ALERT MEMORANDUM

IRS Issues Final Section 162(m) Regulations

December 30, 2020

If you have any questions concerning this memorandum, please reach out to your regular firm contacts in the Executive Compensation and ERISA group.

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On December 18, 2020, the Internal Revenue Service ("IRS") issued final regulations (the "Final Regulations") under Section 162(m) of the Internal Revenue Code (the "Code"), as amended by the 2017 Tax Cuts and Jobs Act (the "TCJA").[1] Section 162(m) limits the deductibility of compensation paid in any year to certain public company executives to $1 million. The TCJA made several significant amendments to Section 162(m) – including eliminating the qualified performance-based compensation exception and expanding the scope of covered employees and companies subject to the deductibility limit – while providing limited transition relief. The Final Regulations provide further guidance on the TCJA's amendments to Section 162(m) and are generally consistent with the IRS' 2019 proposed regulations (the "Proposed Regulations").[2] Key changes from the Proposed Regulations and other clarifications are discussed in more detail below. The Final Regulations will apply to tax years beginning on or after December 30, 2020, with special applicability dates for specified provisions.

[1] The Final Regulations are available at https://www.govinfo.gov/content/pkg/FR-2020-12-30/pdf/2020-28484.pdf.

[2] The Proposed Regulations are available at https://www.govinfo.gov/content/pkg/FR-2019-12-20/pdf/2019-26116.pdf. The Proposed Regulations expanded on previous IRS guidance issued in 2018. For a discussion of the Proposed Regulations and "covered employees" after merger and acquisition transactions, see our alert memorandum "Who Are Your Section 162(m) 'Covered Employees' After Mergers, Acquisitions and Other Transactions?", available at https://www.clearygottlieb.com/-/media/files/alert-memos-2020/who-are-your-section-162m-covered-employees-after-mergers--pdf.pdf. For a discussion of the 2018 IRS guidance in Notice 2018-68, see our alert memorandum "Tax Reform: IRS Issues Guidance on Section 162(m)", available at https://www.clearygottlieb.com/-/media/files/alert-memos-2018/20180827-tax-reform-irs-issues-guidance-on-section-162m-pdf.pdf.

Definition of Publicly Held Corporation

Consistent with the Proposed Regulations, the Final Regulations provide that a corporation is a "publicly held corporation" for purposes of Section 162(m) if, as of the last day of its taxable year, its securities are required to be registered under Section 12 of the Securities Exchange Act of 1934 (the "Exchange Act") or it is required to file reports under Section 15(d) of the Exchange Act. The Final Regulations also include certain clarifications to the definition:

— ***Affiliated Groups.*** The Final Regulations clarify that compensation paid by a member of an affiliated group that is not a publicly held corporation to a covered employee of two or more other members of the affiliated group will be prorated for purposes of determining the deduction disallowance among members that are publicly held corporations and of which the employee is a covered employee.

— ***REITs.*** The Final Regulations provide that a real estate investment trust that owns a qualified real estate investment trust subsidiary ("QRS")[3] will be a publicly held corporation if the QRS issues securities required to be registered under Section 12(b) or is required to file reports under Section 15(d) of the Exchange Act.

— ***Foreign Private Issuers.*** The Proposed Regulations provided that foreign private issuers ("FPIs") required to register securities under Section 12 or file reports under Section 15(d) of the Exchange Act would be subject to the deductibility limit but requested comment as to whether the IRS should provide an exemption for FPIs that are not required to disclose compensation of individual officers in their home jurisdiction. The IRS declined to include that exemption in the Final Regulations.

Privately Held Companies that Become Public

Prior to the enactment of the TCJA, Section 162(m) provided transition relief for privately held companies that had recently become public in order to provide them with sufficient time to meet the shareholder approval requirements of the qualified performance-based compensation exception. This transition relief generally applied until the first meeting of shareholders occurring after the third calendar year following the year in which an IPO occurs,[4] and the first calendar year following a spin-off.

As in the Proposed Regulations, the Final Regulations provide that a private company that becomes public on or before December 20, 2019 may continue to rely on the transition relief. The Final Regulations also clarify that a subsidiary that is a member of an affiliated group may rely on the transition relief in the existing regulations[5] if it became a separate publicly held corporation (e.g., in a spin-off transaction) on or before December 20, 2019.

Despite the requests of several commenters, under the Final Regulations, companies that became public after December 20, 2019 will not qualify for transition relief. The IRS reasoned that because the TCJA eliminated the qualified performance-based compensation exception, a transition period to accommodate a shareholder approval process is no longer warranted.

Grandfather Rule

The Final Regulations make certain changes and clarifications to the grandfather rule, which generally provides that transition relief is available for compensation payable pursuant to a written binding contract that was in effect on November 2, 2017 and not materially modified thereafter.[6] Notable revisions include the following:

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[3] As defined in Section 856(a) and 856(i)(2) of the Code, respectively.

[4] See Treas. Reg. 1.162-27(f)(1) and (2). Such relief will end earlier upon: (i) the expiration date of the plan; (ii) a material modification of the plan; or (iii) exhaustion of all shares reserved under the plan.

[5] See Treas. Reg. 1.162-27(f)(4).

[6] The Final Regulations are separate from the IRS' 1995 regulations under Section 162(m) (60 FR 65534), which

— ***Negative Discretion.*** The IRS confirmed that if a compensation arrangement allows for the exercise of negative discretion, compensation payable under the arrangement will not be grandfathered to the extent the company is not obligated to pay it under applicable law, thus adopting the rules set forth in the Proposed Regulations.

— ***Material Modifications: Extension of Exercise Period for Stock Options and SARs.*** In a change from the Proposed Regulations, the Final Regulations provide that if compensation attributable to the exercise of a non-qualified stock option or a stock appreciation right ("SAR") is grandfathered and the exercise period for such option or SAR is extended, then all compensation attributable to the exercise of such award will be grandfathered so long as the extension complies with Section 409A of the Code and the related regulations. This change will provide flexibility for employers seeking to extend the exercise period for awards held by former employees.

— ***Clawbacks.*** Under the Proposed Regulations, if a company has a right to claw back compensation solely upon the future occurrence of a condition outside of the company's control, the clawback right will be disregarded for purposes of determining the grandfathered amount. However, under the Proposed Regulations, if the clawback right were to be triggered, only the amount the company is required to pay under applicable law would remain grandfathered. In recognition of the fact that a clawback right is contractual and separate from a binding obligation to pay compensation, the Final Regulations continue to provide that the existence of a clawback right will not affect the determination of the amount of compensation the company has a written binding contract to pay as of November 2, 2017, but also provide that this determination will not be affected in the event the clawback right is triggered in the future.

— ***Account and Nonaccount Balance Plans.*** The Final Regulations clarify the application of the grandfather rule to compensation payable under account and nonaccount balance nonqualified deferred compensation plans, providing detailed guidance for determining the grandfathered amount. With respect to both account balance and nonaccount balance plans, the Final Regulations provide that the grandfathered amount is the amount a company is obligated to pay pursuant to the plan terms as of November 2, 2017, as determined under applicable law. The determination of the grandfathered amount is also affected by the plan terms, as described below in respect of account balance plans. Analogous rules apply for nonaccount balance plans.

- *No Right to Terminate.* If a company is obligated to pay the covered employee an account balance credited with earnings and losses and the company does not have a right to unilaterally terminate or materially amend the plan, then the grandfathered amount would be the account balance as of November 2, 2017, plus any additional required contributions, earnings and losses.
- *Right to Terminate and Distribute.* If the plan terms provide that the company may terminate the plan and distribute the account balance to the covered employee, then the grandfathered amount would be the account balance determined as if the company had terminated the plan on November 2, 2017, or, if later, the earliest possible date the plan could be terminated under the plan terms (termination date). The question of whether additional contributions, earnings and losses credited after the termination date through the earliest possible date the account balance could have been distributed are grandfathered depends on whether the plan terms require the company to make such contributions or credit earnings and

continue to remain in place with respect to grandfathered amounts.

losses through the earliest possible date the account balance could be distributed if it were terminated as of the termination date.

- *Right to Freeze Plan.* If the plan terms provide that the company cannot terminate the plan, but may discontinue future contributions and distribute the account balance in accordance with the plan terms, then the grandfathered amount is the account balance determined as if the company had exercised the right to discontinue contributions on November 2, 2017 or, if later, the earliest permissible date the company could exercise that right in accordance with the plan terms (freeze date). If the plan required crediting of earnings and losses on the account balance after the freeze date through the payment date, then such earnings and losses are also grandfathered.
- *Company's Election.* Whether the terms of the account balance plan provide that the company may terminate the plan, or, instead, may discontinue future contributions, the company may elect to treat the account balance as of the termination date (or freeze date, as applicable) as the grandfathered amount regardless of when the amount is paid and regardless of whether it has been credited with earnings or losses prior to payment.

— ***Ordering Rule.*** Consistent with the Proposed Regulations, the Final Regulations indicate that if a grandfathered arrangement provides for a series of payments, grandfathered amounts are allocated to the first otherwise deductible payment under the arrangement. The Final 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. For tax years ending on or after December 20, 2019, the grandfathered amount must be allocated to the first otherwise deductible payment, regardless of the method used for tax years prior to that date.

Coordination with Section 409A

Section 409A and the related regulations provide that payments under nonqualified deferred compensation plans may be delayed past the designated payment date if an employer reasonably anticipates that it would lose a deduction for the payment as a result of the application of Section 162(m). Generally, payments delayed pursuant to this provision of Section 409A are required to be paid no later than the employee's first taxable year in which the deduction of such payment would not be barred by Section 162(m).

The IRS recognized that the TCJA's amendments to the definition of "covered employee" under Section 162(m) could result in a scenario in which amounts payable under a nonqualified deferred compensation plan could require the passage of a significant period of time before the entire amount became deductible, and that such amounts may never be deductible. Thus, the Proposed Regulations provide that companies may amend their nonqualified deferred compensation arrangements to remove provisions requiring payment delays if the company reasonably anticipates at the time of the payment that the deduction would not be permitted under Section 162(m), provided that any such amendments were made no later than December 31, 2020.[7] Further, companies could continue to delay payment of any grandfathered amounts even if non-grandfathered amounts would no longer be subject to the delay. The IRS noted that it would incorporate this guidance into regulations issued under Section 409A.

The Final Regulations provide that until guidance is issued under Section 409A, taxpayers may continue to rely on the preamble to the Proposed Regulations, such that the proposed deadline of December 31, 2020 for eliminating provisions requiring payment delays in nonqualified deferred compensation plans remains in effect.

[7] Such an amendment would not result in an impermissible acceleration under Section 409A and would not be considered a material modification for purposes of the grandfather rule.

Other Clarifications

— ***Covered Employees and Predecessor Corporations.*** Under Section 162(m) as amended, "covered employees" include the CEO, CFO and three other most highly compensated executive officers of the company. Once an executive officer qualifies as a covered employee, he or she will continue to be treated as a covered employee indefinitely. Further, covered employees include any employee who was a covered employee of a "predecessor" of a publicly held corporation for any preceding tax year beginning after December 31, 2016.

The Final Regulations affirm that the term "covered employee" includes both current and former employees, such that an executive will continue to be considered a covered employee even after separating from the company, and that "applicable employee remuneration" includes compensation paid to a covered employee for services provided as an employee, independent contractor or otherwise. In addition, the Final Regulations retain the predecessor rules set forth in the Proposed Regulations, with one clarification: with respect to asset acquisitions, if an acquiror acquires at least 80% of the operating assets (determined by fair market value on the date of the acquisition) of a publicly held target, the target would be a predecessor of the acquiror. The Final Regulations indicate that for purposes of this rule, "operating assets" refers to gross (rather than net) operating assets.

— ***Compensation Paid by a Partnership to a Covered Employee.*** Under both the Final Regulations and Proposed Regulations, a publicly held corporation must take into account its distributive share of a partnership's deduction for compensation paid to the corporation's covered employee in determining the allowable deduction amount. The Final Regulations clarify that the distributive share includes the partnership's deduction for a payment to the covered employee for services under Section 707(a) or 707(c) of the Code.

Effective Dates

The Final Regulations will generally be applicable to tax years beginning on or after December 30, 2020. However, taxpayers can choose to apply the Final Regulations to any tax year beginning after December 31, 2017, provided they are applied in their entirety and in a consistent manner to such tax year and all subsequent tax years.

The Final Regulations also provide special applicability dates for certain provisions:

— ***Definition of Covered Employee.*** The definition of "covered employee" in the Final Regulations applies to tax years ending on or after September 10, 2018. However, if a corporation's fiscal and taxable years do not end on the same date, the rule requiring the determination of the three most highly compensated executive officers will apply to taxable years ending on or after December 20, 2019.

— ***Definition of a Predecessor Corporation.*** The predecessor rules will apply to corporate transactions occurring on or after December 30, 2020. If a corporate transaction occurs before December 30, 2020, taxpayers may apply either the definition of predecessor as set forth in the Final Regulations or a reasonable good faith interpretation of the term predecessor as used in Section 162(m)(3)(C) with respect to such transaction. However, the IRS noted that excluding target corporations from the definition of predecessor will not be considered a reasonable good faith interpretation for the following transactions if they occur after December 20, 2019 and before December 30, 2020: (i) a publicly held target the stock or assets of which are acquired by another publicly held corporation in a transaction to which Section 381(a) applies; and (ii) a publicly held target, at least 80% of the total voting power of the stock of which, and at least 80% of the total value of the stock of which, are acquired by a publicly held acquiror (including an affiliated group).

— ***Definition of Compensation.*** The definition of compensation will include an amount equal to the publicly held corporation's distributive share of a partnership's deduction for compensation expense only if the deduction is attributable to compensation paid by the partnership after December 18, 2020. However, this aspect of the definition will not apply to compensation paid after December 30, 2020 if the compensation is paid pursuant to a written binding contract that is in effect on December 20, 2019 and is not materially modified thereafter.

— ***Definitions of Written Binding Contract and Material Modification.*** The definitions of written binding contract and material modification apply to tax years ending on or after September 10, 2018. The account balance plan rules are applicable to tax years beginning on or after December 30, 2020, but taxpayers may choose to apply the Final Regulations for tax years beginning after December 31, 2017 and before December 30, 2020 provided they are applied in a consistent manner and in their entirety.

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