ALERT

January 6, 2020

IRS ISSUES COMPLEX PROPOSED REGULATIONS WITH RESPECT TO SECTION 162(m)

On December 16, 2019, the Internal Revenue Service (IRS) released proposed regulations on the changes to section 162(m) of the Internal Revenue Code (162(m)) enacted by the Tax Cuts and Jobs Act of 2017 (TCJA). The proposed regulations provide extensive guidance on a number of critical issues under 162(m), including in particular:

- What constitutes a publicly held corporation (public company) subject to 162(m).
- How the "covered employees" of a public company are determined, including extensive rules with respect to what constitutes a "predecessor corporation" whose covered employees need to be considered.
- Extensive guidance with respect to the exception from the new rules in the case of written binding contracts in effect on November 2, 2017.

Background

Perhaps the most surprising thing about the IRS's recently proposed regulations with respect to 162(m) is their length. These regulations provide guidance with respect to the changes to 162(m) made by the TCJA. For most public companies, the impact of the TCJA, while dramatic, did not seem overly complex. Prior to the TCJA, 162(m) limited the deductible compensation of covered employees. Covered employees were, generally speaking, the executive officers whose compensation had to be reported in the Summary Compensation Table in the proxy statement. The limit on deductible compensation was $1,000,000, but there was an exception for "performance-based compensation".[1]

The TCJA repealed the exception for performance-based compensation. The second major change was to modify the definition of a covered employee and provide that, instead of covered employee status being determined on an annual basis, once an individual was a covered employee that status was permanent, and even extended to beneficiaries of the employee.

The proposed regulations run 36 pages in the Federal Register and are the longest set of proposed IRS regulations in the executive compensation area since the Tax Code section 409A regulations were proposed in 2005. The scope of the changes is indicated by the fact that, instead of amending the current regulation

[1] The exception had many complexities, none of which this client alert will discuss in light of the exception's repeal.

governing 162(m), Treasury Regulations section 1.162-27, the proposed regulations include an entirely new regulation, section 1.162-33, to explain the new rules. This client alert will necessarily focus on describing the general topics covered in the proposed regulations and not attempt to be definitive.

Important topics covered in the proposed regulations include the following:

- Only public companies are subject to 162(m). The TCJA significantly expanded the definition of a public company and the regulations elaborate at length on the new rules.
- The definition of a covered employee was modified to both include a public company's principal financial officer (PFO) (previously excluded due to a drafting quirk in 162(m)) as were the technical rules with respect to determining covered employee status.
- Uncertainty has existed with respect to how 162(m) applies when a public company is a partner in a partnership that employs a covered employee of the public company (this arrangement is common the case of REITs). The regulations prospectively[2] provide that the compensation paid to the covered employee by the partnership is aggregated with compensation paid by the public company for deduction limitation purposes.
- A transition rule that previously existed for private companies that become public companies has been repealed.
- Extensive guidance is provided with respect to the transition rule in the TCJA that provides that the new rules do not apply to compensation payable under a written binding contract in effect on November 2, 2017.

The Expanded Public Company Definition

The pre-TCJA definition of a public company basically covered any corporation that "issued any class of equity securities required to be registered under section 12 of the Exchange Act." The new definition includes any corporation the securities of which are required to be registered under section 12 of the Exchange Act or that is required to file reports under section 15(d) of the Exchange Act, in each case determined on the last day of a company's fiscal year. One result is that a privately owned corporation that issues public debt is now a public company.

While the concepts of registration under section 12 of the Exchange Act and the determination of when an issuer is required to file reports under section 15(d) of the Exchange Act are not new or overly complex, the IRS provides 26 examples to illustrate the expanded public company definition. It is possible this approach was taken in light of the increased number of entities that could now be subject to 162(m), warranting greater discussion of some of the interpretative issues that existed under the older definition, but which were not considered as worthy of comment because they were relatively uncommon. For example, and as discussed further below, there are complex issues that arise when an affiliated group of companies has two or more companies that are public companies. This could arise under the proposed regulations if a company with

[2] The change does not apply to compensation paid pursuant to a written binding contract that is not materially modified after the date the proposed regulations are published in the Federal Register (December 20, 2019).

publicly owned equity has a subsidiary that issues publicly owned debt. In the past, 162(m) would only potentially apply if the subsidiary issued publicly held equity, which is much rarer.

Below are a few takeaways regarding the expanded public company definition:

- If a corporation owns a "disregarded entity" (for example, a wholly owned LLC), the securities issued by the disregarded entity are treated as issued by the parent; the same rule applies in the case of a qualified subchapter S subsidiary.
- The requirement to register securities under section 12 is deemed to apply when the initial registration statement is due, not when the requirement to file a registration statement arises.
- There is extensive discussion of some of the technical issues that arise with American depositary receipts (ADRs) since the registration of the ADR does not make 162(m) applicable to the corporation that has issued the securities subject to the ADR; this is because the ADR is not a security of the corporation, but of the depositary bank.

Worth more extended discussion are the issues that can arise when there is an affiliated group of corporations and (1) more than one corporation is a public company and (2) an individual is a covered executive with respect to more than one public company in the affiliated group.[3] Several examples in the regulations examine this situation. The most interesting of these examples reveals that in certain limited circumstances the deduction limit for the group is higher than $1 million.

This unexpected result is illustrated in IRS Example 18 and arises if an affiliated group contains two or more public companies and an executive (E) is a covered employee with respect to both public companies (A and B). In this case 162(m) is applied by treating the affiliated group as two separate groups for purposes of the $1 million limitation. So, if the executive is paid $2,100,000 million by A in Group 1 and paid $900,000 by B in Group 2, Group 1 loses $1,100,000 (the difference between $2,100,000 and $1,000,000) in deductions and Group 2 does not lose any deductions (because the amount paid is under $1,000,000). So, $1,900,000 million is deductible and $1,100,000 is nondeductible.

What is even more surprising is the proposed regulations' treatment of a situation where there is a third corporation (C). Suppose C is a third corporation in the affiliated group and C is not a public company (A and B are public companies). Assume A pays E $1,500,000, B pays E $900,000, and C pays E $600,000, so the total amount paid to E by the affiliated group is $3,000,000. Example 22 indicates that two separate groups are formed, the group (Group 1) consisting of A and C (total compensation of $2,100,000) and a group (Group 2) consisting of B and C (total compensation of $1,500,000). In this case Group 1 loses $1,100,000 in deductions (the difference between $2,100,000 and $1,000,000) and Group 2 loses $500,000 in deductions (the difference between $1,500,000 and $1,000,000), so total lost deductions are $1,600,000, reducing the deductible amount to $1,400,000, which is $500,000 worse than Example 18. It appears that, in effect, the compensation of E attributable to C ($600,000) is twice being taken into account.

[3] If the affiliated group contains only one public company, the $1 million deduction limit applies to the aggregated compensation paid to a covered employee by all members of the group.

This is the exact result of Example 22. We do not consider this result logical and expect commentators on the proposed regulations to criticize this result.

The Covered Employee Definition

Prior to the TCJA, covered employee status applied only to the principal executive officer (PEO) as of the end of the fiscal year and the three individuals who as of the end of the fiscal year were (1) executive officers, (2) employed, and (3) most highly paid (using the Summary Compensation Table methodology). The PFO was not counted.

The new rules now include (1) anyone who was a PEO or PFO at any time during the year, (2) the three executive officers who received the greatest amount of compensation during the year, regardless of whether they were employed at the end of the year or whether their compensation is subject to disclosure under the proxy rules, and (3) anyone who was previously a covered employee of the public company or any predecessor of the public company.

There are a lot of changes in the new definition, but perhaps the most complex change is the concept of a "predecessor corporation." Covered employee status was determined on a year-to-year basis before the TCJA and focused on which executives were listed in the Summary Compensation Table, so there was little need to think about predecessor issues. The new covered employee-for-life rule makes it important, however, to determine which corporations are predecessors of your public company, since the covered employee of that predecessor is now your covered employee—forever. The fact that the individual was never a covered employee of the ongoing public company is irrelevant.

Some of the predecessor categories in the new rules are:

- Any public company acquired in a corporate reorganization by another public company under Tax Code section 368(a)(1) (most standard corporate mergers, as well as acquisition of control through a stock or asset purchase, etc. are covered by this subparagraph).
- A public company that becomes privately held then public again before 36 months have elapsed since the due date of the tax return (ignoring extensions) for the last tax year when the corporation was a public company (this might occur if a private investor took the public company private and then took it public again before 36 months have elapsed).
    - This concept of a 36-month measuring period is extended to a number of other situations involving multiple corporations where one corporation is not a public company at the time of the transaction but later becomes a public company, for example, when a public company merges into a private corporation and that private corporation becomes a public company within the 36-month period.
- Executives of a public company (PC1) that spins off a subsidiary that itself becomes a public company (PC2) if the executives of PC1 join PC2 within 12 months prior to or 12 months following the spinoff.
- Any public company that joins an affiliated group with another public company.

- If a public company acquires 80% of the operating assets of another public company, the second public company is considered a predecessor of the first public company.
- If public company (PC1) is a predecessor to public company (PC2), and PC2 is a predecessor to public company (PC3), then PC1 is also a predecessor to PC3.
- Other rules cover certain transactions under section 336(e) and 338 of the Tax Code, publicly traded partnerships, disregarded entities (like certain LLCs), and qualified Subchapter S subsidiaries.

The IRS uses 31 examples to illustrate these rules, none of which appears to provide much color beyond the language of the rules.[4]

The "Written Binding Contract" Transition Rule

In Notice 2018-68 the IRS issued guidance on the application of the "written binding contract" exception to the 162(m) amendments.[5] The proposed regulations are consistent with Notice 2018-68, but include additional details with respect to the application of the transition rule.

Some of the key elements of the transition rules as explained in the proposed regulations are the following:

- An amount is "grandfathered" (not subject to the new 162(m)) only to the extent it had to be paid under the terms of the contract and applicable law as of November 2, 2017. Negative discretion to reduce the compensation may result in loss of grandfather status. Accordingly, if a bonus plan in existence on November 2, 2017 provided a target bonus based on satisfaction of specific metrics but reserved the company's discretion to pay a lesser amount or no bonus at all, none of the bonus would be subject to grandfathering. However, some portion of the bonus (or other payment) may be protected in cases where state law restricts or caps the exercise of discretion.
- If only a portion of a series of payments is grandfathered, payments are considered first made from the grandfathered portion. This might occur if a bonus plan provided for a target bonus of $1,000,000 if performance metrics were met, subject to a discretionary reduction to $400,000. If the $1,000,000 were earned, but paid in two equal annual installments, the $400,000 grandfathered amount would be considered paid from the first installment (with the remaining $600,000 not grandfathered as a result of available discretion).
- If a written binding contract is renewed after November 2, 2017, payments under the renewed contract are not grandfathered. A written binding contact is considered renewed in situations where the contract is automatically extended absent notice of termination, with the renewal date being calculated as of the earliest date the contract could have been terminated.

[4] While the examples did not contain any substantive surprises relative to the language in the rules, several left us confused. In Examples 18 and 21, employees RR and AAA, respectively, appear to be treated as covered employees even though they joined the relevant company more than twelve months before the relevant transaction (RR joined April 1, 2020 and the relevant transaction was June 30, 2021; AAA joined January 15, 2021 and the relevant transaction was January 31, 2022). In Example 24, it appears to us that the last sentence of the first paragraph should reference Corporation DDD, rather than EEE. Also, in Example 25, it is not clear to us why application of the 36-month rule results in April 15, 2025 as the date before which Corporation GGG had to become a public company, rather than April 15, 2026.

[5] The FW Cook Alert on September 7, 2018 discussed this Notice.

- The existence of a "clawback" or "recoupment" right does not necessarily preclude a contract from being grandfathered (and is not treated as negative discretion). Specifically, if a company has discretion to recover previously paid compensation under a written binding contract upon the occurrence of a future event that is objectively determinable and outside of the company's control, this does not affect the grandfathered status of the payments unless the future event occurs. If the event occurs, the grandfathered status of the initial payment is limited to the amount that cannot be recovered (per the terms of the contract).
    - The examples in the proposed regulations indicate that this rule was intended to deal with the potential application of clawback policies triggered by financial restatements, "bad boy" type behaviors post-termination, or similar circumstances. The examples appear to indicate that the application of this rule might require the filing of an amended tax return by the corporation. For example, if payment is made in 2020 of $1,000,000 under what would otherwise have been a written binding contract and a triggering event occurs in 2022 that allows the corporation to recover in its discretion up to $600,000, it appears that the 2020 return needs to be amended to show that only $400,000 (of the originally grandfathered $1,000,000 payment) was deductible (assuming that other compensation was at least $1,000,000). This would appear to be the result even if the corporation recovers $600,000 in 2022 (it is not at all certain that the recovery could be excluded from income by the corporation in 2022).
- A material modification of a written binding contract is treated as occurring if a supplemental contract is adopted that provides for increased compensation or a payment of additional compensation is made and "circumstances demonstrate that the additional compensation to be paid is based on substantially the same elements or conditions as the compensation that is otherwise paid pursuant to the written binding contract." For example, if a PFO had a written binding contract in effect on November 2, 2017 providing a salary of $1,000,000 per year, any increase in the amount of the annual salary (except for amounts considered a "reasonable cost-of-living increase") loses the grandfather exception for the entire amount, whether the increase occurs through a contract amendment or otherwise. This loss of grandfather protection would also apply to any elements of compensation based on salary, for example, if severance pay equal to two times salary were grandfathered, the increase in salary (if above reasonable cost-of-living) would also strip the severance pay from grandfathered status.
- Accelerating *the payment* of grandfathered compensation (including equity) is a material modification unless the amount of compensation paid is discounted to reasonably reflect the time value of money. On the other hand, modifying a contract to *accelerate vesting* (remove a substantial risk of forfeiture) is not a material modification. Example 24 illustrates the interplay of these two concepts. The written binding contract provided for a payment of $2,000,000 on July 14, 2020 if the employee serves as the PFO through that date. The contract is amended November 29, 2019 to provide for immediate vesting and payment. Even though payment is made without any discount, the payment is treated as grandfathered.

Several of the 24 examples illustrating the written binding contract exception demonstrate how the grandfathered amount is computed if the written binding contract exception applies. A couple of points struck us as noteworthy:

- Amending a written binding contract to defer the payment date for an amount is not a material modification if the deferred amount is not increased by more than a reasonable rate of interest or the rate of return on a predetermined investment. Earnings credited on deferred compensation, severance payments, and other compensatory amounts may be grandfathered only to the extent a company is obligated to pay such amounts under a written binding contract as of November 2, 2017 and pursuant to applicable law. Several examples deal with the amount of earnings that are grandfathered.
    - Example 7 concerns a written binding contract to pay $2,000,000 of salary to a PFO for 2018 through 2020. The PFO elected to defer $200,000 of the 2019 salary, and $250,000 (reflecting earnings based on the S&P 500 Index) is paid December 15, 2020. The initial contract was entered into prior to November 2, 2017, but the PFO made the deferral election in 2018. The earnings are not grandfathered, despite being based on a predetermined investment measure, apparently because, as of November 2, 2017, there was no obligation to pay any earnings on the amount deferred.
    - Example 17 also concerns an account balance plan, but this time the deferral arrangement was entered into before November 2, 2017. This example highlights the interplay of section 162(m) with a regulation under section 409A[6] that provides that, when a company retains the right to terminate a deferred compensation plan, the account balance cannot be paid out for 12 months. Importantly, Example 17 appears to differ from Example 7, because the deferral was entered into prior to November 2, 2017, and "under the plan terms and applicable law, if [the employer] terminates the plan, then it is obligated to pay any earnings that accumulated through the date of payment." Accordingly, the grandfathered amount includes earnings accumulated through November 2, 2018 (reflecting the earnings the company was obligated to pay if it had terminated the plan on November 2, 2017).
    - Similarly, Example 13 applies this same regulation to a grandfathered plan that is a nonaccount balance type plan. The plan provided a termination benefit equal to 25% of base pay for each year of service. As of November 2, 2017, the executive had base pay of $2 million and five years of service, which might suggest the grandfathered amount was $2,500,000 (125% of $2,000,000). Instead, the grandfathered amount is $2,575,000, the additional $75,000 reflecting the interest that would be earned over 12 months at a reasonable rate of interest (3%). The key to this result appears to be the statement in the example that "under applicable law, if an employer terminates a NQDC plan and does not make payment until 12 months after the date of termination, then, to reflect the time value of money, the employer is obligated to pay a reasonable rate of interest (compounded annually) on any benefit accrued under the plan at the date of termination until the date of payment."

[6] Treasury Regulations section 1.409A-3(j)(4)(ix)(C)(3).

- Severance is grandfathered under a written binding contract only to the extent the company was obligated to pay the amounts and the components, each as of November 2, 2017, and any severance increases due to discretionary base salary increases after such date lose grandfathering protection. Each component of severance will be analyzed separately.

Effective Dates

Reflecting the complexity of the proposed regulations, there are six different effective dates. The general effective date is for taxable years beginning after the date of publication of the final rule. In certain cases, however, the rules are intended to be effective upon a different date. These exceptions are for:

- The definition of covered executives - generally applies to taxable years ending on or after September 10, 2018, with an alternative effective date of taxable years beginning on or after December 20, 2019 in certain situations for public companies whose fiscal year and taxable year do not end on the same date.
- Certain situations involving the definition of a predecessor public companies - generally applies with respect to corporate transactions for which all events necessary for the transaction occur on or after publication of the final rules and until then taxpayers may rely on the proposed regulations or a reasonable good faith interpretation of the term "predecessor."
- The definition of compensation in the case of allocable shares of partnership deductions - generally applies for any deduction for compensation that is otherwise allowable for a taxable year ending on or after December 20, 2019, with a transition rule for compensation paid pursuant to a written binding contract in effect on December 20, 2019.
- Certain situations involving corporations that go from privately held to public company status - generally applies for corporations that become publicly held after December 20, 2019.
- The definitions of written binding contract and material modification - generally applies to taxable years ending on or after September 18, 2018.

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