

IRS Releases Final Regulations on \$1 Million Executive Compensation Deduction Limitation

December 31, 2020

On December 18, 2020, the Internal Revenue Service (the “IRS”) issued final regulations on amended Section 162(m) of the Internal Revenue Code, a full year after issuing proposed regulations on December 16, 2019. The final regulations largely adopt the proposed regulations with a few key changes and clarifications. As a result, we now have a full picture of the post-Tax Cuts and Jobs Act (the “TCJA”) Section 162(m) regime, which is summarized below.

Expansion of Covered Employees

The final regulations largely adopt the section of the proposed regulations regarding the employees covered by the \$1 million deduction limit, and clarify one aspect of the determination of predecessor corporations, as noted below.

- *Identity of Covered Employees Generally.* Covered employees are any employees who serve as CEO and CFO (irrespective of whether they still serve in those roles at the end of the taxable year), plus the next three most highly compensated executive officers (even if disclosure of the compensation of the officer is not required by SEC disclosure rules). Highly compensated employees who are not executive officers (as defined by SEC rules) are not covered employees.
- *Once a Covered Employee, Always a Covered Employee.* Any officer who is a “covered employee” for a taxable year after 2016 will be treated as a “covered employee” for all subsequent years, regardless of later changes to employment status or compensation, and even after the individual has died. If a covered employee separates from service as an executive officer and subsequently provides services to the publicly held corporation in any capacity, including as a common law employee, a director or an independent contractor, any compensation (including director fees) received will continue to be subject to the deduction limit.
- *Clarification of What Constitutes a “Predecessor” of a Public Company.* Covered employees include any employee who was a covered employee of any “predecessor”

of the publicly held corporation. The proposed regulations provide examples as to how different corporate transactions (i.e., acquisitions, spin-offs, and other restructurings) may impact the status as a predecessor of a publicly held corporation. For example, any publicly held corporation that becomes a member of the affiliated group of another publicly held corporation is treated as a predecessor of such other publicly held corporation. The final regulations clarify, with respect to an asset transaction, if an acquiror corporation acquires at least 80% of the *gross* operating assets of a publicly held target corporation, then the target corporation is a predecessor of the acquiror corporation.

What Is a Publicly Held Corporation?

The term “publicly held corporation” is any corporation that is an issuer of securities that is required to be registered under Section 12 of the Securities Exchange Act of 1934 (the “Exchange Act”) or that is required to file reports under Section 15(d) of the Exchange Act.

- *No Change to Treatment of Partnerships and S Corporations.* A publicly traded partnership treated as a corporation for federal tax purposes, an S corporation and an S corporation parent of a qualified subchapter S subsidiary qualify as a publicly held corporation for purposes of Section 162(m) if the entity has any class of securities required to be registered under Section 12 of the Exchange Act, or is required to file reports under Section 15(d) of the Exchange Act (for instance, an S corporation with publicly traded debt).
- *No Change to Rules for Affiliated Groups.* Each public company in an affiliated group is separately subject to Section 162(m) and has its own set of covered employees. Further, the members of an affiliated group as a whole are subject to Section 162(m). In addition, an affiliated group includes a publicly held corporation that is a wholly owned subsidiary of a privately held parent corporation, which means the privately held parent company is also subject to the Section 162(m) deduction limit for compensation paid to the subsidiary’s covered employees.
- *No Change to Foreign Private Issuer Rules.* Foreign private issuers (FPIs) are considered publicly held corporations for Section 162(m) if the FPI is required to register securities under Section 12 of the Exchange Act or file reports under Section 15(d) of the Exchange Act, regardless of whether the FPI is required to disclose compensation of its officers on an individual basis in their home countries.

- *Clarification of Effective Date for Elimination of IPO Transition Exemption.* Prior to the TCJA, compensation paid under a new public company's compensation plans or agreements that were in effect and disclosed to the corporation's shareholders prior to the initial public offering were not subject to Section 162(m) during a specified transition period. This transition relief is not available to companies that became publicly held after December 20, 2019. Accordingly, the pre-TCJA IPO transition relief still applies for companies that became publicly held (including through a spin-off transaction) on or before December 20, 2019.

What Is Applicable Employee Remuneration?

- *No Change to General Rule.* The general rule is that "applicable employee remuneration" to which the Section 162(m) limitation applies includes the aggregate amount of compensation allowable as a deduction for the taxable year (determined without regard to Section 162(m)) for remuneration for services performed by a covered employee in any capacity, regardless of whether the services were performed during the taxable year, including compensation that is includible in the income of, or paid to, an individual other than the covered employee, such as a death beneficiary of the covered employee, for services performed by the covered employee.
- *Adoption of Rules Regarding Compensation Paid by a Partnership; Clarification of Special Applicability Dates.* Covered compensation includes compensation paid after December 18, 2020 by a partnership owned by a publicly held corporation to a covered employee of such corporation, such as in an umbrella partnership C corporation (or "Up-C") structure. If a publicly held corporate partner is allocated a distributive share of the partnership's deduction for compensation paid by the partnership, the allocated distributive share of the deduction is subject to Section 162(m), even though the corporation did not directly pay the compensation to the covered employee and regardless of the level of ownership by the publicly held corporation. However, assuming that the partnership is respected for federal income tax purposes, compensation paid to a covered employee of the publicly held corporation by a corporate subsidiary of the partnership for the covered employee's services to the corporate subsidiary would generally not be subject to the Section 162(m) deduction limit, because the corporate subsidiary would not be a member of the publicly held corporation's affiliated group of corporations. However, this definition does not apply to compensation paid by a partnership pursuant to a written binding contract that was in effect on December 20, 2019 (and that is not materially modified after that date).

Grandfathered Status

Compensation pursuant to written binding contracts in effect on November 2, 2017 is grandfathered and subject to the pre-TJCA rules, including any applicable pre-TCJA exemptions or exclusions, so long as those contracts are not materially modified. If a contract is materially modified, only those amounts received by an employee prior to the material modification are grandfathered.

- *No Change to Negative Discretion Analysis.* If a contract provides for negative discretion (i.e., the company can unilaterally reduce the payment amounts), then the contract is grandfathered only to the extent of any guaranteed or earned payment that cannot be reduced under applicable law.
- *New Guidance on the Impact of Clawbacks on Grandfathering.* For compensation subject to a recovery by the corporation upon the occurrence of an objective future event, the employer's right to recover is ignored for purposes of determining grandfathered status. The final regulations confirm that a clawback provision does not affect the grandfathering analysis, whether or not the corporation exercises its discretion to recover any compensation through the clawback provision upon the occurrence of the event.
- *New Guidance on the Effect of Extending the Exercise Period on Options and Stock Appreciation Rights.* The final regulations clarify that the extension of the exercise period of a stock option or stock appreciation right is not a material modification, provided that the extension complies with Section 409A of the Code.
- *No Change to Grandfathering Analysis of Accelerated Vesting or Payment.* For all forms of compensation (e.g., cash and equity) that are subject to a substantial risk of forfeiture, the acceleration of vesting or lapse of substantial risk of forfeiture is not a material modification. However, the actual *payment* of cash compensation earlier than as provided in the agreement is a material modification unless the amount of compensation paid is discounted to reasonably reflect the time value of money.
- *No Change to Severance Analysis.* Each component of a severance formula must be analyzed separately to determine the amount of the severance that is grandfathered. The amounts are only grandfathered to the extent the corporation is obligated to pay each component pursuant to a written contract (though "obligated" here does not mean that the severance is in pay status, but rather that the contractual terms are fixed). As such, a discretionary or performance bonus component may not be grandfathered. In addition, the grandfathered amount is limited to the amount that would be payable under the contract as of November 2, 2017.

- *Clarification of Treatment of Account and Nonaccount Balance Plans.* The grandfathered amount under any account or nonaccount balance plan is the amount that the corporation is obligated to pay pursuant to the terms of the plan as of November 2, 2017, as determined under applicable law:
 - If the corporation is obligated to pay the employee the balance, credited with earnings and losses, and has no right to terminate or materially amend the contract, then the grandfathered amount would be the account balance as of November 2, 2017, plus any additional contributions and earnings and losses that are required to be credited before the date of payment.
 - If the corporation may terminate the plan and distribute the account balance to the employee, the grandfathered amount is the balance determined as if the corporation had terminated the plan on November 2, 2017, or, if later, the earliest possible date the plan could be terminated (termination date).
 - If the corporation may not terminate the plan, but may discontinue future contributions to the balance and distribute the balance in accordance with the terms of the plan, then the grandfathered amount is the balance determined as if the corporation had exercised the right to discontinue contributions on November 2, 2017 or, if later, the earliest permissible date the corporation could exercise that right in accordance with the terms of the plan (the freeze date).

Therefore, in each case, the terms of the plan determine the grandfathered status of additional contributions and earnings and losses credited to the account balance after the termination date or freeze date but prior to the distribution date. However, a corporation may treat the account balance as of the termination date or freeze date as the grandfathered amount regardless of when it is paid and ignoring subsequent earnings, losses or new contributions prior to payment to minimize the administrative burden of tracking balances after November 2, 2017.

Section 409A Coordination

The final regulations leave the proposed regulations unchanged with respect to Section 409A and instruct taxpayers to continue to rely on the proposed regulations. The following illustrates these key Section 409A considerations.

- Prior to the enactment of the TCJA, payments to covered employees under nonqualified deferred compensation arrangements were often delayed pursuant to a special Section 409A rule, which allows delay until the individuals are no longer

covered employees subject to the Section 162(m) deduction limit. Because covered employee status is now perpetual, deferred amounts owed to covered employees may be paid over extended periods of time or not at all (instead of the year after the employee ceased to be an officer under the prior rule). The regulations allow for the delay of grandfathered payments without delaying the payment of non-grandfathered amounts, and the delay of the grandfathered amounts will not be treated as a subsequent deferral election under Section 409A.

- Relatedly, employers can amend their nonqualified deferred compensation arrangements to remove the provision requiring the corporation to delay a payment if the corporation reasonably anticipates at the time of the scheduled payment that the deduction would not be permitted under Section 162(m) without being considered a material modification under the grandfather rule or an impermissible acceleration of payment under Section 409A. Any such plan amendment must be adopted by December 31, 2020.

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Please do not hesitate to contact us with any questions.

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