

Treasury Proposes New Regulations on Section 162(m) Executive Compensation Deduction Limits

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Just in time for the holidays, the Treasury Department (the “Department”) published proposed regulatory changes (the “Proposed Regulations”) interpreting the \$1 million deduction limit for compensation paid to certain top executives at public companies under Section 162(m) of the Internal Revenue Code (the “Code”). The Proposed Regulations would provide comprehensive guidance on the significant expansions to Code Section 162(m) included as part of the 2017 tax reforms of Public Law 115-97 (the “Act”), and would incorporate and expand on interim IRS guidance published last year in Notice 2018-68. For more information on the Act and Notice 2018-68, please refer to our January 12, 2018 article at <https://www.groom.com/resources/tax-reform-series-iii-executive-compensation-provisions/> and our August 23, 2018 article at <https://www.groom.com/resources/irs-clarifies-grandfather-rule-and-other-code-section-162m-issues/>.

Background

Code Section 162(m) restricts publicly held corporations’ ability to take an income tax deduction for compensation paid to “covered employees” in excess of \$1 million. While Code Section 162(m) has been in the books for decades, the Act significantly expanded the employees, employers and compensation types subject to the limit for tax years beginning after December 31, 2017. However, the Act also included a “grandfather rule” preserving the old Code Section 162(m) rules for compensation provided under a written binding contract which was in effect on November 2, 2017, and which is not materially modified on or after such date. The Proposed Regulations would answer many important questions regarding how the new Code Section 162(m) rules apply in practice.

“Publicly Held Corporations”

Code Section 162(m) applies to “publicly held corporations.” Prior to its amendment in 2017, Code Section 162(m) defined a “publicly held corporation” as a corporation issuing common equity securities

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subject to the reporting obligations of Section 12 of the Securities Exchange Act. As amended, the new definition of “publicly held corporation” includes any issuer of securities (debt or equity, preferred or common) required to be registered under Section 12 of the Exchange Act, or required to file reports under 15(d) of the Exchange Act. This change expands the group of covered entities.

The Proposed Regulations clarify that this new definition means a number of previously exempt companies, such as privately held C and S corporations, foreign private issuers, publicly traded partnerships, and other disregarded entities are potentially subject to Code Section 162(m). In addition, an affiliated group containing one or more publicly traded corporations is itself considered a publicly traded corporation. For example, the Proposed Regulations suggest that if a privately held parent corporation owns a publicly traded subsidiary corporation, which in turn owns another publicly traded subsidiary corporation, the affiliated group and the two subsidiaries are each subject to Code Section 162(m). This broad approach would largely preclude attempts to avoid Code Section 162(m) coverage through creative corporate structuring.

“Covered Employees”

Code Section 162(m) limits a publicly held corporation’s deduction for compensation paid to “covered employees.” Prior to the Act, an employer’s “covered employees” generally consisted of its CEO and its three most highly compensated officers other than the CEO and CFO whose compensation is required to be reported to shareholders, as determined on the last day of the applicable tax year. The amendments to Code Section 162(m) expanded the definition of “covered employee” to include a company’s CFO, eliminated the end-of-year employment requirement, and provided that an individual who is a covered employee in any tax year beginning after December 31, 2016 will remain a covered employee permanently. Thus, under the new Code Section 162(m) rules, a publicly held corporation’s list of covered employees will likely grow over time.

Under the Proposed Regulations, a company’s covered employee list may also grow through corporate transactions. Specifically, the Proposed Regulations provide that any covered employee of a “predecessor of a publicly held corporation” in any tax year beginning after December 31, 2016 will remain a covered employee in all subsequent tax years. The Proposed Regulations contain detailed rules to determine whether a corporation is a “predecessor of a publicly held corporation,” including rules involving public companies that become privately held, reorganizations, corporate distributions, and asset sales. In addition, the Proposed Regulations include a “cumulative” concept whereby predecessors of a predecessor may also be included in the definition.

Considering the complexity of these rules and the permanent nature of covered employee status, it may prove increasingly challenging for companies that frequently engage in corporate transactions to keep track of their covered employees in future years. It is also conceivable that a company may consider an individual’s status as a covered employee at a predecessor when making decisions regarding continued employment, hiring, promotion, compensation and termination.

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“Applicable Employee Remuneration”

The Code Section 162(m) deduction limit applies to “applicable employee remuneration” paid to a covered employee. Prior to enactment of the Act, “applicable employee remuneration” did not include “qualified performance-based compensation,” compensation paid on a commission basis, post-termination compensation (e.g., consulting or director fees paid to a retired covered employee), or compensation paid to a beneficiary of a deceased covered employee. The qualified performance-based compensation exception was particularly popular with publicly held corporations, many of whom structured their compensation packages such that most, if not all, of their covered employees’ compensation over \$1 million met this definition. The Act eliminated the Code Section 162(m) exceptions for commissions, qualified performance-based compensation, post-termination compensation, and beneficiary payments, in effect dramatically expanding the scope of compensation subject to the \$1 million deduction limitation. The Proposed Regulations continue this expansionary trend by closing two regulatory exceptions to “applicable employee remuneration.”

First, the Proposed Regulations address compensation paid by a partnership to a covered employee of a publicly held corporation, an issue that has been subject to a “no rule” position for private letter rulings (“PLRs”) since 2010. In a reversal of IRS rulings in four PLRs issued between 2006 and 2008, the Proposed Regulations provide that compensation paid by a partnership to a covered employee of a publicly held corporation is included in the covered employee’s “applicable employee remuneration” for Code Section 162(m) purposes. Therefore, a publicly held corporation’s deduction for compensation paid to such a covered employee may be limited even if the corporation itself pays less than \$1 million. However, the Proposed Regulations provide transition relief for companies that have previously taken a contrary position.

In addition, under the existing Code Section 162(m) regulations, “applicable employee remuneration” does not include compensation paid by a publicly held corporation pursuant to a plan or arrangement that existed during the period a corporation was not publicly held (e.g., prior to an initial public offering (“IPO”)). The Proposed Regulations generally eliminate this IPO transition rule, subject to special transition relief for companies that became publicly held on or before December 20, 2019. The preamble to the Proposed Regulations explains that the transition rule was intended to provide relief for private companies that may have had difficulty adopting compensation arrangements that meet the requirements for the qualified performance-based compensation exception, and that the transition rule is no longer necessary now that this exception has been eliminated.

The Grandfather Rule

Generally, the new Code Section 162(m) rules are applicable for tax years beginning after December 31, 2017. However, the Act provided a “grandfather rule” with respect to compensation provided under a written binding contract which was in effect on November 2, 2017, and which is not materially modified on or after such date. Such compensation is subject to the Code Section 162(m) rules in effect

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prior to the enactment of the Act (including the qualified performance-based compensation exception). Thus, in certain cases, compensation that would otherwise become nondeductible under the new Code Section 162(m) rules may remain deductible if it meets the grandfather rule. Generally, a “grandfathered” amount would be subject to the existing Code Section 162(m) regulations (Treas. Reg. § 1.162-27) rather than the final version of the Proposed Regulations (Treas. Reg. § 1.162-33).

As discussed in detail in our August 23, 2018 article, Notice 2018-68 provided interim guidance on key questions regarding the scope of the grandfather rule, including the definitions of a “written binding contract” and “material modification,” as well as the impacts of accelerations and deferrals of compensation, contract renewals, and a service recipient’s “negative discretion” to reduce compensation. The Proposed Regulations generally incorporate and expand upon the guidance set forth in Notice 2018-68. Some notable additions to the existing grandfather rule guidance include:

- Clawback Provisions. A company’s discretion to reduce or recoup compensation from a covered employee is not considered “negative discretion” if the discretion is contingent on a condition objectively outside the company’s control (e.g., the employee’s conviction for a felony).
- Earnings. Earnings that accrue after November 2, 2017 on a grandfathered amount are generally not grandfathered, unless the company is obligated to pay such earnings under a written binding contract in effect on November 2, 2017. For this purpose, earnings are generally not grandfathered under an arrangement that can be terminated at any time at the company’s discretion. However, because plans subject to Section 409A may not be liquidated for at least 12 months after a company takes discretionary action to terminate, earnings on grandfathered amounts under such plans that accrue in the 12 months following November 2, 2017 may also be grandfathered. A similar rule applies for the increase in a SERP benefit’s present value due solely to the passage of time during the 12 months following November 2, 2017.
- Severance. Severance payable under a written binding contract in effect on November 2, 2017 is grandfathered only if the severance is based on compensation elements the employer is obligated to pay under the contract as of November 2, 2017. For example, severance based on a covered employee’s base salary is grandfathered only if the company is required to pay both the base salary and the severance under the contract as in effect on November 2, 2017.
- Accelerated Vesting. A grandfathered amount will not lose grandfathered status merely because vesting is accelerated. Further, although an acceleration in payment timing of a fixed payment will constitute a material modification unless the payment is discounted to reflect the time value of money, accelerations of vesting for equity-based compensation, such as restricted stock, stock options, and SARs, are generally not considered material modifications.
- Grandfathered Portion Paid First. Where a partially grandfathered nonqualified deferred compensation plan benefit is paid in installments, the grandfathered portion is generally treated as paid first.



- Integration with Code Section 409A. Under the Code Section 409A rules, an employer may exercise discretion to delay a payment until the first year in which the employer's deduction for the payment would not be subject to the Code Section 162(m) limit. While this delay is still permitted under the Code Section 409A rules, it may be impractical for non-grandfathered amounts now that covered employee status continues after termination of employment. The preamble to the Proposed Regulations clarifies that employers may treat grandfathered and non-grandfathered amounts separately, and may choose to apply the delay exclusively to the grandfathered portion of a benefit. In addition, nonqualified plans that require this delay may be amended to remove the feature by no later than December 31, 2020.

Applicability Dates

Taxpayers may rely upon the Proposed Regulations until the final regulations become applicable. Generally, Notice 2018-68 may no longer be relied upon for taxable years ending on or after December 31, 2019. However, the Proposed Regulations provide special applicability timing rules for the definitions of "covered employee," "written binding contract," and "material modification," as well as for the predecessor and IPO transition rules.

Action Items and Next Steps

The Proposed Regulations confirm the expanded scope of Code Section 162(m) as amended by the Act. A proactive approach to compliance will ease the transition to the new rules and help preserve the relief offered by the grandfather rule. In particular, employers should:

- Begin to establish internal procedures for tracking covered employees, and consider strategies to address covered employees in future acquisitions.
- Ensure that they can identify the extent to which these employees' benefits are grandfathered under the Proposed Regulations. To this end, employers should work with their nonqualified plan recordkeepers to confirm sufficient tracking procedures are in place.
- Determine whether any of their plans require payments to be delayed until the first year in which the employer's deduction for the payment would not be subject to the Code Section 162(m) limit. Employers whose plans contain this feature should consider whether it is still desirable under the new Code Section 162(m) rules. The special transition relief period for removing this feature ends on December 31, 2020.

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