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TOPIC: IRS Issues New 162(m) Rules Related to Grandfathered Benefits under Deferred Compensation Plans.

MARKET TREND: IRS Notice 2018-68 (the "Notice"), issued on August 21, 2018, further explains how the "grandfather rules" in the Tax Cuts and Jobs Act (the "Tax Act") under Internal Revenue Code Section 162(m) ("162(m)") apply to amounts accrued under nonqualified deferred compensation plans ("NQDC").

SYNOPSIS: Changes to 162(m) made by the Tax Act expand the $1 million deduction limit for covered employees at public companies. NQDC amounts accrued as of November 2, 2017 can escape these expanded deduction limits if the NQDC amounts meet certain grandfather requirements to remain covered by the pre-Tax Act 162(m) rules ("old 162(m)"). The Notice provides additional standards as to what can be covered by the grandfather rule and what could be a material modification that results in a loss of grandfathered treatment. Examples in the Notice include application of the grandfather rule to NQDC. While the new rules add some clarity about how the grandfather rule applies to NQDC, they also leave some questions unanswered.

TAKEAWAYS: Public companies should review their NQDC plans in light of the new rules to better identify NQDC amounts that can be treated as grandfathered under old 162(m). This may require additional administrative steps to separately identify grandfathered balances.

Future IRS regulations may provide additional clarity on open questions, especially as to the treatment of non-account balance NQDC (such as defined benefit SERPs). There is an opportunity to provide comments to the IRS on these rules. The comment period ends November 9, 2018.

Background on Tax Act Changes to 162(m)[1]

Internal Revenue Code Section 162(m) ("162(m)") provides a $1 million limit on the amount of compensation that certain companies can deduct for compensation paid to certain "covered employees." The Tax Cuts and Jobs Act (the "Tax Act") expands the scope of this deduction limit in a number of important respects beginning in 2018:

Feature	Old 162(m) (pre-2018)	New 162(m) (beginning 2018)
Covered Companies	- Any "publicly held corporation," meaning a corporation with a class of common equity securities required to be registered under §12 of the '34 Act	- Expanded to include companies that are required to file reports under §15(d) of the '34 Act, such as certain foreign issuers of ADRs or issuers of public debt
Covered Employees	- The year-end CEO and the top-3 other year-end highest paid executives whose compensation is required to be reported in the proxy statement under SEC rules - Does not include the CFO - Year-by-year determination (i.e., does not apply if not in the position at year-end)	- Anyone who served as CEO or CFO during the year (not just year-end) - Top-3 other highest paid executives whose compensation is required to be reported in the proxy statement under SEC rules (or would be if those rules applied), regardless of year-end status - Will be considered a covered employee for the year of determination and each year thereafter, including individuals determined as covered employees under old 162(m) for 2017
Compensation Excluded from Deduction Limit	- The deduction limit does not apply to compensation that qualifies as "commissions" or "performance-based"	- No exceptions

Under old 162(m), NQDC payable after an executive's termination of employment escaped the 162(m) deduction limit because the executive would not be a year-end "covered employee" for the year of payment under the old 162(m) definition.[2]

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[1] For more information on the Tax Act changes to 162(m), see our WRMarketplace alert {hyperlink}.

[2] In fact, deferring payment of compensation as a technique to avoid a 162(m) lost deduction was expressly blessed by the government in the final regulations for Internal Revenue Code Section 409A (which permit deferral of compensation that a company reasonably believes would not be deductible because of 162(m) until such time as the amount would be deductible). See Treas. Reg. §1.409A-2(b)(7)(i).

Under new 162(m), once an executive has been determined to be a covered employee for a tax year, the individual remains a covered employee for all future tax years, including as to payments made after termination of employment or death.

The 162(m) Grandfather Rule May Permit Continued Deductibility of Some NQDC

The Tax Act provides that compensation payable under a written binding contract in effect on November 2, 2017, and which is not materially modified after that date, remains subject to the old 162(m) rules—i.e., the compensation is "grandfathered" under old 162(m). This grandfather rule can potentially apply to NQDC that was accrued on or before November 2, 2017, so that the previous tax treatment can be preserved on the payments of that NQDC in later years, without regard to the limitations of new 162(m).

IRS Notice 2018-68 (the "Notice"), issued on August 21, 2018, provides guidance on the scope of the 162(m) grandfather rule.[3] The Notice applies a relatively unsurprising but narrow reading of the grandfather rule included in the statute.

The Notice defines a "written binding contract" as an arrangement under which the company is "obligated under applicable law" to pay the compensation if the covered employee meets any vesting conditions included in the arrangement, such as continued employment. The Notice does not define what "obligated under applicable law" means — this will be a legal judgment based on the facts. The Notice clarifies, however, that if the company can unilaterally terminate or cancel the obligation without also having to terminate the covered employee's employment, there is no legal obligation and thus no written binding contract. For a contract that can be unilaterally terminated by the company as of a given date without terminating the employee's employment (such as an employment agreement with an automatic renewal date as of which the company can unilaterally choose with prior notice to not renew), the contract will no longer be grandfathered after that date, even if no action is taken. **In other words, unfettered company discretion to reduce or terminate an obligation = no grandfather**.

The Notice provides that if an individual was employed with the company on November 2, 2017, and as of that date had a contractual right to begin participation in a plan or receive a grant at a later date, that contractual obligation to future compensation could be a written binding contract such that the future compensation would be covered by old 162(m) under the grandfather rule. But if that future participation or award is conditioned on any future discretionary act of the company, such as future board approval, that obligation would not be a written binding contract for purposes of the grandfather rules. Again, unfettered company discretion = no grandfather.

[3] The Notice also addresses rules on the determination of covered employees under new 162(m).

The Notice explains that a "material modification" to a written binding contract occurs — thereby nullifying the 162(m) grandfather rule — if the contract is changed to increase the amount of compensation payable to the employee. The Notice states that it is not a material modification to adjust the amount of the compensation for an accelerated payment, if a reasonable discount is applied, or a further deferral, if the amount is adjusted for a reasonable rate of interest or deemed investment in a predetermined actual investment. The Notice cautions, though, that the material modification rules cannot be circumvented by supplementing a compensation arrangement or providing additional compensation on the same basis as the grandfathered compensation (other than an adjustment providing no more than a reasonable cost-of-living increase).

Application of the 162(m) Grandfather Rule to NQDC -- Four Examples From the Notice

The Notice includes four examples that illustrate the application of the 162(m) grandfather rule to defined contribution NQDC:

Example # in Notice	Summary of Facts	Result
2	- Executive elects in 2015 to defer a $200K bonus otherwise payable in 2016 - The deferral receives earnings based on a predetermined actual investment - The company has no discretion to change or cancel the deferral - Payment is required to be made after termination of employment - The executive is the CEO in 2020 when he/she terminates employment (before the end of the year), and is paid by year-end $225K, equal to the deferral plus earnings	- As of Nov. 2, 2017, the company was legally obligated under applicable law to pay the deferral plus earnings at the later termination of employment; therefor the deferral agreement is a grandfathered "written binding contract" - Old 162(m) applies to the payment in 2020. Because the executive is not the year-end CEO in 2020, the executive is not a covered employee under old 162(m) (even though the executive is a covered employee for 2020 under new 162(m)) - As a result, applying older 162(m), the full $225K payment is deductible by the company in 2020
4	- CFO and the company enter into an account-balance deferred compensation agreement in 2016 in which the company credits $100K as of 12/31 each year for 2016, 2017, and 2018 - The deferred compensation is credited with interest each 12/31 based on a predetermined actual investment - The deferred compensation balance is payable on a specified date in 2019, subject to the CFO's continued employment (i.e., an in-service payment)	- As of Nov. 2, 2017, the company was legally obligated under applicable law to pay the $100K credited to the account as of that date (i.e., the 12/31/16 credit); therefore, this amount is covered by a "written binding contract" and is grandfathered - Because the company has the unfettered discretion as of Nov. 2, 2017 to not make any future credits (including earnings), the company is not considered to be legally obligated to make those future credits; therefore, those credits are not covered by a

	- The company reserves the right to reduce or cancel future credits to the account in its discretion (but it cannot reduce or cancel amounts previously credited) - In 2019, the executive is still the CFO and is paid $350K (i.e., $300K in principal credits plus $50K in earnings)	"written binding contract" and are not grandfathered - In 2019, old 162(m) applies to the first $100K of the payment. Because the executive is the CFO, the executive is not a covered employee under old 162(m) (even though the executive is a covered employee under new 162(m) in 2019) - As a result, $100K of the payment is deductible in 2019 without regard to the 162(m) deduction limit, but the remaining $250K of the payment is subject to the new 162(m) deduction limit in 2019
5	- The facts are the same as example 4, except that earnings are required to be credited quarterly - As of Nov. 2, 2017, the amount credited to the CFO's account is $110K (i.e., the initial $100K credit at 12/31/16 plus earnings for the first three quarters of 2017)	- The same results as in example 4 apply, except that the amount grandfathered is $110K -- i.e., the account balance at Nov. 2, 2019 that the company was legally obligated to pay (subject to the CFO's continued employment) - As a result, $110K of the payment is deductible in 2019 without regard to the 162(m) deduction limit, but the remaining $240K of the payment is subject to the new 162(m) deduction limit in 2019
6	- The facts are the same as example 4, except that the executive is the year-end CEO in 2019 (the year of payment)	- The executive is a covered employee in 2019 under both old and new 162(m), and the deferrals were not otherwise "performance-based compensation" under old 162(m) - As a result, under both old and new 162(m), the payment is subject to the 162(m) deduction limit, and therefore the entire $350K payment in 2019 is subject to the 162(m) deduction limit

Implications of the Grandfather Rule and Unanswered Questions

The Notice clarifies that account balance NQDC accrued as of November 2, 2017 should remain subject to old 162(m), which means that amounts could remain deductible when payable in the future either because the amounts are payable after the executive's termination of employment or the executive otherwise occupies a position that would not have been a covered employee under old 162(m) in the year of payment. The same analysis should apply to an amount deferred as of November 2, 2017 that qualified as "performance-based compensation" under old 162(m) (assuming earnings are at no more than a reasonable interest rate or based on a predetermined actual investment).

Whether amounts credited to the account after November 2, 2017 are grandfathered is less clear. This will require an inspection of the underlying plan or deferred compensation agreement. If, as is commonly the case, the company has reserved the right to terminate the plan at any time and pay out balances credited through the date of termination, the Notice appears to say that no future credits (earnings or otherwise) after November 2, 2017 would be considered grandfathered. Again, unfettered company discretion = no grandfather. But if the deferred compensation agreement cannot be terminated or changed without employee consent (i.e., not the company's unilateral discretion), the grandfather may apply to future credits required by the agreement as in effect on November 2, 2017 (and assuming no subsequent material modification). In any event, companies should closely review with their legal counsel the specific terms of each potentially grandfathered NQDC arrangement.

Assuming a portion of the NQDC account can be grandfathered, the company will need to separately account for this portion of the account to determine what is potentially deductible under old 162(m) when payment is later made. It is unclear under the Notice how this accounting would be applied if later payments are made other than in a lump sum. For example, if payments are made in installments from an account after termination of employment, a portion of which is grandfathered, will the first payments be considered the grandfathered amounts (and therefore deductible), or will the grandfathered portion have to be applied proportionately to each installment payment?

The Notice also does not specifically address application of the grandfather rule to non-account balance NQDC, such as a final average pay defined benefit SERP. The same legal principles should apply, so that the amount accrued based on compensation and service through November 2, 2017, at a minimum, should be grandfathered. The extent to which the company retains the right to terminate or amend the arrangement should determine whether future accruals can be considered as grandfathered. It is unclear how actuarial adjustments to grandfathered accruals would be treated. The separate accounting of a grandfathered accrual may also present challenges when amounts are later paid, especially if payable as a lifetime annuity.

The IRS has invited comments on the rules in the Notice and certain other aspects of new 162(m). Comments must be submitted by November 9, 2019. The IRS is then expected to issue formal regulations on new 162(m) at a later date. In the meantime, companies should be able to apply reasonable, good faith interpretations of these rules.

Conclusion

The Notice confirms certain aspects of the 162(m) grandfather rule as applied to NQDC, including the ways that old 162(m) can continue to apply from and after 2018 to amounts accrued as of November 2, 2017. But the Notice includes certain undefined standards — such as "obligated under applicable law" — that will require legal judgments and that will be highly dependent on the specific facts and circumstances of each case.

Some actions that public companies with NQDC should consider now include:

- Create an inventory of all NQDC plans and agreements that were in place as of November 2, 2017;

- Review those plans and arrangements to determine the extent to which the company has unfettered discretion to terminate or reduce amounts deferred, in order to decide what amounts may be grandfathered;

- Begin to consider with NQDC recordkeepers how any 162(m) grandfathered amounts can be separately accounted; and

- Consider whether the company wants to file a comment letter with the IRS by the November 9, 2018 deadline.