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IRS Explains New $1M Compensation Deduction Rule

IRS Notice 2018-68 explains how publicly held companies, and non-public organizations that are required to file statements with the SEC, can determine whether payments under compensation agreements — including deferred compensation agreements — are deductible under the modified $1 million compensation limitation in the 2017 Tax Cuts and Jobs Act for post-2017 years.

Background

Code Section 162(m) was amended late last year by the Tax Cuts and Jobs Act (Tax Act). As amended, Section 162(m) provides that publicly held companies, and non-public organizations that are required to file statements with the SEC, may annually deduct up to $1 million of compensation paid to a covered employee. The definition of covered employee has been changed to include both the principal (aka chief) executive officer (PEO) and the principal (aka chief) financial officer (PFO) who served in that role at any time during the year, the employees who are the three highest compensated officers (other than the already included PEO and PFO), and individuals who were covered employees at any time after December 31, 2016. Prior to the change, the $1 million limit did not apply to performance-based compensation or commissions, and covered employees only included the chief executive officer employed on the last day of the year and the four highest compensated officers (not including the CEO). The amendments were effective for taxable years beginning after December 31, 2017 and would not apply to compensation paid pursuant to a written binding contract that was in effect on November 2, 2017 and was not modified in any material respect after that date.

Note: This is old news for certain health insurance providers: the Affordable Care Act restricted to $500,000 deductible compensation paid to “applicable individuals” (generally, all employees and directors) for services rendered in a taxable year beginning after 2012 and for services performed in a taxable year beginning after 2009 and before 2013 that were deductible in a taxable year beginning after 2012. However, while this ACA rule has similarities to the general limitation of Section 162(m), there are many differences in their details.

IRS Explains New Law

In August, in response to requests for guidance, the IRS issued Notice 2018-68 to address the definition of covered employee and the application of the written binding contract exception.

Once Covered, Always Covered

The Tax Act eliminated the last day of the year requirement for the PEO to be a covered employee and provided that once an individual becomes a covered employee, even after termination or retirement, he or she will always be a covered employee, as will the covered employee's beneficiaries. This means that all future payments to the individual and his or her beneficiaries will be counted in the $1 million annual deduction limit, and that an individual who is the PEO or PFO for just a part of the year will be a covered employee in perpetuity.

> Note: This also means that an officer who receives a single, large retention bonus may become a covered employee forever if the bonus positions them as one of the three highest-paid officers in that year.

Also, individuals who were covered employees under prior law during 2017 will continue to be covered employees in 2018 and beyond, requiring the entire amount of remuneration payable after December 31, 2017 generally to be considered under the new rules, including the grandfather rules.

Some Contracts Grandfathered – If Not Materially Modified

The amendments to Section 162(m) do not apply to remuneration payable under a written binding contract in effect on November 2, 2017 that is not modified in any material respect after that date. A binding contract is one in which the company must pay under applicable law (e.g., state contract law) if the employee performs the services or satisfies the applicable vesting conditions stated in the contract.

Grandfathered Written Binding Contract

Compensation under a contract that is "grandfathered" is subject to the rules prior to November 2, 2017. Any amount of compensation that exceeds the amount that the company was obligated to pay currently or in future years based on the contract as of November 2, 2017 is not grandfathered. Grandfathering will reflect the employee's status under prior law. If the employee was not previously a covered employee, grandfathering applies (until there is a material modification) even if the payment is not subject to performance criteria. For example, base salary under a 2016 contract with a PFO would be exempt from the new rules because the PFO would not have been a covered employee under the old rules. But if the employee was a covered employee under prior law, then grandfathering hinges on whether the compensation was performance-based or if there was a termination of employment before the end of the year in which the payment was made — in which case the employee would no longer be a covered employee under prior rules.

For example, the Notice describes a situation where deferred compensation (not performance-based) is paid to a PEO who served through December 31, 2019 pursuant to an agreement that was entered into in 2016. Since the 162(m) limitations would have applied under prior rules, there is no grandfather relief for any of the compensation. However, though not explicit, the example implies that if the PEO retired before the end of 2019, under prior rules he or she would not have been a covered employee at the time of payment in April 2019 and the deferred compensation would not be subject to the deduction limitation.

Discretionary clauses can affect grandfathered status. If the company has discretion to reduce or not pay the compensation, even if the discretion is not exercised, then compensation only up to the amount that cannot be reduced is grandfathered. Many agreements provide the company with discretion to reduce the amount payable — for example, if targets are not reached. The Notice includes an example whereby a covered employee under a bonus plan could receive up to $1.5 million, but the employer retained the discretion to reduce the bonus to $400,000. Although the employer paid the employee $500,000, only $400,000 was grandfathered.

> Note: Most contracts do not specify the amount of the potential reduction. Many practitioners are interpreting the language in the Notice — with the specific reference to applicable law — to mean that whether no amount, or the amount actually paid, is grandfathered depends on the applicable state's contract law.

Material Modification

If a material modification is made, then the grandfathering does not apply for any payments following the modification. A material modification will subject the *entire* amount of the payment following the modification to the new rules under Section 162(m); a change that is not a material modification will only affect the additional compensation produced by the modification. Note that reasonable cost-of-living increases are not considered an increase that results in a material modification, but that increase itself is not grandfathered.

A separate contract or agreement that provides for an increase in compensation or the payment of additional compensation is a material modification if the facts and circumstances demonstrate that the additional compensation is paid based on substantially the same elements or conditions as the compensation under the original written binding contract.

Contract renewal considered material modification. Contracts that automatically renew unless notice is provided by either party are considered to have been renewed as of the date on which termination would be effective if such notice was given. For example, an employment agreement with a three-year term beginning on January 1, 2016 that automatically renews for another three years — unless the company terminates the agreement 60 days before the end of the three-year term — will be considered to have been renewed on January 1, 2019. Therefore, the payments made on or after that date would not be grandfathered. Contracts that may be terminated unilaterally are considered to have been renewed as of the date on which such termination could have been effective; however, contracts that terminate only upon an employee's termination are not considered terminable.

Amendments to accelerate or defer payment generally considered material modifications. However, an acceleration is not a material modification if it is discounted to reflect the time value of money; similarly, a deferral is not a material modification if the increase is based on a reasonable rate of interest or a predetermined actual investment.

Analyze Nonqualified Deferred Compensation Plans Carefully

Post-2017 distributions from account balance plans are likely grandfathered for those who were not covered employees under prior law for deferrals and contributions made through November 2, 2017 (and in some cases even thereafter) if all such amounts were made pursuant to a binding agreement in effect at November 2, 2017. Nonqualified defined benefit plans might be grandfathered for accruals even beyond November 2, 2017, but only if such accruals are made pursuant to a binding agreement in effect at November 2, 2017 and the plan does not provide for unilateral plan changes or termination by the company; otherwise only accruals through November 2, 2017 would likely be grandfathered for such employees.

Stock Appreciation Rights, Stock Options, Restricted Stock

Performance-based stock appreciation rights and nonstatutory stock options granted pursuant to a written binding contract before November 2, 2017 — even though exercised in the future by a covered employee — will be grandfathered. The treatment of restricted stock has not changed since it is not, and never was, considered performance-based compensation.

What Should Companies Be Doing Now?

There are a number of actions companies subject to Section 162(m) should be taking at this time:

- Prepare a list of current covered employees and continue to monitor who is a covered employee, including beneficiaries
- Carefully review and inventory all written compensation plans and agreements — including nonqualified plans — and determine which may qualify for grandfathered status
- For grandfathered agreements, determine the extent to which amounts are grandfathered — especially for those subject to discretionary adjustment (though it is not entirely clear if general discretion to decrease the payment without specifics would effectively reduce the grandfathered amount to zero) or unilateral plan termination
- Consider structuring new agreements to make payments through annuities or installments spread over multiple years on a post-retirement basis to allow efficient utilization of the $1 million exemption

In Closing

Though the IRS attempted to address many questions that were raised with the amendment of Section 162(m), there are still several that remain unanswered and for which the IRS has requested comments. In the meantime, companies must make a reasonable, good-faith interpretation in applying the law.

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