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Your Guide to The 162(m) Grandfathering Rule



Deb Lifshey

MANAGING DIRECTOR

The IRS Transition Provides Narrow Relief

Since the early 90's, navigating Section 162(m)—which generally limits the deduction allowed for compensation paid to "covered employees" during a taxable year to $1M—has been a perennial, labor-intensive exercise among those involved in executive compensation. So it was something of a shock when at the end of 2017, this section was amended by the Tax Cuts and Jobs Act ("TCJA" or "the Act") in two important ways.

First, under the "old" 162(m) rule, "covered employees" were narrowly defined to include only those who served as the CEO during the year and the next three highest paid executive officers who were with the company at the end of the year. The TCJA expanded the definition of "covered employees" to include the CFO, as well as any executive who at any time (for tax years beginning in 2017), was a "covered employee", regardless of whether they were still employed by the company at the end of the reporting year.

In addition, under old 162(m), certain "performance-based" compensation was exempt from the deduction limit. After the TCJA amendments, the "performance-based exception" was eliminated. Thus, the TCJA has put significantly more executive compensation at risk of being non-deductible going forward.

Importantly, some amendments to Section 162(m) were subject to an important grandfathering exception which could significantly reduce certain lost deductions in upcoming years. The Act provided that certain *written binding contracts* in effect on 11/2/17 (the date the TCJA was initially proposed) are grandfathered and subject to the rules and exceptions provided under the old Section 162(m) rule. A contract that is *materially modified* or renewed after 11/2/17 ceases to qualify for the grandfathering after the modification or renewal date. The IRS recently released Notice 2018-68 which specifically addresses application of the grandfathering provisions, as follows:

- Enforceable: Quite simply, in order to qualify for the grandfathering rules, a legally binding contract in effect as of 11/2/17 must be in writing and enforceable (i.e., requiring a company to make payments) under applicable law. If the payment is

subject to either further company approvals or negative discretion (as most 162(m) plans had been written), it may not qualify, as payments may be unilaterally reduced by the company (and therefore not binding by the employee). If there is a position that the payments must be paid despite the negative discretion, or that company approval is just a formality, it is possible that grandfathering could be preserved.

- Options and SARs: Options and SARs (stock appreciation rights) granted on or prior to 11/2/17 qualify as long as they are not subject to further approval or materially amended.
- Restricted Stock: Restricted stock granted prior to 11/2/17, should be grandfathered to the extent it qualified as performance-based compensation under the old 162(m) rule.
- Non-Qualified Deferred Compensation (NQDC): If a NQDC plan existed on 11/2/17, all amounts accrued prior to 11/2/17 under that plan (that cannot be unilaterally taken away by the employer) are grandfathered, but amounts not yet accrued (and not guaranteed) under the pre-existing plan would not so qualify.
- Employment Agreements: Payments made under agreements in place on 11/2/17 will qualify until the agreement is renewed by the company (either proactively or auto-renewed) or materially amended (see below). In addition, compensation under a grandfathered employment agreement to a non-covered employee under old 162(m) rules (e.g., the CFO), will not be subject to new 162(m) rules until similarly renewed or amended.
- Material Modification: A material modification of a written binding contract will generally include anything deemed to be an increase in compensation, with the following exceptions: (1) increases for reasonable cost-of-living estimates only; (2) acceleration of payments if they are discounted for the time value of money; (3) deferrals that include only a reasonable amount of interest. Note that a material modification will not be triggered by a company's failure to exercise negative discretion.
- Impact of Material Modification: Significantly, a material modification will not disallow grandfathering of all payments pursuant to the contract. Rather, amounts paid under a written binding contract before the material amendment are still grandfathered, but amounts received afterwards are subject to the new 162(m) rules.

The Notice also clarified that "covered employees" do not need to be employed at year-end, nor do they need to be reported as proxy officers for SEC purposes.

Clearly, the IRS chose to take a narrow view in its application of the grandfather rule. Based on the guidance, companies should be carefully assessing any agreements they were hoping to grandfather. In particular, they should understand whether such agreements auto-renew or the extent to which they provide negative discretion. Special consideration should also be given to the possibility of preserving any agreements or arrangements for a CFO in order to exempt such position from status as a "covered employee" to the extent possible.

About the Author

Deb advises on executive compensation from a legal and regulatory perspective, including securities disclosure, tax and governance matters, contract negotiation, and reasonableness opinion letters.

About Pearl Meyer

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