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Takeaways from the Final Code Section 162(m) Rules on Executive Pay Caps

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Last month, the Internal Revenue Service (the “IRS”) issued final rules under Internal Revenue Code (“Code”) Section 162(m), providing clarity on the rules that limit corporate deductions for certain executive compensation over \$1 million. This Client Alert summarizes those clarifications and interpretations that are most pressing to our clients.

Code Section 162(m) limits the tax-deduction publicly traded companies can make for payments to a “covered employee” for any year to \$1 million. Originally, Code Section 162(m) included an exemption for certain forms of performance-based compensation. That exemption was removed in 2017, along with other changes, under the Tax Cuts and Jobs Act of 2017. The IRS’s final rules with respect to those changes include two categories of changes that could affect your executive pay arrangements.

[Determining “Covered Employees”](#)

The 2017 changes included some revisions regarding which employees are “covered employees,” generally defined as the CEO/CFO and three next most highly paid employees.

The 2017 changes included a new rule that provides that once an employee is a “covered employee,” that employee forever remains a covered employee (even if he or she is not a CEO/CFO or top-three highest paid employee in a later year). Commentators to the proposed rule requested clarification that this classification should only include people whose pay is required to be disclosed under SEC rules. The IRS rejected that request. Under the final rule, “top three earners” is not a classification limited to those employees reported in SEC Filings. For example, an employee could be a top-three earner in a year, but not be reported in that year’s proxy because he or she left the company mid-year.

Takeaway: It’s very important for companies subject to Code Section 162(m) to keep a running list of anyone who is or has been a “covered employee” for 162(m) purposes. It is also important to keep documentation of why certain employees are or are not classified as “covered employees,” since that classification might not match what is reported in SEC filings.

[Grandfather Rule](#)

The 2017 rules only apply to taxable years beginning after December 31, 2017. However, there is a grandfather rule that exempts certain performance-based pay, payable under an arrangement “in effect” on or before November 2, 2017.

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This rule had a few considerations:

- **MATERIAL MODIFICATIONS:** A compensation arrangement is only considered “in effect” on or before November 2, 2017 if it is established by that date and there have been no “material modifications” since that date.

Takeaway: Any modifications to pre-November 2, 2017 performance-based pay arrangements need to be reviewed for whether they are material (and ruin grandfather status) or not (which don’t ruin grandfather status).

- **EXTENSIONS:** The American Bar Association requested that stock options that were extended after the grandfather period also be exempted. The IRS agreed (for both options and stock appreciation rights (“SARs”)), so long as the extension is compliant under Code Section 409A.

Takeaway: Extensions of pre-November 2, 2017 options and SARs can be extended and still fall under the previous performance-based compensation exemption to 162(m), but the extensions need to be reviewed to assure they are Code Section 409A compliant.

- **CLAWBACKS:** The final rule confirms that clawbacks of pre-November 2, 2017 performance-based compensation do not constitute a “material modification” that takes away grandfathered status.

Takeaway: Clawbacks will not wreck grandfather status under Code Section 162(m).

- **NEGATIVE DISCRETION (STATE LAW APPLIES):** If a pre-November 2, 2017 contract allows for negative discretion – i.e. that company has discretion to reduce or eliminate certain compensation – the determination of whether it is grandfathered is based on state, not federal, contract law.

Takeaway: Any pre-November 2, 2017 performance-based compensation containing negative discretion should be reviewed on a state law basis.

If you have any questions about the final rule under Code Section 162(m) or how its changes impact your executive compensation arrangements, please contact one of the members of the Kutak Rock [Employee Benefits Practice Group](#).

