WR Marketplace

a Finseca Washington Report

The WR Marketplace is created exclusively for Finseca members by experts at Troutman Pepper Hamilton Sanders LLP and the Finseca staff. WR Marketplace #20-24 was written by Jim Earle and Christopher Stock.

The Finseca WR Newswire and WR Marketplace are published by Finseca as part of the Essential Wisdom Series, the trusted source of actionable technical and marketplace knowledge for Finseca members—the nation's most advanced life insurance professionals.

December 17, 2020 **WRM 20-24**

Topic: Upcoming December 31, 2020 Deadline to Amend Certain Nonqualified Deferred Compensation Arrangements

Market trend: Some nonqualified deferred compensation ("NQDC") arrangements sponsored by public companies require payments to certain executive officers to be delayed to the extent the payments cannot be deducted due to the $1 million deduction limit under Section 162(m) of the Internal Revenue Code ("Section 162(m)"). The Tax Cuts and Jobs Act of 2017 (the "TCJA") made a number of changes to Section 162(m) that expand the scope of the deduction limit. Some of those changes make a mandatory Section 162(m)-related payment delay for NQDC problematic, potentially requiring payment delays for many years following an executive's termination of employment. Proposed regulations related to Section 162(m) issued by the IRS on December 20, 2019 (the "Proposed Regulations")[1] allow companies to amend these mandatory Section 162(m)-related payment delay provisions, but only if the amendment is made by December 31, 2020.

Synopsis: IRS regulations implementing Section 409A of the Internal Revenue Code ("Section 409A") allow NQDC arrangements to either permit or require payments of NQDC to be delayed until such time as the payment is reasonably expected to be deductible under Section 162(m). Before changes to Section 162(m) made by the TCJA ("old" Section 162(m)), the Section 162(m) deduction limit applied only for tax years in which a Section 162(m)-covered executive

[1] Certain Employee Remuneration in Excess of $1,000,000 Under Internal Revenue Code Section 162(m), 84 FR 70356-01 (Dec. 20, 2019).

was in service as of the end of the year. As a result, payments of NQDC made in the year the executive terminated employment (or any later year) would not be subject to the Section 162(m) deduction limit, and any Section 162(m)-related payment delay therefore would not extend beyond the year of employment termination. However, changes made to Section 162(m) by the TCJA ("new" Section 162(m)) now require the Section 162(m) deduction limit to apply to a Section 162(m)-covered executive for all years following termination of employment. The IRS recognized that this change could cause NQDC payments to be indefinitely delayed for companies that have NQDC provisions mandating a Section 162(m)-related payment delay. As a result, the Proposed Regulations allow companies to amend these mandatory payment delay provisions to eliminate them altogether or limit their application to amounts that are grandfathered under old Section 162(m). Such amendments must be made no later than December 31, 2020.

Takeaways: Companies should evaluate their NQDC arrangements to determine if such arrangements contain a mandatory Section 162(m)-related payment delay provision and, if so, adopt any appropriate amendments before December 31, 2020. Companies that have NQDC arrangements with provisions that permit, but do not require, a Section 162(m)-related payment delay do not have to be amended.

Background on Changes to Section 162(m) Impacting NQDC

Section 162(m) limits an employer's compensation deduction to $1 million per year for each "covered employee" of a publicly held corporation.

Under old Section 162(m) before the amendments made by the TCJA, payments of NQDC made in the year of a covered employee's termination of employment or after were not subject to the Section 162(m) deduction limit. This result followed from how old Section 162(m) defined "covered employee." Under old Section 162(m), a "covered employee" was limited to the principal executive officer and the top three other highest compensated officers (excluding the principal financial officer) whose compensation for the taxable year was required to be reported in the company's annual proxy statement. The determination of who qualified as a covered employee under old Section 162(m) was determined at year end. Accordingly, if an individual terminated employment with the company during the year, he or she would not be a Section 162(m)-covered employee for that year or any later year.

The TCJA significantly expanded the Section 162(m) definition of "covered employee" for tax years beginning after December 31, 2017 to include any employee of the company who:

- Is the principal executive officer of the company at any time during the taxable year.
- Is the principal financial officer of the company at any time during the taxable year.
- Is among the top three highest compensated officers for the taxable year (excluding the principal executive officer and the principal financial officer) whose compensation for the taxable year was required to be reported in the company's annual proxy statement.

- Was a covered employee of the company (or any predecessor) for any taxable year beginning after December 31, 2016.

As a result of this last rule, as implemented by the Proposed Regulations, once an individual is determined to be a covered employee, the individual remains a covered employee indefinitely, including beyond termination of employment. As such, any NQDC payments made to a covered employee after December 31, 2017 (other than grandfathered amounts described below) will be subject to the Section 162(m) deduction limit whenever made, including if paid in any year after termination of employment (even for payments to beneficiaries after death).

The TCJA includes a grandfather rule that permits application of old Section 162(m) to certain payments. Under the grandfather rule, compensation payable under a written binding contract in effect on November 2, 2017, which is not materially modified after that date, remains subject to old Section 162(m). Consistent with the rules under old Section 162(m), such grandfathered amounts will not be subject to the Section 162(m) deduction limit if paid after a covered employee's termination of employment. The Proposed Regulations include rules that allow application of the grandfather rules to NQDC balances accrued through November 2, 2017, subject to certain conditions.[2]

Background on Section 162(m)-related Payment Delays Under Section 409A

Section 409A sets forth requirements for NQDC arrangements that must be met to avoid adverse tax consequences (primarily for the employee), including accelerated income inclusion and additional taxes. Among other requirements, NQDC arrangements must designate a time and form of payment based on a limited set of permitted payment events. Once the time and form and payment is set, Section 409A generally prohibits payments to be accelerated or further deferred, with limited exceptions.

Under one of these exceptions, companies may delay payments to a Section 162(m) covered employee if the company reasonably anticipates that the payment, as scheduled, would not be deductible under Section 162(m). Under this rule, the payment may be delayed until the covered employee's first taxable year in which the company reasonably anticipates that the Section 162(m) deduction limit would not apply to the payment. The Section 409A rule requires the Section 162(m)-related payment delay to apply to all payments otherwise due in a given year – i.e., the payment delay cannot be selectively applied to some payments but not others.

The Section 409A rules do not require that the Section 162(m)-related payment delay be included in the NQDC plan document or, if included, that the payment delay be mandatory. Many companies, though, have included these payment-delay provisions in their plan documents. In some cases the provisions are written as mandatory payment delays.

When this Section 162(m)-related payment delay rule was originally adopted, it was anticipated that payments would not be delayed beyond the year of a covered employee's termination of

[2] For additional background on the Section 162(m) grandfather rules as applied to NQDC, see our prior article here.

employment, based on the old Section 162(m) rule described above. But under new Section 162(m) as noted above, payments subject to a Section 162(m)-related payment delay may now have to be delayed for many years after termination of employment.

> Example: Assume a NQDC arrangement includes a mandatory Section 162(m)-related payment delay. Before the TCJA, the delay would have applied only to scheduled in-service payments, and would have potentially delayed payments only to the year of termination of employment. But after the TCJA, the payment delay could apply to any payments whenever scheduled. For example, if an executive has a $10 million NQDC account balance payable in a lump sum at termination of employment, a mandatory Section 162(m)-related payment delay provision under new Section 162(m) would permit payment of only $1 million per year over ten or more years (depending on whether there are other payments from the company in those years and the impact of earnings on the amount of the NQDC).

Special Transition Rule

In the Release accompanying the Proposed Regulations, the IRS has provided special transition relief to companies that have a mandatory Section 162(m)-related payment delay provision in their NQDC arrangements. Companies may amend their NQDC arrangements either to (i) completely eliminate the mandatory Section 162(m)-related payment delay provision or (ii) limit the application of the provision only to Section 162(m) grandfathered amounts. This amendment must be made no later December 31, 2020.

If the amendment is made by December 31, 2020, the amendment will not result in an acceleration of payment in violation of Section 409A and will not be considered a material modification for purposes of the Section 162(m) grandfather rule.

For companies with a NQDC arrangement that includes a permissive Section 162(m)-related payment delay, no amendment is required. In the Release accompanying the Proposed Regulations, the IRS states that it will allow companies to limit application of those permissive payment delays to Section 162(m) grandfathered amounts. This transition relief would allow a company to delay payment of a scheduled in-service payment of a Section 162(m) grandfathered NQDC balance until the covered employee's termination of employment, without having to delay payments of non-grandfathered amounts. The transition relief modifies the Section 409A rules that ordinarily require a Section 162(m)-related payment delay to apply to all payments due in a year, not just to a sub-set of payments. The IRS states that it intends to amend the Section 409A regulations to reflect these transition rules.

Conclusion

Companies should review all of their NQDC arrangements to determine if any of their arrangements contain either mandatory or permissive Section 162(m)-related payment delay provisions. If any of the arrangements contain a mandatory payment delay provision, the company should adopt an amendment by December 31, 2020 to either remove this provision or limit its applicability to Section 162(m) grandfathered amounts. If the amendment is not made by

December 31, 2020, the company may be stuck with required delayed payments that could extend for an indefinite period following an executive's termination of employment.