

Guidance on the Application of Section 162(m)

Notice 2018-68

I. PURPOSE

This notice provides initial guidance on the application of section 162(m) of the Internal Revenue Code (Code), as amended by section 13601 of “An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018,” Public Law 115-97 (2017) (the Act). Section 162(m)(1) generally limits the allowable deduction for a taxable year for remuneration paid by any publicly held corporation with respect to a covered employee. Section 13601 of the Act made significant amendments to section 162(m) and provided a transition rule applicable to certain outstanding arrangements (commonly referred to as the grandfather rule).

Stakeholders have submitted comments indicating that they would benefit from initial guidance on certain aspects of the amendments made by section 13601 of the Act, in particular on the amended rules for identifying covered employees and the operation of the grandfather rule, including when a contract will be considered materially modified so that it is no longer grandfathered. This notice addresses these limited issues. The Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) anticipate that further guidance on the amendments made by section 13601 of the Act will be issued in the form of proposed regulations, which will incorporate the guidance provided in this notice.

II. BACKGROUND

Section 162(m)(1) disallows the deduction by any publicly held corporation for applicable employee remuneration paid to any covered employee to the extent that such remuneration for the taxable year exceeds \$1,000,000.

A. Amendments to the Definition of Publicly Held Corporation

Section 162(m)(2) defines the term “publicly held corporation” for purposes of identifying the entities subject to the deduction limitation of section 162(m)(1). Before the amendments made by section 13601(c) of the Act, section 162(m)(2) defined the term “publicly held corporation” as any corporation issuing any class of common equity securities required to be registered under section 12 of the Securities Exchange Act of 1934. Section 13601(c) of the Act amended the definition of “publicly held corporation” in section 162(m)(2) to mean any corporation which is an issuer (as defined in section 3 of the Securities Exchange Act of 1934) (A) the securities of which are required to be registered under section 12 of the Securities Exchange Act of 1934, or (B) that is required to file reports under section 15(d) of the Securities Exchange Act of 1934.

B. Amendments to the Definition of Covered Employee

Section 162(m)(3) defines the term “covered employee” for purposes of identifying employees whose remuneration may be subject to the deduction limitation under section 162(m)(1). Before the amendments made by section 13601(b) of the Act, section 162(m)(3) defined the term “covered employee” as any employee of the taxpayer if (A) as of the close of the taxable year, such employee is the chief executive officer of the taxpayer or is an individual acting in such capacity, or (B) the total compensation of such employee for the taxable year is required to be reported to

shareholders under the Securities Exchange Act of 1934 by reason of such employee being among the four highest compensated officers for the taxable year (other than the chief executive officer). Section 13601(b) of the Act amended the definition of “covered employee” in section 162(m)(3) to mean any employee of the taxpayer if (A) such employee is the principal executive officer (PEO) or principal financial officer (PFO) of the taxpayer at any time during the taxable year, or was an individual acting in such a capacity, (B) the total compensation of such employee for the taxable year is required to be reported to shareholders under the Securities Exchange Act of 1934 by reason of such employee being among the three highest compensated officers for the taxable year (other than any individual described in subparagraph (A)), or (C) such employee was a covered employee of the taxpayer (or any predecessor) for any preceding taxable year beginning after December 31, 2016.

Section 13601(c) of the Act also added flush language to section 162(m)(3) providing that the term “covered employee” includes any employee who would be described in section 162(m)(3)(B) if the reporting described in such subparagraph were required as so described. The legislative history to section 13601 of the Act explains that the term “covered employee” includes “officers of a corporation not required to file a proxy statement but which otherwise falls within the revised definition of a publicly held corporation.” House Conf. Rpt. 115-466, 489. Furthermore, the legislative history provides that the term “covered employee” includes “officers of a publicly traded corporation that would otherwise have been required to file a proxy statement for the year (for example, but for the fact that the corporation delisted its securities or underwent a transaction that resulted in the nonapplication of the proxy statement requirement).” *Id.*

C. Amendments to the Definition of Applicable Employee Remuneration

Section 162(m)(4) defines the term “applicable employee remuneration” for purposes of identifying the remuneration of a covered employee that may be subject to the deduction limitation under section 162(m)(1). Section 162(m)(4) generally provides that the term “applicable employee remuneration” means, with respect to any covered employee for any taxable year, the aggregate amount allowable as a deduction for such taxable year (determined without regard to section 162(m)) for remuneration for services performed by such employee (whether or not during the taxable year). Before the amendments made by section 13601(a) of the Act, the term “applicable employee remuneration” did not include remuneration payable on a commission basis (as defined in section 162(m)(4)(B)) or qualified performance-based compensation (as described in section 162(m)(4)(C)). Section 13601(a) of the Act amended the definition of “applicable employee remuneration” in section 162(m)(4) to remove these two exclusions. Section 13601(d) of the Act also amended the definition of “applicable employee remuneration” by adding a special rule for remuneration paid to beneficiaries. As amended, section 162(m)(4)(F) provides that remuneration shall not fail to be applicable employee remuneration merely because it is includible in the income of, or paid to, a person other than the covered employee, including after the death of the covered employee.

D. Grandfather Rule

Section 13601(e) of the Act generally provides that the amendments made to section 162(m) shall apply to taxable years beginning after December 31, 2017. However, section 13601(e) of the Act further provides that the amendments to section

162(m) shall not apply to remuneration which is provided pursuant to a written binding contract which was in effect on November 2, 2017, and which was not modified in any material respect on or after such date. The text of section 13601(e) of the Act is almost identical to the text of pre-amendment section 162(m)(4)(D), which provides a grandfather rule addressing the initial addition of section 162(m) to the Code and grandfathers remuneration payable under a written binding contract which was in effect on February 17, 1993, and which was not modified thereafter in any material respect before such remuneration was paid. Section 1.162-27(h) of the Income Tax Regulations (Regulations) provides guidance under pre-amendment section 162(m)(4)(D) on the definitions of “written binding contract” and “material modification” for purposes of applying that original grandfather provision.

III. GUIDANCE

A. Application of Amended Definition of Covered Employee

Section 162(m)(3)(A)¹ provides that the term “covered employee” includes 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 a capacity.

Section 162(m)(3)(B) provides that a “covered employee” also includes any employee 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 employee being among the three highest compensated officers for the taxable year (other than the PEO or PFO, or an individual acting in such capacity). Stakeholders have asked whether an employee must have served as an executive officer at the end of the taxable

¹ References to section 162(m) in sections III, IV and V of this notice refer to section 162(m) as amended by section 13601 of the Act, except as otherwise explicitly provided herein.

year to be a covered employee under section 162(m)(3)(B). The statutory provisions do not impose an end-of-year requirement, and nothing in the legislative history indicates that Congress intended such a requirement to apply. Accordingly, the Treasury Department and the IRS have determined that there is no end-of-year requirement under section 162(m)(3)(B).

Some commenters have asserted that an end-of-year requirement should apply under section 162(m)(3)(B) because the Securities and Exchange Commission (SEC) rules relating to executive compensation disclosure under the Securities Exchange Act of 1934 require disclosure of the compensation of the registrant's three most highly compensated executive officers other than the PEO and the PFO who were serving as executive officers at the end of the last completed fiscal year. See Item 402 of Regulation S-K, 17 CFR §229.402(a)(3)(iii).² The SEC rules, however, do not limit the disclosure of compensation by reason of an executive officer being among the highest compensated executive officers solely to executive officers who serve at the end of the last completed fiscal year. For example, in addition to requiring the disclosure of the three most highly compensated executive officers (other than the PEO and PFO) who were serving as executive officers at the end of the last completed fiscal year, the SEC rules also require disclosure of the compensation of up to two additional individuals for whom disclosure would have been required pursuant to 17 CFR §229.402(a)(3)(iii) but for the fact that the individual was not serving as an executive officer of the registrant at the end of the last completed fiscal year. See Item 402 of Regulation S-K, 17 CFR

² References to Item 402 in this Notice refer to Item 402 of Regulation S-K, 17 CFR §229.402, which contains the SEC rules regarding the executive compensation disclosure requirements.

§229.402(a)(3)(iv).³ Moreover, as previously noted, the section 162(m)(3)(B) statutory language and legislative history do not impose an end-of-year requirement. While certain aspects of section 162(m) are interpreted consistent with the SEC rules, the SEC rules do not serve as the sole basis for interpreting section 162(m).

Stakeholders have also questioned whether an employee whose compensation is not required to be disclosed under the SEC rules could nevertheless be a covered employee under section 162(m)(3)(B). The flush language at the end of section 162(m)(3) provides that the term “covered employee” includes any employee who would be described in section 162(m)(3)(B) if the reporting described there were required. Although this flush language was added by a conforming amendment under section 13601(c) of the Act, which expanded the definition of publicly held corporation to include issuers required to file reports under section 15(d) of the Securities Exchange Act of 1934, the legislative history clarifies that the flush language was intended to apply more broadly, explaining that this language applies, for example, to a corporation that does not file a proxy statement for the year because it delists its securities. See House Conf. Rpt. 115-466, 489. Thus, executive officers of publicly held corporations can be covered employees under section 162(m)(3)(B) even when disclosure of their compensation is not required under the SEC rules.

Accordingly, the term “covered employee” for any taxable year means any

³ See also Item 402(m)(2) of Regulation S-K, 17 CFR §229.402(m)(2) (SEC rules for executive compensation disclosure requirements for smaller reporting companies and emerging growth companies). These rules require disclosure of compensation with respect to (i) all individuals serving as the PEO or acting in a similar capacity during the last completed fiscal year, regardless of compensation level; (ii) the two most highly compensated executive officers other than the PEO who were serving as executive officers at the end of the last completed fiscal year; and (iii) up to two additional individuals for whom disclosure would have been provided based on compensation level but for the fact that the individual was not serving as an executive officer at the end of the last completed fiscal year.

employee who is among the three highest compensated executive officers for the taxable year (other than the PEO or PFO, or an individual acting in such capacity), regardless of whether the executive officer is serving at the end of the publicly held corporation's taxable year, and regardless of whether the executive officer's compensation is subject to disclosure for the last completed fiscal year under the applicable SEC rules. The determination of the amount of compensation used to identify the three most highly compensated executive officers for purposes of section 162(m)(3)(B) is made consistent with the Instructions to Item 402(a)(3) and the Instructions to Item 402(m)(2), 17 CFR §229.402(a)(3), §229.402(m)(2). In cases in which a publicly held corporation's last completed fiscal year and the taxable year do not end on the same date (for example, due to a short taxable year as a result of a corporate transaction), the publicly held corporation will have three most highly compensated executive officers under section 162(m)(3)(B) for the taxable year. The Treasury Department and IRS request comments on the application of the SEC executive compensation disclosure rules to determine the three most highly compensated executive officers for a taxable year that does not end on the same date as the last completed fiscal year. Until additional guidance is issued, to determine the three most highly compensated employees for purposes of section 162(m)(3)(B), taxpayers should base their determination upon a reasonable good faith interpretation of the statute, taking into account the guidance provided under this notice.

Pursuant to section 162(m)(3)(C), the term "covered employee" also includes any individual who was a covered employee of the publicly held corporation (or any predecessor) for any taxable year beginning after December 31, 2016. For taxable

years beginning prior to January 1, 2018, “covered employees” are identified pursuant to section 162(m)(3) as in effect before the amendments made by section 13601(b) of the Act. Accordingly, covered employees identified for the taxable year beginning during 2017 (in accordance with the pre-amendment rules for identifying covered employees) will continue to be covered employees for taxable years beginning in 2018 and beyond.

The following examples illustrate how these rules apply under certain circumstances, including how their application may differ from the application of the SEC’s executive compensation disclosure requirements. For each example, assume that none of the employees were covered employees for the 2017 taxable year (since being a covered employee for the 2017 taxable year would provide a separate and independent basis for classifying that employee as a covered employee for the 2018 taxable year). For each example, assume that the corporation has a fiscal year ending December 31 for SEC reporting purposes.

Example 1. (i) **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).

(ii) 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.

(iii) 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.

(iv) 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. (i) 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).

(ii) 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. (i) 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.

(ii) 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.

(iii) 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.

(iv) 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.

(v) 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. Remuneration Provided pursuant to a Written Binding Contract

1. Written Binding Contract

The amendments to section 162(m) made by the Act do not apply to remuneration payable under a written binding contract which was in effect on November 2, 2017, and which is not modified in any material respect on or after such date. Remuneration is payable under a written binding contract that was in effect on November 2, 2017, only to the extent that the corporation is obligated under applicable law (for example, state contract law) to pay the remuneration under such contract if the employee performs services or satisfies the applicable vesting conditions. Accordingly, the amendments to section 162(m) made by the Act apply to any amount of remuneration that exceeds the amount of remuneration that applicable law obligates the corporation to pay under a written binding contract that was in effect on November 2, 2017, if the employee performs services or satisfies the applicable vesting conditions.

The Act's amendments to section 162(m) also apply to a written binding contract that is renewed after November 2, 2017. A written binding contract that is terminable or cancelable by the corporation without the employee's consent after November 2, 2017, is treated as renewed as of the date that any such termination or cancellation, if made, would be effective. Thus, for example, if the terms of a contract provide that it will be automatically renewed or extended as of a certain date unless either the corporation or the employee provides notice of termination of the contract at least 30 days before that date, the contract is treated as renewed as of the date that termination would be effective if that notice were given. Similarly, for example, if the terms of a contract provide that the contract will be terminated or canceled as of a certain date unless either the corporation or the employee elects to renew within 30 days of that date, the contract

is treated as renewed by the corporation as of that date (unless the contract is renewed before that date, in which case, it is treated as renewed on that earlier date).

Alternatively, if the corporation will remain legally obligated by the terms of a contract beyond a certain date at the sole discretion of the employee, the contract will not be treated as renewed as of that date if the employee exercises the discretion to keep the corporation bound to the contract. A contract is not treated as terminable or cancelable if it can be terminated or canceled only by terminating the employment relationship of the employee. A contract is not treated as renewed if upon termination or cancellation of the contract the employment relationship continues but would no longer be covered by the contract. However, if the employment continues after such termination or cancellation, payments with respect to such employment are not made pursuant to the contract (and, therefore, are not grandfathered).

If a compensation plan or arrangement is binding, the amount that is required to be paid as of November 2, 2017, to an employee pursuant to the plan or arrangement will not be subject to the Act's amendments to section 162(m) even though the employee was not eligible to participate in the plan or arrangement as of November 2, 2017. However, the Act's amendments to section 162(m) will apply to such compensation plan or arrangement unless the employee was employed on November 2, 2017, by the corporation that maintained the plan or arrangement, or the employee had the right to participate in the plan or arrangement under a written binding contract as of that date.

2. Material Modification

The Act's amendments to section 162(m) will apply to any written binding

contract that is materially modified after November 2, 2017. A material modification occurs when the contract is amended to increase the amount of compensation payable to the employee. If a written binding contract is materially modified, it is treated as a new contract entered into as of the date of the material modification. Thus, amounts received by an employee under the contract before a material modification are not affected, but amounts received subsequent to the material modification are treated as paid pursuant to a new contract, rather than as paid pursuant to a written binding contract in effect on November 2, 2017. A modification of the contract that accelerates the payment of compensation is a material modification unless the amount of compensation paid is discounted to reasonably reflect the time value of money. If the contract is modified to defer the payment of compensation, any compensation paid or to be paid that is in excess of the amount that was originally payable to the employee under the contract will not be treated as resulting in a material modification if the additional amount is based on either a reasonable rate of interest or a predetermined actual investment (whether or not assets associated with the amount originally owed are actually invested therein) such that the amount payable by the employer at the later date will be based on the actual rate of return on the predetermined actual investment (including any decrease, as well as any increase, in the value of the investment).

The adoption of a supplemental contract or agreement that provides for increased compensation, or the payment of additional compensation, is a material modification of a written binding contract if the facts and circumstances demonstrate that 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. However, a material modification of a written binding contract does not include a supplemental payment that is equal to or less than a reasonable cost-of-living increase over the payment made in the preceding year under that written binding contract. In addition, the failure, in whole or in part, to exercise negative discretion under a contract does not result in the material modification of that contract.

The following examples illustrate the rules in this section III.B of this notice. For each example, assume for all relevant years that the corporation is a publicly held corporation within the meaning of section 162(m)(2) and is a calendar year taxpayer.

Example 1. (i) 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.

(ii) 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. (i) 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.

(ii) 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 year 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. (i) 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.

(ii) 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. (i) 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).

(ii) 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. (i) Facts. Assume the same facts as in Example 4, 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).

(ii) 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. (i) Facts. Assume the same facts as in Example 4, 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.

(ii) 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. (i) 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.

(ii) 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. (i) 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.

(ii) 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. (i) 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.

(ii) 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. (i) 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.

(ii) 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.

(iii) 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. (i) Facts. Assume the same facts as in Example 10, 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.

(ii) 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.

IV. EFFECTIVE DATE

The Act's amendments to section 162(m) apply to taxable years beginning on or after January 1, 2018. The Treasury Department and the IRS anticipate that the guidance in this notice will be incorporated in future regulations that, with respect to the issues addressed in this notice, will apply to any taxable year ending on or after September 10, 2018. Any future guidance, including regulations, addressing the issues covered by this notice in a manner that would broaden the definition of "covered employee" as described under section III.A, or restrict the application of the definition of "written binding contract" as described in section III.B, will apply prospectively only.

V. REQUEST FOR COMMENTS

The Treasury Department and the IRS anticipate issuing further guidance on other aspects of section 162(m), including the Act's amendments to section 162(m). Accordingly, comments are requested on additional issues under section 162(m) that future guidance, including regulations, should address. Specifically, comments are requested on (1) the application of 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, (2) the application of the definition of "covered employee" to an employee who was a covered employee of a predecessor of the publicly held corporation, (3) the application of section 162(m) to corporations

immediately after they become publicly held either through an initial public offering or a similar business transaction, and (4) the application of the SEC executive compensation disclosure rules for determining the three most highly compensated executive officers for a taxable year that does not end on the same date as the last completed fiscal year.

Written comments may be submitted through November 9, 2018. Comments should include a reference to Notice 2018-68. Send submissions to CC:PA:LPD:PR (Notice 2018-68), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (Notice 2018-68), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224, or sent electronically, via the following e-mail address: Notice.comments@irs.counsel.treas.gov. Please include "Notice 2018-68" in the subject line of any electronic communication. All material submitted will be available for public inspection and copying.

VI. DRAFTING INFORMATION

The principal author of this notice is Ilya Enkishev of the Associate Chief Counsel (Tax Exempt and Government Entities), although other Treasury and IRS officials participated in its development. For further information on the provisions of this notice, contact Ilya Enkishev at (202) 317-5600 (not a toll-free number).