Significant Changes Proposed to Section 162(m) Regulations

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On December 16, 2019, the Internal Revenue Service (the "**IRS**") released **proposed regulations** on the changes to section 162(m) of the Internal Revenue Code ("**§162(m)**") enacted by the Tax Cuts and Jobs Act of 2017 (the "**Act**"). The proposed regulations address and elaborate on the changes under the Act, providing detailed rules on the treatment of covered employees in M&A transactions, the universe of entities subject to §162(m), and include the repeal of the IPO transition rule.

Background

§162(m) imposes a $1 million annual limit on deductions for the compensation of certain covered employees of publicly held corporations. As described in more detail in our prior memorandum, *Compensation Season 2018: Section 162(m) and Related Considerations Post-Tax Reform*, effective, December 31, 2017, the Act made significant changes to this rule by expanding the scope of corporations subject to the limit, changing the definition of covered employee, and removing the exemption for performance-based compensation. The Act also provided for a grandfather rule to protect certain outstanding arrangements which were in effect as of November 2, 2017.

As described in more detail in our prior memorandum, *Initial Guidance on Recent Changes to Section 162(m): Covered Employees and Grandfather Rule*, the IRS has previously issued guidance on the changes to §162(m) in *Notice 2018-68* (the "**Notice**"). The guidance provided under the Notice was largely focused on classifying "covered employees" and the operation of the grandfather rule and, while the new proposed regulations largely follow the Notice, the Notice is superseded by the proposed regulations.

Expansion of Definition of "Publicly Held Corporation"

Only "publicly held" corporations are subject to §162(m). The Act significantly expanded the definition of publicly held corporation, and a large portion of the text of the newly proposed regulations is devoted to this new definition (including 26 examples).

Under prior law, §162(m) had only applied to corporations with publicly traded equity. The Act expanded the universe of corporations subject to §162(m) to include those with publicly traded debt, and foreign companies publicly traded through American depositary receipts ("**ADRs**").

Impact on Foreign Private Issuers ("FPIs"): Prior to the Act, FPIs were not subject to the §162(m) deduction limitation based on various IRS private letter rulings. The proposed regulations include extensive discussion of the issues arising with ADRs and, confirm that if the ADRs are listed on a national securities exchange, the FPI will be subject to 162(m). The newly proposed regulations make clear that if, however, the ADRs are traded on the over-the-counter market or quoted on over the counter bulletin board, such FPIs' would generally *not* be subject to §162(m) as long as the FPI qualifies for an exemption from registration

under Rule 12g3-2(b) (for example, if the FPI maintains a listing on a foreign exchange that constitutes the primary trading market). This is the result even though the ADRs would be required to be listed under the Securities Act by the depositary bank.

Impact on Affiliated Groups: The proposed regulations include extensive discussion and many examples regarding the application of §162(m) to affiliated groups of corporations where one or more entities are required to be registered under Section 12 or Section 15(d) of the Exchange Act, and to disregarded entities. Key takeaways include:

- A publicly traded partnership that is treated as a corporation for federal tax purposes will be subject to the rules if, as of the last day of its taxable year, its securities must be registered under Section 12 or Section 15(d) of the Exchange Act.
- A privately held parent will be included in the affiliated group of a subsidiary that is a publicly held corporation. The proposed regulations provide rules for prorating the deduction across entities for an employee paid by more than one entity within an affiliated group (including where the group contains one or more publicly held corporations).
- If a privately held corporation owns a "disregarded entity" (such as a wholly owned LLC or and S-corporation subsidiary) that has a class of securities that must be registered under Section 12 or Section 15(d) of the Exchange Act, the securities issued by such disregarded entity are treated as issued by the privately held parent for purposes of §162(m).
- A corporate subsidiary of a publicly held corporation that separately must register or file under Section 12 or 15(d) of the Exchange Act is a separate publicly held corporation and will have its own set of covered employees.

Covered Employees and Impact on Corporate Transactions

As noted in our prior alerts, the Act expanded the definition of "covered employees" for purposes of §162(m) to include CFOs and makes "covered employee" status permanent for any executive who was a "covered employee" for any tax year beginning after December 31, 2016.

Since covered employee status was determined on a year-to-year basis prior to the Act (and focused on which executives were listed in the Summary Compensation Table), determining the universe of covered employees had not been a significant issue in the context of corporate transactions. Following the Act, the Notice and as further elaborated on in the proposed regulations, more care will need to be taken in determining the ability to deduct compensation of employees who are covered employees as a result of their being a covered employee for any predecessor corporation.

The proposed regulations establish the following rules covering the predecessor corporation concept:

- A predecessor corporation includes any public company acquired in a corporate reorganization by another public company under Tax Code section 368(a)(1) (in other words, if a public company merges into another public company, the covered employees of the target company remain covered employees of the public buyer).
- A predecessor includes any public company that becomes privately held then public again before 36 months have elapsed since the due date of the corporation's tax return (excluding extensions) for the last tax year in which the corporation was public (e.g., where a private investor takes a company private and then completes an IPO within a 36 months period following closing of the initial transaction).
- If a publicly held corporations spins off a subsidiary to its shareholders, any covered employee of the publicly held corporation that become employees of the spun-off subsidiary within 12 months pre- or post-spin, will be a covered employee of such entity.
- In the context of an asset purchase, if a publicly held corporation (or an affiliate) acquires at least 80% of the assets of a public target, the covered employees of the target will become covered employees of the buyer if hired within 12 months before or after the 80% threshold is achieved.

The proposed regulations further clarify that, if after separation from service, a covered employee becomes reengaged (in any capacity) to provide services to the publicly held corporation, then any deduction for

compensation paid to the covered employee is subject to §162(m). The non-deductible compensation may also include the amount paid to a beneficiary on behalf of a decease former covered employee.

Termination of IPO Transition Relief

The prior §162(m) regulations included a special transition rule for corporations that become publicly held. Under the transition rule, compensation paid to employees pursuant to plans and agreements that pre-date the Company becoming public and that are disclosed to prospective shareholders were exempt from the deduction limit for a period of time (generally three years depending on the circumstances) following the go-public event as long as those arrangements were not materially modified. The proposed regulations terminate the transition relief, effective for all going-public events that occur after December 20, 2019.

Grandfather Rule

As described in our prior memoranda, the Act's changes to §162(m) do not apply to compensation under written binding contracts in effect as of November 2, 2017, so long as the contracts are not materially modified thereafter. Corporations are allowed to deduct compensation (i) under performance-based arrangements in effect on November 2, 2017, including existing stock options and other performance-based equity awards, (ii) for amounts earned and deferred under deferred compensation arrangements as of November 2, 2017 and (iii) under arrangements in effect on November 2, 2017 with any individuals who would first be covered by §162(m) solely due to the changes to §162(m) under the Act.

Consistent with prior IRS guidance issued under the Notice, the proposed regulations provide that the presence of negative discretion in preexisting contracts (even if not used) prevents grandfathering unless the exercise of such contractual negative discretion is limited under state law. Other key takeaways under the proposed regulations include:

- **For account and non-account balance plans**: The amount grandfathered is the amount the corporation is obligated to pay under applicable law on November 2, 2017. Earnings credited after November 2, 2017 are grandfathered only if the corporation is obligated to pay the earnings under applicable law pursuant to a written binding contract in effect on November 2, 2017.
- **Contract Renewal**: If a written binding contract is renewed after November 2, 2017, payments under the renewed contract are not grandfathered. A written binding contact is considered renewed where it is automatically extended absent a termination notice; the renewal date is the earliest date on which the contract could have been terminated.
- **Clawbacks**: The presence of clawback rights to recover compensation previously paid upon the occurrence of a objectively determinable events outside the corporation’s control do not necessarily preclude grandfathering until the event occurs. If the event occurs, the grandfathered status of the payment is limited to the amount that cannot be recovered (per the terms of the contract).
- **Accelerated Vesting**: Accelerating vesting is not considered a material modification. However, if the payment of grandfathered compensation (including equity) is accelerated, this would be a material modification unless the amount of compensation paid is discounted to reasonably reflect the time value of money.
- **Severance Payments**: Severance is grandfathered under a written binding contract only to the extent the corporation was obligated to pay the amounts as of November 2, 2017; any increase in the severance amount due to discretionary base salary increases after such date will not be grandfathered.

Practical Considerations

Going forward, companies contemplating corporate transactions (whether in the context of M&A or a reorganization or spin-off) or an IPO should work with their advisers to (i) identify the universe of “covered employees”, (ii) consider the implications of 162(m) on the deductibility of compensation as a result of the transaction and (iii) build in to any pricing model the potential additional costs or loss of deduction. Companies should also continue to implement procedures to (i) monitor arrangements which may be grandfathered for purposes of §162(m), and (ii) determine whether and how subsequent renewals or modifications will affect this status under the proposed regulations.

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