

IRS Issues Guidance on Amended Section 162(m) & Rules

August 24, 2018

On Tuesday, the IRS issued widely-anticipated guidance regarding certain amendments that were made by the Tax Cuts and Jobs Act to Section 162(m) of the Internal Revenue Code. Under Section 162(m), compensation paid to a publicly held corporation's "covered employees" that exceeds \$1 million per year for any covered employee is non-deductible. Among other changes, the Act amended Section 162(m) to expand the scope of covered employees and eliminate the qualified performance-based compensation exemption from the \$1 million deduction limit.

The amendments to Section 162(m) apply to taxable years beginning on or after January 1, 2018. However, the Act provides transition relief under which certain compensation paid pursuant to a written binding contract in effect on November 2, 2017 will be grandfathered and not subject to the amended rules, provided that the contract is not materially modified on or after that date.

In [Notice 2018-68](#), the IRS provided guidance on the following topics:

- **Amended definition of covered employee** – The amended definition includes (i) any employee who is the PEO or PFO of the publicly held corporation at any time during the taxable year, or was an individual acting in such capacity, and (ii) any other employee whose total compensation for the taxable year is required to be reported to shareholders by reason of such employee being among the three highest compensated officers for the taxable year. Additionally, the Act provides that anyone who was a covered employee for any preceding taxable year beginning on or after January 1, 2017 is a covered employee. As a result, covered employees identified for the taxable year beginning during 2017 under the pre-amendment rules will continue to be covered employees for taxable years beginning in 2018 and beyond. The Notice clarifies that while certain aspects of the amended definition are consistent with the SEC rules used to determine the named executive officers for whom compensation disclosure is required, in some cases the amended definition diverges from the SEC rules. For example, for purposes of identifying covered employees under the amended definition, it is not relevant whether the SEC rules for smaller reporting companies or emerging growth companies apply to the corporation, nor is it relevant whether the specific executive officers' compensation must be disclosed under the SEC rules applicable to the corporation.
- **Operation of the grandfather rule** – The Notice explains that compensation may be grandfathered only to the extent that the corporation is obligated under applicable law (for example, state contract law) to pay the compensation if the applicable service or vesting conditions are met. As a result, certain types of arrangements may not be grandfathered, such as arrangements where the compensation committee retains the ability to use negative discretion to reduce the amount of compensation payable under the arrangement and employment agreements which provide for future equity award grants subject to board approval. The Notice also addresses whether a contract will be considered materially modified so that it is no longer grandfathered in certain circumstances, such as amendments to increase the amount of compensation payable or to accelerate or defer the payment.

The guidance in the Notice is expected to be incorporated in future regulations that, with respect to the issues addressed in the Notice, will apply to taxable years ending on or after September 10, 2018. Any future guidance (including regulations) addressing the issues covered by the Notice that would broaden the definition of "covered employee" or restrict the application of the definition of "written binding contract" will apply prospectively only.

The Notice does not provide any guidance regarding the reliance period exception for newly public corporations, which provides that certain compensation paid by newly public corporations is exempt from the \$1 million deduction limit for a certain period of

time after the corporation becomes publicly held, and the Act did not address this exception. However, the IRS specifically requested comments on this issue and we expect that it may be addressed in future guidance.

We will be providing further analysis on the application of the guidance in the Notice in a future alert, including advice on preserving the grandfathered status of eligible arrangements. If you have any questions regarding the Notice or this alert, please contact any member of the Cooley compensation & benefits group.

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Key Contacts

| | |
|---|---------------------------------------|
| Soo Kim New York | skim@cooley.com +1 212 479 6477 |
| Barbara Mirza Los Angeles Santa Monica | bmirza@cooley.com +1 310 883 6465 |
| Megan Arthur Schilling San Diego | marthur@cooley.com +1 858 550 6195 |
| Thomas Welk San Diego | twelk@cooley.com +1 858 550 6016 |

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