whole for awards eliminated other than for cause. Such language may indicate that the employee has a written binding contract, and, for grants before November 2, 2017, such awards may be grandfathered. This applies even if the grants are not yet vested.
4. Check whether some of the grants are automatic/locked in place. As an example, a company might have a plan or employment agreement that promises specific grants of shares (exact numbers of shares or percentages of shares that is determinable) to certain employees each year based on continued employment. Other plans may be less clear or simply give the compensation committee the right to decide how many shares the employee will be granted in a given year. The amount of discretion and timing of the document may help determine whether these sorts of grants are protected or partly protected under the transition rules.
5. Make sure the grant or related document has not been materially modified after November 2, 2017. It is generally advisable that companies considering the transition rule speak to a tax adviser before making any changes to their plans.

In some cases, a plan may be protected for all employees already in the plan for a substantial duration, such as a plan that provides a specific automatic formula and is designed to pay only after employees completely separate from service. In other cases, employees or the employer have to make decisions or choices each year with regard to the benefit amount, in which case only parts of the accrued benefit may be protected (amounts already earned and on which the employer already has a written binding right to a later payment). Later grants or accruals in 2018 forward are not likely to be grandfathered.

The fact that a grant is still subject to a substantial risk of forfeiture (such as time-based vesting or even some performance vesting) is not generally determinative. Instead, the determination is made at the time of vesting. There is a binding contract if, once the employee has satisfied the various conditions (time vesting conditions, performance metrics, etc.), the employee could take the written plan or grant to court and enforce the promised payment (or could enforce payment of a portion of the amount under the written binding agreement). Part of this determination may be made based on state contract law.

Plans that provide the employer or compensation committee with specific discretion at the time of distribution are less likely to be grandfathered under the transition rule. As an example, a discretionary bonus set to pay in 2018, and the compensation committee is expected to make decisions about the payment amounts at the 2018 compensation committee meeting (like certain "umbrella" plan grants), is less likely to be grandfathered. An annual bonus clearly described to employees before November 2, 2017, with a set payment formula and no discretion with regard to the determination of the bonus amount or to whom the amounts will be paid in early 2018 might still be protected, even where employees have to be employed until the date of payment. Likewise, a Performance Stock Unit Plan with a mechanical formula under which the number of shares will be paid out to the employee if the employee satisfies certain metrics, and under which the compensation committee is not expected to exercise, and has not been exercising, discretion at the time of vesting, seems more likely to satisfy the transition rule.

Next Steps

Treasury/IRS

The Department of the Treasury and the IRS anticipate that further guidance will be issued in the form of proposed regulations, which will incorporate the guidance provided in the Notice. It is anticipated that such guidance will apply to any taxable year ending on or after September 10, 2018.

Employers

Concerned parties should reach out to their qualified compensation/rewards professionals for assistance with reviewing DTAs as well as going-forward compliance by reviewing the specific changes in the rules relative to arrangements, reviewing plan documents to assist with determinations of which grants may be protected, and working with legal advisers as needed.

The KPMG Global Reward Services (GRS) practice can assist companies with such matters.

FOOTNOTE:

1 For Notice 2018-68, see: https://www.irs.gov/pub/irs-drop/n-18-68.pdf .

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