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3 Key Questions On IRS' Proposed Executive Pay Changes

By **Emily Brill**

Law360 (February 14, 2020, 7:57 PM EST) -- Now that the shock waves from the IRS' proposed changes to executive compensation rules have died down, attorneys are mulling three questions about how these and other recent alterations to IRS regulations might affect their clients and the business world at large.

Here, Law360 considers these questions, which concern who is affected by the proposed policies, how companies can get grandfathered in to old rules and how the changes might affect companies' approaches to executive pay and going public.

How Do Companies Identify 'Covered Executives'?

The IRS' proposed regulations, released Dec. 20, would implement more changes to executive compensation authorized by 2017's Tax Cuts and Jobs Act. Some changes have already gone into effect.

The tax law's biggest change to executive compensation stopped companies from deducting more executives' salaries. The change altered Internal Revenue Code Section 162(m), which was enacted in 1993 to prohibit public companies from writing off more than $1 million of executives' pay during tax season. When Section 162(m) passed, its $1 million limit did not apply to performance-based compensation, and many executives were exempt from it.

When the tax law passed, though, that changed. The law eliminated the exception for performance-based compensation. And the list of executives covered by Section 162(m) grew to include chief financial officers, newly public companies' top brass, certain foreign companies' C-suite executives and any employee who's previously been dubbed a "covered executive," even if they change positions.

As a result, a question on executive compensation attorneys' minds is: How are my clients going to identify and keep track of their covered employees?

"It's going to be an administrative nightmare for a lot of [corporations]," said Gretchen Harders, a partner at Epstein Becker Green.

Identifying "covered employees" would likely be particularly tough for foreign private companies that aren't used to complying with American financial rules — but they will have to get used to it if December's regulations go into effect, Harders said.

As an example of an area where difficulty might arise, Harders pointed to the fact that Section 162(m)'s $1 million deduction limit applies to, among other executives, companies' three most highly compensated employees.

Though an outsider may think it's simple to point to a company's best-paid employees, executive compensation attorneys know that identifying these people gets complicated because "compensation" comprises many forms of remuneration, not just a salary.

An executive could own stock options and equity compensation or have racked up millions in deferred compensation or bonuses. And private companies often don't have lists of their most highly compensated employees at the ready because they don't file proxy statements, attorneys said.

"It'll be very complicated for employers that are more dispersed and have more affiliates as well as for entities who have never been subject before," Harders said.

Which Executive Pay Agreements Can Be Grandfathered In?

If an executive compensation arrangement was established before the Tax Cuts and Jobs Act passed, companies can continue using it as if the IRS never modified Section 162(m) under three conditions.

First, the arrangement must be set forth in a written, binding contract. Second, the contract must have been in effect on Nov. 2, 2017. Third, the contract cannot have been materially modified since then.

Figuring out whether a contract was in effect on Nov. 2, 2017, is easy enough, attorneys say. But determining whether an agreement constitutes a "written, binding contract" and whether it has been "materially modified" is trickier.

"If you materially modify that contract, then you eliminate the grandfather. But there's a fair amount of uncertainty as to what is a material modification. If you have a contract and you add dividend equivalents to an equity grant, is that a material modification?" asked Morgan Lewis & Bockius LLP partner Mims Maynard Zabriskie. "There's a fair amount of nuance around what is a material modification. ... Sometimes there are questions on where the lines are."

Jeffrey G. Aromatorio, a partner at Reed Smith LLP, said he'd like to see the IRS issue guidance clarifying what types of changes to contracts constitute material modifications. Specifically, he'd like to know whether extending stock option terms is a material modification, he said.

Similar ambiguity exists around the meaning of the term "written, binding contract," said Mary B. Hevener, a partner at Morgan Lewis.

"IRS says, 'Refer to state law.' Their only guidance is, 'Go look at state law.' [But] there's not any specificity on what's a written, binding contract under state law," Hevener said.

What Might Corporations Do Differently?

Another question on attorneys' minds about the IRS' changes to Section 162(m) is: How will these alterations affect the business world?

So far, many companies have continued structuring executive pay as they did before the changes, "even though this would be an opportunity to go back to a simpler [structure]," Harders said.

"The processes are so ingrained in people's practices. Maybe in a couple years, people will start to rethink that," she said.

For now, though, "having performance-based compensation and an independent committee reviewing that seems to still be effective," Harders said. "It's almost become good corporate governance."

Aromatorio agreed, pointing to the fact that proxy advisory firms — which advise shareholders on how to vote on corporate governance issues — encourage companies to include performance-based compensation in executives' pay packages.

In the future, though, some companies may begin increasing executives' salaries and changing the structure of their bonus plans, said Andrew Liazos, a partner at McDermott Will & Emery LLP.

"For a while, there were some companies who would just limit the salary to $1 million, saying ... we can shift more of the pay to the bonus," Liazos said.

But now that companies can only deduct up to $1 million of performance-based compensation, like bonuses, per executive, there's no need to structure pay packages that way, he said.

Beyond wondering about the changes' effects on executive pay, attorneys have questioned how one proposed alteration — the removal of a temporary 162(m) exemption for newly public companies — may affect private companies' willingness to go public.

The IRS introduced this potential change through its proposed regulations in December, rejecting the idea that companies needed time to adjust pay arrangements after an initial public offering. That proposal caught some attorneys off guard, Hevener said.

"People believing there was a good policy reason for having post-IPO protection assumed that IPOs would continue to be protected," Hevener said. "It's been controversial enough to cause even securities lawyers to complain — they think it may be a damper on IPOs."

--Additional reporting by Amy Lee Rosen. Editing by Kelly Duncan and Brian Baresch.