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HIGHLIGHTS FROM PROPOSED SECTION 162(M) REGULATIONS

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Section 162(m) of the Internal Revenue Code disallows a deduction by any publicly held corporation for applicable employee remuneration paid with respect to any covered employee to the extent that remuneration for the taxable year exceeds $1 million. As we've previously blogged here, here, and here, the bill popularly referred to as the Tax Cuts and Jobs Act of 2017 significantly amended and expanded the scope of Section 162(m) for taxable years beginning after December 31, 2017, including by eliminating its performance-based compensation exception. Now, Proposed Regulations on the amended Section 162(m) have been released which expand on the entities, individuals and compensation that are now subject to Section 162(m).

This blog highlights some of the common questions that the Proposed Regulations attempt to clarify. The Proposed Regulations supersede (but largely confirm) the guidance in Notice 2018-68 (released in August 2018) and will generally be effective for taxable years beginning after the publication of the final regulations, except with respect to guidance relating to covered employees and grandfathered arrangements, which will be effective as of September 10, 2018.

1. **What does it mean to be a "publicly held corporation"?**

A publicly held corporation includes any corporation whose securities (debt or equity) are required to be registered under Section 12 of the Exchange Act or that is required to file reports under Section 15 of the Exchange Act, in each case, as of the end of the corporation's taxable year. The Proposed Regulations confirm that Section 162(m) applies to foreign private issuers, publicly traded partnerships and affiliated groups including two or more publicly held corporations.

In addition, effective December 20, 2019, any transition periods for corporations that go public through an IPO or spin-off have been eliminated. Previously, such newly public corporations were not subject to Section 162(m)'s $1 million deduction limitation until the first stockholder meeting that occurred after the third (in the case of IPOs) or first (in the case of spin-offs) calendar year after the corporation became public.

2. **Who is a "covered employee"?**

Consistent with Notice 2018-68, the Proposed Regulations confirm that a "covered employee" includes any person who was (i) the principal executive officer or principal financial officer at any time during the taxable year, (ii) one of the three highest compensated executive officers for the taxable year or (iii) a covered employee for any taxable year beginning on or after January 1, 2017, in each case, regardless of whether that person remains employed by the corporation at the end of the taxable year.

The Proposed Regulations clarify that a covered employee includes any person who was previously a covered employee under the following categories of predecessor corporations:

- A publicly held corporation that becomes a privately held corporation and, within 36 months following going private, again becomes a publicly held corporation;
- A publicly held corporation whose stock is acquired by another publicly held corporation;
- A publicly held corporation whose stock or assets are acquired in a corporate reorganization or merger under Section 368(a)(1) of the Code;
- A publicly held parent corporation of a spin-off subsidiary, provided that the covered employee becomes an employee of the spun-off subsidiary within 12 months before or 12 months after the spin;
- A publicly held target corporation, if 80% of such target's assets are purchased by a publicly held acquiror corporation and the covered employee becomes an employee of the acquiror within 12 months before or 12 months after such 80% acquisition threshold is met;
- A privately held target corporation that was previously a publicly held corporation, if the target is acquired by a publicly held corporation and if the acquisition occurs within 36 months following the due date for the target's federal income tax return for the last taxable year for which the target was a publicly held corporation;
- A publicly held target corporation, if the acquiror is a privately held corporation that becomes a publicly held corporation within 36 months following the due date for the target's federal income tax return for the last taxable year in which the acquisition is taken into account; and
- A privately held target corporation that was previously a publicly held corporation, if the acquiror is a privately held corporation that becomes a publicly held corporation within 36 months following the due date for the target's federal income tax return for the last taxable year for which the target was a publicly held corporation.

The Proposed Regulations also confirm that publicly held companies who have separate taxable and fiscal years will need to separately track their covered employees for purposes of Section 162(m) and their named executive officers for purposes of SEC reporting requirements.

3. **What compensation is subject to Section 162(m)'s $1 million limitation?**

The Proposed Regulations provide that the compensation that may be subject to Section 162(m) is the aggregate amount allowed as a deduction under Chapter 1 of the Code for the covered employee's services in any capacity (including as a director, advisor or consultant following termination of employment), whether or not (i) such services were performed during the taxable year and (ii) the covered employee or a third party (such as a beneficiary) receives such amounts.

In addition, compensation paid to a covered employee by an operating partnership is also subject to Section 162(m) to the extent that the publicly held corporation is allocated a distributive share of the partnership's deduction for that compensation.

4. **What compensation receives grandfathered treatment under the old Section 162(m)?**

Consistent with Notice 2018-68, the Proposed Regulations confirm that:

- Compensation payable under a written binding contract that was in effect on November 2, 2017 and that is not subsequently modified in any material respect (with any increases in the amount of compensation payable constituting a material modification for this purpose) is grandfathered such that the Proposed Regulations do not apply to such compensation.
- Negative discretion will be taken into account for purposes of determining whether the compensation is the subject of a binding contract, but only to the extent that applicable law permits such negative discretion.
- Written binding contracts that contain evergreen renewal provisions are deemed materially modified as of the effective date of any notice of non-renewal.

With respect to grandfathered contracts, the Proposed Regulations clarify that:

- Any clawback provisions in such contracts will not automatically result in the loss of grandfathered status.
- The amount of grandfathered compensation is based on the amounts that the corporation would have been obligated to pay on November 2, 2017. Therefore, earnings on grandfathered amounts and increases in non-account balance plan payments are only grandfathered to the extent the corporation is obligated to pay such amounts as of November 2, 2017. Similarly, severance payments under grandfathered arrangements are only grandfathered to the extent of the amount of severance that would have been due upon a qualifying termination on November 2, 2017, with any components of such severance (such as base salary and annual bonus) evaluated separately for purposes of determining such amounts.
- Accelerated vesting (but not accelerated payment) will not constitute a material modification that nullifies grandfathered status.

5. **How is Section 409A implicated by the changes to Section 162(m)?**

Section 409A provides that a corporation may delay payment of nonqualified deferred compensation beyond a designated payment date to the extent that the corporation reasonably anticipates that such payment would not be deductible under Section 162(m) if paid on that date. In the preamble to the Proposed Regulations, the Treasury Department and IRS acknowledge that changes to the definition of covered employee, in particular, will require changes to Section 409A's regulations at a later date. In the interim, taxpayers may rely on the following guidance described in the preamble for any taxable years beginning after December 31, 2017:

- Corporations may delay the scheduled payment of Section 162(m) grandfathered compensation under a nonqualified deferred compensation plan until such amounts otherwise would be deductible without such delay being treated as a subsequent deferral election and without delaying the payment of non-grandfathered amounts; and

- Corporations may amend nonqualified deferred compensation plans to remove provisions requiring delay of payments until the underlying amounts would be deductible under Section 162(m) and such amendment will not result in an impermissible acceleration of payment or be considered a material modification of such plan, provided that such amendment is made no later than December 31, 2020. If a payment under such amended nonqualified deferred compensation plan would have been required by December 31, 2020, then such payment must be made no later than December 31, 2020.

6. **What's next?**

Comments to the Proposed Regulations are due by February 18, 2020, with a public hearing scheduled for March 9, 2020 and final regulations promulgated at some point thereafter.

The Proposed Regulations provide helpful guidance and examples as to the breadth of Section 162(m)'s applicability, in particular with respect to which entities fall within the definition of a publicly held corporation and which employees are covered employees. We recommend that public companies and companies that are looking to become public carefully review the Proposed Regulations to understand the impact on current and future tax deductions.

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