SULLIVAN & CROMWELL LLP

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IRS Releases Proposed Regulations on the Limitation on Deduction for Executive Compensation

Proposed Regulations Widen Scope of Section 162(m), Include Significant Guidance Related to Partnerships and Generally Adopt the Grandfathering Provisions Contained in Notice 2018-68

SUMMARY

The IRS released proposed regulations (the "Proposed Regulations") on December 16, 2019, which provide proposed rules with respect to changes made by the Tax Cuts and Jobs Act of 2017 (the "TCJA") to the Internal Revenue Code (the "Code") limitation on the deduction for executive compensation.

Section 162(m) of the Code generally imposes a $1 million deductibility limit on compensation paid to "covered employees" of a "publicly held corporation" for any taxable year, unless an exception applies. Section 162(m) was significantly amended by the TCJA, which removed a long-standing exemption for certain performance-based compensation, expanded the definitions of "covered employee" and "publicly held corporation" and provided a transition rule applicable to certain arrangements outstanding as of November 2, 2017, referred to as the "grandfather rule."

The Proposed Regulations provide guidance on these provisions and propose additional changes to the application of Section 162(m). Notably, the Proposed Regulations would (1) eliminate the Section 162(m) IPO transition relief; (2) expand a corporation's covered employee population to include covered employees of an acquired corporation; (3) provide that Section 162(m) applies to a corporation's distributive share of a partnership's deduction for compensation paid by a partnership (for example, in an "Up-C" structure); and (4) provide that Section 162(m) may apply to foreign private issuers.

BACKGROUND

Section 162(m)

Under Section 162(m), the deduction of a "publicly held corporation" (a "Publicly Held Corporation") for "applicable employee remuneration" paid to "covered employees" ("Covered Employees") is limited to $1 million. Prior to the changes imposed by the TCJA, the IRS interpreted "covered employee" to mean the CEO of a Publicly Held Corporation and its three highest-compensated officers, other than the CEO and CFO, based on an annual determination that was applied on the last day of the applicable taxable year.

The statute provided a long-standing exception to the deduction limitation for commissions and performance-based compensation, including stock options, so long as certain conditions were met, including approval of performance-based compensation by a compensation committee of the board of directors consisting of two or more outside directors.

TCJA Amendments to Section 162(m)

The TCJA[1] amended Section 162(m) significantly by (1) removing the performance-based pay exception, (2) broadening the definition of Covered Employees to include the CEO, CFO, the three other highest-compensated executive officers and any individual who was a Covered Employee for any taxable year beginning after 2016, and (3) expanding the definitions of "publicly held corporation" and "applicable employee remuneration."

Under the grandfather rule, the TCJA amendments do not apply to compensation paid pursuant to a written binding contract in effect on or prior to November 2, 2017, so long as the contract is not modified in any material respect or renewed.

Notice 2018-68

The IRS released Notice 2018-68 ("Notice 2018-68") on August 21, 2018,[2] which provided initial guidance on the TCJA's changes to Section 162(m). The Notice clarified the definition of Covered Employee under the amended Section 162(m), provided guidance on the operation of the grandfather rule and requested comments on several issues.

THE PROPOSED REGULATIONS

1. Expansion of Publicly Held Corporations Subject to Section 162(m)

General Definition. Prior to the TCJA, a Publicly Held Corporation under Section 162(m) was any corporate issuer of common equity securities required to be registered under section 12 of the Securities Exchange Act of 1934 (the "Exchange Act"), i.e., any company which listed its common equity securities on a national securities exchange. The TCJA amended the definition of Publicly Held Corporation to be any corporation which is an issuer of <u>any</u> class of securities required to be registered under section 12 of the Exchange Act <u>or</u> that is required to file reports under section 15(d) of the Exchange Act.

The Proposed Regulations provide that whether a corporation is subject to either of these requirements would be determined as of the last day of the corporation's taxable year. If a corporation's obligation to file reports under section 15(d) of the Exchange Act is suspended at that time, the corporation would not be treated as required to file reports.

Foreign Private Issuers May Be Subject to Section 162(m). The IRS previously ruled in private letter rulings that Section 162(m) did not apply to foreign private issuers, which are not required to file a summary compensation table under Exchange Act rules. The Proposed Regulations provide that a foreign private issuer that is required to register its securities under section 12 of the Exchange Act or to file reports under section 15(d) of the Exchange Act would be subject to Section 162(m). For example, the Proposed Regulations provide that a foreign private issuer that issues American Depositary Receipts ("ADRs") would be a Publicly Held Corporation if the issuer is required to register the securities underlying the ADRs pursuant to section 12 of the Exchange Act.

Application to Publicly Traded Partnerships and Disregarded Entities. The Proposed Regulations provide that a publicly traded partnership that is generally treated as a corporation for purposes of the Code could qualify as a Publicly Held Corporation, but a publicly traded partnership that is not so treated could not be a Publicly Held Corporation. In addition, under the Proposed Regulations, an entity that is a disregarded entity for tax purposes but that is owned by a privately held corporation could cause such corporation to be treated as a Publicly Held Corporation for purposes of Section 162(m) if the disregarded entity is an issuer of securities required to be registered under section 12 of the Exchange Act or is required to file reports under section 15(d) of the Exchange Act. The preamble to the Proposed Regulations (the "Preamble") notes that the general anti-abuse rule in the Code applicable to the use of partnerships could apply where a corporation turns a disregarded entity into a partnership in an attempt to circumvent the foregoing rule.

Application to Affiliated Groups. The Proposed Regulations would revise the treatment of affiliated groups that applies under the existing Treasury Regulations: currently, for purposes of Section 162(m), an affiliated group of corporations may be treated as a single Publicly Held Corporation, except that a subsidiary that is itself a Publicly Held Corporation is separately subject to Section 162(m), with the result that a privately held parent corporation does not become subject to Section 162(m) by virtue of its affiliated subsidiary's qualification as a Publicly Held Corporation. Under the Proposed Regulations, a privately held parent corporation and a publicly held subsidiary would be treated as a single affiliated group that may be subject to Section 162(m).

The Proposed Regulations also provide that in the case of a single affiliated group that contains multiple Publicly Held Corporations, each Publicly Held Corporation would be separately subject to Section 162(m), and the affiliated group as a whole would also subject to Section 162(m). The Proposed Regulations provide rules that address the proration of the deduction disallowance under Section 162(m) in situations in which a Covered Employee is paid compensation by more than one Publicly Held Corporation in a single affiliated group.

The treatment of affiliated groups under the Proposed Regulations is a departure from the treatment in the existing Treasury Regulations issued under Section 162(m), which provide that a publicly held subsidiary and a publicly held parent are separately subject to Section 162(m). The testing of multiple publicly held affiliates as a single group could be significant in a situation where an employee qualifies as a Covered Employee of a publicly held subsidiary and receives compensation from the publicly held parent, even though such employee is not a Covered Employee of the publicly held parent. The definition of Covered Employee in the Proposed Regulations, as discussed in more detail below, provides that a Covered Employee of a Publicly Held Corporation (as determined on a stand-alone basis) would also be a Covered Employee of the affiliated group that contains the Publicly Held Corporation.

IPO Transition Relief Eliminated. The existing Treasury Regulations issued under Section 162(m) provide that Section 162(m) generally does not apply to compensation paid pursuant to a compensatory plan or agreement that existed during the period in which a Publicly Held Corporation was not publicly held and the terms of which were disclosed to shareholders in the prospectus accompanying the IPO. According to the Preamble, the transition rule existed primarily to enable newly public corporations to satisfy the requirements for the exception for performance-based compensation.

The Proposed Regulations would eliminate this transition rule because performance-based compensation is no longer subject to an exception from the Section 162(m) deduction limitation. As a result, the deduction limitation of Section 162(m) would apply to any compensation that would otherwise be deductible for the taxable year ending on or after the date that the corporation becomes a Publicly Held Corporation, which would be deemed to be on the date that the corporation's registration statement becomes effective.

2. Expansion of Covered Employee Population

General Definition. The TCJA amended the definition of Covered Employee to provide that the deduction limitation applies to the CFO, in addition to the CEO and the top three highest-paid officers. The TCJA also provides that any employee who was a Covered Employee of the taxpayer (or any predecessor) for any taxable year beginning after December 31, 2016 would remain a Covered Employee going forward.

The Proposed Regulations clarify that a former employee would continue to be treated as a Covered Employee following the termination of employment. An executive officer of a disregarded entity would not be treated as an executive officer of the 100% owner of the disregarded entity for purposes of determining whether such executive officer is a Covered Employee of a Publicly Held Corporation.

Interaction with SEC Rules. Consistent with guidance issued in Notice 2018-68, the top three highest-paid officers (other than the CEO or CFO) of a Publicly Held Corporation would be treated as Covered Employees under the Proposed Regulations even if the officers' compensation is not required to be disclosed under SEC rules. For example, the top three highest-paid officers of emerging growth companies, which are permitted to disclose the compensation of fewer executive officers under SEC rules, would be Covered Employees under the Proposed Regulations. As a result, executive officers of Publicly Held Corporations may be Covered Employees (and would remain Covered Employees in the future) even when SEC rules do not require annual proxy disclosure of their compensation.

Also consistent with Notice 2018-68, the Proposed Regulations provide that the definition of Covered Employee would apply without regard to whether an individual is an employee as of the end of the taxable year, notwithstanding that the SEC proxy disclosure requirements for larger reporting companies in Item 402 of Regulation S-K provide for different reporting requirements for certain executive officers depending on whether such officers were serving at the end of the company's fiscal year.

Where a corporation's fiscal year and taxable year are different, the Proposed Regulations require that the amount of compensation used to identify the most highly compensated executive officers of a corporation would be determined pursuant to the executive compensation disclosure rules of the Exchange Act using the corporation's taxable year rather than the fiscal year.

Covered Employees of Acquired Companies and Predecessor Corporations. The TCJA amendments to Section 162(m) provide that a corporation's Covered Employees include any Covered Employee of a predecessor of the corporation for any tax year beginning after December 31, 2016. The Proposed Regulations provide guidance regarding the circumstances in which one corporation would be treated as the "predecessor" of another corporation for purposes of determining whether a Covered Employee of the first corporation would be a Covered Employee of the second corporation going forward.

The Covered Employees of a target corporation acquired in certain transactions would become the Covered Employees of the acquiring corporation. Specifically:

- **Corporate Reorganizations and Stock Acquisitions**: The Covered Employees of a Publicly Held Corporation that is acquired in corporate reorganization under Section 368(a)(1) of the Code, or that becomes part of the acquiring corporation's affiliated group (for example, through a stock acquisition), would be the Covered Employees of the acquiring corporation.
- **Asset Acquisitions**: If at least 80% of the operating assets of a Publicly Held Corporation are acquired by another Publicly Held Corporation, then the Covered Employees of the target who become employees of the acquiring corporation within 12 months before or after the acquisition would be Covered Employees of the acquiring corporation. Asset acquisitions within any 12-month period would be aggregated for purposes of determining whether at least 80% of the target's operating assets are acquired.
- **Spin-Offs**: The Covered Employees of a Publicly Held Corporation that was a distributing corporation in a tax-free spin-off who begin performing services for the spun-off corporation (or certain affiliates of the distributed corporation) within 12 months before or after the spin-off would be Covered Employees of the spun-off corporation.

These rules would apply to transactions that close on or after the date on which the final rules are published in the federal register.

Under the Proposed Regulations, a predecessor of a Publicly Held Corporation also would include (A) the corporation itself, if the corporation previously was a Publicly Held Corporation, became privately held, and again became publicly held within three years of the last taxable year in which the corporation first was publicly held; and (B) a predecessor of a predecessor.

3. Compensation Paid by Partnerships to Covered Employees is Potentially Subject to Section 162(m)

Private letter rulings issued by the IRS between 2006 and 2008 stated that if a Publicly Held Corporation is a partner in a partnership, then Section 162(m) does not apply to the corporation's distributive share of the partnership's deduction for compensation paid by the partnership for services performed for the partnership.

Under the Proposed Regulations, Section 162(m) would apply to a Publicly Held Corporation's distributive share of a partnership's deduction for compensation paid by the partnership for services performed by a Covered Employee, including where the payment is treated for tax purposes as a "guaranteed payment." The Preamble acknowledges that this proposed rule would mark a departure from the private letter rulings previously issued by the IRS. Neither the Preamble nor the Proposed Regulations suggest that the rule introduced by the Proposed Regulations would apply with respect to an allocation of partnership income by a partnership to a partner who is also an employee of the partnership or a partner of the partnership.

The rule contained in the Proposed Regulations would apply to any deduction for compensation that is otherwise allowable for a taxable year ending on or after December 20, 2019 but would not apply to compensation paid pursuant to a "written binding contract" in effect on December 20, 2019 that is not "materially modified" after that date. The meaning of these terms is discussed in the next section.

The Treasury Department and IRS request comments on whether similar rules should apply to trusts.

4. Grandfather Rule

Under the grandfather rule, the TCJA's amendments to Section 162(m) do not apply to "a written binding contract" in effect on November 2, 2017, which is not modified in any material respect on or after that date. The Proposed Regulations substantially incorporate the approach taken in Notice 2018-68 to the application of the grandfather rule.

Written Binding Contract. For purposes of determining whether a contract is covered by the grandfather rule, the Proposed Regulations provide that compensation is payable under a written binding contract only to the extent that applicable law (for example, state contract law) obligates the corporation to pay compensation under the contract if the employee performs services or satisfies the applicable vesting conditions.

Written binding contracts that are terminable or cancelable by the corporation without the employee's consent after November 2, 2017, even if renewal or extension would occur automatically without action being taken by the corporation, would be treated as "renewed" as of the earliest date that the termination or cancellation would be effective.

- If a contract provides that it will be terminated or canceled as of a certain date unless either party elects to renew within 30 days of that date, the contract would be treated as renewed as of that date, unless the contract is actually renewed prior to that date, in which case the contract would be treated as renewed on that earlier date.
- A contract that may be renewed or terminated beyond a certain date at the sole discretion of the employee would not be treated as renewed if the employee exercises discretion to continue the corporation's obligations under the contract.
- In addition, a contract that can be terminated or canceled only by termination of the employee's employment would not be treated as "terminable or cancelable."
- If employment continues after the termination or cancelation of a contract, then the contract would not be treated as "renewed"; however, payments made to the employee after termination or cancelation would not be grandfathered.

A binding compensation plan or arrangement in effect on November 2, 2017 would be treated as grandfathered for an employee who was not eligible to participate in the plan or arrangement as of November 2, 2017, if the employee was employed on November 2, 2017 by the corporation that maintains the plan or arrangement or if the employee had a right to participate in the plan or arrangement under a written binding contract as of that date.

Material Modification. The rules in the Proposed Regulations for determining whether a "material modification" to a written binding contract (a "Material Modification") has been made after November 2, 2017 also closely adhere to the guidance contained in Notice 2018-68. Under the Proposed Regulations, a Material Modification would cause a contract to be treated as a new contract that is subject to the TCJA's amendments to Section 162(m) as of the date of the Material Modification.

- **Amendments to Increase or Accelerate Compensation**. An amendment to a written binding contract to increase the compensation payable to the employee generally would result in a Material Modification (other than increases equal to or less than a reasonable cost-of-living adjustment). Amendments that accelerate the time of payment under the contract also would constitute Material Modifications unless the amount of compensation paid is discounted to reasonably reflect the time value of money. Adoption of a supplemental contract or agreement that provides for increased or additional compensation would not be treated as a Material Modification unless the facts 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.
- **Amendments to Defer Payment**. If a contract is modified to defer payment, any compensation paid in excess of the amount originally payable under the contract would not be treated as resulting in a Material Modification if the excess amount is based on applying to the original amount either a "reasonable rate of interest" or the rate of return on a "predetermined actual investment" (whether or not assets are actually invested).

- **Impact of Employer Discretion**. Compensation is not payable pursuant to a written binding contract to the extent that the corporation has discretion to reduce or claw back the compensation, and that discretion is permissible under applicable law. Under the Proposed Regulations, a clawback that is only triggered upon a condition that is objectively outside of a corporation's control (for example, if an employee is convicted of a felony) would not result in the corporation being deemed to have discretion.
- **Failure to Exercise Negative Discretion**. The failure, in whole or part, to exercise "negative discretion" under a contract would not result in a Material Modification. The Proposed Regulations provide an example illustrating the application of this exception, wherein a corporation's bonus plan that was in place prior to November 2, 2017 provides for an employee to be paid a bonus of $1,500,000, which amount the compensation committee retains the right to reduce at its discretion, but not below $400,000. If the committee exercises negative discretion to reduce the award to $500,000, Section 162(m) does not apply to $400,000 of the $500,000 payment.
- **Vesting Acceleration is Not a Material Modification**. A modification to the contract that results in a lapse of a substantial risk of forfeiture would not be a Material Modification.

Severance Arrangements**.** The Proposed Regulations provide that severance would be grandfathered only to the extent that it is calculated based on compensation elements that the corporation was required to pay under the contract as of November 2, 2017. The grandfathered amount of severance would not include the portion of severance calculated based on discretionary increases in salary after November 2, 2017 (even where the discretionary increases do not constitute a Material Modification) and discretionary elements of pay (for example, discretionary bonuses).

5. Coordination with Section 409A

The Preamble contains guidance that addresses the interaction of Section 162(m) and Section 409A of the Code following the TCJA. Under the Treasury Regulations applicable to Section 409A, a payment under a nonqualified deferred compensation ("NQDC") plan that would be subject to Section 162(m) generally may be delayed until the payment of such amount would no longer be nondeductible under Section 162(m). The Preamble states that the IRS intends to issue proposed regulations that provide that where a service recipient has discretion to delay a scheduled payment under a NQDC arrangement, the service recipient may delay the scheduled payment of grandfathered amounts under Section 162(m) without delaying the scheduled payment of non-grandfathered amounts, and the delay of grandfathered amounts will not be required to comply with the Section 409A requirements for "subsequent deferral elections."

Additionally, the Preamble notes that the IRS intends to issue proposed regulations that provide that if a NQDC arrangement is amended to remove a provision requiring the corporation to delay a payment if the corporation reasonably anticipates that deduction for the payment would not be permitted under Section 162(m), that amendment would not result in an impermissible acceleration of payment under Section 409A and would not be treated as a Material Modification of a grandfathered amount for purposes of Section 162(m). Any such plan amendment must be made no later than December 31, 2020.

6. Applicability Dates and Request for Comment

The Proposed Regulations generally would apply to tax years beginning on or after the date that final regulations are published in the federal register. However, certain provisions of the Proposed Regulations would apply as of an earlier date. The definition of Covered Employee and the grandfather rule contained in the Proposed Regulations would apply to taxable years ending on or after September 10, 2018. The portion of the definition of "compensation" that relates to allocable shares of partnership deductions for compensation paid by the partnership would apply to deductions for compensation otherwise allowable for a taxable year ending on or after December 20, 2019, except that such definition would not apply to compensation paid pursuant to a written binding contract in effect on December 20, 2019 that is not subject to a Material Modification after that date.

The IRS requests comments on the Proposed Regulations. Written or electronic comments to the Proposed Regulations must be received by the IRS by February 18, 2020.

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ENDNOTES

1 Section 13601 of Pub. L. 115-97, 131 Stat. 2054 (2017). *See* our memorandum to clients "U.S. Tax Reform," dated December 20, 2017.

2 *See* our memorandum to clients "IRS Releases Initial Guidance on the 2017 Amendments to the Internal Revenue Code's Limitation on Deduction for Certain Executive Compensation," dated August 23, 2018.

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