Executive Comp Plans Merit Broad Relief, Practitioners Say

by Stephanie Cumings

As tax practitioners await guidance from the IRS on what executive compensation agreements will still be deductible under the new tax law, some are pushing for most existing plans to qualify for relief.

Multiple practitioners told Tax Analysts that most existing compensation arrangements contain a provision that could prevent them from being grandfathered in under recent revisions to the tax code, which they say thwarts Congress's intent.

The Tax Cuts and Jobs Act (P.L. 115-97) eliminated the deduction for performance-based executive compensation under section 162(m). It includes a transition rule that applies to any written, binding contract in effect on November 2, 2017, that was not materially modified on or after that date. Guidance on the changes to section 162(m) appeared in the recent update to the priority guidance plan as part of the initial implementation of the TCJA. (Related coverage: p. 950.)

Jeffrey Kroh of Groom Law Group told Tax Analysts that the key question is what constitutes a written, binding contract. He noted that most executive compensation arrangements that qualify as performance-based compensation under the prior rules include some form of negative discretion, meaning the award can be reduced. Such reductions were permitted under the prior version of section 162(m), which allowed a deduction for performance-based pay.

"If you ask the executives whether they feel they have an enforceable right under the outstanding performance-based compensation awards so long as they meet the objective criteria, I think many of them if not all would emphatically say yes," Kroh said, adding that this would suggest the existence of a binding contract despite the presence of a negative discretion provision.

J. Marc Fosse of Trucker Huss APC noted that in most cases, negative discretion doesn't mean the executive can be paid nothing. "Usually, there are different thresholds that are performance-based, and there's negative discretion to lower awards with a certain range," Fosse said. "That's why I think that in general, negative discretion would not mean that there's no legally binding right."

In a recent comment letter to the IRS, Francesco A. Ferrante of Thompson Hine said that employees who have awards subject to negative discretion still retain enforceable rights. Ferrante pointed to an Illinois state court decision — *McCleary v. Wells Fargo Securities LLC*, No. 1-14-1287 (Ill. App. Ct. 2015) — that found that any discretion regarding an employee's bonus was subject to an implied standard of good faith and fair dealing and that it couldn't be exercised in a way that resulted in an abuse and unjust enrichment to the employer. Ferrante argued that many performance-based awards include a statement that no amendment shall hurt the rights of the grantee without the grantee's consent. "Inclusion of this statement further strengthens the position that there is a binding agreement for covered employees to receive a payout," he said.

The transition rule at issue is functionally identical to the one put in place when section 162(m) was enacted in 1993. Ferrante said that under an IRS legal memorandum (ILM 199926030) interpreting the regulations (T.D. 8650) for the prior transition rule, positive discretion to increase compensation didn't disqualify a plan from relief. "If the stated discretion to increase compensation does not impair the application of the transitional relief (as interpreted in the IRS ILM), how can the discretion to reduce compensation have such effect?" he asked.

Practitioners have questioned whether the prior rule and its regulations are a helpful guidepost or whether the grandfather rule under section 409A would be a better analogue. But Stephen Tackney, deputy associate chief counsel (employee benefits), IRS Office of Associate Chief Counsel (Tax-Exempt and Government Entities), recently asked: "If in putting in a grandfather on 162(m), [Congress] put in the exact same language they had in 1993 — for which there are existing final regulations — why wouldn't we assume they intended it to apply the same way it did in 1993?"

Ferrante said that in the section 409A context, there is a general rule that negative discretion can prevent a deferral arrangement. "However, for Section 409A purposes, a negative discretion

provision has never been viewed as preventing a legally binding right for deferral purposes," he wrote. "Instead, negative discretion provisions have been treated as not having substantive significance and, thereby, not negating a legally binding right."

Kroh said that most conservative practitioners wouldn't take the position that negative discretion eliminates a legally binding right under section 409A . Similarly, he said the presence of negative discretion in a section 162(m) performance-based compensation award shouldn't render it a nonbinding agreement. Kroh said that approach to negative discretion in the section 162(m) context would therefore be consistent with how most practitioners have been interpreting similar language under section 409A.

Kroh and Kevin Walsh, also of Groom, said the legislative history of the transition rule supports broad application. Initially lawmakers hadn't included a transition rule, but one was eventually added and expanded during the legislative process, they noted. They said that because most of the arrangements include negative discretion, the transition rule would be essentially rendered meaningless for this type of outstanding award if negative discretion were found to disqualify a plan from grandfathering.

Ferrante agreed, arguing that finding negative discretion disqualifying would wipe out transitional relief for all outstanding performance-based arrangements. "When reviewing the changes made to the transitional relief as the bills moved through Congress, eliminating transitional relief for outstanding performance-based awards would be totally inconsistent with the consideration and efforts by Congress," he said.

Kroh said there are many variations when it comes to negative discretion provisions, and that it might be difficult to administer an IRS rule that allows some to qualify for relief and not others. Walsh noted that a complex rule that treats these variations differently would also take longer to draft. Kroh said he thinks it's more likely the IRS will either find negative discretion disqualifying or not, rather than finding it disqualifying in some cases and not others. ■

New Inflation Adjustment Could Complicate Estate Planning

by Nathan J. Richman

Differences between how the chained consumer price index and the standard CPI are published may complicate estate tax planning by forcing taxpayers to rely on estimated adjustments.

The Tax Cuts and Jobs Act (P.L. 115-97) has permanently changed the measure for inflation adjustments under 46 code sections — including the estate tax exemption — from standard to chained CPI, which is expected to slow dollar adjustments in the code.

While standard CPI is reported monthly and those reports do not change, chained CPI is estimated annually, in February, with final values published one year later, according to Kimberly E. Cohen of Ropes & Gray LLP, who spoke during a February 6 American Law Institute Continuing Legal Education webinar.

Having to rely on those estimates will make it difficult for taxpayers to use up the exact amount of the gift and estate tax exclusion without resorting to a formula gift, according to Cohen. While the IRS has accepted formula gifts in some situations, like for the marital deduction, it often can be hostile to such planning, Cohen said. "This raises the question as to whether gifts tied to an individual's remaining basic exclusion amount will be valid." Because individual taxpayers will have few alternatives in this context when trying to make gifts in a particular year, she expects that those formulas will be respected.

> ***An estate could have to pay the estate tax before the inflation adjustment for the exclusion amount has been finalized, Cohen said.***

Further, an estate could have to pay the estate tax before the inflation adjustment for the exclusion amount has been finalized, Cohen said. Presumably, using the estimate when the final number turns out to be different will not result in a penalty, she said.

Jeffrey N. Pennell of Emory University School of Law agreed that it would be "cheeky for the government to come down on you for using a