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Bad Grandpa: Notice 2018-68 Provides Initial 162(m) Guidance, Including a Narrowly Crafted Grandfathering Provision

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Notice 2018-68 provides initial guidance on the tax law changes to the section 162(m)[1] deduction limitation for compensation paid to certain executive officers of publicly held corporations. As this article explains, the notice provides guidance on a variety of issues including the definition of a covered employee, grandfathering under the prior section 162(m) rules, and material modifications.

Overview

The enacted H.R. 1 includes several significant provisions amending the section 162(m) deduction limitation for compensation paid to named executives of publicly traded companies, including but not limited to amendments:

- Expanding the definition of companies subject to section 162(m) beyond those with publicly traded stock to include certain companies with publicly traded debt as well certain companies with American depository receipts ("ADRs")
- Expanding the definition of covered employee to include anyone serving as the CEO or CFO during the year (beyond the individuals serving in those roles at the end of the year) as well as

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[1] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

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extending the definition of covered employee to include anyone identified as a covered employee from 2017 forward

- No longer exempting performance-based compensation, including stock options and performance-based bonuses or equity awards
- Providing a transition rule (grandfathering rule) for compensation paid pursuant to a written binding contract in effect as of November 2, 2017, if not materially modified after that date

Notice 2018-68 provides much needed initial guidance on an array of areas affecting section 162(m), including the applicable employer, covered employees, and transition or grandfathering rules. Treasury and the IRS anticipate that further guidance will be issued in the form of proposed regulations, which will incorporate the guidance provided in the notice. It is anticipated that the guidance will apply to any tax year ending on or after September 10, 2018.

Expansion of Applicable Employer

H.R. 1 expanded the types of companies subject to section 162(m) to include any corporation that is an issuer (as defined in section 3 of the Securities Exchange Act of 1934)—(1) the securities of which are required to be registered under section 12 of the Securities Exchange Act of 1934, or (2) that is required to file reports under section 15(d) of the Securities Exchange Act of 1934, which would include those with publicly traded debt or ADRs traded in the United States.

Notice 2018-68 did not shed much additional light on this definition, but made a request for comments on the application of the definition to foreign private issuers. The notice did provide additional clarification on the related definition of covered employees.

Covered Employees

H.R. 1 expands the list of employees who will be subject to the section 162(m) limits. For the 2017 tax year, the covered employee group remains the CEO and the three highest paid officers other than the CFO. For the 2018 tax year, the covered employee group expands to anyone who serves as the CEO and/or CFO at any point during the year as well as the highest three paid employees (the “High Three”). The new law also provides that once an individual is identified as a covered employee after 2016, the individual is forever going forward a covered employee, even in years when the individual would not otherwise meet the definition.

The rule provides that the covered employee treatment applies even after termination or death (e.g., with respect to amounts paid to a beneficiary), and that the designation could follow the covered individuals even if the individual were a covered employee at a predecessor company. The application of the definition to an employee who was a covered employee at a predecessor company is expected in future guidance. The notice requested comments on this specific issue.

The new law provides that the group of employees who were covered employees during 2017 (under the pre-H.R. 1 rules) will be in the covered group for 2018. However, it appears that for employees who

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were not in the covered group in 2017 (such as a person who retired during 2017 and was not an officer on the last day of the company's year), that person is not likely to be a covered employee in 2018 even if the employee has significant compensation paid in 2018 (e.g., paid to the individual as a former or retired employee). The notice specifically provides that the determination of covered employees during 2017 is made using the prior 162(m) rules, not the expanded rules under H.R. 1.

Notice 2018-68 clarifies that the term covered employee includes:

- Officers of a corporation not required to file a proxy statement but otherwise falls within the revised definition of a publicly held corporation. For example, if a corporation delisted its securities or underwent a transaction that resulted in the non-application of the proxy statement requirement, it would still have covered employees as defined under section 162(m). Furthermore, the High Three for purposes of section 162(m)(3)(B) in such instances should be based upon a reasonable good faith interpretation of the statute, taking into account the guidance provided under the notice.

- Certain individuals not employed at the tax year-end even though Securities and Exchange Commission ("SEC") disclosure rules may not be in alignment.

The guidance provided in the notice was clear that the High Three are determined regardless of whether the individuals are employed by the corporation at the end of the tax year and regardless of whether their compensation is subject to SEC disclosure. However, the determination of the amount of compensation used to identify the highest compensated executive officers must be consistent with applicable SEC instructions. Additional covered employees that are different than the individuals disclosed on the SEC filing could occur due to termination or retirement of executive officers during the year, and also when smaller reporting companies or emerging growth companies may file disclosures for a more limited group of officers.

The notice provides several examples to illustrate and provide further guidance.

Example 1

Example 1 involves Corporation Z, a calendar year taxpayer and publicly held corporation with the following relevant employees for 2018:

- Employee A served as PEO
- Employee B and C served as PFO at different times
- Employees D, E, and F are the three mostly highly compensated executive officers (other than PEO and PFO); all three retired before the end of the tax year.
- Employees G, H, and I were the fourth, fifth, and sixth highest compensated and were serving at the end of 2018

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On its March 2019 Form 10-K filing, Corporation Z discloses the following employees:

- Employee A as PEO
- Employees B and C as PFO
- Employees D, E, G, H, and I as highly compensated

The notice concludes that the following are corporation Z's covered employees for 2018:

- Employee A as PEO
- Employees B and C as PFO
- Employees D, E, and F as High Three

This example clarifies that the High Three are determined based on highest compensation under the SEC compensation guidance regardless of which employees are actually reported on the SEC disclosure. In this manner, although certain aspects of section 162(m) are consistent with the SEC rules, the SEC rules are not the sole basis for interpreting section 162(m).

Example 2

Example 2 starts with the same facts in Example 1. However, in Example 2, Corporation Z is a smaller reporting company or emerging growth company under the SEC rules. As a result, for 2018 the SEC disclosure reports are a bit different:

- Employee A as PEO
- Employees D, E, G, and H are also reported

Although only a limited group is required to be disclosed for a smaller reporting or emerging growth company, under the expanded rules of section 162(m), there are still at least five covered employees for these corporations. In this example, the covered employees are the same as in Example 1 regardless of the different SEC disclosure rules:

- Employee A as PEO
- Employee B and C as PFO
- Employees D, E, and F as High Three

The SEC may not require any reporting of the PFO for these corporations. However, under the expanded section 162(m), the PFOs are included as covered employees. Guidance on the prior section 162(m) rules narrowed the covered employees to the limited group disclosed under the SEC filings for smaller reporting companies; this limitation no longer applies. See Chief Counsel Advice 201543003 regarding the pre-2018 rules.

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Example 3

The notice includes an example addressing the determination of covered employees during a short tax year, such as following an acquisition.

In Example 3, Corporation Y is a domestic publicly held corporation and a calendar year tax payer. Corporation X is not publicly held during 2018 or 2019 and is a calendar year taxpayer. On July 31, 2019, Corporation X acquires for cash 80 percent of the only class of stock in Corporation Y. The group (Corporations X and Y) file a consolidated return. Corporation Y has a short taxable year ending July 31, 2019. Corporation Y does not change its fiscal year for SEC reporting purposes. Corporation Y remains a publicly held corporation for its short year ending July 31, 2019, and for its tax year ending December 31, 2019, for the consolidated return with Corporation X. These are the relevant employees for Corporation Y for the 2019 calendar year:

- Employee N serves as the PEO during 2019, but this position ends effective July 31, 2019; Employee N continues to provide services to Corporation Y
- Employee M is the PEO starting August 1, 2019
- Employee O is the PFO for all of 2019
- Employees J, K, and L are the three most highly compensated executive officers for the short tax year ending July 31, 2019, and the tax year ending December 31, 2019

Example 3 provides that the covered employees for July 31, 2019, include Employee N as PEO, Employee O as PFO, and Employees J, K, and L as the High Three.

For the tax year ending December 31, 2019, the covered employees are Employee N because N was a covered employee for July 31, 2019 (once a covered employee, always a covered employee); Employee M as the new PEO; Employee O as the PFO; and Employees J, K, and L as the High Three.

The guidance specifies that Employee O would be a covered employee for the December 31, 2019 tax year even if Employee O was not PFO. Similar to the treatment of Employee N, once an employee is a covered employee, he or she remains a covered employee in future years. In addition, Employees J, K, and L are covered employees as the highest compensated officers even if they were not required to be reported on any SEC disclosures.

Transition Rule–Grandfathering

Companies have commonly used performance-based compensation exemptions to exempt payments from the section 162(m) deduction limit. Specifically, payments of commissions, bonuses, performance-based restricted stock units, and stock options were often exempt from section 162(m) under the performance-based exemption. For deductions taken in 2018 and forward, the performance-based exemption was eliminated.

Although there is no longer a performance-based exemption, H.R. 1 provides a limited transition rule for certain arrangements affected by the changes in section 162(m). The transition rule provides that to the

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extent a benefit was already subject to a written, binding contract on November 2, 2017, and is not materially modified after that date, the benefit provided is outside the purview of the changes in section 162(m).

The Joint Committee's explanatory provision clarified that merely having a live plan on November 2, 2017, is not enough to protect the benefits under that plan. The question as to what extent a particular grant for a particular employee is under a written *binding* contract as of November 2, 2017, is not entirely clear for many executive arrangements because the board often retains negative discretion to reduce payments under the terms of the plan. This discretionary language *may* result in the arrangement (in whole or in part) not being respected as a binding contract depending on applicable law.

Further, the transition rule only protects a company against the *changes* made in section 162(m). Thus, if the award would not have been exempt under section 162(m) previously, it is not protected by the transition rule.

Written Binding Contract

Notice 2018-68 clarifies that amendments to section 162(m) under H.R. 1 do not apply to remuneration payable under a written binding contract that was in effect on November 2, 2017, and that is not modified in any material respect on or after such date. However, remuneration is payable under a written binding contract that was in effect on November 2, 2017, *only to the extent that the corporation is obligated under applicable law (for example, state contract law*) to pay the remuneration under such contract if the employee performs services or satisfies the applicable vesting conditions.

Furthermore, the notice indicates that the transition period ends and the rules under H.R. 1 apply as soon as a written binding contract is unilaterally terminable or cancelable by the corporation after November 2, 2017. However, such contracts are not treated as subject to the new rules if:

- Employee consent is required,
- The contract is terminated or canceled only by terminating the employment relationship of the employee, or
- The amount is required to be paid under an arrangement in place as of November 2, 2017, even though the employee was not eligible to participate in the plan or arrangement as of November 2, 2017, as long as the employee had the right to participate in the plan or arrangement under a written binding contract as of that date.

Particularly instructive is Example 3 in the notice under the written binding contract discussion. In Example 3, Employee P serves as the PEO of Corporation U for the 2017 and 2018 tax years. On February 1, 2017, Corporation U establishes a bonus plan, under which Employee P will receive a performance-based cash bonus (that otherwise satisfies the old 162(m) rules for performance-based compensation) of $1.5 million. The compensation committee retains the right, even if the performance goal is met, to reduce the bonus payment to no less than $400,000. According to the notice, on

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November 2, 2017, under applicable law, which takes into account the employer's ability to exercise negative discretion, the bonus plan established on February 1, 2017, constitutes a written binding contract to pay $400,000. Thus, only $400,000 is considered grandfathered in the example.

Interestingly, within the details of the example in the notice, the corporation does use negative discretion. When a corporation has not used negative discretion, there may nonetheless be a written binding contract "under applicable law" as noted in the notice. The notice also provides examples in which the corporation retains a right to terminate or amend contribution or accrual of payments on a go-forward basis only and clarifies that a portion of the total future payments may be considered binding under applicable law as of November 2, 2017 (e.g., the non-forfeitable amount accrued as of that date), and therefore only a portion of the total payments may be considered grandfathered while the remainder is not.

Material Modification

The grandfathering provisions do not apply if the contract is materially modified after November 2, 2017. The notice provides that a material modification occurs when the contract is amended to increase the amount of compensation payable to the employee. If a contract is materially modified, it is treated as a new contract.

Notice 2018-68 clarifies that the following do not constitute material modifications:

- Acceleration of a payment if the compensation paid is discounted to reasonably reflect the time value of money
- The failure (in whole or in part) to exercise negative discretion
- A modification for deferral of compensation where the additional amount paid (amount in excess of the original payment amount) is based on a reasonable rate of return or a predetermined actual investment
- A supplemental payment that is equal to or less than a reasonable cost-of-living increase over the payment made in the preceding year under the written binding contract

In addition, the following are examples of material modifications:

- A supplemental contract or agreement that provides for increased compensation or a payment of additional compensation (greater than a cost of living adjustment), if the additional compensation is paid on the basis of substantially the same elements as the compensation pursuant to the written binding contract
- An accelerated payment of compensation that is not discounted for the time value of money
- A modification for deferral of compensation where the additional amount paid (amount in excess of original deferral amount) is not based on a reasonable rate of interest or a predetermined actual investment

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The notice provides some examples of the material modification rules. In Example 10, Corporation P executed a five-year employment agreement with Employee S on January 1, 2017, for a salary of $1.8 million to serve as PFO. The agreement constitutes a written binding contract under applicable law. During 2019, Corporation P increase, Employee S's compensation with a supplemental payment of $40,000. On January 1, 2020, Corporation P increases Employee S's salary to $2.4 million.

The examples provides that the annual $1.8 million salary is part of a written binding contract and is grandfathered under the prior section 162(m) rules unless materially modified. The $40,000 supplemental payment does not constitute a material modification because it is less than or equal to a reasonable cost-of-living increase from 2017. The important note is that while the $40,000 payment does not change the grandfathering for the $1.8 million salary, the additional payment is subject to section 162(m) deduction limitation.

The example provides that the salary increase in 2020 to $2.4 million is a material modification. As such, the full amount of the new salary (not just the increase) is subject to the expanded section 162(m) rules. Corporation P's deduction for Employee S's compensation is limited to $1 million.

Example 11 relies on the same facts as Example 10, but in this example, instead of increased salary Employee S receives a restricted stock grant. The restricted stock grant is not a material modification of the written binding contract because any additional compensation paid as a result of the grant is not paid on the basis of substantially the same elements as the salary. The stock grant is based on both stock price and continued service. The compensation from the stock grant is subject to the expanded rules under section 162(m). Corporation P's deduction for the restricted stock is limited under section 162(m) while the $1.8 million salary remains exempt.

Deferred Tax Asset ("DTA") Considerations and Action Items

DTAs related to covered employee compensation (bonuses, deferred compensation expense, and share-based compensation expense, etc.) should be evaluated to determine if the new section 162(m) rules will affect the ability to claim a deduction in the future and be adjusted accordingly. At the very least, the change in tax rates have already affected the DTA.

Going forward, a DTA should only be recognized for future compensation expense if a tax deduction is expected under the new rules or the arrangement is grandfathered under the transition rules.

In some cases, the application of the transition rule will depend on each grant or grant type. While the determination of whether a given grant is protected by the transition rule is very fact based, there are some steps to help sort through the types of plans that may or may not be protected.

In some cases, a plan may be protected for all employees already in the plan for a substantial duration, such as a plan that provides a specific automatic formula and is designed to pay only after employees completely separate from service. In other cases, employees or the employer have to make decisions or choices each year with regard to the benefit amount, in which case only parts of the accrued benefit may be protected (amounts already earned and on which the employee already has a written binding right to a later payment). Later grants or accruals in 2018 forward are not likely to be grandfathered.

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The fact that a grant is still subject to a substantial risk of forfeiture (such as time-based vesting or even some performance vesting) is not generally determinative. Instead, the determination is made at the time of vesting. There is a binding contract if, once the employee has satisfied the various conditions (time vesting conditions, performance metrics, etc.), the employee could take the written plan or grant to court and enforce the promised payment (or could enforce payment of a portion of the amount under the written binding agreement). Part of this determination may be made based on state contract law.

Plans that provide the employer or compensation committee with specific discretion at the time of distribution are less likely to be grandfathered under the transition rule. As an example, a discretionary bonus set to pay in 2018 under which the compensation committee is expected to make decisions about the payment amounts at the 2018 compensation committee meeting (like certain "umbrella" plan grants) is less likely to be grandfathered. An annual bonus clearly described to employees before November 2, 2017, with a set payment formula and no discretion with regard to the determination of the bonus amount or to whom the amounts will be paid in early 2018 might still be protected, even when employees have to be employed until the date of payment. Likewise, a performance stock unit plan with a mechanical formula under which the number of shares will be paid out to the employee if the employee satisfies certain metrics, and under which the compensation committee is not expected to and has not been exercising discretion at the time of vesting, seems more likely to satisfy the transition rule.

For employers, preliminary actions and considerations include but are not limited to the following:

1. Catalog covered employees and begin a list that will need to be durable for future additions.

2. Inventory existing arrangements (including plan documents and employment agreements). This may entail computing the value of benefits under certain plans (such as SERPs) as of November 2, 2017, which may raise recordkeeping complexities.

3. Analyze exiting arrangements to determine whether and to what extent payments thereunder are grandfathered, this includes checking:

    a. The actual plan document(s) to determine whether the compensation committee has discretion to change and reduce the benefits once granted. This language is fairly typical in a lot of plans, but it is not in all plans or may be present but have limitations.

    b. The "choice of law" statement that is in the back of many plan documents. If the plan provides the compensation committee with a level of discretion, the choice of law provision may set forth the state laws controlling the "binding contract" determination. A state with laws leaning toward employee rights might lead to a different conclusion than a state that leans towards protecting employer rights.

    c. The actual grant to see whether the company has given up the right to eliminate the benefit or provides a minimum benefit. As an example, a typical stock option or stock appreciation right may have language in the grant requiring an employer to make the

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employee whole for awards reduced or eliminated other than for cause. Depending upon state law, such language may indicate that the employee has a written binding contract, and, for grants before November 2, 2017, such awards *may* be grandfathered.

d. Whether some of the grants are automatic/locked in place. As an example, a company might have a plan or employment agreement that promises specific grants of shares (exact numbers of shares or percentages of shares that is determinable) to certain employees each year based on continued employment. Other plans may be less clear or simply give the compensation committee the right to decide how many shares the employee will be granted in a given year. The amount of discretion and timing of the document may help determine whether these sorts of grants are protected or partly protected under the transition rules.

e. Make sure the grant or related document has not been materially modified after November 2, 2017. It is generally advisable that companies considering the transition rule speak to a tax advisor before making any changes to their plans.

4. Determine whether plans have delayed payments provisions dependent on section 162(m) deductibility. Some plans contained provisions to delay payments until the date when such payments would, in fact, be deductible under section 162(m). Those provisions may be affected by H.R. 1 depending upon the facts and circumstances.

5. Finally, make a business decision on the direction to pursue with existing arrangements, considering whether preserving deductions is a priority, and whether it is worth the complexity of complying with the grandfathering rules.

Next Steps

The KPMG Global Reward Services (GRS) practice can assist companies in reviewing DTAs as well as compliance going forward by reviewing the specific changes in the rules relative to arrangements, reviewing plan documents to assist with determinations of which grants may be protected, and working with legal advisors as needed.

These rules are complex and it is important that reasonable interpretations are made consistent with H.R. 1 and recent guidance as these will affect a company's effective tax deductions and rate as well as the adjustment to DTAs.

KPMG's WNT Compensation and Benefits group has prepared a list of frequently asked questions regarding Notice 2018-68 and section 162(m).

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