CLEARY GOTTLIEB

ALERT MEMORANDUM

Who Are Your Section 162(m) "Covered Employees" After Mergers, Acquisitions and Other Transactions?

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

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Section 162(m) of the Internal Revenue Code (the "Code") limits the deductibility of compensation paid by public companies to certain of their executives in any year to $1 million. The 2017 Tax Cuts and Job Act (the "TCJA") amended Section 162(m) to expand the number of executives at a public company[1] whose compensation may be non-deductible by reason of its provisions ("Covered Employees"). On December 16, 2019, the Internal Revenue Service ("IRS") issued proposed regulations under Section 162(m) as amended by the TCJA (the "Proposed Regulations").[2]

This alert memorandum discusses newly proposed IRS rules under which a public company can effectively inherit Covered Employees – employees whose compensation above $1 million, including base salary, cash and equity incentive awards, retention awards and severance benefits, will be non-deductible – in connection with mergers, acquisitions and other transactions. The impact of these rules, if adopted as proposed, could be financially significant to some acquisitions, and the potential accumulation by acquisitive public companies of numerous Covered Employees could have ongoing notable financial impact.

[1] The TCJA also expanded the definition of "publicly held corporation" to include (a) corporations with any class of securities (as opposed to a class of common equity securities) required to be registered under section 12 of the Securities Exchange Act of 1934 ("Exchange Act") and (b) corporations required to file reports under section 15(d) of the Exchange Act. Most significantly this will expand the scope of Section 162(m) to cover issuers of publicly traded debt and foreign private issuers who offer or list their securities in the United States and, as a result, are required to register their securities under section 12 of the Exchange Act.

[2] The Proposed Regulations are available at https://www.govinfo.gov/content/pkg/FR-2019-12-20/pdf/2019-26116.pdf. The Proposed Regulations confirm and, in part, expand, previous IRS guidance issued in August 2018. For a discussion of the IRS guidance contained 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.

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Background

For nearly twenty-five years, Section 162(m) contained an exception for "qualified performance-based compensation"; however, this exception was eliminated by the TCJA. The TCJA also expanded the group of executives whose compensation is subject to the deductibility limitation. Covered Employees include the CEO, CFO and three other most highly compensated executive officers of the company. However, under the TCJA, once an executive officer qualifies as a Covered Employee, he or she will continue to be treated as a Covered Employee indefinitely, even after ceasing to serve as an executive officer or separating from the company.[3]

Predecessor Corporations and M&A Transactions

Under Section 162(m) as amended by the TCJA, Covered Employees include any employee who was a covered employee of any "predecessor" of the taxpayer for any preceding taxable year beginning after December 31, 2016. The Proposed Regulations explain that an individual who is a Covered Employee of a predecessor of a public company for a taxable year is a Covered Employee of the public company for subsequent taxable years. This aspect of the rule functions cumulatively so as to include any predecessor of a predecessor of a public company and so on.

The Proposed Regulations set forth how the predecessor rule applies in the context of merger and acquisition transactions. Under the Proposed Regulations, target companies will generally be considered predecessors of an acquiror. Thus, Covered Employees of any company acquired by a public company may become Covered Employees of the acquiring public company forever, significantly expanding the scope of Covered Employees at acquisitive public companies and requiring the acquiror to carefully track Covered Employees of the target for purposes of Section 162(m). These provisions are proposed to apply to corporate transactions effectuated on or after the date of publication of final regulations in the Federal Register.[4]

Affected Transactions

The predecessor rule in the Proposed Regulations is broadly applicable across several types of corporate transactions ("Affected Transactions"). Affected Transactions under the Proposed Regulations include the following transactions involving public companies[5]:

— ***Corporate Reorganizations*.** The Proposed Regulations provide that predecessors include public companies whose stock or assets are acquired in tax-free corporate reorganizations[6], such as mergers or certain other acquisitions of corporations for stock of the acquiring corporation. Accordingly, for example, if public company A acquires public company B in a stock-for-stock reverse subsidiary merger, the Covered Employees of company B become Covered Employees of company A forever. Incentive, severance and other compensation payable to the former Covered Employees of company B following the acquisition would be subject to Section 162(m)'s $1 million deductibility limitation. The same limitation would apply to those company B Covered Employees if years later company A were acquired in an Affected Transaction by public company X.

[3] For example, post-separation severance and deferred compensation payouts to Covered Employees would be subject to the deduction limitation. Prior to the TCJA, if an individual was not an executive officer as of the end of the relevant taxable year, he or she could not qualify as a Covered Employee and therefore such payments would not be subject to the limitation.

[4] Until the effective date under final regulations, taxpayers may rely upon the Proposed Regulations or a "reasonable good faith interpretation" of the term "predecessor."

[5] The Proposed Regulations provide an extensive set of examples intended to illustrate the application of the proposed predecessor rules to various types of corporate transactions.

[6] As defined in Section 368(a)(1) of the Code.

— ***Corporate Divisions.*** The Proposed Regulations also apply to spin-offs. Under the Proposed Regulations, Covered Employees of a publicly held distributing corporation that commence employment with the spun-off company within the period beginning 12 months before, and ending 12 months after, the spin-off are Covered Employees of the spun-off company.

— ***Stock Sales.*** The Proposed Regulations provide that Covered Employees of a public company target that becomes part of a public company acquiror's affiliated group, for example through a tender offer, will become Covered Employees of the acquiror.

— ***Asset Sales.*** Under the Proposed Regulations, if a public company acquiror acquires at least 80% of the operating assets (determined by fair market value on the date of acquisition) of a public company target, and the Covered Employees of the target commence employment with the acquiror (or an affiliate) within the period beginning 12 months before, and ending 12 months after, the date of the transaction, those employees will become Covered Employees of the acquiror. For asset sales that occur over time, only assets acquired within a 12-month period are taken into account in determining whether the 80% threshold has been met. Such 12-month period includes any continuous period that ends or begins on any day during which the acquiror has an arrangement to purchase (directly or indirectly) the target's assets.

The Proposed Regulations also contain guidance regarding the application of the predecessor rule to companies that are not public at the time of the transaction. In particular:

— ***Target is Not a Public Company.*** If the target was previously public, but is not a public company at the time of the transaction, the target will nonetheless be a predecessor to the acquiror if the acquiror is a public company at the time of the transaction and the transaction takes place during a taxable year ending before the 36-month anniversary of the due date for the target's US federal income tax returns for the last taxable year for which the target was previously publicly held.

— ***Acquiror is Not a Public Company.*** If the target is a public company, but the acquiror is not, the target will still be considered a predecessor of the acquiror if the acquiror becomes a public company for a taxable year ending before the 36-month anniversary of the due date for the target's US federal income tax return for its last taxable year in which the transaction is taken into account.

— ***Neither Corporation is a Public Company.*** If the target was previously publicly held, but neither the target nor the acquiror is publicly held at the time of the transaction, the target is a predecessor if the acquiror becomes a public company for a taxable year ending before the 36-month anniversary of the due date for the target's US federal income tax return for the last taxable year for which the target was previously publicly held.

Key Takeaways

— We expect that accounting for a target's Covered Employees will become a common part of the diligence process and representation and warranty requests for transactions involving public companies.

— If in connection with an Affected Transaction a public company becomes obligated to pay Covered Employees of the target substantial incentive, retention or severance compensation in the year or two after the acquisition occurs (e.g., a retention bonus or a change in control payment), these payments will largely no longer be deductible. Currently, Section 162(m) deductibility limits usually do not impact post-closing compensation paid to Covered Employees of a target. To the extent the parties to the transaction agree to allocate the cost of such liabilities to the sellers/target via a purchase price adjustment (e.g., through a company transaction expense, transaction tax benefit and/or indebtedness concept), acquirors may want to

consider how the loss of any deduction is accounted for (if at all) in such adjustment.

— Acquisitive companies, or companies that acquire acquisitive companies, should be prepared for the possibility that the number of their Covered Employees will grow substantially as a result of the Proposed Regulations.

If you have any questions or would like to discuss this further, please do not hesitate to reach out to your regular contacts at the firm.

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