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IRS Issues Guidance on Deductibility of Executive Compensation

The Internal Revenue Service (IRS) recently published guidance interpreting the changes to Section 162(m) of the Internal Revenue Code that were part of the Tax Cuts and Jobs Act of 2017 (TCJA). Section 162(m) generally imposes a US$1 million limit on the amount of compensation paid to each of certain executives that publicly held corporations and certain other corporations can deduct as a business expense.

The TCJA left the US$1 million annual deductibility limit per executive in place but expanded the scope of the deduction limit in other ways. It eliminated an exception for deductibility in excess of US$1 million per executive for qualified performance-based compensation and commissions, expanded the number of executives who are subject to the limitation, and broadened the application of the deduction limit to more businesses.

These changes are generally applicable to tax years beginning after December 31, 2017. However, the TCJA provides a transition rule that "grandfathers" compensation provided under a written binding contract in effect on November 2, 2017, if the contract is not materially modified on or after such date. Grandfathered compensation is subject to Section 162(m) as written prior to the TCJA.

IRS Notice 2018-68 (the Notice), which is scheduled to be published in the September 10, 2018, Internal Revenue Bulletin, provides detailed guidance on the transition rule. It also answers some questions on identifying covered employees. At some point in the future, the IRS and the Department of the Treasury expect to issue proposed regulations that will incorporate the guidance provided in the Notice and cover additional topics related to the implementation of amended Section 162(m). To this end, the Notice requests public comment on the following issues:

- The application of the definition of "publicly held corporation" to foreign private issuers, including the reference to issuers that are required to file reports under Section 15(d) of the Securities Exchange Act of 1934
- The application of the definition of "covered employee" to an employee who was a covered employee of a predecessor of the publicly held corporation
- The application of Section 162(m) to corporations immediately after they become publicly held either through an initial public offering or a similar business transaction
- The application of the Securities and Exchange Commission's executive compensation disclosure rules for determining the three most highly compensated executive officers for a taxable year that does not end on the same date as the last completed fiscal year

Comments may be submitted to the IRS until November 9, 2018.

A summary of the guidance provided in the Notice follows.

Grandfathered Compensation Arrangements and the Transition Rule

Under the TCJA's transition rule, the amendments to Section 162(m) do not apply to compensation payable under a written binding contract in effect on, and not materially modified on or after, November 2, 2017. The key factor is the corporation's legal obligation under the contract on November 2, 2017. Only amounts that the corporation is legally obligated to pay an employee for services or to satisfy vesting rules on that date are grandfathered. If the obligation is later increased, the additional amount to be paid under the contract will be subject to the TCJA's amended Section 162(m) rules.

Contract renewal and termination. The renewal of a contract is considered a material modification and, as explained in the Notice, an otherwise written binding contract that can be terminated by the employer without the employee's consent after November 2, 2017, is treated as renewed as of the date it could have been unilaterally terminated. Consistent with this rule,

a) a contract that will be automatically renewed or extended as of a specified date unless either party provides notice of termination is treated as renewed as of the automatic renewal date, and

b) a contract that will be terminated as of a specified date unless either party affirmatively elects to renew the contract is treated as renewed as of the date of the affirmatively elected renewal (unless the contract is renewed before that date, in which case, it is treated as renewed on that earlier date). A contract that can be terminated only by terminating the employment relationship of the employee is not treated as one that can be terminated by the employer for this purpose.

According to the Notice, if a contract provides an employee with sole discretion to extend a company's obligation under a written binding contract beyond a certain date and the employee exercises that discretion, the contract will not be treated as renewed as of that date.

Other material modifications. Only a contract amendment that increases the compensation payable to an employee amounts to a material modification of the contract. The acceleration or deferral of a payment of compensation is not a material modification if the amount paid is discounted to reflect the time value of money (for an accelerated payment) or earns interest or investment returns based on a reasonable interest rate or a predetermined actual investment (for a deferred payment). A reasonable cost-of-living increase paid pursuant to a written binding contract is not a material modification of the contract. However, while the contractual compensation amount will be grandfathered (assuming it was established pursuant to a written binding contract in effect on November 2, 2017), the increase itself will be subject to the new rules under the TCJA's amended Section 162(m).

Further, where a written binding contract gives an employer the discretion to reduce the compensation to be paid, the employer's failure to fully exercise such discretion is not a material modification. However, any amount paid that exceeds a legally enforceable minimum payment will be subject to the Section 162(m) limitation in accordance with the TCJA's amended rules. As a result, performance pay agreements that provide the employer with negative discretion can be grandfathered only to the extent that the agreement guarantees a minimum payment. If the employer does not exercise negative discretion to reduce the payment, the application of Section 162(m) will be bifurcated. The required minimum payment (if any) will be subject to the rules that existed prior to the TCJA and any additional payment will be subject to the amended rules. If no minimum required payment is specified, an example provided in the Notice indicates that none of the performance-based compensation paid pursuant to the agreement will be grandfathered.

To Whom Does Section 162(m) Apply?

The term "covered employee" identifies the employees whose compensation is subject to the deduction limit under Section 162(m). Prior to the TCJA, Section 162(m) applied to the chief executive officer (CEO) (or individual acting as the CEO) as of the close of the taxable year and the three highest-compensated officers (other than the CEO and the chief financial officer (CFO) unless the CFO was one of such highest-compensated officers or the CFO of a smaller reporting company) of any publicly held corporation for the taxable year. The TCJA expanded the application of Section 162(m) from corporations with publicly traded equity to those with publicly traded equity or debt and foreign corporations publicly traded through American depository receipts. The Notice does not offer guidance on these changes.

The term "covered employee" was amended by the TCJA to include the principal executive officer (PEO) and the PFO (or an individual acting in either capacity) at any time during the year and the three highest-compensated officers (other than the PEO or PFO or an individual acting in either capacity) for the taxable year.

Most significantly, as a result of the TCJA's amendment to Section 162(m), the term "covered employee" was expanded so that any employee that is a covered employee for any taxable year beginning after December 31, 2016 (regardless of whether the pre- or post-amendment definition applied), will always be a covered employee subject to the Section 162(m) US$1 million annual deduction limitation per covered employee.

The Notice reiterates that an employee does not have to be an executive officer at the end of the taxable year to be a covered employee under Section 162(m). It also clarifies that executive officers of publicly held corporations can be covered employees even if disclosure of their compensation is not required under the Securities and Exchange Commission's rules.

The Notice includes numerous detailed examples of the application of the amended definition of covered employee and the transition rule in a variety of factual contexts.

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