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# 3 Key Provisions In The Final Executive Pay Cap Rules

By **Amy Lee Rosen**

*Law360 (January 22, 2021, 5:05 PM EST)* -- Final Internal Revenue Service rules on the limitation of corporate deductions for excess executive compensation have provided clarity on the effect of changes in the 2017 tax overhaul and how compensation over $1 million will be treated.

In December the IRS issued final rules on Section 162(m), which was enacted in 1993 to prohibit public companies from deducting executive pay in excess of $1 million. Congress, however, exempted performance-based pay — payments made for meeting certain performance-based company goals.

Under the Tax Cuts and Jobs Act of 2017, Congress eliminated the exception for performance-based pay from the $1 million deduction limit. The final rules discuss which employees are subject to this new change and what old compensation plans still fall under the previous statute and its regulations.

Here, Law360 examines three key areas of clarity provided in the final rules.

**Covered Employees**

The deduction limit under Section 162(m)(3) applies to a company's "covered employees." These can include a CEO or chief financial officer and the three other highest-paid officers as required to be reported in a company's public financial statements under Securities and Exchange Commission rules. However, once an employee has been designated as a covered employee, the executive will always be considered a covered employee, which was not the case before the TCJA.

The IRS followed its stance taken in proposed rules that any of the three highest-paid executives of the corporation that year, as well as the CEO and CFO, are covered employees, regardless of whether that person is an officer at the end of the year or if that person's pay must be disclosed under SEC rules. The final rules rejected a suggestion from a commenter that a covered employee only include officers whose pay must be disclosed under SEC executive pay rules because such a reading is inconsistent with the flush language from Section 162(m)(3), the government said.

The section on covered employees is likely one of the most important parts of Section 162(m)'s final rules because now companies will have to start tracking applicable workers from 2017 onward, according to Jeff Martin, a partner at Grant Thornton's national tax office.

"Once you're a covered employee, you're always a covered employee, so keeping track of that list is

crucial for taxpayers to comply with 162(m) down the road," he said.

Jason Ertel, a partner at Fried Frank Harris Shriver & Jacobson LLP, pointed out that while it is easy to know who the CEO and CFO are, the more cumbersome portion will be figuring out the other three highest-paid officers because they may not be the same people who are reported on a company's proxy statement.

"The once covered, always covered [rule] certainly will be burdensome on companies over time because that list can only grow until people die, so it's just something they'll have to monitor when taking tax positions," Ertel said. "But I think the more burdensome part of that rule is the fact that the IRS had the opportunity to align this definition more with the SEC's disclosure rules and they didn't."

SEC rules require reporting the CEO, CFO and the other top three earners on the proxy statement at the end of the calendar year, he said, but if someone quits or is terminated midyear, that individual isn't reported on a proxy statement and may still be one of the highest-paid workers under Section 162(m).

As it stands, tracking these once covered, always covered employees over time will become a huge burden for many companies, according to Mary B. Hevener, a partner at Morgan Lewis & Bockius LLP. It will involve keeping tabs on many people who may no longer work at the company.

There may be an issue with just locating the covered employees, she said, and "that is creating a lot of issues for companies in trying to find people."

For example, Hevener said, imagine a situation in which Company XYZ acquires private company A, which has its own CEO, founders and several officers who made over $1 million because of their stock options. The company A executives resign after the acquisition. Those prior company A executives will not be listed in the proxy statement but may include the top three highly paid officers at the company, therefore their compensation over $1 million cannot be deducted by the public company, she said.

"Once you find [a covered employee] there's a tattoo rule — they're in forever," Hevener said. "So now you have two jobs: Find the people in every year who aren't limited to the proxy, and now once you find them, whatever you pay them over $1 million is disallowed."

**Grandfather Rule**

The TCJA provides that the changes to Section 162(m) apply to taxable years beginning after Dec. 31, 2017. However, the TCJA includes a grandfather rule: Elimination of the exception to performance-based pay exceeding $1 million does not apply when those amounts are payable under a written binding contract that was in effect on Nov. 2, 2017, and hasn't been materially modified.

The final rules retained those provisions and definitions so that the new 162(m) applies only to all compensation paid over the $1 million limit unless it is paid under a written binding contract that was in effect on Nov. 2, 2017, and has not been materially changed since then.

The American Bar Association's Section of Taxation asked the IRS in a letter to allow for extensions of stock options, so that they wouldn't count as a material contract change that would trigger un-grandfathering under Section 162(m).

According to the proposed rules, pay that was attributable to exercising an option is grandfathered only

if, as of the 2017 date, the employer was obligated to transfer the option's underlying shares of stock to the employee upon exercise of the option, pursuant to terms of the option and under applicable law.

The government said in the final rules it recognized that employers would, for bona fide business reasons, sometimes want to extend an exercise period for nonqualified stock options or stock appreciation rights. As long as these options or rights comply with another statute, Section 409A, which regulates nonqualified deferred pay, there will be no loss of grandfathered status.

"I think it's helpful what the IRS did here," said Martin at Grant Thornton, since there had been a lot of questions about what would happen to stock options and stock appreciation rights when a company accelerated vesting or extended the exercise period.

If a company terminates an employee, that person typically has only 90 days to exercise an option, but it was unclear if extending the exercise period to one year was a material modification that would make the business lose the grandfathered status of the employment agreement, he said.

The IRS said in the final regulations that as long as certain conditions are met — basically so that extending the term of the option is not an extension of the option under Section 409A of the code — this is not a material modification, Martin said.

"And believe me, no one is going to extend the term of an option in a way that causes a 409A problem because that's bad news there," he said.

The final rules changed the stance on clawbacks, a typical part of an executive compensation agreement that allows a company to take back pay it's already given, usually because an officer had engaged in fraud or misconduct. Clawbacks are fairly common with performance-based pay, so that if performance metrics are created but are later found to be wrong, the related awards can be called back, Martin said.

In the proposed rules, if a clawback were triggered to allow a recovery of money paid, the grandfather status for that amount would be lost. Under the final rules, neither the right to clawback nor the clawback itself makes a contract lose its grandfather status.

"In the real world we hope there's not much clawbacking going on, but it's important to make sure you're not losing grandfather status to the extent you have to claw back something," Martin said.

The final rules also provided clarity on negative discretion, the right of a company's compensation committee to reduce or eliminate pay for an employee. If a pay plan allows for negative discretion, the amount paid under that arrangement is not grandfathered to the extent a company is not obligated to pay it under applicable law.

A commenter had requested that negative discretion be disregarded in determining if pay is grandfathered because many pay plans provide compensation committees such discretion, the final rules said. But this practice has been well known, the government said in the final regulations. Congress could have added a grandfather rule for negative discretion and did not, which is why the final regulations do not have a separate standard to apply the grandfather rule.

Martin told Law360 the IRS took the position that one determines whether there's a written binding contract under applicable law, which is typically state contract law, to determine if amounts are grandfathered or not. The IRS was deliberate in going this route because it did not want to take state

contract law and put it into federal tax regulations, since state contract law can change, he said.

Now, "you have to go through and look at state contract law, outside of the tax law," he said. "If my plan does have negative discretion or allows the comp committee to exercise negative discretion, do I still have a written binding contract to pay that?"

If negative discretion is allowed under state contract law, then the amounts aren't grandfathered because there is no binding contract and if negative discretion is disallowed, then the contract can still be binding and therefore grandfathered, Martin said.

"This is burdensome because it makes the company have to figure out if the contract is binding or not under state law," he said.

**IPO Transition Relief**

Before the TCJA amended Section 162(m), private companies that became public were exempt from the $1 million tax deduction limit — typically for about three years — if the pay plan was approved by shareholders before an initial public offering and the pay arrangements were not materially altered thereafter.

In the proposed rules, the U.S. Department of the Treasury rejected the idea that companies that recently went public needed time to adjust pay arrangements to take Section 162(m) into account. Those rules said any private company that became public on or before Dec. 20, 2019, might use the transition relief but none may rely on it after that date.

The final regulations maintained the denial of transition relief. The relief was originally provided in 1995 for shareholders to approve of performance-based pay, the regulations said, but performance-based pay is no longer excluded since the TCJA eliminated that exception.

"Thus, a transition period to accommodate a shareholder approval process is no longer needed," the IRS said. "There is no indication in the language of the amended Section 162(m) or the legislative history to the amendments that the transition period was intended [to] be extended even though the original basis for its adoption no longer exists."

It was unfortunate the IRS decided to take away the IPO transition relief, but this was not unforeseen, Martin said.

"It's unfortunate but at the same time I can understand the IRS' rationale for eliminating it because they didn't feel there was a need for it anymore," he said.

Hevener at Morgan Lewis said there could be overlap between the IPO rule and the grandfather rule. Pay plans at companies that had IPOs before Dec. 20, 2019, can still be grandfathered in — they may be subject to the old law — so it is important to look at these disclosures to see if they follow the old rules, she said.

"The old compensation uses the old law unless you've done something to un-grandfather it," she said. If an IPO became public before Dec. 20, 2019, there may be pay that is grandfathered, so it is important to look at those agreements and find out which amounts could still be fully deductible, she said.

Just because a company went public before that date, that doesn't mean any pay is automatically grandfathered because those private companies still had to follow the old regulations, which required disclosure in the IPO-related proxy, Hevener said. But it's not enough just to say in one's prospectus that the company has a lot of outstanding stock options, she said.

"I think you have to go into some detail as to what you have, what was grandfathered and what wasn't," she said.

While some practitioners have said the transition relief may make some private companies hesitate to go public, this likely may not be the deciding factor, Ertel said, since newly public companies were never exempt from 162(m) forever, but only for a few years.

"I don't think that would impact a company's decision to go public or not because it's just a delay," he said. "In the old rules, that newly public company was still going to face 162(m) at some point … the transition relief was intended to give companies the ability to put in place plans that satisfied the exemptions that were available, and they're no longer available."

It's likely just an additional calculation that companies now need to make earlier when deciding whether to go public, Ertel said.

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