# IRS Issues Guidance Clarifying Tax Reform Changes to Section 162(m)

August 27, 2018

On August 21, 2018, the IRS issued **Notice 2018-68**, which provides initial guidance on two aspects of the amendments to Section 162(m) of the Internal Revenue Code made by the Tax Cuts and Jobs Act (TCJA):

- how to identify the expanded group of employees who are covered by new Section 162(m); and
- how a plan or agreement can qualify as grandfathered from new Section 162(m).

This memorandum summarizes this guidance, as well as the additional aspects of new Section 162(m) on which the IRS is seeking comment.

Key takeaways from the notice include the following:

- Umbrella plans or agreements that provide for negative discretion to reduce compensation do not qualify as grandfathered from new Section 162(m); and
- A grandfathered employment agreement that provides for auto-renewal at the end of the term, unless either party elects not to renew, loses its grandfathered status for amounts earned after the renewal date.

The notice applies to any taxable year ending on or after September 10, 2018.

The notice includes 14 examples, which are reproduced in the appendix to this memorandum.

## Overview of Section 162(m)

Section 162(m), which became effective in 1994, provides that a publicly traded corporation may not deduct compensation in excess of $1 million per year paid to any "covered employee" of the corporation. Before the TCJA was enacted in December 2017, the deduction limitation:

- excluded "qualified performance-based compensation" and certain commissions;
- covered compensation payable to a company's CEO and each of the company's next three most highly compensated executive officers for the taxable year, other than the CFO; and
- generally applied only to companies with publicly traded equity securities.

The TCJA expanded the scope of Section 162(m) by:

- eliminating the exclusions for "qualified performance-based compensation" and commissions;
- broadening the covered employee group; and
- expanding the types of covered companies.

The TCJA's changes apply to compensation for taxable years beginning after December 31, 2017, except for compensation payable pursuant to a "written binding contract" (generally, as determined under applicable state law) in effect as of November 2, 2017, when the TCJA's changes were proposed.

For a summary of the TCJA's changes to Section 162(m), see our **memorandum** from January 31, 2018.

## Who Are "Covered Employees"?

The $1 million deduction limit under Section 162(m) applies to employees who are considered "covered employees" for the taxable year for which the deduction would otherwise be taken.

New 162(m) expanded the definition of covered employees by:

- expressly including the CFO; and
- providing that, if an individual was a covered employee during any taxable year beginning on or after January 1, 2017, the individual is a covered employee for all subsequent years, even after the individual terminates employment.[1]

The IRS notice provides guidance on how to identify covered employees.

***Does an employee need to serve as an executive officer at the end of the taxable year to be a covered employee?***

No. In the notice, the IRS explains that the statutory provisions do not impose an end-of-year requirement, and that the legislative history does not indicate that Congress intended for such a requirement to apply.

The IRS also dismisses the assertion made by some commentators that an end-of-year requirement should apply because the SEC rules relating to executive compensation cover the three most highly compensated executive officers other than the CEO and CFO who were serving as executive officers at the end of the last completed fiscal year. The IRS points to the SEC rules that require disclosure for certain individuals who were not serving as executive officers at the end of the last fiscal year (e.g., the up to two additional individuals who would have been among the three most highly compensated executive officers, other than the CEO and CFO, had they been serving as executive officers at the end of the last fiscal year).

***Can an employee be a covered employee even if the employee's compensation is not required to be disclosed under SEC rules?***

Yes. The IRS, again pointing to the statutory language and the legislative history, determined that executive officers of publicly held corporations can be covered employees even if their compensation is not required to be disclosed under SEC rules (e.g., executive officers of a corporation that does not file a proxy statement for a year because it delists its securities).

***So, who are covered employees?***

The notice provides that—in addition to the CEO and CFO and the covered employees from prior years—the covered employees for a taxable year are the three most highly compensated employees who acted as executive officers at any time during the taxable year, regardless of whether they were serving as executive officers at the end of the year, and regardless of whether their compensation is required to be disclosed for the year under SEC rules.

[1] Although new Section 162(m) provides that the covered employees for 2017 remain covered employees permanently, they are determined under old Section 162(m). I.e., they are the CEO who was serving at the end of 2017, plus the three next most highly compensated executive officers (other than the CFO) who were actively serving in their executive officer roles at the end of 2017 and whose compensation was required to be disclosed in the Summary Compensation Table in the 2018 proxy statement.

The notice includes an example, which assumes the following:

- six individuals (other than the CEO and CFO) served as executive officers during a taxable year;
- the three individuals with the highest compensation for the year retired before the end of the year;
- the other three individuals served as executive officers at the end of the year.

The covered employees include the three retirees and not the three continuing employees. This is the case even though:

- the three retirees were not serving as executive officers at the end of the year;
- one of the retirees (the one with the lowest compensation for the year among the three retirees) did not appear in the Summary Compensation Table for that year;[2] and
- the three continuing employees appeared in the Summary Compensation Table for that year.

***Are covered employees different for a smaller reporting company or emerging growth company?***

No. The notice clarifies that, for purposes of determining the covered employees under new Section 162(m), it does not matter whether a company is a smaller reporting company or emerging growth company under SEC rules. Even though smaller reporting companies and emerging growth companies generally are required to disclose compensation for fewer individuals than other public companies, the covered employees for all public companies are the CEO, CFO and three other most highly compensated executive officers.

***Who are the covered employees when a company's fiscal year and taxable year do not align?***

In certain situations, for example following a corporate transaction, a company's fiscal year and taxable year do not align, leaving a question as to how the company should determine its three most highly compensated executive officers (other than the CEO and CFO). The IRS notice states that, until additional guidance is issued, companies should make this determination based on a reasonable good faith interpretation of the statute, taking into account the guidance provided under the notice.

## Grandfathered Arrangements

The TCJA provides that a "written binding contract" in effect on November 2, 2017 (the date the TCJA was initially proposed) is grandfathered from new Section 162(m), unless and until it is materially modified or renewed. The IRS notice released on August 21, 2018 provides some clarification about the applicability of the written binding contract exception, as summarized below.

***If an agreement is automatically renewed, does it lose the grandfather?***

Generally, yes. Many employment and similar agreements provide for a term that is automatically renewed on a specified date unless either party gives prior notice of non-renewal. The IRS notice makes clear that an agreement whose term automatically renews after neither party gives notice of non-renewal becomes ungrandfathered on the date that the agreement would have expired had such notice been given.[3]

---

[2] This seems to contradict the statutory language that "covered employees" include employees whose "total compensation…for the taxable year is required to be reported to shareholders under the Securities Exchange Act of 1934 by reason of such employees being among the 3 highest compensated officers for the taxable year" (Section 162(m)(3)(b)).

[3] The notice does state that an agreement is not treated as terminable or cancelable if it may only be terminated by terminating the employment relationship, which raises the question of the treatment of an employment contract that provides for severance upon the employer's election not to renew the contract. If this type of contract were deemed the same as a contract that could only be terminated by the employer by terminating the employment relationship, then it would still be eligible for grandfather status even though it includes an automatic renewal feature. However, the guidance does not provide clarity around this question.

The notice includes an exception whereby, if an agreement provides that the employee, in his or her sole discretion, may elect to renew or not renew the term, the agreement is not ungrandfathered on that date if the employee makes that election. Given that agreements rarely provide the employee with such an election, few agreements are likely to qualify for this exception.

***Can an agreement with an indefinite term qualify for the grandfather?***

Yes. If an agreement that otherwise qualifies for the written binding contract exception provides for an indefinite term and can only be terminated by ending the employment relationship, the agreement remains grandfathered until and unless it is terminated or materially modified.

***When is an agreement materially modified?***

An agreement is materially modified when it is amended to increase the amount of compensation payable under the agreement. 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 to new Section 162(m). Amounts paid before the modification date remain grandfathered.

***Is acceleration of compensation a material modification?***

If a grandfathered agreement is modified to accelerate the payment of compensation, the agreement is considered materially modified and therefore is ungrandfathered, unless the amount of compensation paid is discounted to reasonably reflect the time value of money.

***Is deferral of compensation a material modification?***

If a grandfathered agreement is modified to defer compensation, and if the amount paid at the end of the deferral period does not exceed the original amount deferred, the agreement is not considered materially modified. If the amount paid at the end of the deferral period exceeds the original amount deferred, the agreement is considered materially modified, unless the additional amount paid is based on either a reasonable interest rate or a predetermined investment reference.

***Is a salary increase a material modification?***

Yes, unless the increase does not exceed a reasonable cost-of-living increase. The notice includes an example involving a grandfathered employment agreement with a CFO that provides for a $1.8 million salary. In 2019, the company increases the CFO's salary by $40,000. Because the $40,000 increase does not exceed a reasonable cost-of-living increase, the agreement is not considered materially modified, and only the additional $40,000 is subject to the deduction limit.

The example further provides that in 2020, the company increases the CFO's salary to $2.4 million. Because the $560,000 increase exceeds a reasonable cost-of-living increase, the agreement is considered materially modified, and the entire $2.4 million is subject to the $1 million deduction limit.

However, the grant of additional compensation of a type not provided in a contract will not constitute a material modification. The notice provides an example in which, rather than the salary increases to the CFO described above, the company grants the CFO a restricted stock award subject to continued employment through the end of the term of the employment agreement. This restricted stock grant would not materially modify the employment agreement because any additional compensation paid to the CFO under the grant is not paid on the basis of substantially the same elements or conditions as the salary (i.e., because the compensation attributable to the restricted stock grant is based on stock price and continued employment).

***Can compensation paid to an employee who becomes eligible to participate in a plan or arrangement after November 2, 2017 be grandfathered?***

Yes, as long as the plan or arrangement was binding on November 2, 2017 and, on that date, the employee either was employed by the company or had the right under a written binding contract to participate in the plan or arrangement.[4]

***Is the failure to exercise negative discretion a material modification?***

No. The notice provides an example of a bonus plan that was in effect on November 2, 2017 and that was structured to comply with the "qualified performance-based exception" under old Section 162(m). The plan provides that the CEO will receive a bonus of $1.5 million for 2017 if specified objective performance goals are achieved, subject to the compensation committee's ability to reduce the payment, in its discretion based on subjective factors, but not below $400,000. The performance goals are met, and the committee exercises its discretion to reduce the bonus to $500,000. The committee's failure to exercise negative discretion to reduce the payment to $400,000 (rather than $500,000) is not a material modification. Therefore, the $400,000 minimum payment is not subject to the deduction limit, and the remaining $100,000 is subject to the limit.

As a practical matter, this exception will not generally provide any relief, because most negative discretion plans permit the compensation committee to reduce the objectively determined amount to zero. The notice suggests that such arrangements likely do not qualify for the grandfather, because they likely are not "written binding contracts" under applicable law (i.e., because there is no minimum amount that is guaranteed to be paid if the performance goals are achieved).

***Is compensation grandfathered if it is subject to board approval obtained after November 2, 2017?***

No. The notice provides an example of an employment agreement in effect on November 2, 2017 that provides for grants of equity awards on January 2, 2018, subject to approval by the board of directors. Had these grants been made before November 2, 2017, they would have constituted qualified performance-based compensation under old Section 162(m). However, because under applicable law these potential grants did not constitute a written binding contract on November 2, 2017 given the board's discretion to withhold approval, compensation attributable to the grants is subject to the deduction limit.

## Effectiveness and Future Guidance

***When does the guidance become effective?***

The IRS and Treasury Department expect to incorporate the guidance in the notice in future regulations that will apply to any taxable year ending on or after September 10, 2018. Any additional guidance or regulations released by the IRS that expand the definition of "covered employee" or that restrict the application of the definition of "written binding contract" will only apply prospectively.

[4] The text of the notice provides that, on November 2, 2017, the employee must either be employed by the company or have the right under a written binding contract to participate in the plan or arrangement. However, the notice includes an example of an employee who, on November 2, 2017, was both employed by the company and had the right under a written binding contract to participate in a deferred compensation plan. The example concludes that a payment to the employee under the plan qualifies as grandfathered. Although not entirely clear, because the example does not state that both conditions must be met for the payment to be grandfathered, and because the text of the notice states that only one of the conditions must be met, it appears that the grandfather should apply if either condition is met.

***What topics has the IRS requested comment on?***

In the notice, the IRS requests comment on the applicability of the following:

- 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 definition of "covered employee" to an employee who was a covered employee of a predecessor of the publicly held corporation;
- new Section 162(m) to corporations immediately after they become publicly held, either through an IPO or a similar business transaction; and
- the SEC executive compensation disclosure rules for purposes of determining the three most highly compensated executive officers when a corporation's taxable and fiscal years do not align.

Comments may be submitted through November 9, 2018.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.


| | | |
|---|---|---|
| **Jeffrey P. Crandall** | **212 450 4880** | jeffrey.crandall@davispolk.com |
| **Edmond T. FitzGerald** | **212 450 4644** | edmond.fitzgerald@davispolk.com |
| **Rachel D. Kleinberg** | **650 752 2054** | rachel.kleinberg@davispolk.com |
| **Kyoko Takahashi Lin** | **212 450 4706** | kyoko.lin@davispolk.com |
| **Jean M. McLoughlin** | **212 450 4416** | jean.mcloughlin@davispolk.com |
| **Veronica M. Wissel** | **212 450 4794** | veronica.wissel@davispolk.com |
| **Ron M. Aizen** | **212 450 4568** | ron.aizen@davispolk.com |
| **Gregory D. Hughes** | **650 757 2045** | gregory.hughes@davispolk.com |
| **David Mollo-Christensen** | **212 450 3295** | david.mollo@davispolk.com |
| **Christie Michelle Falco** | **212 450 4945** | christie.falco@davispolk.com |

# APPENDIX

Notice 2018-68 includes the following examples:

**A. Covered Employee**

**Example 1:**

Facts. Corporation Z is a calendar year taxpayer and a publicly held corporation within the meaning of section 162(m)(2). Corporation Z is not a smaller reporting company or emerging growth company under the SEC rules. For 2018, Employee A served as the sole PEO of Corporation Z and Employees B and C both served as the PFO of Corporation Z at different times during the year. Employees D, E, and F were, respectively, the first, second, and third most highly compensated executive officers of Corporation Z for 2018 other than the PEO and PFO, and all three retired before the end of 2018. Employees G, H, and I were, respectively, Corporation Z's fourth, fifth, and sixth highest compensated executive officers other than the PEO and PFO for 2018, and all three were serving at the end of 2018. On March 1, 2019, Corporation Z filed its Form 10-K, Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 with the SEC. With respect to Item 11, Executive Compensation (as required by Part III of Form 10-K), Corporation Z disclosed the compensation of Employee A for serving as the PEO, Employees B and C for serving as the PFO, and Employees G, H, and I pursuant to Item 402 of Regulation S-K, 17 CFR §229.402(a)(3)(iii). Corporation Z also disclosed the compensation of Employees D and E pursuant to Item 402 of Regulation S-K, 17 CFR §229.402(a)(3)(iv).

Conclusion: PEO. Because Employee A served as the PEO during 2018, Employee A is a covered employee under section 162(m)(3)(A) for 2018.

Conclusion: PFO. Because Employees B and C served as the PFO during 2018, Employees B and C are covered employees under section 162(m)(3)(A) for 2018.

Conclusion: Three Highest Compensated Executive Officers. Even though the SEC rules require Corporation Z to disclose the compensation of Employees D, E, G, H, and I for 2018, Corporation Z's covered employees for 2018 under section 162(m)(3)(B) are Employees D, E, and F, because these are the three highest compensated executive officers other than the PEO and PFO for 2018.

**Example 2:**

Facts. Assume the same facts as in Example 1, except that Corporation Z is a smaller reporting company or emerging growth company under the SEC rules. Accordingly, with respect to Item 11, Executive Compensation (as required by Part III of Form 10-K), Corporation Z disclosed the compensation of Employee A for serving as the PEO, Employees G and H pursuant to Item 402(m) of Regulation S-K, 17 CFR §229.402(m)(2)(ii), and Employees D and E pursuant to Item 402(m) of Regulation S-K, 17 CFR §229.402(m)(2)(iii).

Conclusion. The results are the same as in Example 1. For purposes of identifying a corporation's covered employees under section 162(m)(3), it is not relevant whether the SEC rules for smaller reporting companies and 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.

**Example 3:**

Facts. Corporation Y is a domestic publicly held corporation within the meaning of section 162(m)(2) for its 2018 taxable year and a calendar year taxpayer. Corporation X is a domestic corporation and a calendar year taxpayer; however, Corporation X is not a publicly held corporation within the meaning of section 162(m)(2) for its 2018 and 2019 taxable years. On July 31, 2019, Corporation X acquires for cash 80% of the only class of outstanding stock of Corporation Y. The group (comprised of Corporations X and Y) elects to file a consolidated income tax return. As a result of this election, Corporation Y has a short taxable year ending on July 31, 2019. Corporation Y does not change its fiscal year for SEC reporting purposes to correspond to the short taxable year. Corporation Y remains a domestic publicly held corporation within the meaning of section 162(m)(2) for its short taxable year ending on July 31, 2019 and its subsequent taxable year ending on December 31, 2019, for which it files a consolidated income tax return with Corporation X. For Corporation Y's taxable year ending July 31, 2019, Employee N serves as the only PEO, and Employee O serves as the only PFO. Employees J, K, and L are the three most highly compensated executive officers of Corporation Y for the taxable year ending July 31, 2019, other than the PEO and PFO. As a result of the acquisition, effective July 31, 2019, Employee N ceases to serve as the PEO of Corporation Y.

Instead, Employee M begins serving as the PEO of Corporation Y on August 1, 2019. Employee N continues to provide services for Corporation Y and never serves as PEO again (or as an individual acting in such capacity). For Corporation Y's taxable year ending December 31, 2019, Employee M serves as the only PEO, and Employee O serves as the only PFO. Employees J, K, and L continued to be the three most highly compensated executive officers of Corporation Y, other than the PEO and PFO, for the taxable year ending December 31, 2019.

Conclusion: Employee N. Because Employee N served as the PEO during Corporation Y's taxable year ending July 31, 2019, Employee N is a covered employee for Corporation Y's taxable year ending July 31, 2019. Furthermore, Employee N is a covered employee for Corporation Y's taxable year ending July 31, 2019, even though Employee N's compensation is required to be disclosed pursuant to the SEC executive compensation disclosure rules only for the fiscal year ending December 31, 2019. Because Employee N was a covered employee for Corporation Y's taxable year ending July 31, 2019, Employee N is also a covered employee for Corporation Y's taxable year ending December 31, 2019.

Conclusion: Employee O. Because Employee O served as the PFO during Corporation Y's taxable years ending July 31, 2019, and December 31, 2019, Employee O is a covered employee for these taxable years. Furthermore, Employee O is a covered employee for Corporation Y's taxable year ending July 31, 2019, even though Employee O's compensation is required to be disclosed pursuant to the SEC executive compensation disclosure rules only for the fiscal year ending December 31, 2019. Employee O would be a covered employee for Corporation Y's taxable year ending December 31, 2019 even if Employee O did not serve as the PFO during this taxable year because Employee O was a covered employee for Corporation Y's taxable year ending July 31, 2019.

Conclusion: Employees J, K, and L. Employees J, K, and L are covered employees for Corporation Y's taxable years ending July 31, 2019, and December 31, 2019, because these employees are the three highest compensated executive officers for these taxable years. Employees J, K, and L would be covered employees for Corporation Y's taxable year ending December 31, 2019, even if Employees J, K, and L were not the three highest compensated executive officers during this taxable year because Employees J, K, and L were covered employees for Corporation Y's taxable year ending July 31, 2019. Accordingly, Employees J, K, and L would be covered employees for Corporation Y's taxable years ending July 31, 2019 and December 31, 2019, even if their compensation would not be required to be disclosed pursuant to the SEC executive compensation disclosure rules.

Conclusion: Employee M. Because Employee M served as the PEO during Corporation Y's taxable year ending December 31, 2019, Employee M is a covered employee for Corporation Y's taxable year ending December 31, 2019.

**B. Written Binding Contract**

**Example 1:**

Facts. On October 2, 2017, Corporation W executed a 3-year employment agreement with Employee V for an annual salary of $2,000,000 beginning on January 1, 2018. Employee V serves as the PFO of Corporation W for the 2017, 2018, 2019, and 2020 taxable years. The terms of the agreement provide for automatic extensions after the 3-year term for additional 1-year periods, unless the corporation exercises its option to terminate the agreement within 30 days before the end of the 3-year term or, thereafter, within 30 days before each anniversary date. Termination of the employment agreement does not require the termination of Employee V's employment relationship with Corporation W. Under applicable law, the agreement constitutes a written binding contract in effect on November 2, 2017, to pay $2,000,000 of annual salary to Employee V for three years through December 31, 2020. '

Conclusion. Employee V is a covered employee for Corporation W's 2018, 2019, and 2020 taxable years. Before the Act's amendments to section 162(m)(3), an individual serving as a PFO was not considered a covered employee. Thus, Employee V is a covered employee solely as a result of the Act's amendment to section 162(m)(3). Because the employment agreement executed on October 2, 2017, is a written binding contract under applicable law to pay Employee V an annual salary of $2,000,000, the Act's amendments to section 162(m) do not apply to Employee V's annual salary. Accordingly, Employee V's annual salary of $2,000,000 for the 2018, 2019, and 2020 taxable years is not subject to the deduction limitation under section 162(m). However, the employment agreement is treated as renewed on January 1, 2021, unless it is previously terminated, and the Act's amendments to section 162(m) apply to any payments made under the employment agreement on or after that date.

**Example 2:**

Facts. On December 31, 2015, Employee U, an employee of Corporation V, makes an election to defer the entire amount that would otherwise be paid to Employee U under Corporation V's 2016 annual bonus plan. Pursuant to the deferral election, the bonus, plus earnings based on a predetermined actual investment, is to be paid in a lump sum at Employee U's separation from service. Employee U earns a $200,000 bonus for the 2016 taxable year. Under applicable law, the deferred compensation agreement into which Corporation V and Employee U entered on December 31, 2015 constitutes a written binding contract. On January 1, 2018, Employee U is promoted to serve as PEO of Corporation V. Prior to January 1, 2018, Employee U was never a covered employee as defined in section 162(m)(3). On December 15, 2020, Employee U separates from service and, on that date, Corporation V pays $225,000 (the deferred $200,000 bonus plus $25,000 in earnings) to Employee U.

Conclusion. Employee U is a covered employee for Corporation V's 2020 taxable year because Employee U served as the PEO of Corporation V during the taxable year. Moreover, Employee U is a covered employee for Corporation V's 2020 taxable because Employee U was a covered employee of Corporation V for a prior taxable year beginning after December 31, 2016. Before the Act's amendment to section 162(m)(3), a PEO qualified as a covered employee under section 162(m)(3)(A) only if that employee served as the PEO as of the close of the taxable year, and the rule in section 162(m)(3)(C) did not apply. Thus, Employee U is a covered employee for the 2020 taxable year solely as a result of the

Act's amendment to section 162(m)(3). Because, under applicable law, the deferred compensation agreement into which Corporation V and Employee U entered on December 31, 2015, constitutes a written binding contract to pay the bonus plus earnings based on a predetermined actual investment, the Act's amendments to section 162(m) do not apply to the $225,000 payment Corporation V is obligated to pay Employee U at Employee U's separation from service. Accordingly, the $225,000 payment is not subject to the deduction limitation under section 162(m).

**Example 3:**

Facts. Employee P serves as the PEO of Corporation U for the 2017 and 2018 taxable years. On February 1, 2017, Corporation U establishes a bonus plan, under which Employee P will receive a cash bonus of $1,500,000 if a specified performance goal is satisfied; the outcome of the performance goal is uncertain on February 1, 2017. The compensation committee retains the right, if the performance goal is met, to reduce the bonus payment to no less than $400,000 if, in its judgment, other subjective factors warrant a reduction. On November 2, 2017, under applicable law, which takes into account the employer's ability to exercise negative discretion, the bonus plan established on February 1, 2017 constitutes a written binding contract to pay $400,000. On March 1, 2018, the compensation committee certifies that the performance goal was satisfied. However, the compensation committee reduces the award to $500,000 due to the sale of certain corporate assets that resulted in the lowering of the fair market value of Corporation U's goodwill. On April 1, 2018, Corporation U pays $500,000 to Employee P. The payment satisfies the requirements of §1.162-27(e) as qualified performance-based compensation.

Conclusion. Employee P is a covered employee for Corporation U's 2018 taxable year. Prior to the Act's amendment to section 162(m)(4), section 162(m) did not apply to qualified performance-based compensation because such compensation was excluded from the definition of applicable employee remuneration. Thus, the $500,000 payment constitutes applicable employee remuneration solely as a result of the amendment to section 162(m)(4). Because, under applicable law, as of November 2, 2017, the bonus plan established on February 1, 2017, constitutes a written binding contract to pay $400,000, the Act's amendments to section 162(m) do not apply to $400,000 of the $500,000 payment to Employee P. Furthermore, the failure of the compensation committee to exercise negative discretion to reduce the award to $400,000, instead of $500,000, does not result in a material modification of the contract. Accordingly, the $400,000 is not subject to the deduction limitation under section 162(m). The remaining $100,000 of the $500,000 payment is subject to the deduction limitation under section 162(m) regardless of whether the payment satisfies the requirements of §1.162-27(e) as qualified performance-based compensation.

**Example 4:**

Facts. Employee Q serves as the PFO of Corporation T for the 2016, 2017, and 2018 taxable years. On January 4, 2016, Corporation T and Employee Q enter into a nonqualified deferred compensation arrangement that is an account balance plan. Under the terms of the plan, Corporation T will pay Employee Q's account balance on April 1, 2019, but only if Employee Q continues to serve as the PFO through December 31, 2018. Pursuant to the terms of the plan, Corporation T credits $100,000 to Employee Q's account annually for three years on December 31 of each year beginning on December 31, 2016, and credits earnings on each principal amount on each subsequent December 31. The plan also provides that Corporation T may, at any time, amend the plan to either stop or reduce the amount of future credits to the account balance in its discretion; however, Corporation T may not deprive Employee Q of any benefit accrued before the date of any such amendment. Under applicable law, the plan constitutes a written binding contract in effect on November 2, 2017, to pay $100,000 of remuneration that Corporation T credited to the account balance on December 31, 2016. On April 1, 2019, Corporation T pays Employee Q $350,000 (including earnings).

Conclusion. Employee Q is a covered employee for Corporation T's 2019 taxable year. Prior to the Act's amendment to section 162(m)(3), an individual serving as a PFO was not considered a covered employee. Thus, Employee Q is a covered employee solely as a result of the amendment to section 162(m)(3). Because, as of November 2, 2017, the nonqualified deferred compensation arrangement between Corporation T and Employee Q is a written binding contract under applicable law only with respect to the $100,000 credited as of that date, the Act's amendments to section 162(m) do not apply to $100,000 of the payment. Accordingly, $250,000 of the $350,000 payment (the difference between the $350,000 payment on April 1, 2019 and the $100,000 credited to the account balance on December 31, 2016) is subject to the deduction limitation under section 162(m).

**Example 5:**

Facts. Assume the same facts as in 0, except that under the plan earnings are credited quarterly; thus, under applicable law, the plan constitutes a written binding contract in effect on November 2, 2017, to pay the account balance as of November 2, 2017, to Employee Q on April 1, 2019. On November 2, 2017, the account balance under the plan is $110,000 (the $100,000 credited on December 31, 2016, plus earnings).

Conclusion. Employee Q is a covered employee for Corporation T's 2019 taxable year. Prior to the Act's amendment to section 162(m)(3), an individual serving as a PFO was not considered a covered employee. Thus, Employee Q is a covered employee solely as a result of the Act's amendment to section 162(m)(3). Because the nonqualified deferred compensation arrangement between Corporation T and Employee Q is a written binding contract under applicable law to pay only the $110,000 account balance as of November 2, 2017, to Employee Q on April 1, 2019, the Act's amendments to section 162(m) do not apply to $110,000 of the $350,000 payment. Accordingly, $240,000 of the $350,000 payment (the difference between the $350,000 payment on April 1, 2019 and the $110,000 account balance on November 2, 2017) is subject to the deduction limitation under section 162(m).

**Example 6:**

Facts. Assume the same facts as in 0, except that, Employee Q serves as PEO (rather than PFO) of Corporation T for the 2016, 2017, and 2018 taxable years, and continues to serve as the PEO through December 31, 2019.

Conclusion. Employee Q is a covered employee for Corporation T's 2019 taxable year because Employee Q served as the PEO of Corporation T during the taxable year. Moreover, Employee Q is a covered employee for Corporation T's 2019 taxable year because Employee Q was a covered employee of Corporation T for a prior taxable year beginning after December 31, 2016. Prior to the Act's amendments to section 162(m)(3)(A), a PEO was a covered employee if such employee served as the PEO as of the close of the taxable year. Because Employee Q continues to serve as the PEO through December 31, 2019, Employee Q is a covered employee not solely as a result of the amendments to section 162(m)(3). Accordingly, the entire $350,000 payment is subject to the deduction limitation under section 162(m).

**Example 7:**

Facts. On January 2, 2017, Corporation S executed a 4-year employment agreement with Employee R to serve as its PEO. Employee R serves as the PEO of Corporation S for four years and receives an annual salary of $1,000,000. Pursuant to the employment agreement, on January 2, 2017, Corporation S granted to Employee R nonstatutory stock options to purchase 1,000 shares of Corporation S stock, stock appreciation rights (SARs) on 1,000 shares, and 1,000 shares of Corporation S restricted stock. On the date of grant, the stock options had no readily ascertainable fair market value as defined in §1.83-7(b) and neither the stock options nor the SARs provided for a deferral of compensation under section 409A and §1.409A- 1(b)(5)(i)(A). The stock options and SARs vest and become exercisable on January 2, 2019. Employee R can exercise the stock options and the SARs at any time from January 2, 2019, through January 2, 2022. On January 2, 2019, Employee R exercises the stock options and the SARs, and the 1,000 shares of restricted stock become substantially vested (as defined in §1.83-3(b)). The grants of the stock options, SARs, and shares of restricted stock constitute a written binding contract under applicable law. The compensation attributable to the stock options and the SARs satisfy the requirements of §1.162-27(e) as qualified performance-based compensation.

Conclusion. Employee R is a covered employee for Corporation S's 2019 taxable year. Because the January 2, 2017, grants of the stock options, SARs, and shares of restricted stock constitute a written binding contract in effect on November 2, 2017, under applicable law, the Act's amendments to section 162(m) do not apply to compensation received pursuant to the exercise of the stock options and the SARs, or the restricted stock becoming substantially vested (as defined in §1.83-3(b)). Section 162(m) does not disallow Corporation S's deduction for compensation attributable to the stock options or the SARs, because the compensation satisfies the requirements of §1.162-27(e) as qualified performance-based compensation, and the Act's elimination of the exception for qualified performance-based compensation does not apply. However, Corporation S's deduction for the compensation attributable to the restricted stock is disallowed by section 162(m) even though the Act's amendments do not apply to this compensation.

**Example 8:**

Facts. Assume the same facts as in Example 7, except that the employment agreement provides that the stock options, SARs, and restricted stock will be granted on January 2, 2018, subject to the approval of the board of directors of Corporation S. As of November 2, 2017, under applicable law, the potential grants of stock options, SARs, and restricted stock do not constitute a written binding contract.

Conclusion. Because, under applicable law, as of November 2, 2017, the potential grants of the stock options, SARs, and shares of restricted stock do not constitute a written binding contract, the Act's amendments to section 162(m) apply to compensation paid pursuant to the exercise of the stock options and SARs, and the restricted stock becoming substantially vested (as defined in §1.83-3(b)). Accordingly, section 162(m) disallows Corporation S's deduction with respect to compensation attributable to the stock options, SARs, and restricted stock.

**Example 9:**

Facts. On January 2, 2015, Corporation R executes a deferred compensation agreement with Employee T providing for a payment of $3,000,000 if Employee T continues to provide services through December 31, 2017. On October 2, 2017, Employee T terminates employment with Corporation R, executes an employment agreement with Corporation Q to serve as its PFO, and commences employment with Corporation Q. The employment agreement, which is a written binding contract under applicable law, provides that, on April 1, 2018, Employee T will participate in the nonqualified deferred compensation plan available to all executive officers of Corporation Q and that Employee T's benefit accrued on that date will be $3,000,000. On April 1, 2021, Employee T receives a payment of $4,500,000, which is the entire benefit accrued under the plan.

Conclusion. Employee T is a covered employee for Corporation Q's 2021 taxable year. Before the Act's amendment to section 162(m)(3), an individual serving as a PFO was not considered a covered employee. Thus, Employee T is a covered employee solely as a result of the Act's amendment to section 162(m)(3). Even though Employee T was not eligible to participate in the nonqualified deferred compensation plan on November 2, 2017, Employee T was employed on November 2, 2017 and had the right to participate in the plan under a written binding contract as of that date. Because, as of November 2, 2017, the amount that is required to be paid pursuant to the written binding contract is $3,000,000, the Act's amendments to section 162(m) do not apply to $3,000,000 of the $4,500,000 payment made on April 1, 2021. Accordingly, $1,500,000 of the $4,500,000 payment (the difference between the $4,500,000 payment and the $3,000,000 grandfathered amount) is subject to the deduction limitation under section 162(m).

**Example 10:**

Facts. Corporation P executed a 5-year employment agreement with Employee S on January 1, 2017, providing for a salary of $1,800,000 per year to serve as Corporation P's PFO. The agreement constitutes a written binding contract under applicable law. In 2017 and 2018, Employee S receives the salary of $1,800,000 per year. In 2019, Corporation P increases Employee S's compensation with a supplemental payment of $40,000. On January 1, 2020, Corporation P increases Employee S's salary to $2,400,000.

Conclusion: $40,000 Payment in 2019. Employee S is a covered employee for Corporation P's 2018, 2019, and 2020 taxable years. Before the Act's amendment to section 162(m)(3), an individual serving as a PFO was not considered a covered employee. Thus, Employee S is a covered employee solely as a result of the Act's amendment to section 162(m)(3). Accordingly, the salary of $1,800,000 per year payable to Employee S under the employment agreement, which is a written binding contract under applicable law, is grandfathered unless the change in Employee S's compensation in either 2019 or 2020 is a material modification. The $40,000 supplemental payment does not constitute a material modification of the written binding contract because the $40,000 payment is less than or equal to a reasonable cost-of living increase from 2017. However, the $40,000 supplemental payment is subject to the Act's amendments to section 162(m). Therefore, section 162(m) disallows Corporation P's deduction for the $40,000 supplemental payment, but does not disallow any portion of Corporation P's deduction for the $1,800,000 salary.

Conclusion: Salary Increase to $2,400,000 in 2020. The $560,000 increase in salary in 2020 is a material modification of the written binding contract because the additional compensation is paid on the basis of substantially the same elements or conditions as the compensation that is otherwise paid pursuant to the written binding contract and it is greater than a reasonable, annual cost-of-living increase. Because the written binding contract is materially modified as of January 1, 2020, all compensation paid to Employee S in 2020 and thereafter is subject to the Act's amendments to section 162(m). Therefore, section 162(m) disallows Corporation P's deduction for Employee S's compensation in excess of $1,000,000.

**Example 11:**

Facts. Assume the same facts as in 0, except that instead of an increase in salary, Employee S receives a restricted stock grant subject to Employee S's continued employment for the balance of the contract.

Conclusion. The restricted stock grant is not a material modification of the written binding contract because any additional compensation paid to Employee S under the grant is not paid on the basis of substantially the same elements and conditions as Employee S's salary because it is based both on the stock price and Employee S's continued service. However, compensation attributable to the restricted stock grant is subject to the Act's amendments to section 162(m). Therefore, section 162(m) disallows Corporation P's deduction for the restricted stock, but does not disallow any portion of Corporation P's deduction for the $1,800,000 salary.