# *Client Alert*: Bad News for Employers! New IRS Guidance Regarding Expanded 162 (m) Rules

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We previously wrote about the changes to 162(m) under the “Tax Cuts and Jobs Act” which significantly expanded the $1,000,000 deduction cap on compensation paid by publicly traded companies to certain executive officers. On August 21, 2018, the IRS released Notice 2018-68 providing the first official glimpse of their interpretation of the changes to 162(m). It is mostly bad news for employers.

## Which employees are subject to the deduction limitation?

The guidance reflects that the new 162(m) deduction limit may apply to a different list than the proxy disclosure rules. In general, the test will be applied without requiring the individual to be employed on the last day of the fiscal year or be listed in the proxy materials. The 162(m) status is determined the same way whether the company is a smaller reporting company or a larger company subject to the full disclosure rules. The interpretation is best illustrated with an example:

Role/Compensation

Proxy Reporting

162(m) status

CEO at any time during the year (whether or not employed at year end)

Reported

Covered

CFO at any time during the year (whether or not employed at year end)

Reported

Covered

HCE1 (highest ranked by pay non-CEO/CFO of all executive officers, terminated during year)

Reported

Covered

HCE2 (second highest ranked by pay of all executive officers, terminated during year)

Reported

Covered

HCE3 (third highest ranked by pay of all executive officers, terminated during year)

Not reported

Covered

HCE4 (fourth highest paid non-CEO/CFO executive officer overall, highest who was employed on the last day of the fiscal year)

Reported

Not covered

HCE5 (fifth highest paid non-CEO/CFO executive officer overall, second highest who was employed on the last day of the fiscal year)

Reported

Not covered

HCE6 (sixth highest paid non-CEO/CFO executive officer overall, third highest who was employed on the last day of the fiscal year)

Reported

Not covered

If the company has a short-fiscal year, the list of covered employees could be determined twice for one 12 month period (once for each short fiscal year).

## What compensation is grandfathered (subject to transition relief)?

Compensation that would have been exempt under prior law remains deductible if it is payable 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. This is referred to as grandfathering and/or transition relief. The IRS proposes to define this exception very narrowly:

- For individuals who were employed on 11/2/2017 and who were covered by a plan or agreement, that plan or agreement will generally be grandfathered for the term that was in effect as of 11/2/2017.
    - Grandfathered status will be lost for certain material amendments. For example, if during the original term the company enters into a side agreement to materially increase a type of compensation under the original contract, that side agreement will be treated as an amendment to the original contract that causes a loss of grandfathered status for the original contract compensation as well as the new compensation. In contrast, if the side agreement provides a different type of compensation, then it won't cause a loss of grandfathered status for the original contract compensation, but the new compensation will be subject to the deduction limit. Importantly, side agreements that provide a "reasonable cost-of-living increase" will not be deemed to be a material increase. The ability to amend the original contract by mutual consent or by unilateral action of the employee will not trigger a loss of grandfathered status (until the contract is actually amended).
    - If the plan contains typical amendment provisions that allow the company to amend the plan to freeze or reduce contributions in the future, so long as current accrued benefits are protected, then only the portion of the benefit that is accrued as of 11/2/2017 is grandfathered. Otherwise, the future contributions and earnings credits that would have been credited under the written plan also would be potentially grandfathered.
    - If the compensation would not have been deductible under pre-amendment law at the time paid, then the fact that it was accrued under a plan that could be grandfathered does not protect it. For example, if in 2016 the CEO had elected to defer base salary into a deferred compensation plan to be paid in 2020 and the CEO is actively employed on the scheduled payment date, then that compensation would not have been deductible under prior law and still isn't deductible.
- The negative discretion provisions found in most incentive compensation arrangements will cause that incentive compensation to be non-deductible except to the extent that state law or the plan prohibits the reduction. The notice includes an example of a $1.5M bonus opportunity where the committee had discretion to reduce an attained award to no less than $400k and found that the $400k was deductible but any bonus in excess of that threshold would not be deductible. Because few plans contain an express limitation on the committee's discretion, this analysis will depend on analysis of state law limits, which will vary across the country. Companies will likely need a legal opinion to support a position that any part of the agreement was binding.
- Similarly, if an employment agreement provides that an employee will receive an annual equity grant, then that future grant would still be potentially grandfathered. If instead the employment agreement conditioned that future grant on the board approval at that time, then the future grants are not grandfathered because the board would have the discretion to not award the grant.
- An amendment accelerating payment will trigger a loss of the grandfathered status unless the amount paid is discounted to reasonably reflect the time value of money.

Companies subject to the deduction limitation should act now: (1) to confirm that the list of individuals that they have identified as subject to the deduction limitation comply with this methodology, (2) to determine what portion, if any, of current compensation arrangements would be able to be grandfathered, and (3) consider methods to maximize the deductibility of current and future compensation. The grandfathering analysis will be very nuanced with minor changes in the facts or plan provisions changing the deduction status.

If you have questions or want assistance evaluating the impact of this interpretation on your compensation programs, contact your Vorys relationship attorney.