August 31, 2018

Client Alert

IRS Issues Guidance on Section 162(m) Amendments

EXEQUITY

Independent Board and Management Advisors

On August 21, 2018, the Internal Revenue Service (IRS) and the Department of the Treasury issued guidance[1] on the recent amendments to Section 162(m) of the Internal Revenue Code that were made by the Tax Cuts and Jobs Act of 2017 (TCJA). The guidance addressed the grandfather rule for pay under outstanding arrangements and provided insight into how covered employees will be determined. Unfortunately, the guidance contains some unexpected surprises, including some which jeopardize the viability of grandfathering for plans that contain negative discretion.

Exequity Comment: *The most significant impact of the IRS Notice is that payments under the great majority of 162(m) "umbrella" plans will not qualify for grandfathered deductibility under the TCJA. This results from the interpretation of what constitutes a company "obligation" to an employee—if the company reserves the right to exercise negative discretion to reduce payments (which is a standard feature of 162(m) "umbrella" plans), then the IRS Notice treats payments under the program as non-obligatory. Unless a portion of the payments under such a plan are mandated as a floor amount (which is rarely the case), the plan will not qualify for grandfathered deductibility.*

Written Binding Contract

Compensation payable under a written binding contract that was in effect on November 2, 2017 and which was not modified in any material respect will remain exempt for the 162(m) changes. The IRS Notice clarifies that this rule only applies to the extent the corporation is obligated under applicable law to pay the compensation if the employee provides services and satisfies the vesting obligations. As a result:

- If the Board maintains discretion to reduce/eliminate a performance-based award which was a typical feature in performance-based exempt compensation under the prior 162(m) regime, the compensation subject to such discretion will not be treated as exempt from the new rules as there is not a contractual right to the benefit.
- Further, to the extent that a contractual right can be terminated or cancelled at the company's discretion, the contract will be deemed terminated at the first instance such event could occur for purposes of the new 162(m) rules. Thus, to the extent participation in a plan or program is at the discretion of the company, compensation under that plan will be subject to the new rules and therefore is more likely to be non-deductible.

[1] IRS Notice 2018,68, available at: https://www.irs.gov/pub/irs-drop/n-18-68.pdf.

***Exequity Comments**: In general, most compensation payable under a contract entered into on or prior to November 2, 2017 must qualify as performance exempt under the old 162(m) rules to ensure full deductibility.*

Since most annual incentive programs provide the Compensation Committee with downward discretion on the amount earned, as allowed under the old 162(m) rules, they are likely to be subject to the new rule even if in effect before November 2, 2017. As such, most annual incentive plans will not be grandfathered under the prior 162(m) rules, and therefore will be more likely to be non-deductible.

Traditional stock options and stock appreciation rights granted prior to November 2, 2017 are likely to remain exempt as they are unlikely to be modified and do not include downward discretion by the Committee.

Companies should review their outstanding awards to determine how Section 162(m) may impact their deductibility.

The flow chart in Appendix A provides a systematic approach to evaluate whether the grandfather rule will be available for a written binding contract.

Modification of Written Binding Contracts in Effect on November 2, 2017

Material modification to a written binding contract occurs when:

- The contract is modified to increase compensation payable;
- The contract is modified to accelerate a payment unless the compensation is reasonably reduced to reflect the time value of money; or
- The contract is modified to defer the payment and excess compensation is paid, unless the excess compensation is based on either reasonable rate of interest or a predetermined investment.

In addition, compensation can increase by a reasonable cost-of-living adjustment over prior year payments and remain subject to the prior 162(m) rules though the application of this rule is unlikely to provide any significant relief.

***Exequity Comment**: Many employment contracts have a term of up to three years from the date of signing with automatic renewal features. Compensation pursuant to those contracts will come under the new 162(m) regime at the first time at which the contracts auto renew after November 2, 2017*.

Covered Employee

For tax years beginning after December 31, 2016, covered employee will include the CEO, CFO, and the three next highest paid executive officers, regardless of whether the executive's compensation is disclosed in the company proxy and regardless of whether the company is a smaller reporting company or emerging growth company. The guidance indicates that the tax rules will not follow the SEC disclosure rules which generally require the individuals disclosed in the proxy be employed on the last day of the year.[2] Thus, a covered employee includes any individual serving as CEO during the year, any individual serving as CFO during the year, and the three next highest paid employees regardless of whether they were employed on the last day of the year. Further, as provided in the Act, all individuals who were covered employees at any time after the tax year beginning after December 31, 2016 will remain covered employees in all future tax years. As a result, while it would be unusual, it is possible to have the deduction for compensation for a covered employee who has never been disclosed in the proxy be limited by 162(m) if they were one of the three highest paid employees in a single year but were not employed at the end of that year. Further, it is possible to have executives who are not subject to the new 162(m) rules despite having had their pay disclosed in a proxy in a single year.

***Exequity Comment**: Given that the status of covered employee continues for all future years after the 2017 tax year, companies will need to continue to monitor the compensation of the current year and prior years' covered employees. With the new guidance, this may not simply be individuals whose compensation was previously disclosed in the proxy.*

Conclusions and Next Steps

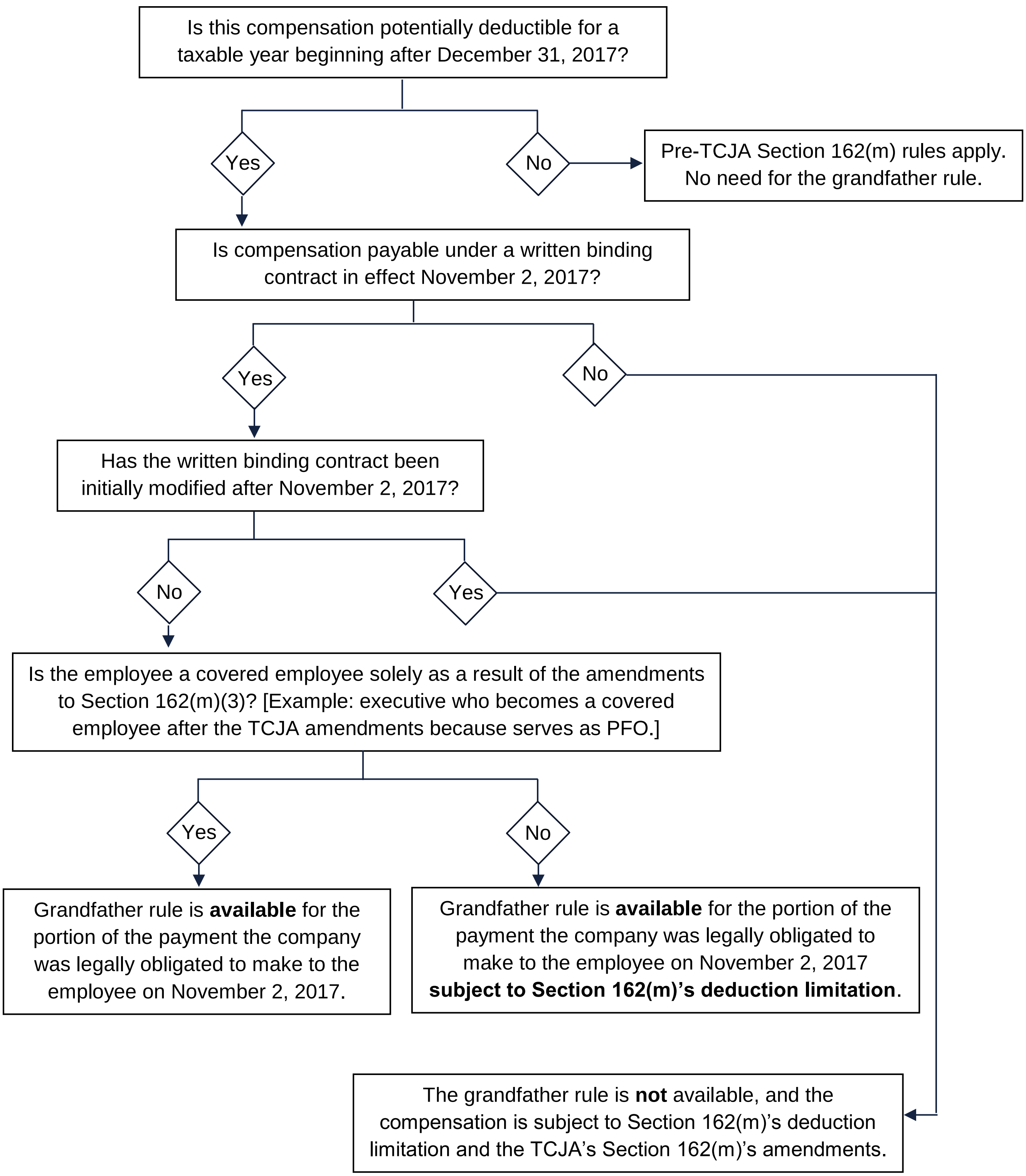
While the IRS Notice does provide some much-needed guidance on the TCJA's Section 162(m) amendments, it fails to address all of the issues companies are wrestling with regarding the amendments. The IRS notes that it is seeking guidance on establishing the three most highly compensated executive officers other than the PEO and PFO for purposes of amended Section 162(m). We expect the proposed regulations may elaborate on this and other issues, but it may take the IRS some time to issue proposed regulations.

Unfortunately, the guidance appears to substantially lessen the utility of the grandfather rule. Consequently, it is much more likely that compensation paid out under written binding contracts in effect November 2, 2017 will be or become subject to the TCJA's Section 162(m) amendments and, therefore, would likely be non-deductible to companies paying such compensation.

Companies should evaluate existing written binding contracts, including compensation plans and arrangements, in effect November 2, 2017 to determine whether and to what extent the relief offered from TCJA's Section 162(m) amendments is available under the grandfather rule. Additionally, companies should develop procedures to determine and track covered employees identified after December 31, 2016. Finally, companies should be aware of the challenges in determining covered employees for any short taxable year.

[2] Note, the proxy rules do require disclosure of up to two additional executives who were not employed on the last day of the fiscal year if their compensation would have made them one of the three highest paid officers other than the CEO or CFO. These individuals would be covered employees under the new rule.

Appendix A: Determining If, And To What Extent, The Grandfather Rule is Available



.

If you have any questions about this ***Client Alert***, please contact
Mike Sorensen (847- 996-3996 or Mike.Sorensen@exqty.com) or
Ed Hauder ((847) 996-3990 or Edward.Hauder@exqty.com) or any of the following:

Ben Burney	(847) 996-3970	Ben.Burney@exqty.com
Chris Fischer	(847) 996-3972	Chris.Fischer@exqty.com
Robbi Fox	(847) 948-8655	Robbi.Fox@exqty.com
Mark Gordon	(925) 478-8294	Mark.Gordon@exqty.com
Jeff Hyman	(203) 210-7046	Jeff.Hyman@exqty.com
Lynn Joy	(847) 996-3963	Lynn.Joy@exqty.com
Stacey Joy	(847) 996-3969	Stacey.Joy@exqty.com
Chad Mitchell	(949) 748-6169	Chad.Mitchell@exqty.com
Jeff Pullen	(847) 996-3967	Jeff.Pullen@exqty.com
Dianna Purcell	(718) 273-7444	Dianna.Purcell@exqty.com
Bob Reilley	(856) 206-9852	Bob.Reilley@exqty.com
Jim Woodrum	(847) 996-3971	Jim.Woodrum@exqty.com
Ross Zimmerman	(847) 996-3999	Ross.Zimmerman@exqty.com

Illinois Office (Headquarters) – 1870 West Winchester Road, Suite 141 ● Libertyville, IL 60048
California Offices – 2 Park Place, Suite 820 ● Irvine, CA 92614
– 2840 Comistas Drive ● Walnut Creek, CA 94598
Connecticut Office – 108 Pine Ridge Road ● Wilton, CT 06897
New Jersey Office – 309 Fellowship Road, Suite 200 ● Mt. Laurel, NJ 08054
www.exqty.com

You are receiving this ***Client Alert*** as a client or friend of Exequity LLP. This ***Client Alert*** provides general information and not legal advice or opinions on specific facts. If you did not receive this directly from us and you would like to be sure you will receive future ***Client Alert***s and our other publications, please click on the following link to add yourself to our subscription list: http://www.exqty.com/References/Subscribe.aspx. If you want to unsubscribe from our list, please click on "Manage Subscription" at the bottom of the e-mail sent to you.

PUB/CA/IRS Guidance 162(m) Amendments_20180831