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5 Tips For Meeting Tax Bill's Challenges On Executive Pay

By **Amy Lee Rosen**

Law360 (April 5, 2018, 12:45 PM EDT) -- The new federal tax law alters the tax treatment of executive compensation, and companies could find themselves in hot water if they don't adjust their payment plans and are later audited by the Internal Revenue Service.

The Tax Cuts and Jobs Act, signed into law by President Donald Trump on Dec. 22, made performance-based compensation subject to a $1 million limit on tax deductions for executive pay under Internal Revenue Code Section 162(m). A transition rule exempts plans from the change if they were in effect on Nov. 2, 2017, and haven't been materially modified since.

The deduction limit applies to covered employees, typically defined as the CEO, the chief financial officer and the three other highest-paid officers reported in the summary compensation table of a company's proxy statement. 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 tax law also expanded the types of companies subject to IRC Section 162(m), so that in addition to businesses with publicly registered equity, those with publicly registered debt as well as foreign private issuers will need to comply with the $1 million deduction limit.

Here, Law360 shares tips for tax practitioners, employment benefit lawyers and their clients to comply with the changes.

Get Organized

Now that employees subject to the executive pay restrictions will always be covered employees under the new law, companies need to keep track of those executives, both those now and those of the past, according to Eric Winwood, a partner at Baker Botts LLP.

"The big thing that I'm telling my clients is that you need to get organized now with respect to these new rules," Winwood said. "You need to have systems put in place like HR software or somewhere in internal record-keeping procedures to keep track of who at the company has become subject to 162(m)."

Anyone who has been a CEO or chief financial officer after the end of 2016, or anyone who has been one of the top employees, is lumped into the covered employee designation forever, Winwood said, so companies must keep track of that information so they can make informed compensation decisions.

For example, if a company wants to give its general counsel a bonus after she worked on a large merger deal, it must consider that awarding a large bonus could put her among the most highly paid executives that year, which would make her a covered employee indefinitely, he said.

To avoid that problem, the bonus could be structured so it's broken up into payments over multiple years, which would keep the general counsel, or another executive, outside the covered employee window, Winwood said.

"A company will only know that if a company gets organized in the first place," he said. "It's helpful to have software in place that shows someone who may get triggered into that status, and then make informed decisions going forward."

Examine Documents

Companies should not only revisit payment contracts to determine whether the transition rule may apply, but should also be aware of any changes or anticipated amendments made to those documents in case the modifications could disqualify the executive from the exception to the $1 million pay cap.

Companies and their counsel should scrutinize not only payment contracts but also equity plans, which are submitted to shareholders for approval, and severance and retirement plans, which may not be part of an original employment agreement.

According to the TCJA conference report, if a party can cancel or terminate a compensation plan, or if a compensation committee has discretion to reduce awards — which are typical components of almost all types of plans — either provision may be considered a material modification that may invalidate a grandfathered pay plan, even if neither is actually used.

"Right now there is no guidance and there's a lot of uncertainty with respect to grandfathering," said Alessandra K. Murata, a partner at Goodwin Procter LLP. "Companies should not rush to make changes to things that are currently in place until we receive guidance."

There are significant tax penalties that may apply to businesses that run afoul of the rules, Murata warned.

Even though IRS regulations on IRC Section 162(m) in the past have prohibited positive discretion, which is the ability for compensation committees to increase pay, the rules are no longer applicable, so that may be an element to consider adding back to future equity plans, Murata said. Proxy advisory firms, however, may continue to look askance at plans that allow compensation committees to increase pay, she said.

"It's bad if you're adding that into an existing equity plan, because it could result in a material modification unless you're very surgical about the change," Murata said. "But in the context of a new plan, I think that type of positive discretion is fine."

Seek Outside Help

The TCJA expands the IRC Section 162(m) rules to apply to foreign private issuers required to make certain reports on Form 6-K with the Securities and Exchange Commission and to companies with publicly traded debt. Those companies may not be aware that the new tax deduction limits now apply to them, so they should seek outside help to navigate the rules, Mims Maynard Zabriskie, a partner at Morgan, Lewis & Bockius LLP, said.

Many foreign companies that have never had to worry about tax restrictions on executive compensation in the past now need to think about how the rules apply to them, Zabriskie said.

“We’ve been advising them that they’re going to have to determine who their five most highly paid employees are each year and keep an ongoing list,” she said. “And if any of those individuals has U.S.-source income or if the U.S. company is trying to take a tax deduction for that person’s compensation, then the U.S. company will be subject to the 162(m) deduction limit.”

For example, if a global bank has an executive working in Switzerland who’s one of its most highly paid employees, he will not be subject to the deduction limit if he has no U.S. income, Zabriskie said. But if he gets promoted or comes to the U.S. to run the North American business unit, all of a sudden that tax deduction can be limited.

Companies should solicit outside legal advice because it doesn’t make sense for in-house counsel to come up to speed on the rules when they can seek help elsewhere to obtain a road map for what must be done, she said.

“It’s just a big change for global companies to track it because they aren’t generally in the business of evaluating that,” Zabriskie said.

Amend Proxy Disclosures

Executive compensation is an important element in a company’s proxy statement, and despite uncertainty about how the transition rule will be executed, companies need to discuss the changes to IRC Section 162(m) with shareholders, Winwood said.

“Of course they’re going to need to address the effects of the change in the 162(m) rules in their proxies,” he said.

Proxy statements should acknowledge that IRC Section 162(m) rules have changed due to the TCJA, that the company intends to comply with any grandfather rules in place with respect to the change and that the business is watching for any additional guidance that comes out to help it understand whether it's in compliance or not in compliance with those rules, Winwood said.

For example, coatings and specialty materials manufacturer PPG Industries Inc. explained in its proxy statement that the pay its compensation committee structured in 2017 and before may no longer be fully deductible, depending on the application of the special grandfathered rules, Winwood said.

Watch Out for New Guidance

The IRS has said that guidance on the TCJA’s changes to the deduction of executive compensation is a high priority, but it is uncertain how the agency will interpret the transition rule.

While representatives from the IRS told Law360 the agency cannot provide timing for the possible release of guidance, the rules are among a list of priority projects that the IRS hopes to complete by June 30.

Companies should avoid materially modifying any severance packages until the guidance is issued, to preserve the grandfather exception, Winwood said.

One issue that needs to be clarified, for example, is whether the automatic renewal of a plan will disqualify it from the grandfather rule, he said. Until guidance is issued, companies should take the position they have not changed anything with respect to those severance provisions, even if they automatically renew, Winwood said.

Sinead M. Kelly, a partner at Baker McKenzie LLP, said the Joint Committee on Taxation's "Bluebook" explanation of the TCJA may elucidate the transition rule, but that is not expected to be released until later in the year.

JCT Chief of Staff Thomas Barthold told Law360 that timing for completion of the Bluebook depends upon the demands placed on the staff by members of Congress. The JCT is working to try to provide a comprehensive explanation of the TCJA and identify the possible necessary technical corrections to the legislation, he said.

"The Bluebook's potential audience should not expect those goals to be achieved rapidly," he said.

--Editing by Eric Kroh, Robert Rudinger and Neil Cohen.
