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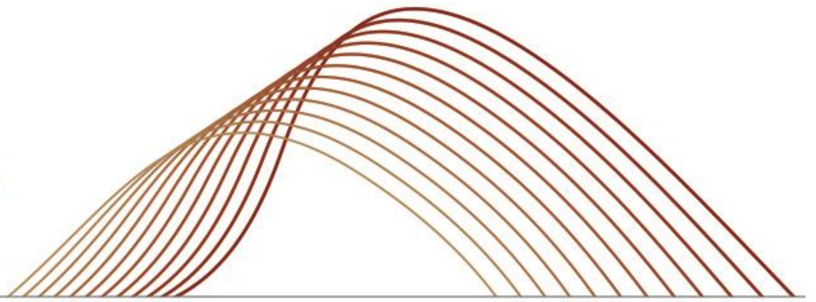

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Who's Covered and What's Grandfathered? A Look at the New 162(m) Guidance

By the Global Compensation, Benefits, and ERISA Practice Group

On August 21, the IRS issued Notice 2018-68, the first guidance on the changes to 162(m) from last year's Tax Cuts and Jobs Act (the "Act").[1] Generally, the Act (i) eliminated the ability to deduct compensation in excess of $1 million for covered employees of public companies by virtually gutting the performance based compensation exception to that limit and (ii) expanded the definition of both covered employees and public companies. The more interesting aspects of the Notice are:

I. Covered Employees.

It sets forth the rule that whether an individual is a covered employee by virtue of being one of the three highest compensated employees (other than the PEO and PFO) is determined *without regard* to whether the individual remains employed at the end of the year—diverging from the Proxy disclosure rules in certain instances.

Practice Pointer: This will require ongoing monitoring by public companies with respect to employees who terminate during the year and were paid at least $1 million.

II. Grandfathering.

Grandfathering applies to written binding contracts in effect on November 2, 2017 that have not subsequently been materially modified in two primary instances: (a) employees who become covered employees because of the Act and (b) performance based awards to the extent the payment at issue is legally required.

> Example: Assume a PFO had a binding written contract prior to November 3, 2017 to be paid $3 million per year in base salary until 2020, subject to continued employment; although the PFO would be subject to amended 162(m), because those $3 million payments were legally required as of November 2, 2017 they would remain subject to the pre-Act standards and generally would be deductible.

> Example: Assume a PEO had a binding written contract on November 2, 2017 requiring payment of $5 million if the company satisfied performance goals that satisfied the pre-Act requirements; those payments generally would be deductible.

Practice Pointer: Clients that have not yet identified contracts subject to grandfathering should do so to evaluate whether they want to consider preserving grandfathered status.

A. Material Modifications.

A material modification will not occur if reasonable cost-of-living increases are provided, but any other agreement (whether or not an amendment to the otherwise grandfathered contract) for payment of additional amounts is a material modification that will cost grandfathering status, if those additional amounts are paid on substantially the same terms and conditions as compensation paid pursuant to the otherwise grandfathered contract (e.g., the Notice indicates that additional monthly payments are bad because they look too much like a base pay increase, but that the grant of restricted stock would be okay because it looks different enough because payment is based on company share price and future services).

Acceleration of future payments is a material amendment unless appropriately discounted for the time value of money (but remember to consider 409A before accelerating payments) and deferrals and earnings on deferrals are not as long as the earnings are based on a reasonable interest rate or a predetermined actual investment (although actual investment is not required).

***Practice Pointer: Clients with contracts subject to grandfathering that they want to keep grandfathered should remember to analyze any compensatory changes in advance to determine whether they will cost grandfathering*.**

B. Written Binding Contract.

The ability to exercise negative discretion to reduce the amount of performance based compensation does not materially modify the contract; *however*, it does prevent there being a "binding" contract to the extent of the ability to exercise negative discretion (because applicable law will not require payment of such amounts). This will torpedo many employers' ability to deduct what otherwise would have been grandfathered performance based compensation.

The Notice clarifies that evergreen contracts (e.g., contracts that automatically renew unless notice of non-renewal is provided) are not subject to grandfathering after the first date any such non-renewal notice could be effective.

Most non-qualified deferred compensation plans will satisfy the written binding contract requirement as to amounts (including earnings) that were vested as of November 2, 2017. If such a non-qualified deferred compensation plan required earnings to be credited until November 2, 2027, for example, it appears that all earnings would be grandfathered as well.

Practice Pointer: Clients that have grandfathered non-qualified deferred compensation plans will want to take stock of what amounts are eligible for grandfathering, if any.

III. Other Matters.

The Notice anticipates that the issues addressed in the Notice will be reduced to regulations and that any such regulations will apply to any taxable year starting on or after January 1, 2018 and ending on or after September 10, 2018.

The IRS hints that future guidance may expand the group of covered employees or narrow what contracts qualify as written binding contracts, but that any such guidance will be prospective only.

The IRS invites comments to be submitted through November 9, 2018.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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[1] The IRS reminds us that the formal name of the Act wasn't the Cut, Cut, Cut Act or the Tax Cuts and Jobs Act, but that it actually is "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018."

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