

## Treasury Issues Final Regulations on Section 162(m) Executive Compensation Deduction Limits

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On December 18, 2020, the Internal Revenue Service (“IRS”) and Treasury Department released final regulations (the “Final Regulations”) interpreting the Tax Cuts and Jobs Act’s (the “Act’s”) revisions to Section 162(m) of the Internal Revenue Code (the “Code”), which limits a publicly held corporation’s deductions for compensation paid to “covered employees” in excess of \$1 million. The Final Regulations arrive one year after the proposed regulations published on December 20, 2019 (the “Proposed Regulations”). For more information on the Proposed Regulations, please refer to our January 6, 2020 article [here](#).

### Background

Code Section 162(m) generally restricts a publicly held corporation’s ability to take an income tax deduction for compensation paid to “covered employees” in excess of \$1 million per year. The Act significantly expanded the employees, employers and compensation types subject to the limit for tax years beginning after December 31, 2017, and also includes a “grandfather rule” preserving the pre-Act Code Section 162(m) rules for compensation 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 Final Regulations largely adopt the Proposed Regulations, with some significant changes and clarifications.

### “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 subject to the reporting obligations of Section 12 of the

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Securities Exchange Act. The Act expanded the scope of “publicly held corporations” to include any corporation that (i) issues securities (debt or equity, preferred or common) that are required to be registered under Section 12 of the Securities Exchange Act of 1934 (the “Exchange Act”) or (ii) that is required to file reports under Section 15(d) of the Exchange Act.

The Final Regulations confirm that, under the Act’s expanded definition of a “publicly held corporation,” Code Section 162(m) applies to a number of previously exempt organizations, such as privately held C and S corporations with publicly-traded debt, foreign private issuers, publicly traded partnerships, REITs that own a qualified real estate investment trust subsidiary, and other disregarded entities. The Final Regulations also adopt the rule from the Proposed Regulations that the term “publicly held corporation” includes an “affiliated group” of corporations consisting of one or more publicly held corporations, and that each member of the affiliated group that is a publicly held corporation is separately subject to Code Section 162(m).

## “Covered Employees”

Code Section 162(m) limits a publicly held corporation’s deduction for compensation paid to “covered employees.” Prior to the Act, “covered employees” generally consisted of a publicly held corporation’s CEO and the next three highest compensated officers for the taxable year, other than the CEO and CFO. 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.

The Final Regulations also adopt the rule in the Proposed Regulations that any covered employee of a “predecessor” of a publicly held corporation for any tax year beginning after December 31, 2016, will remain a covered employee of the corporation in all subsequent years. However, the Final Regulations helpfully provide that if a corporate transaction occurred before publication of the Final Regulations in the Federal Register on December 30, 2020, then taxpayers generally may apply either the definition of a predecessor of a publicly held corporation in the Final Regulations or a reasonable good faith interpretation of the term (with certain exceptions).

## “Applicable Employee Remuneration”

The Code Section 162(m) deduction limit applies to “applicable employee remuneration” paid to a covered employee. Prior to the passage of the Act, Code Section 162(m) excluded from “applicable employee remuneration” amounts that were considered “performance-based compensation,” compensation paid on a commission basis, post-termination compensation (such as consulting or directors fees paid to retired employees) and compensation paid to a beneficiary of a deceased covered employee. The performance-based compensation exception was particularly popular, and many corporations designed their compensation packages to take advantage of this rule. In an effort to expand the scope of compensation subject to Code Section 162(m), the Act eliminated the qualified-

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performance based compensation exclusion, as well as the exclusions for commissions, post-termination compensation, and beneficiary payments.

The Final Regulations preserved two regulatory exceptions to the definition of “compensation” included in the Proposed Regulations. First, the Final Regulations adopt the Proposed Regulations’ requirement that a publicly held corporation take into account its distributive share of a partnership’s deduction for compensation paid to the corporation’s covered employee for services performed for the partnership in determining the amount allowable to the corporation as a deduction for compensation. However, under the Final Regulations, this rule is effective only for compensation paid after December 18, 2020 (rather than December 20, 2019, as originally provided in the Proposed Regulations). The rule also does not apply to compensation paid pursuant to a written binding contract in effect on December 20, 2019, and that is not materially modified after that date.

In addition, like the Proposed Regulations, the Final Regulations eliminate the prior regulatory exception for compensation pursuant to a preexisting plan or agreement for a limited period following the date the corporation becomes publicly held, though corporations that became publicly held on or before December 20, 2019, may continue to rely on this exception.

## The Grandfather Rule

The Act provides that the amendments to Code Section 162(m) are applicable for tax years beginning after December 31, 2017. However, the Act further provides a “grandfather rule” that preserves the pre-Act Code Section 162(m) rules for compensation payable pursuant to a written binding contract that was in effect on November 2, 2017, and that is not materially modified on or after such date. Thus, compensation that would otherwise be nondeductible under the post-Act Code Section 162(m) framework (such as performance-based compensation), may remain deductible if it meets the grandfather rule.

The Final Regulations generally preserve the Proposed Regulations’ grandfather provisions, with a few significant, generally taxpayer-friendly changes:

- The Final Regulations provide that a publicly held corporation’s right to recover (or “claw back”) compensation upon the occurrence of an event outside the corporation’s control does not affect the grandfathered status of the compensation, regardless of whether the corporation exercises its clawback right. This contrasts with the approach of the Proposed Regulations, which granted grandfathered status only to compensation the corporation was obligated to pay after taking into account the occurrence of a clawback condition. However, the Final Regulations retain the Proposed Regulations’ rule that compensation is not grandfathered to the extent the corporation is not obligated to pay it under applicable law – including where the corporation has “negative discretion” to unilaterally reduce or eliminate a compensation payment under the arrangement.
- The Final Regulations clarify how grandfathered amounts are determined under plans that can be unilaterally terminated or discontinued (i.e., frozen) by the employer. Generally, if the

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terms of the plan permit the corporation to terminate or freeze the plan, the grandfathered amount is the account balance (for account balance plans) or the present lump sum value (for nonaccount balance plans) determined as of November 2, 2017 or, if later, the earliest possible date the plan could be terminated or frozen. If the plan requires crediting earnings or increasing the lump sum value through to the payment date, such earnings and increases are also grandfathered (though the corporation may elect to disregard such earnings or increases in determining the grandfathered amount).

- The Final Regulations clarify that an extension of the exercise period for a grandfathered nonqualified stock option or a stock appreciation right will not be treated as a material modification that would cause a loss of grandfathered status if the extension complies with Code Section 409A regulations.

Notably, the Final Regulations do not expand on the limited guidance contained in the Preamble to the Proposed Regulations relating to the Code Section 162(m) delay rules under Code Section 409A. The Final Regulations provide that further guidance regarding coordination between Code Section 162(m) and Code Section 409A will be forthcoming, and that until then, taxpayers may continue to rely upon the Code Section 409A guidance in the preamble to the Proposed Regulations.

## Applicability Dates and Next Steps

The Final Regulations apply to taxable years beginning on or after December 30, 2020, which is the publication date of the Final Regulations in the Federal Register. Taxpayers may choose to apply the Final Regulations to a taxable year beginning after December 31, 2017, provided the taxpayer applies the Final Regulations in their entirety and in a consistent manner to that taxable year and all subsequent taxable years.

A proactive approach to compliance will ease the transition to the new post-Act Code Section 162(m) framework and help preserve the relief offered by the grandfather rule. Employers should consider taking the following steps:

- Determine whether your organization is considered a publicly held corporation and thus subject to Code Section 162(m).
- Review your organizational structure and identify all other publicly held corporations in your affiliated group, including predecessor corporations.
- Establish internal procedures for tracking covered employees.
- Identify the extent to which these employees' benefits are grandfathered under the Final Regulations. To this end, employers should work with their nonqualified plan recordkeepers to confirm sufficient tracking procedures are in place.

Please contact any of the attorneys listed here or your regular Groom Law Group attorney for help preparing a compliance strategy for your company.

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