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Awaiting IRS Insight On Taxing Exec Pay, Cos. Craft New Plans

By **Joseph Boris**

Law360, Washington (May 13, 2018, 9:58 PM EDT) -- The U.S. tax overhaul's removal of performance-based pay as an exception to deduction limits on executive compensation is prompting some public companies to create new pay plans to ensure such incentives remain available, practitioners said at an American Bar Association conference Friday.

Because the Internal Revenue Service has yet to state how it will apply the grandfather rule to this change in the tax code, some companies worry they could be disqualified from deducting performance-based pay even though they followed regulations that were in place before the change.

Under the Tax Cuts and Jobs Act, enacted in December, commissions and deferred pay in cash or stock based on performance of certain executives are no longer exempt from the $1 million cap on deductions for executive compensation. The law's revised Section 162(m) still allows performance-based pay above the cap to qualify for the deduction under transitional provisions that the TCJA conference committee in Congress said will apply to pay plans in effect on Nov. 2, 2017.

But there is one possible caveat: whether a company's compensation committee had the discretion to decrease pay.

The TCJA conferees said that if a public company compensation plan could be terminated by either party, it must be considered a new contract and therefore not subject to the transition rule. That suggests the grandfather rule might 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.

Previous IRS rules made negative discretion the standard for deferred pay in employment contracts. Positive discretion, or companies' ability to defer pay, wasn't allowed, but the TCJA lifted that prohibition.

As the IRS considers whether to link negative discretion to provisional use of the exemption, some companies have decided to play it safe. To increase or restructure performance incentives for executives, they're devising new equity pay structures that assume a narrow interpretation of the grandfather rule rather than risk making current, pre-Nov. 2 plans invalid by amending them, practitioners said on a panel at the ABA Section of Taxation conference in Washington, D.C.

“Many clients, instead of analyzing and getting into a defensible position, just decided, ‘We’re not going to risk it, and we’re just going to do an entirely new plan’” for this year, said Amy Wood, head of Cooley LLP’s compensation and benefits practice in San Diego. “There was a default to the most conservative [approach] and 'let’s just do no amendment just in case.'”

Ali Fawaz, a partner with Proskauer Rose LLP in New York, told the conference that most of his public company clients contemplating new stock awards for employees have gone the same cautious route.

“We’re advising them to put in replacement plans; now they have two plans to administer,” he said.

Another panelist, Nathan Holmes of Thompson Hine LLP, urged the IRS to provide favorable guidance for the revised Section 162(m) in line with what the TCJA conference committee indicated for Section 409A, which addresses deferred salary to employees that a company can’t deduct until it has been paid out. Although the TCJA tightened some Section 409A rules on reporting and withholding wages, the congressional conferees made clear it should be grandfathered in a way that precludes any attempted clawbacks in existing pay plans.

“They slapped on an amendment that basically said, ‘No matter what we do with respect to the plan going forward, none of it’s going to affect what was earned and invested beforehand,’” Holmes said. “Certainly, one of the areas for guidance that would be appreciated would be, 'why can’t we do the same thing in 162(m)?'”

“If you make it clear that any amendment doesn’t affect anything that’s been previously approved, unless it’s explicit in the amendments so that, as a matter of contract, it’s clear, there shouldn’t be any need to set up new plans. It doesn’t serve any policy purpose. It doesn’t serve any business purpose. It’s just a lot more work,” he added.

Determining how to apply the deduction exemption is listed third among 20 actions in the latest quarterly update, dated May 9, to the IRS’ Priority Guidance Plan for 2017-2018. The update provides no indication how the IRS may act, but the agency set itself a June 30 deadline for this and other guidance items.

Stephen Tackney, an IRS deputy associate chief counsel specializing in employee benefits, participated on Friday’s conference panel but declined to speculate about the timing or substance of guidance on the grandfather rule or other Section 162(m) matters. He said the IRS remains in “triage mode” in responding to TCJA-related questions and will decide on a case-by-case basis whether to issue proposals for new rulemaking, notices with substantive interpretations of the law or compliance guidance for taxpayers.

Mark Wincek, a partner with Kilpatrick Townsend & Stockton LLP, told the panel that the part of the TCJA conference committee’s report on Section 162(m) is nearly identical to text prepared for tax legislation passed in 1993. In the earlier report, a company with discretion to cancel a performance pay plan wouldn’t trigger the creation of a new contract unless it actually used that right past a certain date.

Given the TCJA’s “cloning” of the statutory and conference report language from 1993, the grandfather rule should preserve rights that existed in pay plans as of Nov. 2, 2017, Wincek speculated.

The panel also discussed the TCJA’s revised Section 162(m) definition of public companies’ “covered employees” to whom deduction limits for performance-based pay apply.

Previously, these were defined as the CEO and the next three highest-paid executives excluding the chief financial officer as of the end of the tax year. The new law defines covered employees as anyone who serves as principal executive officer or principal financial officer during the tax year, plus the next three highest-paid executives, required to be reported on the company's annual proxy statement.

Panelists sought to clarify possible confusion about whether the new definition could cover as many as five executives, but they agreed that the two new "principal" classifications would for most public companies be among three highest-paid executives.

--Editing by Christine Chun.
