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Widening the Net—Proposed Regulations Expand Scope of $1 Million Section 162(m) Deduction Limitation on Certain Executive Compensation Paid by Public Companies

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by the Washington National Tax Compensation and Benefits group

It is important for companies to understand the requirements and limitations of recently released proposed section 162(m) regulations, including the expanded scope of the deduction limitation and narrowed transition relief, as well as how these rules might apply to the companies, their affiliated groups, and their compensation arrangements going forward.

Treasury and the IRS recently released proposed regulations under section 162(m)[1] reflecting the Tax Cuts and Jobs Act ("TCJA")[2] amendments that significantly expanded the scope and application of these rules. This section limits the annual compensation expense deduction available to publicly traded companies to $1 million for certain "covered employees." The release is 129 pages long and includes over 80 examples to illustrate the guidance for when, and how, the amended rules would apply. In particular, it expands on prior guidance to identify certain entities that were not previously considered "public" companies for this purpose, but are now subject to a potential deduction limitation. In addition, the proposed regulations identify structures and arrangements subject to these limitations that prior IRS private letter rulings ("PLRs") noted were outside the purview of section 162(m).

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[1] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

[2] Pub. L. 115-97.

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Public companies (including those under the expanded definition of the TCJA and proposed regulations) should act now to consider the impact of section 162(m) and if any changes should be made to their determination of covered employees or to their calculations and tax treatment of compensation in light of the additional guidance. In addition, transition relief may be available to exempt some compensation items from these limitations if certain actions are taken (or avoided). Furthermore, affected companies should understand the collateral impact of the section 162(m) rules on any compensation arrangements, and amendments thereto, with respect to covered employees or potential covered employees.

Background

Section 162(m) disallows a deduction by publicly held corporations for applicable employee remuneration paid with respect to a covered employee to the extent it exceeds $1 million for the tax year. The tax law enacted in December 2017, commonly referred to as the TCJA, and these proposed regulations significantly expanded the scope and application of section 162(m) by amending key definitions and eliminating frequently used exceptions. A summary of the positions outlined in the proposed regulations is available in a recent *TaxNewsFlash*. While the guidance has shed additional light on how to apply these changes and their implications, open questions and areas that will present new challenges for taxpayers remain.

The TCJA amendments to section 162(m) are generally effective for tax years beginning after December 31, 2017, except to the extent amounts are considered grandfathered. As the existing final regulations issued December 20, 1995,[3] continue to apply to grandfathered compensation, the new regulations are proposed as a separate section.[4] The proposed regulations will take effect when (and if) finalized, as of the date the final rule is published in the *Federal Register*. The proposed effective dates for certain positions outlined in these regulations and its preamble are discussed below. The proposed regulations also provide certain transitional relief.

Publicly Held Corporations

Section 162(m) as amended by the TCJA continues to apply with respect to "publicly held corporations"; however the scope of that definition has been expanded to include entities that may not traditionally consider themselves publicly held, including, but not limited to, entities with publicly traded debt, foreign private issuers, and certain passthrough entities taxed as corporations.

The definition was expanded in two key ways and includes:

> (1) Corporations required to register any securities (not just common equity) under section 12 of the Securities Exchange Act of 1934 (the "Exchange Act"), and
>
> (2) Corporations required to file reports under section 15(d) of the Exchange Act.

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[3] Section 1.162-27.

[4] Proposed section 1.162-33.

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This determination is made as of the last day of the corporation's tax year.

Consistent with pre-TCJA rules, publicly held status is determined on an affiliated group basis; an affiliated group of corporations is defined by reference to the rules of section 1504 (without reference to section 1504(b)). This recent release confirms that section 162(m) applies to *S corporations* that meet the definition described above or that are the parent of a qualified subsidiary ("QSub") that meets this definition (e.g., by issuing public debt), as well as *publicly traded partnerships* if treated as corporations under federal law (e.g., under section 7704).

Applying the same thought process, the proposed regulations confirm that a privately held corporation is considered publicly held for section 162(m) purposes if it is the parent of a *wholly owned disregard* that meets the amended publicly held definition. The preamble to the proposed regulations warns, however, that attempts to form a partnership with a minority partner to circumvent these rules relating to wholly owned disregards will still result in the corporation being treated as publicly held under the anti-abuse rules of section 1.701-2. The preamble warns this may also apply to other attempts to form a partnership to avoid the proposed rules.

The proposed regulations also provide additional clarification with respect to *foreign private issuers*. Contrary to the IRS position expressed in several pre-TCJA PLRs, foreign private issuers may be subject to the deduction limitations of section 162(m) if they meet the definition of a publicly held corporation within the meaning of (1) or (2) above. For example, foreign private issuers trading in the United States by listing or offering its securities in the form of American Depositary Receipts ("ADRs") may be required to register the deposited securities underlying the ADRs under section 12 of the Exchange Act. As many foreign private issuers are not required to gather and disclose the compensation of its executive officers for SEC purposes, many commenters requested that the proposed regulations exclude foreign private issuers from the definition of a publicly held corporation; the IRS declined, noting that the rationale behind excluding foreign private issuers in the pre-TCJA PLRs was that those entities were not required to file summary compensation tables. The preamble explains that the limitation is now inconsistent with the language of the statute, but Treasury and the IRS requested comments and suggestions for a safe harbor to assist foreign private issuers in determining their most highly compensated officers.

The proposed regulations retain the affiliated group rules in the existing final regulations, i.e., that a publicly held corporation includes an affiliated group of corporations. These rules apply differently when there are two related publicly held corporations. Publicly held subsidiaries with a publicly held parent continue to be treated as subject to section 162(m) separate and apart from the public parent, thus both corporations must identify their own set of covered employees. Although this rule is not new, it may be more common and more onerous with the expanded definitions of publicly held corporation and covered employee.

In addition, the proposed regulations do adopt the suggestion from commenters that a corporation considered publicly held because it is required to file reports under section 15(d) will no longer be

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considered publicly held if those filing obligations are suspended. It is important to note that an entity is still considered "required" to file reports even if the statutory requirements are satisfied to allow the corporation to suspend its obligation to file if it has not taken all necessary steps to actually suspend that filling obligation (e.g., filling required forms).

The proposed regulations include many examples that go into detail illustrating various situations that may apply to companies or corporations seeking to determine their status as a publicly held corporation (or not) under section 162(m). It is important that entities work with their SEC counsel to determine their requirements under sections 12 and 15(d). An entity's SEC counsel may be essential in determining whether section 12 or 15(d) applies, so that further analysis regarding section 162(m) application can be performed.

Covered Employees

The definition of covered employees was expanded by the TCJA and clarified in subsequent guidance. As an initial matter, the Chief Financial Officer ("CFO") of a corporation is now a part of the covered employee group; pre-TCJA, the CFO typically was not included. Additionally, the limitation that an individual be in the position on the last day of the tax year was eliminated; as such, an individual who meets the definition of a covered employee at any time during the entity's tax year will be considered a covered employee. Furthermore, the proposed regulations look through certain passthrough entity arrangements to identify covered employees.

Corporations must now identify their:

- Principal executive officers ("PEOs") and principal financial officers ("PFOs") (basically, the chief executive officer ("CEO") or CFO, including anyone acting in that capacity, such as an interim CEO or CFO) at any point during the year;
- Three most highly compensated executive officers for the tax year determined without regard to their employment status on the last day of the year or whether they must actually be disclosed in any SEC filings (e.g., the summary compensation tables in the proxy statement); and
- Covered employees (and those of any predecessor) for all tax years beginning after December 31, 2016.

Generally, covered employees are limited to "*executive officers*" for SEC purposes. The proposed regulations include in the definition an officer of a lower-tier disregard, partnership, or QSub if that officer performs a policy making function for the publicly held corporation during the tax year. If that employee is also among the top highly compensated of the public corporation for the tax year, the individual may be a covered employee of the corporation.

Determining the three highest compensated officers for a year is more complicated than under previous pre-TCJA rules. The guidance clarifies that the compensation must be considered and calculated in line with SEC disclosure rules, which may require tracking and analysis that is not otherwise being performed by other departments within the organization such as payroll. The determination is made

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based on the tax year, which may not necessarily align with the corporation's fiscal year as generally used for SEC purposes (e.g., in the event of transaction creating a short tax year or company that uses a calendar year SEC filing, but different tax year). SEC counsel will need to be involved to determine applicable SEC compensation for the tax year so that the covered employees can be determined.

In addition, the covered employee determination must consider individuals who are not still employed as an executive officer at the end of the year, which may differ from the determinations made for SEC disclosure purposes. In other words, the three highest compensated employees for section 162(m) purposes may not match the named executive officers reported in the compensation disclosure tables filed with the SEC. Further, some corporations that meet the TCJA-amended definition of publicly held corporation may not be required to make compensation disclosures under SEC rules (e.g., foreign private issuers). As such, early involvement of SEC counsel will be crucial in aiding this determination.

Once a Covered Employee, Always a Covered Employee

As amended, the covered employees of a corporation is an ever-expanding group year over year. The amended definition provides that all covered employees of the taxpayer (or any predecessor) for tax years beginning after December 31, 2016, remain covered employees for all future years. Consistent with Notice 2018-68, the proposed regulations respond to commenters to clarify that a covered "employee" is interpreted to include former employees and thus a covered employee maintains that designation following separation from service and even death. Deferred compensation paid to former employees or their beneficiaries is still subject to potential limitation of the deduction under section 162(m). In light of this expanded definition, maintaining and updating a robust database of covered employees and payments due to those individuals on a yearly basis will be a crucial undertaking for publicly held corporations and their affiliated group members.

The proposed regulations provide additional detail on the meaning of "*predecessor*" for purposes of identifying covered employees. In considering additions to the covered employee group, a predecessor includes a publicly held corporation that is acquired, or the assets of which are acquired in certain transactions. The regulations specifically refer to a number of transactions that could result in a predecessor publicly held corporation for the purpose of contributing to the covered employee population. For certain transactions, only employees who are hired by the corporation within 12 months of the transaction will continue to be treated as covered employees of a successor.

A predecessor can also include the publicly held corporation itself if it was previously publicly held, became privately held, then again became publicly held within 36 months of the due date for the corporation's federal tax return (excluding extensions) for its last tax year as a publicly held corporation. This definition of predecessor also includes a privately held target corporation that was previously publicly held and joined an affiliated group with a public corporation within the applicable 36-month timeframe.

It is important to note that the addition of covered employees to this group is cumulative and will include covered employees of predecessors, as well as predecessors of predecessors, etc.

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Applicable Employee Remuneration

Section 162(m) disallows a deduction with respect to excess "applicable employee remuneration." Prior to the TCJA, exceptions existed for commissions and qualified performance-based compensation, allowing corporations to effectively ignore significant amounts of compensation payable to executive officers under certain circumstances, e.g., performance incentive plans and stock options. The TCJA eliminated these exceptions.

In line with the "once a covered employee, always a covered employee" rules, the statute clarifies and the proposed regulations reinforce that compensation can still qualify as applicable employee remuneration subject to section 162(m) limitations even if it is paid to or included in income of someone other than the covered employee. This category would include payments made to the beneficiary following the covered employee's death. In addition, compensation paid to a covered employee for services performed in a capacity other than as an executive officer remains subject to section 162(m). For example, if an officer retires and later returns to the corporation to serve as a director or independent contractor consultant, the payments for those services will continue to count toward the section 162(m) deduction limitations. However, compensation not treated as "wages" for FICA purposes, benefits reasonably believed to be excludable from employee income, and certain salary reduction contributions to nonqualified deferred compensation plans will not be considered applicable employee remuneration for purposes of section 162(m). This may open certain planning opportunities for companies to potentially delay until retirement payment of certain compensation by way of a supplemental executive retirement plan ("SERP"). Though the company would not be entitled to an immediate deduction in this case, a deduction may still be available after the covered employee retires, depending on other yearly benefits paid to the covered employee.

Lower-tier Partnership Compensation

The proposed regulations also provide guidance on compensation paid by a partnership to a covered employee of a corporate partner in a so-called "up-C" partnership structure. Reversing the position stated in several pre-TCJA PLRs, the proposed regulations provide that if a publicly held corporation is allocated a distributive share of a partnership's deduction for compensation paid to a covered employee for services to the partnership, that amount counts toward the corporation's section 162(m) deduction limitation with respect to that employee. This aspect of the compensation definition applies for tax years ending on or after December 20, 2019 (the date the proposed regulations were published in the *Federal Register*), meaning that it can have retroactive effect back to the beginning of that tax year (or, potentially, back to December 21, 2018, if an entity has a tax year end of December 20, 2019).

Treasury and the IRS acknowledge, however, that with the outstanding PLRs and in the absence of generally applicable guidance on this issue, taxpayers may have taken positions contrary to this rule; accordingly, the proposed regulations would allow some transition relief. The regulations state that this rule will not apply to compensation paid pursuant to a written binding contract in effect on December 20, 2019, and not materially modified thereafter. Compensation arrangements that may qualify for this relief should be carefully reviewed and considered, as any material modification of these arrangements could invalidate reliance on this relief and future compensation will not be protected by the transition rule.

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The proposed regulations provide an example illustrating the division of distributive shares of a partnership's deduction. Example 3 under (c)(3) of the proposed regulations: Corporation T is a publicly held corporation for the 2021 tax year, while Corporation S is a privately held corporation for that same year. The two corporations form a general partnership and each have a 50 percent distributive share of the income, loss, and deductions of the partnership. Employee D, a covered employee of Corporation T, performs services for the partnership and is paid $800,000. Pursuant to the partnership agreement $400,000 of the $800,000 deduction is allocated to Corporation T. As a result, $400,000 is applicable employee remuneration when determining the potential section 162(m) deduction disallowance and must be aggregated with other compensation paid to Employee D by Corporation T for that tax year.

Grandfathering Rules

The TCJA provides limited transition relief for "grandfathered" compensation. Remuneration is grandfathered to the extent it is provided pursuant to a written binding contract in effect on November 2, 2017 (the date the TCJA bill was introduced in the House), and was not materially modified after that date. Grandfathered amounts are subject to the pre-TCJA section 162(m) rules rather than the new, amended rules. Applying the pre-TCJA rules provides corporations with the opportunity to exempt certain compensation from the deduction limitation calculation, such as payments that satisfy the qualified performance-based compensation exception or payments made for a tax year when the recipient would not be considered a covered employee applying the pre-TCJA definitions.

Written Binding Contract

The proposed regulations continue to emphasize the importance of "applicable law" (such as state contract law) in determining whether compensation is payable pursuant to a written binding contract. The proposed regulations generally reflect the guidance communicated in Notice 2018-68, clarifying that amounts are payable under a written binding contract only to the extent that the corporation is obligated under applicable law to pay if the employee performs requires services or satisfies applicable vesting conditions. Corporations covered under section 162(m) may need to work with legal counsel to confirm whether—and to what extent—the corporation is obligated to pay under applicable law.

Treasury and the IRS declined to adopt the suggestion from commenters to incorporate a safe harbor treating amounts as subject to a written binding contract if accrued (or if they could have been accrued) as a cost under Generally Accepted Accounting Principles ("GAAP"). They did state, however, that further comments regarding the suggested safe harbor and how it could be implemented were welcome.

Many compensation arrangements provide the employer with some level of discretion regarding payment of the compensation, even if the language is considered boilerplate and the discretion is never exercised. While negative discretion provisions may affect whether or to what extent a written binding contract exists, the proposed regulations acknowledge that an arrangement may provide a corporation with greater negative discretion than applicable law would permit it to exercise. In these situations, applicable law may override the discretion. The proposed regulations further note that a corporation

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would not be treated as having current discretion solely because it may recover an amount at a later time if a condition outside of its control occurs after vesting and payment (e.g., the recipient commits fraud or the financial statements must be restated). When negative discretion is permitted by the plan or arrangement, a legal opinion may be needed to provide comfort with respect to the corporation's obligation to pay under applicable law.

The proposed regulations address certain specific types of compensation arrangements and components with respect to grandfathering. For example, they provide additional guidance and examples regarding account and non-account balance plans, as well as severance arrangements and the treatment of earnings for various arrangements.

Material Modification

A material modification generally occurs when the contract is amended to increase the compensation payable to an employee. All compensation-related actions should be considered carefully as other events—such as the effect of certain renewal provisions or adoption of a separate compensation arrangement—may be considered a material modification. The notice and proposed regulations provide additional clarification on what facts are considered a material modification for this purpose, generally adhering to the definition in the existing final regulations.

A material modification is generally considered to occur as a result of:

— Accelerated payments unless reasonably discounted to reflect the time value of money;

— Adoption of supplemental contracts that provide for payments of increased or additional compensation if payments are based on substantially the same elements or conditions as the original agreement; and

— Amendments that defer compensation if any amount paid exceeds the original amount payable, unless the additional amount is based on either a reasonable interest rate or predetermined actual investment.

However, a material modification is generally not considered to occur as a result of:

— Reasonable cost-of-living increases;

— Accelerated vesting; or

— Clawbacks.

When there is a material modification, it is treated as a new contract as of the date of the modification. The release clarifies that a material modification of one written binding contract does not automatically result in material modification of others.

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Ordering Rules

The proposed regulations provide ordering rules for nonqualified deferred compensation arrangements paid out in a series of payments. Grandfathered amounts are allocated to the first otherwise deductible payment paid under the arrangement; if the grandfathered amount exceeds the first otherwise deductible payment, grandfathered amounts continue to be allocated to the payments until those amounts are fully allocated.

Other Considerations

Privately Held Corporations that Become Publicly Held: Initial Public Offerings

The existing final regulations under section 162(m) include relief for corporations that are privately and become publicly held (e.g., through an initial public offering) for a limited transition period. The proposed regulations do not retain transition relief for privately held corporations that become publicly held despite the suggestion to do so from commenters.

In rejecting the suggestion, the preamble to the proposed regulations notes that transition relief was previously provided in response to a recognition that privately held corporations may have difficulty satisfying the requirements for a compensation arrangement to qualify for the performance-based compensation exception, notably the shareholder approval requirement. As this exception was eliminated by the TCJA, and therefore shareholder approval is irrelevant for section 162(m) purposes, the concern is no longer relevant.

Generally, the guidance applies section 162(m) for any compensation that is otherwise deductible for the tax year ending on or after the date the corporation becomes a publicly held corporation. A corporation is considered to become publicly held on the date that its registration statement becomes effective. In determining covered employees, the predecessor corporation rules should be considered. Corporations that were intending to rely on the previously existing IPO-transition rule should engage in early planning to determine if relevant compensation can be grandfathered under the existing rules or if other planning strategies exist to minimize any potential loss of deduction.

Section 409A Delayed Payments

The preamble acknowledges potential issues that could arise in coordinating the new perpetual covered employee status rules with section 409A provisions. Under section 409A, nonqualified deferred compensation ("NQDC") payments typically may not be further deferred or accelerated except in limited scenarios. One exception to this general rule permits a plan to delay payment of NQDC to the earliest tax year in which payment would not result in a lost deduction by reason of section 162(m). The discussion in the preamble to the proposed regulations states that corporations are permitted to delay payment of only the grandfathered amounts without triggering other section 409A concerns regarding subsequent deferrals.

Further, NQDC arrangements can be amended by December 31, 2020, to remove provisions requiring the corporation to delay payments of non-grandfathered amounts if the corporation reasonably

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anticipates at the time of the scheduled payment that the deduction would not be permitted under section 162(m); the amendment would neither result in an impermissible acceleration under section 409A nor be considered a material modification for purposes of section 162(m) grandfathering. If payments are required to be made as a result of this change to the plan, those payments must be made no later than December 31, 2020. Treasury and the IRS stated their intention to incorporate these modifications into the section 409A proposed regulations, but noted that taxpayers can rely on the preamble in the interim.

Effective and Applicability Dates

The guidance provided in the new regulations is proposed to become effective on the date the final regulations are published in the *Federal Register*, and to apply to compensation that is otherwise deductible in tax years beginning on or after that date. However, there are a handful of proposed "special applicability dates" generally tied on the date of the notice (September 10, 2018) or the date the proposed regulations were published (December 20, 2019). For example:

- Definition of covered employee generally would apply for tax years ending on or after September 10, 2018, with limited exception for corporations whose fiscal and tax years do not end on the same date
- Definition of predecessor would apply to corporate transactions for which all events necessary for the transaction have occurred on or after the final regulations are published
- Definition of compensation to include the allocable share of deductions for amounts paid by a lower-tier partnership to the covered employee of a corporate partner would apply to tax years ending on or after December 20, 2019, but not with respect to compensation paid pursuant to a written binding contract in effect on December 20, 2019 and not materially modified
- Privately held corporations that become publicly held before December 20, 2019, could continue to rely on the transition rules in the existing final regulations (e.g., IPO transition relief)
- The definitions of written binding contract and material modification would apply for tax years ending on or after September 10, 2018

The preamble to the proposed regulations states that taxpayers may choose to rely on the proposed regulations until final regulations become applicable provided that the proposed regulations are applied consistently and in their entirety. Further, it notes that except as provided by the special applicability dates, taxpayers may no longer rely on Notice 2018-68 for tax years ending on or after December 20, 2019 but may instead rely on the proposed regulations.

Next Steps

The deduction limitations of section 162(m) can have a meaningful impact on a corporation's tax compliance, financial statement preparation and compliance, as well as its compensation planning. The TCJA made significant amendments to the rules and application of section 162(m); guidance on how to

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interpret and apply these changes is still developing. It is important for companies to take steps to understand the requirements and limitations of section 162(m), including the expanded scope and limited transition relief in the wake of the TCJA, and how these rules and opportunities apply to the companies, their affiliated groups, and their compensation programs.

With the help of tax professionals and legal counsel, companies should take action to:

- Consider the application of section 162(m) in the context of all related entities including foreign entities and in light of the amended definitions of publicly held corporation;
- Review all existing and anticipated compensation plans and arrangements to:
    - Consider application to covered employees and potential impact of section 162(m)
    - Evaluate application of the grandfathering rules and whether opinions need to be updated. Track status to avoid making any changes to grandfathered arrangements
    - Evaluate whether earnings on grandfathered plans may also be grandfathered. Legal opinions may need to conclude whether company is obligated to pay earnings
    - Consider revisions to arrangements that were previously structured to satisfy requirements for qualified performance-based compensation as long as the revisions do not affect grandfathered arrangements;
- Consider application to REIT and "up-C" structures;
- Consider opportunities for structuring new arrangements to maximize deductibility;
- Consider the collateral impact of any new or amended arrangements on the covered employee pool as well as those that may eventually fall into the covered employee pool;
- Develop a process for identifying potential covered employees, including confirming methodology for calculating compensation of executive officers to determine highest paid three for each tax year;
- Determine the current pool of section 162(m) covered employees and maintain a database to track all covered employees (as well as potential covered employees) for tax years beginning after December 31, 2016; and
- Monitor ongoing developments in additional guidance and interpretations.

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