

IRS to Consider Whether Exec Comp Grandfather Rule Is Too Narrow

by Stephanie Cumings

The IRS will look at whether the grandfathering rule for the executive compensation deduction should be expanded before the regs are finalized.

Whether compensation committees have the power to reduce awards under contracts that require compliance with section 162(m) is an interesting question that the agency will need to examine, Stephen Tackney, deputy associate chief counsel (employee benefits), IRS Office of Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes), said at the March 9 hearing on the proposed executive compensation regs (REG-122180-18).

Henry Talavera of Polsinelli PC, who testified at the hearing on behalf of the Texas State Bar Section of Taxation, argued that the proposed regs too broadly exclude arrangements with negative discretion clauses from being grandfathered.

"These particular regulations are so narrow that the grandfathering would hardly ever apply," Talavera said.

The Tax Cuts and Jobs Act eliminated the performance-based exception to the section 162(m) deduction limitation, but the statute also provided that existing arrangements are grandfathered if there is a written, binding contract that hasn't been materially modified.

Under the proposed regs issued in December 2019, to prove that a contract is legally binding, an employer must show that the amount would be owed under state or other applicable law. That approach was first outlined in initial guidance in Notice 2018-68, 2018-36 IRB 418.

The proposed regs too broadly exclude arrangements with negative discretion clauses from being grandfathered, Talavera said.

One of the biggest questions about the grandfathering rule was whether the presence of negative discretion — that is, the ability to reduce compensation — would render a contract nonbinding.

Talavera said that while many contracts include negative discretion, many also include provisions that require compliance with section 162(m). He argued that in those scenarios, the compensation committee wouldn't be allowed to exercise negative discretion if it would mean losing the deduction.

Tackney said that raises an interesting "chicken or the egg" issue that the IRS would need to analyze. However, he added that the agency can't delve too deeply into state law in drafting its own rules. Tackney also said that the legally binding right analysis could have implications for section 409A.

Contracts in Context

Talavera and the Texas State Bar argued that the regs should be revised so that all the provisions in the contract are read in context.

"If the Proposed Regulations are not revised to require a holistic interpretation of all provisions of a plan in this context, it is possible that a negative discretion provision as outlined in the Proposed Regulations would lead to the retroactive and automatic loss of grandfathered status of many plans," the bar association said in its comment letter.

The letter suggests that contracts that require compliance with section 162(m) should be deemed "binding pursuant to such requirement and state law once the [TCJA] required that a binding contract be in place on [November 2, 2017] in order for the Section 162(m) Requirements to remain satisfied after that date."

Ilya Enkishev, attorney (executive compensation), IRS Office of Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes), questioned why the regs as written — specifically the direction to rely on state or other applicable law — don't produce essentially the same result.

"My concern is creating a rule in the final regs that says that a compensation committee does not have discretion in certain circumstances when, depending upon which applicable law controls, they may want to exercise that discretion," Enkishev said.

Enkishev said in January that the goal is to get the final section 162(m) regs published by the end of the year. ■