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IRS Issues Much Anticipated Proposed Regulations Under Section 162(m)

December 20, 2019

On Monday, December 16, 2019, the IRS issued **proposed regulations** under Section 162(m) of the Internal Revenue Code to reflect certain changes that were made to Section 162(m) by the Tax Cuts and Jobs Act of 2017.

Background

Under Section 162(m), compensation paid to a publicly held corporation's "covered employees" that exceeds $1 million per year for any covered employee is non-deductible. Among other changes, the act amended Section 162(m) to expand the scope of covered employees and eliminate the qualified performance-based compensation exemption from the $1 million deduction limit.

The amended rules under Section 162(m) apply to taxable years beginning on or after January 1, 2018. However, the act provides transition relief under which certain compensation paid pursuant to a written binding contract in effect on November 2, 2017, will be grandfathered and not subject to the amended rules, provided that the contract is not materially modified on or after that date.

As discussed in our prior **Cooley alert**, the IRS issued **Notice 2018-68** in 2018, which provided guidance on the amended rules for identifying covered employees and the operation of the grandfather rule. In the notice, the IRS also requested comments on various other issues regarding Section 162(m), including the reliance period exemption for newly public corporations (as described below).

Proposed regulations

The proposed regulations are generally consistent with the changes made by the act and the guidance provided in the notice. However, the proposed regulations clarify certain issues addressed by the act or the notice and also provide guidance on certain issues that were not addressed by the act or the notice, including the following:

- **Reliance period exemption for newly public corporations:** Under the current regulations, certain compensation paid by newly public corporations is exempt from the $1 million deduction limit for a certain period of time after the corporation becomes publicly held.

  The proposed regulations eliminate this exemption for any corporation that becomes publicly held on or after December 20, 2019. For any such corporation, the $1 million deduction limit would apply to any compensation that is otherwise deductible for the taxable year ending on or after the date that the corporation becomes publicly held (which would also mean that certain compensation paid for such taxable year prior to the date that the corporation becomes publicly held would be subject to the $1 million deduction limit). The exemption under the current regulations continues to apply to corporations that became publicly held before December 20, 2019.
- **Grandfather rule – vesting acceleration:** Under the grandfather rule, if a contract is materially modified on or after November 2, 2017, it will no longer qualify for grandfathering. Under the proposed regulations, the IRS clarified that for all forms of compensation (including equity award compensation), a modification to a contract that accelerates vesting would not be considered a material modification (and, therefore, would not disqualify the compensation from being grandfathered).

- **Grandfather rule – safe harbor for written binding contract:** The notice provided that for purposes of the grandfather rule, compensation is considered payable under a written binding contract only to the extent that the corporation is obligated under applicable law (for example, state contract law) to pay the compensation if the applicable service or vesting conditions are met. The determination of whether a contract constitutes a written binding contract is determined under applicable law.

  In the preamble to the proposed regulations, the IRS acknowledged that making this determination under applicable law may be burdensome and noted that some commenters to the notice had suggested a safe harbor as an alternative. Under the suggested safe harbor, any arrangement in effect on or before November 2, 2017, would be treated as a written binding contract if the compensation payable under the contract was accrued (or could have been accrued) as a cost under GAAP, regardless of whether the corporation is obligated to pay the compensation under applicable law. The proposed regulations do not adopt this safe harbor and instead retain the standard set forth in the notice. However, the IRS stated that it would "welcome the potential for simplification" on this issue, as well as further comments on whether this safe harbor would be administrable, which leaves open the possibility that a less burdensome standard may be adopted in the final regulations.

- **Grandfather rule – negative discretion:** A "negative discretion" provision in a contract allows a corporation to reduce the amount of compensation payable under the contract (typically down to zero). A negative discretion provision may affect whether compensation meets the written binding contract requirement described above. The notice provided that if, under applicable law, it is determined that the negative discretion provision means that the arrangement is not a written binding contract, then the compensation will not be grandfathered.

  In the preamble to the proposed regulations, the IRS noted that some commenters to the notice had suggested that negative discretion be completely disregarded in determining the amount of compensation that may be grandfathered. The proposed regulations do not adopt this approach and instead take the approach set forth in the notice. The IRS clarified that in cases where a contract purports to provide the corporation with a wider scope of negative discretion than the corporation would be permitted to exercise under applicable law, the negative discretion would be taken into account only to the extent the corporation may exercise the negative discretion under applicable law. However, this clarification does not lessen the potential burden on corporations in determining this issue, given that a corporation would still be required to undertake the applicable law analysis described above.

- **Grandfather rule – clawback/forfeiture provisions:** The proposed regulations provide that if a corporation is obligated or has the discretion to recover compensation paid to an individual in a taxable year only upon the future occurrence of a condition that is objectively outside of the corporation's control (e.g., pursuant to a contract with a clawback provision based on the restatement of financial statements or a forfeiture provision based on the individual's criminal wrongdoing), then the corporation's right to recovery is disregarded for purposes of determining the grandfathered amount for the taxable year. If the condition does not occur, the entire amount of compensation paid would remain grandfathered. However, if the condition occurs, only the amount the corporation is obligated to pay under applicable law would remain grandfathered, regardless of whether the corporation chooses to exercise its discretion to recover any compensation.

- **Grandfather rule – severance agreements:** The proposed regulations clarify that if a written binding contract in effect on November 2, 2017, provides for severance, the severance is grandfathered only if it is based on compensation elements (e.g., salary and bonus) that are also grandfathered.

  It appears that in practice, it would be difficult for any severance based on a bonus to qualify for grandfathering under this rule because in order for the severance to be grandfathered, the bonus would need to be grandfathered – and at this point, it is unlikely that any such bonus would be grandfathered. For example, assume that a contract in effect on November 2, 2017, provides for severance based on the target bonus for the year in which the employee has a separation from service. In order for that bonus to be grandfathered, the terms of the bonus would need to have been established as of November 2, 2017. Although the contract may have established the terms of a bonus for 2017 or 2018, it is unlikely that the contract would have established the terms of a bonus for 2019. Under this example, if the employee has a separation from service in 2019, the severance would be based on the target bonus for 2019 – however, if the contract did not establish the terms of the bonus for 2019, then it would not be grandfathered and, accordingly, the severance would also not be grandfathered.

- **Covered employees – once a covered employee, always a covered employee:** One of the changes made to Section 162(m) by the act was the addition of a rule often referred to as the "once a covered employee, always a covered employee" rule. Under this rule, anyone who was a covered employee of the publicly held corporation (or any predecessor) for any taxable year beginning on or after January 1, 2017, will continue to be a covered employee for taxable years beginning in 2018 and beyond,

even after the employee's separation from service.

The proposed regulations clarify that if, after separation from service as an employee, a covered employee returns to provide services to the corporation in any capacity (including as a director or an independent contractor), then any deduction for compensation paid to the covered employee during the later period would be subject to the $1 million deduction limit. The proposed regulations also confirm that the $1 million deduction limit would apply to compensation that is paid to a person other than the covered employee (including a beneficiary after the death of the covered employee) for services performed by the covered employee.

In addition, for purposes of the "predecessor" component of this rule, the proposed regulations provide that a "predecessor" includes a publicly held corporation that is acquired, or the assets of which are acquired, by another publicly held corporation in certain transactions. Accordingly, the covered employees of the acquired target corporation in such transactions would also become covered employees of the acquirer corporation.

- **Covered employees – top three highest compensated officers:** The notice provided that a corporation's covered employees include the corporation's top three highest compensated executive officers (other than the PEO or PFO) for the taxable year, regardless of whether the individual is an executive officer or employed on the last day of the taxable year or whether the individual's compensation must be disclosed under the SEC executive compensation disclosure rules. The proposed regulations are consistent with the notice regarding this issue.

  The notice also provided that the SEC executive compensation disclosure rules are to be used to identify the top three highest compensated executive officers for purposes of Section 162(m). However, the determination of a corporation's top three highest compensated executive officers for purposes of Section 162(m) is based on the corporation's taxable year, while the SEC executive compensation disclosure rules are based on the corporation's fiscal year. In the notice, the IRS acknowledged that a corporation's taxable and fiscal years may not always end on the same date (e.g., due to a short taxable year as a result of a corporate transaction) and requested comments on how the SEC executive compensation disclosure rules should be applied in this scenario. The proposed regulations address this issue by providing that the amount of compensation used to identify the three most highly compensated executive officers for the taxable year would be determined pursuant to the SEC executive compensation disclosure rules (using the taxable year as the fiscal year for purposes of making the determination), regardless of whether the corporation's taxable and fiscal years end on the same date.

- **Coordination with Section 409A for nonqualified deferred compensation arrangements – action may be required by December 31, 2020:** Under Section 409A of the Internal Revenue Code (which sets forth certain requirements for nonqualified deferred compensation arrangements), a corporation may delay a payment past the designated payment date to the extent that the corporation reasonably anticipates that, if the payment were made as scheduled, it would not be deductible as a result of the $1 million deduction limit under Section 162(m). As a result of the new "once a covered employee, always a covered employee" rule under Section 162(m), the payment may never become deductible (or it may take a significant period of time for it to become deductible), which would mean the payment would never be made (or would be significantly delayed).

  In order to better coordinate the Section 409A rules with the amended Section 162(m) rules, the IRS will allow corporations to: (1) delay payments that are grandfathered under Section 162(m), without delaying payments that are not grandfathered under Section 162(m); and (2) amend arrangements to remove any provision that requires a delay due to the $1 million deduction limit, as long as the amendment is made by December 31, 2020. Either of these steps may be taken without triggering any penalty or violation under Section 409A.

Effective date

Generally, the regulations apply to compensation that is otherwise deductible for taxable years beginning on or after the publication date of the final regulations. Taxpayers may choose to rely on the proposed regulations until the applicability date of the final regulations, provided that taxpayers apply the proposed regulations consistently and in their entirety. However, the proposed regulations also set forth certain special applicability dates covering certain aspects of the following provisions:

- The definition of "covered employee" applies to taxable years ending on or after September 10, 2018 (the publication date of the notice, which provided guidance on this definition). However, because the rules in the proposed regulations regarding a

corporation whose taxable and fiscal years do not end on the same date were not discussed in the notice, such rules apply to taxable years ending on or after December 20, 2019.

- The provisions defining a "predecessor corporation of a publicly held corporation" apply to corporate transactions for which all events necessary for the transaction occur on or after the publication date of the final regulations. The proposed regulations also include special applicability dates for the rules that apply to corporations that change from publicly held to privately held status or vice versa.
- The proposed regulations include special applicability dates for certain rules regarding the definition of compensation with respect to a publicly held corporation's distributive share of a partnership's deduction for compensation expense attributable to the compensation paid by the partnership.
- The reliance period exemption for newly public corporations no longer applies to any corporation that becomes publicly held on or after December 20, 2019, and the $1 million deduction limit applies to any compensation that is otherwise deductible for the taxable year ending on or after the date that the corporation becomes publicly held.
- The definitions of "written binding contract" and "material modification" apply to taxable years ending on or after September 10, 2018 (the publication date of the notice, which provided guidance on these definitions).

If you have any questions regarding the proposed regulations, please contact any member of the Cooley compensation & benefits group.

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