

**NYU SCHOOL OF CONTINUING  
AND PROFESSIONAL STUDIES  
77TH INSTITUTE ON FEDERAL TAXATION**

**SECTION 162(M) DEDUCTION LIMITATIONS  
AND TRANSITION RULES**

*October 21, 2018*

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# Section 162(m) - \$1 Million Deduction Limit

## Prior Law

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- No deduction limit for performance-based compensation
- Compensation paid to CFO not subject to \$1 million limit
- Status as a covered employee determined on an annual basis
  - CEO and three other most highly compensated executive officers employed at year end
- No carryover status of covered employee status
- Only covers corporations with publicly traded equity securities

# Section 162(m) - \$1 Million Deduction Limit

## Key Changes under Tax Cuts and Jobs Act

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- Eliminates performance-based compensation exception
- CFOs are automatically covered employees
- Covered employers include:
  - private companies with publicly traded debt under Section 15(d) of the Exchange Act
  - foreign private issuers with ADRs traded on U.S. market
- Once a covered employees, always a covered employee
  - an individual who is a covered employee for any taxable year beginning after 12/31/2016 will continue to be a covered employee for all later taxable years, including after death

# Notice 2018-68

## Who is a Covered Employee?

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- An executive officer can be a covered employee even if:
  - not employed at the end of the corporation's taxable year
  - the officer's compensation is not subject to disclosure for the last completed fiscal year under SEC rules
  
- Covered employee definition includes officers of a corporation that does not file a proxy statement for the year:
  - corporation that delists its securities
  - emerging growth companies
  - smaller reporting companies

## Section 162(m) - \$1 Million Deduction Limit Transition Rule under Tax Cuts and Jobs Act

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- Applies to compensation provided under a “written binding contract” that was in effect by 11/02/17
- The transition rule allows payments to be deductible based on Section 162(m) rules as in effect prior to TCJA if the payments are made pursuant to a “written binding contract”
- Loss of relief if there’s a later “material modification”
- Key terms not defined in the TCJA

# Section 162(m) - \$1 Million Deduction Limit

## Original Transition Rule

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- Transition rule original included as part of § 162(m)
  - relief for certain pre 2/17/1993 arrangements
- Key terms the same as under new transition rule
- Reg. § 1.162-27(h) interpreted the original transition rule
  - “under applicable law, the corporation is obligated to pay the compensation if the employee performs service”

# Section 162(m) - \$1 Million Deduction Limit

## Interpretation of Original Transition Rule

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- CCA199926030
  - Addresses bonus plans in place before 2/17/1993
  - Payments tied to achieving written performance goals
  - “Guideline” bonus earned for performance at budget
  - Amount could be 80% to 120% of the total "guideline" bonus
  - Plan termination allowed only as of January 1st of the following year
  - No right to amend plan to adversely affect existing granted awards

# Section 162(m) - \$1 Million Deduction Limit

## Interpretation of Original Transition Rule

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- CCA199926030: bonuses are “written binding contracts”
  - Executives “relied” on the potential bonus compensation
  - Amendment could not impair rights under a granted award
  - Awards were in writing
  - Executives performed the necessary services for payment
  - Discretion exercised under plan was limited
  - Right to payment existed under state law (NY)

# Notice 2018-68

## What is a Written Binding Contract?

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- A contract is considered to be “written and binding” only to the extent:
  - applicable law obligates the corporation to pay, and
  - the employee performs services or satisfies the vesting conditions
- If payment exceeds the amount the corporation is obligated to pay, the transition rule does not apply to the excess payment amount
- Notice 2018-68 is a significant departure from the CCA
- Automatic renewals terminate grandfathering as of the renewal date

# Notice 2018-68

## Example 3

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- The achievement of a performance-based bonus established on 2/1/2017 is certified by the compensation committee on 3/1/2018
- Under applicable law, taking into account the terms of the bonus plan, the performance-bonus may be reduced by the committee, but not below \$400,000
- The committee exercises negative discretion to reduce the award to \$500,000
- Payment otherwise satisfies the pre-TCJA 162(m) requirements
- Plan is a written binding contract under applicable law to pay \$400,000, and is not subject to 162(m) deduction limitation
- Remaining \$100,000 is subject to the \$1 million deduction limitation even if it is performance-based compensation under pre-TCJA law

# Notice 2018-68

## “Negative Discretion” Conundrum

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- Incentive awards often permit discretionary reduction
- Terms for reduction can vary considerably
- Notice 2018-68 suggests a state law contract analysis
- Consider implied covenant of “good faith and fair dealing”
- Important to consider all the facts and circumstances, including past practice and employee communications
- Unclear whether estoppel principles will also apply
- Transition will not necessarily apply in the same way to all employees

# Notice 2018-68

## What is a Material Modification?

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- An agreement is materially modified when it is amended to increase the amount of compensation payable
- •If a grandfathered agreement is materially modified, amounts paid after the modification date are treated as paid under a new agreement and do not qualify for the written binding contract exception
- Amounts paid before the modification date remain grandfathered

# Notice 2018-68

## What is a Material Modification?

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- Accelerating the payment of compensation is a material modification unless the payment is discounted to reflect the time value of money
- Deferring the payment of compensation is not a material modification if the amount paid at the end of the deferral period does not exceed the original amount deferred plus a reasonable interest rate or a rate based on a predetermined investment reference

# Notice 2018-68

## What is a Material Modification?

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- Types of modifications addressed under original transition rule but note under Notice 2018-68:
  - transfer of options for estate planning purposes (PLR 9551024)
  - changes to options for corporate transaction (PLR 9810024)
  - permitting beneficiary designations for stock options (PLR 9712002)
  - accelerating vesting of stock options (PLR 9649014)
- Is the extension of the option exercise period a material modification?

# Nonqualified Deferred Compensation (NQDC)

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- Change in determining covered employees is grandfathered
- Many NQDC payments are made after termination
  - SERP and DC account balance plans
- Need to account for benefit under transition rule
  - Amounts deferred after 11/02/17 under binding written elections
  - Treatment of post 11/02/17 earnings on deferred amounts?
- Review agreements for deferrals to ensure deductibility

# Section 162(m) - \$1 Million Deduction Limit

## Other Selected Compliance Issues

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- Adjusting results under existing incentive awards
  - Effect of tax rate changes, GAAP revenue recognition rules
- Impact on IPO transition rule for existing equity plans
- Applying covered employee rule within a controlled group when more than one entity issues debt securities

# Section 162(m) - \$1 Million Deduction Limit

## Potential Changes to Incentive Compensation Practices

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- More flexibility to select grant date – 90 day requirement
  - Mid year grants for new hires and promotions
- No advantage to umbrella / “plan within a plan” approach
- Discretionary mid year adjustments can be made
  - But consider potential disclosure and accounting impact
- Easier to take into account individual performance

# Section 162(m) - \$1 Million Deduction Limit

## Potential Changes to Incentive Compensation Practices

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- Committee need not include “outside directors”
  - Former officers can be independent under listing standards
- Committee need not set performance goals for awards
  - But committee action will likely still be needed for grant approval
- No Committee certification requirement
  - But certification by outside directors needed under transition rule
  - Consider changes to compensation committee charter

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## Potential Changes to Incentive Compensation Practices

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- Removal of performance based compensation provisions
  - But consider prior proxy disclosures regarding plan approval
  - Plan provisions requiring plan approval every 5 years?
- Removal of cash bonuses from omnibus equity plans
- Add protection against loss of grandfathered status
- Consider necessity / prudence of stockholder approval
- Should a new plan be adopted

# Other Considerations

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- Impact of changes on say on pay voting?
- Change to voting guidelines by shareholder advisory services (ISS, Glass Lewis)?
- Impact on IPO practice?
- Shift towards salary greater than \$1 million?
- Changes to compensation committee charters?

# Contact Information

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