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Clarity Sought On Tax Law's Treatment Of Executive Pay

By **Amy Lee Rosen**

Law360, Los Angeles (February 26, 2018, 5:30 PM EST) -- The recent tax reform bill placed new restrictions on deductions for executive compensation, and depending on how the Internal Revenue Service interprets a transition rule, companies may be disqualified from deducting performance-based executive pay under the rule even though they followed regulations that were in effect before the change.

Under the Tax Cuts and Jobs Act, P.L. 115-97, performance-based pay no longer qualifies for an exemption from the $1 million cap on deductions of executive compensation under IRC § 162(m). However, performance-based pay above the cap can still qualify for the deduction under a transition rule that applies to compensation plans in effect on Nov. 2, 2017.

The IRS has said that guidance on the TCJA's changes to the deduction of executive compensation is a high priority, but tax practitioners and their clients are unsure how the IRS will construe the grandfather rule. If the rule were broadly applied, performance-based pay would be exempt from the deduction limit under the transition rule when a compensation committee had the discretion to decrease pay, whereas under a narrow approach the transition rule would not apply if a committee could lower pay.

The TCJA conference report suggests the IRS will likely take a more narrow approach, which means that most companies wouldn't qualify under the transition rule, since it is common for compensation committees to have the discretion to lower executive pay, according to Eric Winwood, a partner at Baker Botts LLP.

It is more reasonable to interpret the grandfather clause more broadly, Winwood said. Throughout the history of IRC § 162(m), it has been acceptable for a compensation committee to be able to reduce executive pay, so companies should not be punished now for exercising negative discretion when it has been allowed in the past, he said.

"I think it's unfair to sort of narrowly construe the grandfather at this point," Winwood said.

President Donald Trump signed the TCJA into law on Dec. 22. Among the many changes it made to the tax system, it revised the limitation on the deductibility of compensation expenses in the case of publicly traded corporate employers.

The changes amend the definition of employees subject to the limitations to include anyone who holds the title of principal executive officer or principal financial officer at any time during the year, as well as the three most highly compensated officers required to be reported on the company's proxy statement.

The law also eliminated the exceptions for commissions and performance-based compensation from the definition of compensation subject to the $1 million deduction limit. The changes apply to tax years beginning in 2018, and a transition rule was provided, such that pay given pursuant to a written binding contract in effect on Nov. 2, 2017, that has not been materially modified is exempted from the changes.

The conference report on the TCJA says if a compensation plan can be terminated or canceled by either party, it is treated as a new contract and thus no longer qualifies for the transition rule. That suggests that the grandfather rule may not apply if a compensation committee retains discretion not to pay an award, reduce the amount of an award, or amend or terminate the plan under which the award was granted, Amy Pocino Kelly, a partner at Morgan, Lewis & Bockius LLP, said.

The regulations under IRC § 162(m) prior to the TCJA specifically prohibited positive discretion and authorized negative discretion, so it was common to structure compensation plans that included negative discretion, she said.

"These are all very common features of awards under IRC § 162(m) plans and grants, which really raises the question of what arrangements [actually] qualify for grandfathering," she said.

IRS guidance should, at a minimum, allow the grandfather provision to apply to previously granted awards because of the sudden change in the law in late December, Kelly said.

While tax deductibility is not always the driver in compensation decision-making, companies should certainly evaluate their options going forward and work with legal counsel to review existing executive pay arrangements to determine if they qualify under the grandfather rule, Kelly said.

Sinead M. Kelly, a partner at Baker & McKenzie LLP, said that even though the conference report appeared to preclude applying the transition rule to arrangements that allow for negative discretion, it seemed that Congress intended to allow the rule to apply.

Until clarifications are made, Kelly recommended that companies carefully consider the full scope of employment arrangements to which the grandfather rule may apply.

While there may be a temptation to wipe out all the arrangements that the rules governing IRC § 162(m) originally caused companies to adopt — such as objective formulas to determine elements of pay and individual award limits — businesses should not just throw those measures out the door, Kelly said.

"It's good for governance, even though they don't need it for tax purposes anymore," she said.

--Editing by Eric Kroh, Robert Rudinger and Vincent Sherry.