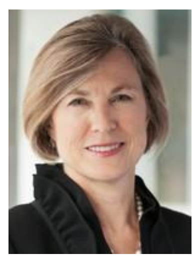
Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

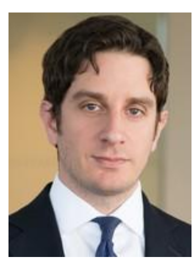
IRS Notice Does Not Jeopardize Exec Comp Grandfather

By **Rosina Barker, Mary Hevener, Mims Zabriskie and Jacob Oksman**
(October 4, 2018, 10:39 PM EDT)


Rosina Barker


Mary Hevener


Mims Zabriskie


Jacob Oksman

In August, the Internal Revenue Service issued Notice 2018-68 providing guidance on changes in Internal Revenue Code Section 162(m) made by the Tax Cuts and Jobs Act of 2017.[1] The notice has triggered concern that the employer's negative discretion to reduce or cancel amounts payable under an award defeats the TCJA's grandfather protection for awards. We believe this concern is off the mark and, in this article, we explain why. We think the notice affirms that negative discretion does not jeopardize the grandfather unless so broad as to render the promise illusory rather than an enforceable contract under state law. Depending on the state and the facts, negative discretion does not necessarily make the promise illusory and does not defeat the grandfather. The question comes down to state contract law.

Overview of Section 162(m) and Notice 2018-68

Section 162(m) sets a $1 million cap on the deduction for compensation paid by a publicly held corporation to a "covered employee." Before amendment by the TCJA, Section 162(m) excluded performance-based compensation from the $1 million cap, including stock options, stock appreciation rights and amounts paid under incentive plans.

The TCJA amended Section 162(m) to delete the exception for performance-based compensation and to expand the definitions of "covered employee" and affected public corporations, effective for taxable years beginning after Dec. 31, 2017. A grandfather applies to amounts paid pursuant to a "written binding contract" in effect on Nov. 2, 2017 and not materially modified thereafter. Grandfathered amounts are deductible under pre-TCJA law.

The notice provides guidance on the TCJA definition of "covered employee" and on the scope of the grandfather rules, effective for taxable years ending on or after Sept. 10, 2018 — provided also, of course, that the taxable year began after Dec. 31, 2017.

Grandfather Rule

Written Binding Contract

Section 13601(e)(2) of the TCJA provides grandfather protection to remuneration provided under a written binding contract in effect on Nov. 2, 2017, that is not materially modified thereafter. The provision is worded substantially identically to the grandfather set forth in Code Section 162(m)(4)(B), as initially enacted by the Omnibus Budget Reconciliation Act of 1993.

The notice explains this standard as follows:

Remuneration is payable under a written binding contract that was in effect on November 2, 2017, only to the extent that the corporation is obligated under applicable law (for example, state contract law) to pay the remuneration under such contract if the employee performs services or satisfies the applicable vesting conditions.

Accordingly, amounts are grandfathered if paid pursuant to an enforceable contract under state contract law. The notice is consistent with regulations issued under the OBRA grandfather rule. Treasury Regulation 1.162-27(h) states that the OBRA grandfather does not apply "unless, under applicable state law, the corporation is obligated to pay the compensation if the employee performs services."

The notice is somewhat broader than the OBRA transition rule set forth in Treasury Regulation 1.162-27(h) and states that the grandfather also applies to remuneration required to by paid by other "applicable law." This presumably includes the federal common law of contracts under ERISA, applicable to supplemental executive retirement plans, or SERPs, and other nonqualified pension plans. Whether "other applicable law" includes law that might compel payment outside of the contract — for example, promissory estoppel or other equitable principles — is not clear.

Negative Discretion

The notice has generated confusion about the impact of "negative discretion" on the grandfather rule. The impact of this uncertainty is significant. The typical pre-TCJA performance incentive plan states that awards will be paid to participants upon the occurrence of stated corporate performance metrics, subject to the company's discretion to reduce or even cancel the awards. The issue of negative discretion thus goes to the heart of the grandfather.

Negative discretion is not specifically addressed in the OBRA transition rule under Code Section 162(m)(4)(B) and Treasury Regulation Section 1.162-27(h). There is some IRS guidance under the regulation, however. In Chief Counsel Advisory 199926030 (July 2, 1999), the IRS reviewed certain pre-OBRA awards under two plans. Under both plans, the company could amend the award but could not "impair" participants' rights and under both plans the company had discretion to reduce the awards subject to certain objective conditions. Analyzing the facts and the terms of the plans under New York state contract law, the CCA concluded that each award constituted a "written binding contract" under the transition rule because the "Company appears obligated under state law to pay the compensation if the employees performed the services" in reliance on the award. The CCA's analysis thus turned entirely on which the awards formed an enforceable contract under state contract law.

The TCJA conference committee report too does not address the issue of discretion. The conference committee report — at pages 345-346 — states that compensation paid under a plan is grandfathered if "the right to participate in the plan is part of a written binding contract" in effect on Nov. 2, 2017. The committee report provides an example, but it is assumed in the example that "amounts payable under the plan are not subject to discretion." The issue is thus avoided.

The concern generated by the notice has been caused by Example 3 of Part III.B. Under Example 3, an executive is entitled to a maximum payment of $1.5 million under a performance-based plan. The example states that the compensation committee has the discretion to reduce the bonus to $400,000 "if in its judgment other subjective factors warrant a reduction." Example 3 further states that the plan "constitutes a written binding contract to pay $400,000." Under the example, the committee exercises its discretion to reduce the payment to $500,000. The example concludes that of the $500,000 paid, only $400,000 is grandfathered, and $100,000 is not.

This example has been cited as possible evidence that "negative discretion" will prevent the grandfather from applying in almost all situations. In our view, this analysis is based on a misreading of the example. It is expressly assumed in Example 3 that the amount subject to negative discretion — the amount in excess of $400,000 — is not part of the "written binding contract." Accordingly, Example 3 illustrates only what the general rule has already stated: Amounts not paid pursuant to a written binding contract are not grandfathered.

If we analyzed an actual contract under actual state law, a different answer might result. For example, assume the plan states that the company reserves the right to reduce the bonus below $1.5 million under certain enumerated business conditions. In many states, this discretion does not render the promise illusory but rather creates an enforceable contract as to the full $1.5 million if those enumerated business conditions do not exist. To reduce the bonus below the $1.5 million amount, the company is contractually obligated to determine that the enumerated business conditions have occurred. Its determination is subject to an abuse of discretion standard and the doctrine of "good faith and fair dealing" in many states.

If we change the assumption so that the plan states: "The company reserves the right at its sole discretion to reduce or cancel the bonus for any reason or no reason," even this broader discretion requires analysis of the entire plan under applicable state law to determine whether the $1.5 million promise is enforceable. This analysis might turn on the parties' course of dealing. For example, if the performance metrics are set forth with specificity and communicated to participants in advance of services being performed, particularly where employees have been performing services for years and there has been no past history, or current expectation, of the exercise of negative discretion, under the contract law of some states, an enforceable contract is created as to the entire $1.5 million and the company's discretion to reduce is bounded by the implied duties of good faith and fair dealing.

In addition, the analysis may turn on the plan's terms. For example, the plan or awards might state that amounts owed after termination of employment are payable only if the participant observes a covenant not to compete. Under the contract law of many states an illusory promise cannot constitute consideration and this provision might be viewed as conclusive evidence the parties viewed the awards as enforceable contract. The plan's amendment provisions might state that no amendment may impair a participant's "rights" under an award or the severability clause might state that, if a provision is determined to be void, other provisions remain "enforceable." Depending on the remainder of the document and the state contract law involved, an enforceable contract might therefore be created as to the entire amount payable under the award and the company's discretion to reduce accordingly constrained.

The plan in Example 3 highly unrealistic in an important respect. An incentive compensation plan like the plan in Example 3, with a minimum guaranteed amount of $400,000 — or any other dollar amount — is highly unusual. A typical plan would promise a bonus of, for example, $1.5 million if certain business goals are met, with company discretion to reduce the full amount with no lower limit. In that case, the company would look at plan provisions, participant communications and past practice to determine whether the entire $1.5 million is subject to an enforceable contract under applicable contract law.

Material Modification

The notice also addresses whether increases in the amounts promised pursuant to a written binding contract in effect as of Nov. 2, 2017 — including increases attributable to earnings and cost of living increases — are grandfathered.

Earnings on grandfathered amounts are grandfathered if the participant's right to earnings is guaranteed by a written binding contract in effect on Nov. 2, 2017. In Example 2 of Section II.B. of the notice, an employee elects to defer the amount otherwise payable to the employee under the 2016 annual bonus plan, to be paid in a lump sum at separation from service, plus earnings at a stated rate. Example 2 concludes that the 2016 bonus amount, plus earnings, are grandfathered. The earnings in Example 2 are based on a predetermined actual investment. It is not entirely clear whether the grandfather applies only to earnings both promised by a contract in effect on Nov. 2, 2017, and based on a predetermined actual investment as in Example 2 — or a reasonable rate of interest. The better argument is that the grandfather should apply to any earnings after Nov. 2, 2017, if the rate of earnings is guaranteed by a written binding contract in effect as of Nov. 2, 2017, even if the rate of earnings is arguably "unreasonable" or untethered to a predetermined actual investment. While supported by the better argument, this position is not expressly supported by Example 2 of Section II.B of the notice.

If earnings are not guaranteed by a contract in effect as of Nov. 2, 2017, they are not grandfathered. Examples 4 and 5 in Section II.B. suggest that if a company has discretion to eliminate crediting future earnings, such that earnings are not subject to a written binding contract under applicable law, such earnings are not subject to grandfather protection.

If earnings are not grandfathered, the issue is whether any increase to the grandfathered amount based on earnings accrued after Nov. 2, 2017, constitutes a "material modification" that invalidates the entire grandfather protection. Notice 2018-68 addresses this issue by expressly stating that earnings added to grandfathered amounts are not a material modification if based on a "reasonable rate of interest" or a "predetermined actual investment."

For example, assume a typical nonqualified 401(k) plan, in which notional earnings are credited to track actual earnings in actual investment funds and the plan sponsor has the right to change the benchmark investment funds as to future earnings. Based on Notice 2018-69, it would appear that in this instance the earnings on the grandfathered account balances are not themselves grandfathered. However, a change in the earnings benchmark should not constitute a material modification, as long as plan earnings are based on a reasonable rate of interest or the earnings on a predetermined actual investment fund, and so the change should not jeopardize the grandfather for the account balance as of Nov. 2, 2017.

The notice further clarifies that an increase in a grandfathered amount is not a "material modification" if it is based on a "reasonable" cost of living increase. In Example 10 of Section II.B, a $40,000 increase in a grandfathered amount is not a "material modification" and therefore does not jeopardize the grandfather because it is based on a reasonable cost of living increase. While not jeopardizing the grandfather, however, the $40,000 increase is not itself grandfathered and is itself subject to the deduction limitations of Code Section 162(m). While not stated in Example 10, it may be inferred that, were a cost of living increase guaranteed in the contract in effect as of Nov. 2, 2017, the $40,000 increase would also be exempt from the $1 million cap of Section 162(m). (Confusingly, Example 10 describes the deduction for the $40,000 cost of living increase as "disallowed" even though it is nowhere stated that compensation exceeds $1 million. Presumably later guidance will clarify this.)

If there is a non-grandfathered increase in a grandfathered amount and the increase does not constitute earnings based on a reasonable interest rate, a predetermined actual investment or a reasonable cost of living increase, the increase is a "material modification" and generally causes grandfather protection to be lost for the entire underlying amount. Specifically, the increase forfeits the grandfather if paid on the basis "of substantially the same elements or conditions as the compensation that is otherwise paid pursuant to the written binding contract."

For example, in Example 10 of Section II.B, the increase to a grandfathered salary amount in excess of a reasonable cost of living increase forfeits the grandfather as to the entire salary amount because the increase is based on "substantially the same elements or conditions" as the guaranteed salary amount.

In contrast, Example 11 states that providing an equity grant instead of an increase in salary would not jeopardize grandfather protection for the salary amount, because the equity grant is not paid on the basis of substantially the same elements or conditions as the salary. Rather, the equity grant is paid on the basis of both the stock price and the employee's continued service.

Conclusion

Awards are grandfathered from the Section 162(m) changes made by TCJA if paid under a written binding contract in effect on Nov. 2, 2017, and not subject to a material modification thereafter. Notice 2018-68 affirms what we think is the best reading of the statute and its legislative history: whether an award is grandfathered turns on an analysis of whether the award constitutes an enforceable contract or merely an illusory promise. The issue of negative discretion accordingly comes down to an issue of state contract law.

Rosina B. Barker, Mary B. Hevener and Mims Maynard Zabriskie are partners at Morgan Lewis & Bockius LLP.

Jacob M. Oksman is an associate with the firm.

[1] Public Law 115-97