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Few Will Benefit From Narrow Exec Comp Transition Tax Rule

By **Amy Lee Rosen**

Law360 (August 28, 2018, 2:56 PM EDT) -- In recent guidance on a tax deduction for performance-based executive compensation, the Internal Revenue Service narrowly construed a transition rule that exempts some companies from a new $1 million cap on the deduction, meaning few are likely to qualify for the carveout.

The IRS and U.S. Department of the Treasury released proposed regulations last week clarifying what types of executives are subject to a $1 million tax deduction limit on performance-based compensation by discussing who are “covered employees” and what agreements are grandfathered under previous rules not subject to the deduction cap.

The limit on executive pay came after the Tax Cuts and Jobs Act, signed in December, added Internal Revenue Code Section 162(m). However, the TCJA also provided a carveout for performance-based pay over $1 million that fell under a “written binding contract” in effect on or before Nov. 2, 2017. While the IRS did not define the term, it said performance pay grandfathered under a "written binding contract” will be exempt from the deduction cap only to the extent a corporation is obliged under applicable law, such as state contract law.

William H. Woolston, a partner at Covington & Burling LLP, told Law360 the notice is useful but also stricter than it could have been, especially in how it applies a "written binding contract" analysis in a situation when a compensation committee has negative discretion to slash performance-based pay, which is usually boilerplate language in pay plans at most companies. Many practitioners hoped negative discretion would not invalidate a grandfather, but the IRS used one example to indirectly show that such negative discretion can mean a contract is not actually binding and therefore potentially not grandfathered.

“I think it’s fair to wonder just how many companies will be able to take advantage of the grandfather rule,” Woolston said. “It’s still new guidance and there’s still more to come and more thinking to do about it, but at first glance it may be tough for companies to have their arrangements be eligible for the grandfather rule.”

The issue with the regulations is that whether there is a “written binding contract” depends upon state law. If a compensation committee has the negative discretion to decrease performance-based pay, which is usually a best practice in corporate governance, things are still unsettled because states may defer in how they interpret state case law or statutes, Woolston said.

“I suspect a lot of states don’t have settled case law that’s directly on point of these types of issues,” he said. “So you may have situations where companies are looking to different state laws to try to come up with a right answer or at least a reasonable answer as to whether or not it’s a written, enforceable binding contract.”

Woolston pointed to an example in the regulations that said an executive could be paid $1.5 million, but if the compensation committee had discretion to decrease compensation to $400,000, that meant only $400,000 was grandfathered and anything over that would be subject to the deduction limit under Section 162(m). The compensation committee in the example paid $500,000, so $400,000 was grandfathered and not subject to a deduction cap, while the remaining $100,000 was not grandfathered.

“The example seems to suggest a strict interpretation of that and how negative discretion could act,” Woolston said. “It puts companies in a tight spot because negative discretion is in a lot of these arrangements, because people were incentivized to put it there, and from a governance perspective, it’s a good thing to have.”

Applying that example more broadly means that a compensation committee with ultimate power to decrease all performance-based pay to zero could result in no amount ever being grandfathered, but the overall conclusion still depends on state law, he said.

Woolston recommended that companies with grandfathered arrangements should review them either with outside counsel or with an accounting firm to figure out whether the amounts are grandfathered. If a corporation is thinking about changing any plans, he said, a business should think long and hard before making any changes, or else the company may jeopardize its ability to deduct the pay under the grandfather rule.

Part of the TCJA conference committee’s report on Section 162(m) was nearly identical to text prepared for tax legislation passed in 1993, so it made sense that the recent regulations followed guidance from 1993 and the similar analysis on grandfathered contracts, Mark Wincek, a partner with Kilpatrick Townsend & Stockton LLP, said in May.

“To me, just the overall macro view of it is that it is aligned with what reasonable practitioners should have expected,” he said. “Essentially it follows the prior 1993 grandfather that set forth in regulations at one point in 162-27(h), which is what in my view was intended by Congress because Congress pretty much took the straight-line language from 1993 and changed the dates.”

Where he expressed dissatisfaction was how the guidance discussed covered employees because sometimes Section 162(m) can apply to executives whose compensation has never been reported in a proxy statement as per the Securities and Exchange Commission’s rules, Wincek said. He said the IRS' decision that employment as an officer at the end of the year was irrelevant surprised him because statutory language suggests that only the top three executives reported under SEC rules should be reported for Section 162(m) purposes, he said.

"The notion that you’d have anybody in the covered employee group [who] is not in the proxy is kind of remarkable," Wincek said. "I don’t think people expected officers to get picked up, who under any SEC rules were not required to be reported to the public."

Nathan E. Holmes, counsel at Thompson Hine LLP, told Law360 he was not surprised that year end did not matter for a covered employee, but noted that the proposed regulations on the scope of the grandfather rule were not necessarily what practitioners had hoped for.

“The notice clearly acknowledges that there are circumstances where an existing performance-based compensation arrangement can include ‘negative discretion’ without losing exempt status under the grandfather rule,” he said. “However, the only example given in the notice of a negative discretion arrangement that qualifies as a ‘written binding contract’ suggests that the IRS and Treasury Department may take a pretty narrow view on this issue.”

Holmes said the notice allows for “written binding contracts” made on or before Nov. 2, 2017, to be grandfathered in, but the ultimate deferral to state law for contracts with negative discretion will result in a fact-intensive determination that will require diving deeply into state law to figure out if any part of the award should be grandfathered.

“From my personal view, I think the IRS got it wrong more broadly on this point, but on the other hand I understand how and why where they ended up where it did,” Holmes said. “The statute says ‘written binding contract’ and that’s what the statute said in 1993 and we had guidance in 1993, so we’re going to follow the same approach because it’s the same language.”

Using guidance from 1993 makes sense, but the problem is that the grandfather rule is supposed to be a transition rule, which should be designed to not upset settled expectations while also providing time to adjust to the new rules, he said. Many performance-based pay plans were granted two to three years ago, but things have changed midstream with Section 162(m) adding a cap to deducting performance-based pay, so it not only has a tax impact but also affects earnings for financial accounting purposes, which Holmes said will be one of the first challenges for companies in this quarter.

Holmes said the IRS did not follow recommendations to instead follow guidance under Section 409A, which applies a “facts and circumstances” test in determining if a contract is binding because it explains when nonqualified deferred pay is a “legally binding right to compensation.” That explanation of “legally binding right” could have been applied to Section 162(m) instead of reliance on a state law determination, he said.

Although he was not surprised by the government's decision to follow 1993 guidelines, Holmes said he was disappointed the IRS did not go the Section 409A route. The agency's 1993 approach, he said, creates potential administrative challenges. It also makes it even more important for tax, legal, HR and financial accounting professionals in companies to coordinate figuring out who the executive officers are and separately who are covered employees for Section 162(m) purposes, Holmes said.

According to Mary B. Hevener, a partner at Morgan Lewis & Bockius LLP, the notice is helpful because it confirmed that the 2017 statute's text is virtually identical to the 1993 grandfather rule, and it covers plans that are written binding contracts under state law. But she said more examples are needed on grandfathered awards and would be especially helpful for multiple-year awards for performance stock units.

If a performance stock unit covered 2016 to 2018 with performance conditions set for each year so that when one year’s performance is completed and the second year’s formula is fixed, but the ultimate payout is based on the average of the performance results from those three years, Hevener said she thinks the grandfathered portion “should be the ultimate payment attributable to the performance results for the 2016 and 2017 year."

So, under the notice, if the results for each year hit their targets and the ultimate payout was at target, then only two-thirds, or about 66 percent, of the payout should be grandfathered, she said.

An even more complex example would occur when each year's payout has a different amount, so the 2016 payout would have been 120 percent of target, the 2017 payout would have been at 100 percent of target but the 2018 payout was set at only 80 percent of target. And while here the average payout is 100 percent of target, the performance for the first two grandfathered years hit 220 percent and 300 percent of the average, or 73.3 percent, so 73.3 percent of the payout would presumably be grandfathered, she said.

Baker Botts LLP partner Eric Winwood said practitioners now need to make a state-by-state analysis to determine whether pay arrangements are grandfathered — especially those that include negative discretion. But it will be hard for practitioners to say for certain whether the grandfather still applies.

"In my view, if there's negative discretion that takes pay down to zero, practitioners will be advising clients that the conservative or reasonable approach is to assume the grandfather doesn't apply," he said.

--Editing by Tim Ruel and John Oudens.