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IRS Releases Proposed Regulations that Clarify the Tax Reform's Impact on Section 162(m)

Two years following the major tax cut bill, proposed regulations provide more updated guidance from the IRS on the $1 million deduction limit under Code Section 162(m).

When the Tax Cuts and Jobs Act of 2017 (TCJA) was enacted on December 22, 2017, the changes to Internal Revenue Code Section 162(m) left a lot of companies with more questions than answers. In fall 2018, the IRS released its first set of clarifying guidance in Notice 2018-68 (see our article here for details), yet there were still gray areas that needed more explanation.

On December 18, 2019, the IRS released proposed regulations under Section 162(m), this time covering:

- What entities are considered a publicly held corporation;
- More information on who are covered employees and covered by 162(m);
- What compensation is subject to the $1 million annual deduction limit;
- Treatment of privately held corporations that become publicly held;
- Grandfathering of compensation covered by a November 2, 2017 binding contract; and
- Coordination of Section 162(m) with Section 409A.

Though the proposed regulations are lengthy (129 pages including the preamble), they mostly confirm the initial guidance provided just over a year ago. In this article, we provide highlights of the proposed regulations with a focus on those areas in which we expect companies to have questions — mainly, grandfathering and 409A.

Background on Changes to 162(m)

The TCJA changes to Section 162(m) largely mean that for tax years beginning on or after January 1, 2018, publicly held corporations can take a deduction only on compensation paid to a “covered employee” (as newly defined by TCJA) for up to $1 million per year with almost no exceptions. This was a huge change from the pre-TCJA 162(m) requirements that said performance-based compensation, as well as any compensation paid after termination of employment, was not subject to the $1 million deduction limit. In addition, under pre-TCJA rules the $1 million limitation for any tax year applied only to the CEO and up to three additional individuals (other than the

CFO) who were serving as executive officers at the end of the tax year and were named in the company's annual proxy statement. Finally, under pre-TCJA rules, certain compensation paid over a brief period following an initial public offering was completely exempt from the $1 million deduction limit.

Now, under TCJA rules, the limitation applies to anyone who at any time served as CEO or CFO or was one of highest three paid executive officers of a publicly held corporation during any tax year beginning after 2016. In other words, once an individual becomes a covered employee under TCJA rules they remain a covered employee for all future tax years.

Upon the enactment of TCJA, it was also clear that the new rules applied to tax years beginning after December 31, 2017. However, there was some clarification needed surrounding the "grandfathering" of compensation payable after that date under certain written binding contracts that were in effect on November 2, 2017.

The Further Definition of a Publicly Held Corporation

When the IRS released guidance in 2018, we noted that there were four items of special interest to the IRS; three of these centered on the definition of a publicly held corporation:

- Treatment of foreign private issuers as publicly held corporations;
- Treatment of individuals who were covered employees of the predecessor of a publicly held corporation; and
- Treatment of corporations immediately after they become publicly held through an IPO or similar business transaction.

The proposed regulations go into greater detail on these as follows:

Treatment of foreign private issuers as publicly held corporations: Under TJCA rules, some foreign private issuers are now subject to the $1 million limit. Since foreign private issuers are not required to disclose their executives' compensation under the SEC's disclosure rules, the IRS recognized that identifying the highest three paid executive officers under the SEC's methodology could be a challenge for these corporations. Under the proposed regulations, foreign private issuers who are classified as a publicly held corporation will have to use the SEC rules to identify covered employees. However, the IRS is requesting comments on whether it should design some type of safe harbor for determining the three most highly compensated executive officers of a foreign private issuer. Though the comment period on the proposed regulations ends February 20, 2020 and hearings will be held soon after, we expect the IRS will not be able to able to provide more guidance until well into the 2020 corporate tax filing season.

Treatment of individuals who were covered employees of the predecessor of a publicly held corporation: As noted above, the manner of identifying covered employees was radically changed under TCJA. Perhaps the most significant change was that individuals who meet the definition of a covered employees under the new rules in a tax year beginning after 2016 remain covered employees in future years. The proposed regulations clarify the gray area surrounding covered employees of a predecessor of a publicly held corporation, in that covered employees of the predecessor corporation will remain a covered employee of the resulting public corporation for all tax years in the future. The proposed regulations include a special rule covering situations where the successor corporation is not publicly held and later becomes publicly held. In that case, the individuals who were originally covered employees in the predecessor corporation may become covered employees again due to their earlier status. This is consistent with the “once covered, always covered” concept that was added as a part of TCJA. The result for companies undergoing mergers and acquisitions is that there will be a greater number of covered employees the successor publicly held corporation will have to track. Also, it would appear that when a single publicly held company splits into two publicly held corporations they both may have to track the same covered employee if a covered employee of the predecessor company goes with the spin company (or is hired by the spin company within 12 months of the spin) and the predecessor company expects to report future compensation payments to the covered employee (e.g., nonqualified deferred compensation payments or stock option exercises of predecessor company stock).

Treatment of corporations immediately after they become publicly held through an IPO or similar business transaction: For IPOs and other transactions that occur on or after December 20, 2019 and result in a privately held corporation becoming a publicly held corporation, the proposed regulations eliminate the prior transition relief that was applicable to privately held corporations that become publicly held. (Generally, companies undergoing an IPO had three years of relief under the prior rules.) The preamble to the Proposed Regulations explain that the prior relief is no longer warranted since under TCJA rules commission- or performance-based compensation is no longer exempt from the $1 million limitation. Since the exemption for this compensation no longer exists, the transition relief that went hand-in-hand with it should no longer exist either. Conversely, if a company is public and then becomes private, the proposed regulations also specify that “covered” employees of the public company would be considered “covered” again if the private company goes public (or becomes part of a public affiliated group) within a 36 month period of time starting with the tax return due date for the tax year in which the company was last public.

Payments After a Covered Employee’s Death and Payments for Services Other Than Employment: While the definition of compensation subject to the $1 million limit under TCJA was for the most part clear, there were still questions involving two areas. The first area involves amounts earned by a covered employee payable after the employee’s death to any beneficiary (e.g., estate, spouse, dependent, etc.). The proposed regulations shed some light on this gray area, stating that any compensation paid to a beneficiary of a deceased covered employee is subject to the same deduction limitation of Section 162(m). Though not explicitly stated, we believe this applies to any payment arising from the services of the covered employee including joint and survivor annuity payments under a nonqualified retirement arrangement. The second area involves amounts paid to a covered employee for services outside his or her capacity as an employee. The proposed regulations confirm directors’ fees and other non-employee compensation paid to someone who is otherwise designated a covered employee under TCJA are also subject to the deduction limitation. (Under pre-TCJA rules, this seldom was an issue because executive officers rarely received such compensation from a corporation before they terminated employment and were therefore no longer subject to the $1 million limitation.)

Grandfathering of Compensation

Perhaps the most vexing part of the 2017 tax bill was the “grandfathering” language. The tax bill effectively said that if the compensation was subject to a “written binding contract” in effect on November 2, 2017, it would remain subject to the pre-TCJA statute and prior regulatory guidance. This meant that some compensation payable in a future year could remain fully deductible including:

- Compensation that met the requirements for performance-based compensation (e.g. stock option exercises and payments under certain other qualifying incentive arrangements);

- Compensation payable after the covered employee was no longer an active named executive officer (such as severance, supplemental retirement benefits, and incentives awards settled after termination of employment);

- Compensation payable to the CFO of the public company; and

- Compensation payable by a public corporation that had recently undergone an IPO.

The proposed regulations expand upon prior guidance in the following areas:

Written Binding Contract: There was a lot of speculation surrounding what constitutes a written binding contract and what types of modifications to the contract would result in loss of the grandfather. In situations where a binding employment agreement was in effect, some speculated on the extent to which future compensation that was subject to the contract would be grandfathered. For example, if the contract provided for performance grants annually, was that enough to warrant grandfathering of all future performance-based awards? The IRS guidance in this area reflects a more straightforward and restricted approach. The proposed regulations offer clarity surrounding this explaining that a written binding contract exists only to the extent that the company was legally obligated as of the date preceding November 2, 2017, to pay the compensation to the employee if the conditions specified in the contract to earn the compensation were met. As a result, any agreement that has negative discretion (a common provision under many pre-TCJA incentive arrangements), or any agreement that does not specify conditions or service terms (i.e. the employment agreement conversation), is not considered subject to a written binding contract and therefore is not grandfathered under the pre-TCJA rules.

Material Modification and the Impact on Grandfathering: The concept of material modifications to previously grandfathered pre-TCJA awards was one that caused concern for many companies. Questions came up a lot about corrections to dates, addition of termination provisions or retirement eligibility provisions, and if those changes were enough to constitute a material modification. The proposed regulations confirmed and amplified the 2018 guidance specifying that the written binding contract must be amended to increase the amount of compensation to the employee or accelerate or defer the payment (with certain exceptions), to result in a material modification. In this context, it will be as if the original contract did not exist and it was replaced by this new contract, which cannot then be grandfathered. For the acceleration of payments, compensation must be appropriately discounted to reflect the time value of money. For the deferral of payments, any additional amount paid must be based on a reasonable rate of interest or predetermined investment. Either way, even though there is not a material modification if these criteria occur, the additional earnings generated would not be considered grandfathered and therefore would be subject to the deduction limitation. Employers cannot avoid a material modification by entering into a new agreement just like the old one, but with increased benefits. Adopting a supplemental contract or agreement that provides for increased compensation is a material modification, if the facts and circumstances demonstrate that the increased compensation is paid based on substantially the same elements or conditions as the written binding contract in effect on November 2, 2017. Though much of the new guidance may be viewed negatively, the proposed regulations do provide some welcome news with respect to certain modifications of written binding contracts. Adopting the recommendation of commenters, the IRS has decided that accelerated vesting of requirements specified under the written binding contract will not result in a material modification. For example, if vesting requirements for grandfathered stock options are waived as part of a separation negotiation, the stock options may remain fully deductible as performance-based compensation.

Treatment of earnings on grandfathered obligations: The grandfathered amount may include earnings the employer must pay under applicable law as of November 2, 2017. Determining whether earnings should be grandfathered will often require careful legal analysis. For example, if a nonqualified retirement plan allows the employer to terminate and liquidate an arrangement subject to special timing requirements under Internal Revenue Code Section 409A, the applicable 409A regulations provide that payment may not be made within 12 months of the date of termination of the plan. If the plan does not explicitly state that earnings must be credited during this period of time, companies may need to consider if applicable law (e.g., state law or ERISA) requires that the employer credit earnings during that 12-month period. If the plan or applicable law require earnings to be credited, then the Section 162(m) grandfathered amount reflects the earnings that would be credited during the 12-month period following November 2, 2017.

Coordination with Code Section 409A: Under pre-TCJA rules, deferred compensation plans often included a provision that requires the delay of payment until the time when the payment would become deductible under Section 162(m). Typically, this would occur after termination of employment when the individual was no longer a covered employee. Under post-TCJA rules this provision may longer be helpful, and the regulations give employers the ability to amend these Plans without being treated as a material modification (for the purpose of grandfathering) nor treated as an impermissible acceleration of the payment. This amendment must occur by December 31, 2020, and payments previously suspended under the original provisions of the plan must then be paid by the same date.

Ordering Rule When a Series of Payments Include Grandfathered and Non-Grandfathered Amounts: When a series of payments under a nonqualified deferred compensation arrangement include both grandfathered and non-grandfathered amounts, the proposed regulations provide that the grandfathered amount is allocated to the first "otherwise deductible" payment paid under the arrangement. If the grandfathered amount exceeds that first payment, the grandfathered amount still remaining is applied to successive payments in the series until the grandfathered amount is fully paid. However, the preamble to the proposed regulations provides a simple example that leaves many related questions unanswered, including:

- How is the grandfathered portion of a life annuity obligation determined and allocated amongst the life annuity payments?
- In the case of a nonqualified voluntary deferral arrangement, are the amounts deferred after November 2, 2017, considered made under the same contract as those elections made on or before date? Or are they treated as separate new contracts (for purposes of allocating the grandfathered amount amongst the serial payments from the nonqualified arrangement)?
- Does the phrase "otherwise deductible" mean without regard to pre-TCJA limits, post-TCJA limits or both?

Key Takeaways

With every update following the 2017 tax bill's passing, certain elements of the tax bill become clearer while other areas once thought to be settled become less so. Refining the definitions, qualifications and requirements are a result of the increase in administrative burden. We expect to see more comments surrounding safe harbors on foreign private issuers and the accrual under U.S. GAAP and the impact on the establishment of a written binding contract. Regardless of the comments that are made, it's clear that the refinement of the terms and conditions of the tax reform specific to IRC Section 162(m) are not likely to be settled in the near future.

If you have questions about the proposed regulations and want to speak with a member of our rewards consulting group, please write to rewards-solutions@aon.com.

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