IRS Issues Final Regulations Under Code Section 162(m)

By Barry Salkin and Mark Poerio

Section 162(m) of the Internal Revenue Code ("Code") denies a deduction to a publicly held corporation for remuneration paid to a covered employee in any taxable year that exceeds $1,000,000. The Tax Cut and Jobs Act of 2017 ("TCJA") significantly modified Section 162(m) by redefining the terms "covered employee" and "publicly held corporation," and eliminating the exclusion for performance-based compensation. The IRS addressed these legislative changes in Notice 2018-68 and proposed regulations in December 2019. On December 18th, the IRS has issued final regulations that for the most part reflected its earlier guidance. The final regulations generally apply to taxable years beginning after the regulations are published in the Federal Register, although, as discussed below, there are some special applicability dates. Taxpayers have the option to apply the final regulations to a taxable year beginning after December 31, 2017, but mixing and matching is not acceptable. If a taxpayer applies the final regulations to a year before 2021, the regulations must be applied in their entirety for that year and all subsequent taxable years.

Under revised Code Section 162(m) and the final regulations, there are three categories of covered employees: (i) the principal executive officer or principal financial officer at any time during the tax year; (ii) any employee whose total compensation is required to be reported under the Securities and Exchange Act of 1934 ("Exchange Act") because the employee is one of the three highest paid executive officers; and (iii) any employee of the taxpayer (or any predecessor) who was a covered employee for any tax year beginning after December 31, 2016 (including periods during which the individual is a former employee and after the employee's death). For these purposes, compensation is not limited to compensation received as a common law employee, but also includes compensation received as an independent contractor or a director. The amount of remuneration taken into account in determining whether an individual is one of the three most highly compensated officers is based on the executive compensation rules under the Exchange Act. Further, an employee can be among the three most highly compensated officers even if he or she is not employed by the publicly held corporation on the last day of its taxable year, and whether or not his or her compensation is subject to disclosure under the SEC rules.

The definition of covered employee is generally applicable to tax years ending on or after September 10, 2018. However, for a corporation whose fiscal and taxable years do not end on the same date, the rule requiring the determination of the three most highly compensated executive officers to be made pursuant to the rules under the Exchange Act applies to taxable years ending on or after December 20, 2019.

Compensation definition

With respect to the determination of compensation, the IRS has maintained its position in the proposed regulations that if a publicly held corporation has an interest in a partnership, then the deduction potentially disallowed to the publicly held corporation includes the amount allocated to the corporate partner by the partnership. Under the final regulations, however, the publicly held corporation must include its share of the partnership's deduction for compensation only if the deduction is attributable for compensation paid by the partnership after December 18, 2020, the date the final regulations were published on the IRS website. In addition, taxpayers may be entitled to transition relief with respect to such partnership payments for compensation paid after the date the regulations are published in the Federal Register if the compensation is paid pursuant to a written binding contract in effect on December 20, 2019, and not modified after that date.

Predecessor corporation

The final regulations define predecessor corporation as it applies to certain corporate transactions. For example, the final regulations provide that if an acquiror corporation acquires at least 80% of the gross operating assets of a publicly held target corporation, the target company is treated as the predecessor of the acquiring company. However, special applicability date rules apply to the determination of the predecessor of a publicly held corporation. If the corporate transaction occurred before the final Section 162(m) regulations were published in the Federal Register, then taxpayers have the option of either applying the definition of predecessor of a publicly held corporation in the final regulations, or a reasonable good faith interpretation of the term predecessor as it is defined under Code Section 162(m). For corporate transactions occurring after December 20, 2019, and before the publication of the final regulations in the Federal Register, the IRS will not treat as a reasonable good faith interpretation of the term "predecessor" the exclusion of a publicly held target corporation target company, if either: (i) its stock or assets were acquired by another publicly held corporation in a transaction to which Code Section 381(a) applies, or (ii) 80% of the total voting power or 80% of the total value are acquired by a publicly held acquiring company. The IRS further indicated that no inference was intended with respect to whether the treatment of a target corporation as other than a predecessor in any other situation is a reasonable good faith interpretation of Code Section 162(m). There is also a special applicability date for corporations that change from being publicly held to private and again become publicly held on or after the date of publication of the final Section 162(m) regulations in the Federal Register.

Coordination with Code Section 409A

One effect of the revised definition of covered employee under Code Section 162(m) was to create a coordination issue with Code Section 409A, which controls the form and timing of nonqualified deferred compensation. While generally Code Section 409A requires deferred compensation plans to provide for a precisely defined limited time period within which payments can be made upon certain specified events, the Code Section 409A regulations permitted a payment to be delayed if a publicly held corporation service recipient reasonably anticipated that the payment would result in a disallowed deduction under Code Section 162(m). However, the payment was required to be made when the service recipient reasonably anticipated the payment could be made without loss of a deduction, which, under pre-TCJA law, could have occurred, for example, if the employee ceased to be one of the three highest paid executive officers or separated from service. However, under TCJA, covered employee status is a permanent status, one that does not end even on a covered employee's death. As a result, the delay in deduction under Code Section 162(m) might be regarded as indefinite in nature.

The IRS was aware of the coordination issue, and in the proposed regulations indicated its intention to amend the Code Section 409A regulations to permit a plan that mandates a delay of payment until the deduction is not limited by Code Section 162(m) to be amended no later than December 31, 2020, to remove the mandated delay provision. If, as a result of the elimination from the plan of the mandated delay language, a corporation would have been required to make a payment before December 31, 2020, the payment was required to be made by December 31. The IRS, in fact, did not propose any amendment to the Code Section 409A regulations, nor did they provide any extension of time within which to act. The IRS did acknowledge in the preamble that coordination between Code Section 162(m) and 409A may be required.

Publicly held corporation

Under the final regulations, a corporation is publicly held if, as of the last day of the taxable year, its securities are required to be registered under Section 12 of the Exchange Act or the corporation is required to file reports under Section 15(d) of the Exchange Act. "Required" is a key word under this definition: for example, a corporation that files voluntarily under Section 15(d) of the Exchange Act will not be a publicly held corporation under Code Section 162(m). Assuming the registration and filing requirements are satisfied, a publicly held corporation includes a publicly traded partnership; a foreign private issuer; a disregarded entity; an S corporation that owns a qualified subchapter S subsidiary; and a REIT that owns a qualified real estate investment trust subsidiary. The IRS also indicated that a company that lists ADRs on an over the counter ("OTC") market is not a publicly held corporation, but an entity that lists ADRs in the OTC Bulletin Board is a publicly held corporation.

Affiliated groups

The IRS confirmed that, if there is more than one publicly held corporation in a group, each publicly held corporation has its own covered employees. Under the final regulations, compensation paid by all members of the affiliated group is aggregated and any amounts disallowed as a deduction are prorated among the payor corporations. The final regulations also clarify that compensation paid by a privately held corporation that is a member of an affiliated group that contains a publicly held corporation to an employee who is a covered employee of two or more publicly held members of the affiliated group, is prorated for purposes of allocating the disallowed deduction among the publicly held members of the affiliated group. The regulations also contain a number of helpful examples addressing various scenarios that could result under an affiliated group.

Claw-back

The final regulations refine the approach provided in the proposed regulations regarding the recovery (a/k/a "claw-back") of compensation when the corporation is obligated or has discretion to recover compensation paid in a tax year upon the future occurrence of a condition outside the corporation's control. The corporation's right to recover compensation is recognized to be a contractual right that is distinct from the corporation's binding obligation under the contract (as of November 2, 2017) to pay the compensation. The final regulations affirm that a corporation's right to recover compensation does not affect the determination of the amount of compensation the corporation has a written binding contract to pay under applicable law as of November 2, 2017. That is the case whether or not the corporation exercises its discretion to recover compensation in the event a claw-back condition arises in the future.

Transition relief

Code Section 162(m) under the TCJA provides for both transitional relief for private companies becoming publicly held corporations and grandfathered relief. A privately held corporation that becomes a publicly held corporation on or before December 20, 2019, may rely on the transition relief provided in the existing Code Section 162(m) regulations until the earliest of the events specified in those regulations. Additionally, a subsidiary corporation that is a member of an affiliated group may rely on the transition relief provided in the existing Code Section 162(m) regulations if it becomes a separate publicly held corporation, whether is a spin-off transaction or otherwise, on or before December 20, 2019.

With respect to the grandfathered amount, the IRS adhered to its position that negative discretion that would permit a corporation to reduce compensation is not grandfathered compensation. However, if a corporation reserves negative discretion under an arrangement but is unable to enforce the provision under state law, the amount can be regarded as grandfathered. The final regulations also contain detailed rules with respect to the grandfathering of amounts payable under account balance and non-account balance plans, taking into account the corporation's right to freeze or terminate the plan. The final regulations provide ordering rules when a potentially nondeductible payment relates to a mixed payment of grandfathered and non-grandfathered amounts. The regulations permit the grandfathered amount to be allocated to the last otherwise deductible payment or to each payment on a pro rata basis for tax years ending before December 20, 2019. However, for tax years ending on or after December 20, 2019, the grandfathered amount must be allocated to the first otherwise deductible payment under the arrangement. If the grandfathered amount exceeds the payment, then the grand-fathered amount is allocated to the next otherwise deductible amount. This process continues until the grandfathered amount is completed.

The TCJA contained a transition rule under which the statutory changes made to Code Section 162(m) do not apply to compensation payable pursuant to a written binding contract that was in effect on November 2, 2017, that is not materially modified after that date. The final regulations and its preamble address several issues with respect to this rule. First, a modification of the contract after November 2, 2017, to offer an additional predetermined actual investment or substitute a predetermined actual investment as an investment alternative under an arrangement is not a material modification. Second, a subsequent deferral is not treated as resulting in a material modification if any additional amount is based on either a reasonable rate of interest or a predetermined actual investment. Third, the lapse of a substantial risk of forfeiture is not treated as a material modification.

While publicly held corporations have already taken into account most of the provisions in the final Code Section 162(m) regulations based on the 2018 notice and the 2019 proposed regulations, it is generally recognized that compliance with Section 162(m) is fraught with potentially costly foot-faults. The issuance of final Section 162(m) regulations makes it timely for companies both to self-audit the past, and to plan for the future. In particular, the guidance regarding the extension of nonqualified stock options and stock appreciation rights and the modification of the IRS position on claw-backs are potentially helpful modifications for compensation committees to take into account.

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