ROPES & GRAY

ALERT

Executive Compensation & Employee Benefits

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IRS Provides New Rules under Stricter $1 Million Tax Deduction Limit for Executive Compensation

In December 2017 Congress significantly broadened the Internal Revenue Code's $1 million deduction limitation under Section 162(m) for compensation paid to top public company executives by, among other things, eliminating previously available exemptions for stock options and other performance-based compensation and deferred compensation paid after cessation of employment. The new, stricter version of Section 162(m) applies generally to taxable years beginning after December 31, 2017, but grandfathered certain arrangements in existence on November 2, 2017.

The IRS has now issued guidance (Notice 2018-68) (the Notice) on the new Section 162(m). While some aspects of the guidance were foreseeable from the statutory language, others are surprisingly restrictive, notably as to the limited availability of grandfathering relief for existing arrangements, the expanded scope of who is a "covered employee" and the effect of the deduction limitation in going-private transactions. The Notice does not address the rule that allows newly public companies to limit the application of Section 162(m) during a post-initial public offering (or similar) transition period but requests comments on that provision, suggesting the possibility of future changes.

More Executive Compensation Affected

Prior to the December 2017 legislative changes, the group of "covered employees" (executives whose compensation might be subject to the deduction limitation under Section 162(m)) was a subset of a company's "named executive officers" (NEOs) under the SEC's executive compensation disclosure rules – the executives whose compensation is required to be disclosed in detail in the company's proxy statement or other filings. Executive officers who ceased to be in office before the end of the year were not included and, for technical reasons, for most larger public companies the CFO was also excluded.

New Section 162(m) includes the CFO and certain former NEOs. This means that amounts payable after termination of employment may continue to be subject to the Section 162(m) deduction limitation. Also, emerging growth companies (EGCs) and smaller reporting companies (SRCs) in particular may be surprised to learn that, for purposes of determining their covered employees for a given year, they will need to first consider which executives would be NEOs if they were subject to the full SEC disclosure requirements. The chart below summarizes how the NEO disclosure rules and the new covered employee (CE) requirements interact for a given fiscal year. The chart assumes that the applicable fiscal year and tax year for which the Section 162(m) deduction limitation is being considered are the same, though that will not always be the case.

Category	Executive Officer Description	Non-EGC/SRC	EGC or SRC
A	CEO at any time during the applicable year	NEO & CE	NEO & CE
B	CFO at any time during the applicable year	NEO & CE	NEO (only if among top 2 highest paid non-CEO EOs serving at year end) & CE
C	3 highest paid executive officers (“EOs”) as of the end of the applicable year other than the CEO and CFO	NEOs & CEs (only if among the 3 highest paid in categories C, D and E)	NEOs (only if among the 2 highest paid in categories B & C) & CEs (only if among the 3 highest paid in categories C, D and E)
D	Up to two additional EOs who are no longer EOs at year-end if their compensation would cause them to be an NEO under category C if serving as an EO at year-end	NEOs & CEs (only if among the 3 highest paid in categories C, D and E)	NEOs (only if higher paid than at least 1 of the 2 highest paid in categories B & C) & CEs (only if among the 3 highest paid in categories C, D and E)
E	Up to one additional EO not described in category D who is no longer an EO at year-end if their compensation would cause them to be a non-EGC/SRC NEO under category C if serving as an EO at year-end	Not NEO but CE (only if among the 3 highest paid in categories C, D and E)	Not NEO but CE (only if among the 3 highest paid in categories C, D and E)
F	CE for tax year beginning on or after January 1, 2017, whether or not a CE thereafter	Not NEO but CE	Not NEO but CE

Which Arrangements Are “Grandfathered”?

The December 2017 legislative changes included a grandfathering provision that applies prior law to arrangements maintained under a written binding agreement in effect as of November 2, 2017. The grandfathering provision has the potential to avoid application of the new Section 162(m) limitations to, among other things, arrangements with individuals who were not previously covered (e.g., CFOs or former executive officers) and compensation arrangements that were previously exempt from Section 162(m) but are no longer exempt (e.g., stock options and other performance-based compensation).

The Notice clarifies that applicable state law determines whether an agreement is binding. Any material modification of an entitlement existing as of November 2, 2017 will eliminate grandfathering protection. Whether a contract has been materially modified for this purpose is generally determined in a manner consistent with existing rules on material modification for other purposes under Section 162(m). Under these rules, a material modification occurs when a contract is amended to increase the amount of compensation payable under it or, in certain cases, when amounts payable under the contract are accelerated.

Importantly, if an agreement allows a company to reduce payments unilaterally (for example, under a performance bonus program), the Notice generally treats the payment commitment as non–binding to the extent such discretion may be exercised, apparently regardless of whether as a matter of past practice the company has ever exercised discretion to reduce payments. While not surprising given the legislative history, the Notice’s rigid position on company discretion is ironic: in many cases existing bonus programs included “negative discretion” (the ability to reduce a nominally large performance payout to reflect other business factors) precisely because they were trying to come within an exemption available under the pre-amendment Section 162(m). The Notice's position on company discretion means that in practice many agreements designed to maximize deductibility under old law will not be grandfathered.

The Notice does not treat as grandfathered an equity award made after the grandfathering date pursuant to a written contract in existence as of the grandfathering date, where the equity award is subject to board approval. Although the Notice does not refer to the more typical case in a public company where approval is required from a board committee (usually the compensation committee), the same conclusion should logically apply where committee action is required.

The Notice helpfully confirms that deferred compensation (and certain earnings on that compensation) attributable to periods prior to the grandfathering date (even if requiring service beyond the grandfathering date) may be treated as grandfathered. However, where the arrangement can be prospectively unilaterally terminated by the company at any time (as is often the case), only those amounts that have been credited to the account prior to the grandfathering date are treated as grandfathered.

Implications for M&A Transactions Involving Publicly Held Corporations

Prior to the December 2017 legislative changes, the IRS had issued guidance indicating that the deduction limitations of Section 162(m) did not apply to compensation deductible in an acquired public company's short pre-acquisition year where, as was typically the case, SEC rules did not require executive compensation disclosure for that fiscal year.

The Notice no longer accommodates that helpful relief. As a result, certain deal-related compensation paid to senior executives that would have been deductible under prior law (assuming no other deduction limitations) may no longer be deductible – for example, cash out payments for stock options, restricted stock units and similar equity awards, the vesting of restricted stock, severance payments and change in control or retention bonuses.

Effective Date

The IRS anticipates that future regulations will incorporate the guidance included in the Notice and will apply to any taxable year ending on or after September 10, 2018, and that any future guidance that expands the definition of covered employee or restricts the grandfathering provision would only apply prospectively.

For further information about how the issues described in this Alert may impact your interests, please contact a member of the Ropes & Gray executive compensation & employee benefits practice or your regular Ropes & Gray attorney.