Executive Compensation Transition Rule in TCJA Raises Questions

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By Stephanie Cumings

It's not clear how a transition rule in the Tax Cuts and Jobs Act that would allow some existing executive compensation arrangements to keep their performance-based pay exception would apply, practitioners told Tax Analysts.

Kevin P. O'Brien of Ivins, Phillips & Barker Chtd. said taxpayers need to get these issues resolved quickly because there are important reporting and accounting ramifications.

The conference report on the tax bill, which Congress is expected to complete consideration of December 20, would no longer allow companies to deduct performance-based executive compensation under section 162(m).

However, lawmakers also included a transition rule for any written binding contract in effect on November 2, 2017, that was not materially modified on or after that date. A joint explanatory statement of the conference committee attempted to clarify the transition rule further, but O'Brien said there are still many questions he hopes Treasury and the IRS will address.

The provision also expands the definition of a "covered employee" so that any such employee would remain a covered employee for all future years. O'Brien said this makes understanding the transition rule even more critical.

Carlisle Toppin of BDO USA LLP agreed that the transition rule could use further clarification. "It is uncertain if the transition rule applies only to the stock option plan itself, such that any underlying option agreements entered into after November 2, 2017, would also be grandfathered," he said. "If so, the ability to grant grandfathered options would extend until the earlier of the expiration of the plan's term or the depletion of its share reserve, unless an evergreen provision was in place to periodically replenish the reserve."

The transition rule presumably applies only to the underlying option agreements, Toppin said, but he added that it's too early to tell and that the issue will likely be clarified in future regulations or other IRS guidance.

Spencer F. Walters, also of Ivins, said that when applying the transition rule to nonqualified deferred compensation plans, it's unclear whether it applies to all accruals or only vested accruals, nor is it clear if it applies only to current plan participants.

O'Brien said it's not entirely clear whether the typical deferred compensation plan constitutes a "contract" within the meaning of the transition rule, because the offer of compensation may not become a contract until the employee performs services. "They've framed the rule in terms of contracts, which always raises questions as to what that means," he said.

If the plan document does constitute a contract, there are further questions about whether the terms would disqualify it from the transition relief, O'Brien said. An example in the explanatory statement of a situation that qualifies for the relief assumes that amounts payable under the plan aren't subject to discretion and that the employer doesn't have the right to materially amend the plan.

There's only a narrow set of plans in which the amounts payable aren't subject to discretion, Walters said. O'Brien said it's unclear what kinds of discretion or modification could disqualify a plan from the transition rule and that depending on how the bill is interpreted, the transition rule could encompass a very large or very small number of plans.

There is also language in the bill about being a covered employee of a "predecessor," O'Brien noted, adding that it's not clear what qualifies as a "predecessor." The provision could be important for mergers and acquisitions, he said.