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Executive Compensation and Employee Benefits Client Alert: IRS Issues Initial Guidance on the Definition of Covered Employees and Application of the “Grandfather Rule” under Section 162(m)

On August 21, 2018, the IRS released Notice 2018-68 (the “Notice”), which provides initial guidance on certain amendments to Section 162(m) of the Internal Revenue Code which were included in the Tax Cuts and Jobs Act passed in December 2017 (“TCJA”). Most notably, the Notice provides additional interpretive guidance on the identification of covered employees and attempts to clarify open questions with respect to the application of the transition relief applicable to compensation paid pursuant to written binding contracts in effect as of November 2, 2017 that have not been materially modified after such date (commonly referred to as the “grandfather rule”).

Additional Guidance on the Definition of Covered Employee

As a reminder, TCJA amended the definition of “covered employee” to mean any employee of a taxpayer if (A) the employee served as the principal executive officer (“PEO”) or principal financial officer (“PFO”) of the taxpayer at any time during the taxable year, or was an individual acting in such capacity, (B) the employee is one of the three highest compensated officers of the taxpayer (other than the PEO or PFO) for the taxable year, or (C) the employee was a “covered employee” of the taxpayer for any preceding taxable year beginning after December 31, 2016. Thus, TCJA significantly broadens the definition of covered employee by including PFOs, and making it so that an individual retains his or her status as a covered employee for future taxable years.

The Notice clarifies two points of uncertainty with respect to the amended definition of covered employees:

- First, a taxpayer’s PEO, PFO and next three highest paid executive officers for the taxable year will still be included in the group of covered employees even for years in which the taxpayer is a publicly held corporation but is not required to provide executive compensation disclosure pursuant to Securities and Exchange Commission (“SEC”) rules.

- For example, if the taxpayer is a smaller reporting or emerging growth company, the group of covered employees may be broader than the group of employees for which executive compensation disclosure is required under applicable SEC rules.
- Second, the group of individuals who are to be included as covered employees are the taxpayer's three highest paid officers for the taxable year (other than the PEO or PFO), even if such individuals are not serving at the end of the employer's taxable year.
 - In other words, Section 162(m) focuses on the highest paid officers of the company, even where disclosure of their compensation is not required under applicable SEC rules.

Further Guidance on Grandfathered Arrangements (Application of Transition Rule for Written, Binding Contracts in Place as of November 2, 2017)

The amendments to Section 162(m) under TCJA generally apply to taxable years beginning after December 31, 2017. However, TCJA provides for transition relief (the "grandfather rule") for compensation paid pursuant to a written binding contract which was in effect as of November 2, 2017, provided that such contract was not materially modified after such date.

Written Binding Contract

- The Notice clarifies that grandfathering will not apply to any amount of compensation that exceeds the amount of compensation that the taxpayer is legally obligated to pay the employee under applicable law (i.e., state and local law) if the employee performs services or satisfies any applicable vesting conditions.
- With respect to written binding contracts that provide for committee discretion to reduce the size of an award, grandfathering will not apply to any amounts paid to the employee which exceed the lowest amount of compensation to which the compensation committee can reduce the size of the award.
 - For example, if an employee would be entitled to receive \$1,000,000 under a bonus program upon the achievement of pre-established performance goals, but the compensation committee retained the discretion to reduce the award to no less than \$400,000, any amount paid to the employee over \$400,000 would not be grandfathered.
 - This likely means that if a corporation retains negative discretion to reduce amounts payable under a contract to zero, then no amount of compensation under such contract would be grandfathered.
- Grandfathering will not apply to contracts that are renewed after November 2, 2017.
 - A written binding contract that can be terminated or canceled at the corporation's election without the employee's consent after November 2, 2017 will be treated as renewed as of the date that such termination or cancellation, if made, would be effective.

- If an employment contract provides for automatic renewals unless the corporation provides an earlier notice of non-renewal, any grandfathering applicable to that contract will only apply up until the date of the first automatic renewal, and payments made pursuant to the contract after the automatic renewal may not be grandfathered and could be subject to Section 162(m) as amended.

Material Modifications

Another point of uncertainty that has existed since TCJA was passed is how the concept of a “material modification” would be applied with respect to the grandfather rule. The Notice clarifies that:

- Amendments to contracts which result in an increase in the amount of compensation payable (unless such increase represents a reasonable cost-of-living increase over the amount paid in the prior year), or result in the acceleration of the time of payment (unless the amount paid is discounted reasonably to reflect the time value of money) will be considered material modifications.
- Where a contract is modified to defer the payment of compensation, the amount of compensation paid in excess of the original amount deferred under the contract will continue to be grandfathered so long as the additional amount is a result of interest paid at a “reasonable rate”, or is the result of a predetermined actual investment based on the actual rate of return.
- If a contract is deemed to be materially modified, it will be treated as a new contract as of the date of the modification and grandfathering will no longer apply to future amounts paid under such contract.

Conclusion

Although the Notice provides welcome guidance with respect to certain points of uncertainty that resulted from the amendments to Section 162(m), there are still a number of interpretive questions to be clarified by the IRS. While awaiting further guidance from the IRS, employers should continue to analyze the impact that Section 162(m) (as amended) may have on their compensation arrangements:

- Employers should continue to review their existing compensation arrangements with this guidance in mind in order to identify which items of compensation may still be deductible for 2018 and future taxable years.
- Employers should also remain mindful of any changes to the terms of any existing binding contracts; if any changes result in a material modification, this could result in a loss of deductibility with respect to all future payments under such contract.
- Employers should also begin to take stock of which of its employees will be considered covered employees for 2018 and future taxable years, keeping in mind that this group may also include former employees.

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Please feel free to discuss any aspects of this Client Alert with your regular Milbank contacts or any of the members of our Executive Compensation and Employee Benefits Group.

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