December 19, 2019

IRS Issues Proposed Regulations on Section 162(m) Amendments

The IRS on December 16 issued proposed regulations implementing the provisions of the 2017 Tax Cuts and Jobs Act that significantly expanded the scope of the $1 million per executive annual limitation on the deductibility of compensation paid to specified executives under §162(m) of the Internal Revenue Code (the "Code"). The proposed regulations supersede the IRS's 2018 transition guidance set forth in Notice 2018-68, and may be relied upon until the issuance of final regulations. The proposed regulations generally preserve the key terms of the transition guidance, but include significant new rules that broaden the application of §162(m).

Covered Employees Generally. Under the amended statute, an employee subject to the $1 million limit in one year generally will remain a covered employee for future years. The proposed regulations confirm that covered employee determinations, unlike for proxy statement purposes, disregard whether an executive remains employed at the end of the year. The proposed regulations also contain various technical rules regarding covered employee determinations. Companies should be careful to separately track their executives–both current and former–for proxy statement and §162(m) purposes.

Covered Employees of Predecessors. The proposed regulations provide an elaborate framework for determining when a public company must treat an individual as a covered employee by virtue of the person having been a covered employee of a predecessor of the public company. The rules vary based on transaction context, but generally sweep quite broadly. Former covered employees of a public company that is acquired by another public company, or at least 80% of whose assets are sold to a public company, will generally become covered employees of the acquirer. In the spinoff context, covered employees of the distributing corporation will generally continue to be covered employees at their post-spinoff employer. Additionally, public companies that are taken private but become public again within three years of their prior final public company tax return will be required to treat formerly covered employees as covered employees. These rules further exacerbate the unfortunate impact of §162(m) in creating a competitive imbalance between public and private companies.

Expansion of Impacted Companies. Significantly, the proposed regulations expand the scope of corporations subject to §162(m), including the potential coverage of foreign private issuers, companies with public debt, and

partnerships, and also confirm that newly public companies are no longer eligible for transition relief. In a reversal of prior IRS guidance, the proposed regulations apply §162(m) to a public corporation's distributive share of a deduction for compensation paid by a partnership to the corporation's covered employees, subject to certain grandfathered arrangements in effect on December 20, 2019.

Impact on Other Tax Provisions. The proposed regulations provide that the §162(m) deduction limit is reduced by any payments to a covered employee rendered nondeductible by the golden parachute deduction limitation under §280G of the Code. In addition, the new rules have raised concerns that compensation which §409A of the Code permits to be deferred until it becomes deductible, may never be deductible under §162(m), resulting in a perpetual deferral. The proposed regulations do provide transition relief for this concern, permitting amendment of deferred compensation arrangements prior to December 31, 2020 to remove such deferral provisions.

Grandfathered Arrangements. The proposed regulations generally preserve the key rules set forth in the transition guidance with respect to qualification of written binding contracts in effect on November 2, 2017 for grandfathering, and the rules governing material modifications of such arrangements. See our memorandum of August 23, 2018 for a fuller discussion of these issues. In a welcome development, the proposed regulations confirm that acceleration of a service-based vesting condition will not constitute a material modification that would "de-grandfather" a legacy arrangement. The proposed regulations also clarify the treatment of severance under a grandfathered arrangement and clarify that installment payments which encompass both grandfathered and non-grandfathered amounts, will be deemed to distribute grandfathered amounts prior to non-grandfathered amounts.

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The proposed regulations underscore that the 2017 statutory changes have overhauled the §162(m) landscape. This new regime has resulted in a significant increase in disallowed tax deductions. However, companies have generally accepted this result as a necessary consequence of the competitive marketplace for talent, and preservation of deductions under the new §162(m) has not been a driver of compensation design. Companies should continue to carefully track their covered employee population, avoid unnecessary classification of employees as executive officers, and avoid non-essential amendments to grandfathered arrangements that could be viewed as material modifications.

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