ABA 2020 Midyear Tax Section Meeting
Boca Raton, FL
February 1, 2020

HOT TOPICS IN EXECUTIVE COMPENSATION:
PROPOSED 162(M) REGULATIONS

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Amber R. Salotto, Attorney Advisor, U.S. Department of the Treasury
Stephen Tackney, Deputy Associate Chief Counsel (Employee Benefits), Employee Benefits, Exempt Organizations, and Employment Taxes, Office of Chief Counsel, Internal Revenue Service
Agenda

• Background
• Key definitions
  – Publicly held corporation
  – Covered employee
  – Compensation
• Corporations that become publicly held
• Applicability dates and grandfathering
• Coordination with section 409A
Background

• Section 162(m) generally imposes an annual limit of $1 million per tax year on deductions:
  – by a publicly held corporation
  – for payments to a covered employee
  – of compensation
Key Dates

- **8/10/93**  Enactment (OBRA 1993)
- **12/20/93**  Proposed regulations
- **12/2/94**  Amended proposed regulations
- **12/20/95**  Final regulations
- **12/22/17**  TCJA amendments
- **8/21/18**  Notice 2018-16 (released)
- **12/20/19**  Proposed regulations
- **??/??/??**  Final regulations
Key Definitions:
Publicly Held Corporation
Statutory Amendments

Pre-TCJA
• Common equity securities required to be registered under section 12 of the Exchange Act

TCJA
• Securities required to be registered under section 12 of the Exchange Act, or
• Reports required to be filed under section 15(d) of the Exchange Act
Relevant SEC Rules

- **Section 12(b)** registration is required to list on national securities exchange.
- **Section 12(g)** registration is required for an issuer with total assets exceeding $10 million if held of record by 2,000+ persons or 500+ non-accredited investors.
- **Section 15(d)** reports are required when securities are offered for sale in a transaction subject to the Securities Act of 1993 and the SEC declares the registration statement effective.
Proposed Regulations—General Rules

• C corporation or S corporation with publicly traded common stock, preferred stock, or debt
• Determined as of the last day of the taxable year
• Each subsidiary required to file under section 15(d) is a separate publicly held corporation with its own set of covered employees and $1 million limit per covered employee
• A corporation is not a publicly held corporation if its reporting obligation under section 15(d) is suspended as of the last day of the tax year
Proposed Regulations—FPIs

• Foreign private issuers (FPIs) were not “publicly held corporations” prior to the TCJA amendments because they were not required to file a summary compensation table.

• Under the proposed regulations, an FPI is a publicly held corporation to the extent the underlying securities are required to be registered under section 12 or subject to 15(d) reporting.

• Comments are requested on possible safe harbors for identifying covered employees.
Proposed Regulations—PTPs

• To the extent a publicly traded partnership (PTP) is treated as a corporation under section 7704, the proposed regulations treat the PTP as a publicly held corporation.

• This rule may have limited application:
  – Section 7704(c) exception for passive-type income
  – Some partnerships have converted to corporations
Proposed Regulations—Affiliated Groups

• General rule follows 1995 final regulations: “publicly held corporation” includes section 1504 affiliated corporations (80% threshold)

• New proposed rules
  – Include privately held corporate parent of publicly held corporation
  – Contain additional examples for prorating compensation among affiliated group members (with a separate $1 million limit for each publicly held corporation receiving services from a covered employee)
Proposed Regulations—DREs & QSubs

- Proposed regulations address disregarded entities (DREs) and qualified subchapter S subsidiaries (QSubs) that are wholly owned by a corporation and not treated as separate entities for federal income tax purposes.

- Under the proposed regulations, if a DRE or QSub issues securities required to be registered under section 12(b) or is required to file reports under section 15(d) then the corporation that owns it is a “publicly held corporation”
Key Definitions:
Covered Employee
## Statutory Amendments

<table>
<thead>
<tr>
<th>Pre-TCJA</th>
<th>TCJA</th>
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<tbody>
<tr>
<td>• CEO and 3 highest compensated officers other than CEO</td>
<td>• CEO or CFO at any time during the year</td>
</tr>
<tr>
<td>• Only if employed at the end of the taxable year</td>
<td>• 3 highest compensated officers for the year other than CEO or CFO</td>
</tr>
<tr>
<td>• Only if reported on summary compensation table</td>
<td>• Once a covered employee (after 2016), always a covered employee (including service at predecessor)</td>
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</table>
Notice 2018-68

• No end-of-year employment requirement for any covered employee
  – Although SEC disclosures rules will determine the amount of compensation, an executive officer that does not appear on the summary compensation table may nevertheless be a covered employee

• Requested comments on how to identify 3 highest compensated officers other than CEO and CFO where tax year and fiscal year are not coextensive
Proposed Regulations—General Rules

• Reaffirm Notice 2018-68 rules
• Clarify that covered employees are limited to executive officers
• Treat an executive officer of a DRE or QSub owned by a publicly held corporation as a covered employee of the publicly held corporation, but only if the executive officer performs policy making functions for the publicly held corporation
Proposed Regulations—Predecessors

- Proposed regulations provide detailed rules for identifying predecessor corporations
  - Cooling off period
    - Publicly held corporation goes private, then becomes publicly held again for a taxable year ending before the 36-month anniversary of the tax return due date for its last public year
  - Transactions
    - Corporate reorganizations under section 368(a)(1)
    - Corporate divisions under section 355(a)(1)
    - Stock acquisitions in which the acquired corporation joins an affiliated group (80% threshold under section 1504)
    - Asset acquisitions in which 80% of operating assets (by value) are acquired
Key Definitions:
Compensation
Pre-TCJA
• No specific statutory rule for payments to a person other than the covered employee

TCJA
• Applicable employee remuneration may include amounts includible in the income of, or paid to, a person other than the covered employee, including after death of the covered employee
Proposed Regulations—General Rules

- Like the 1995 final regulations, the proposed regulations use the term “compensation” instead of “applicable employee remuneration”
Proposed Regulations—Partnerships

• New rule for compensation paid by partnerships
  – Section 162(m) applies to a publicly held corporation’s distributive share of the deduction taken by a partnership for compensation paid to the publicly held corporation’s covered employee

• Affects taxpayers with “Up-C” and “Up-REIT” partnership structures

• Consider tax, financial statement, and Form 1099 reporting consequences
Proposed Regulations—Ind. Contractors

• Preamble:
  – Section 162(m) can apply to compensation earned as a non-employee as well as compensation earned as an employee before becoming a covered employee
  – This has been the rule since enactment in 1993

• Examples
  – Former executive officer’s director/consulting fees
  – Current executive officer’s separately stated director fees
  – Amounts earned as an employee but not paid until after becoming a covered employee
Corporations that become publicly held
Statutory Amendments

Pre-TCJA
- Exception for commissions
- Exception for other performance-based compensation

TCJA
- Both exceptions eliminated
Proposed Regulations

• “IPO Transition Rule” (not limited to IPOs)
  – Transition relief in the 1995 final regulations
  – Section 162(m) applies on latest of:
    • Expiration of plan/agreement
    • Material modification of plan/agreement
    • Issuance of all employer stock/compensation allocated under plan/agreement
    • First meeting of shareholders at which directors are elected after close of 3rd calendar year following go-public transaction

• The proposed regulations do not include the IPO transition rule, which the preamble explains was linked to the performance-based compensation exception
Applicability dates and grandfathering
<table>
<thead>
<tr>
<th>Proposed Rule</th>
<th>Proposed Applicability Date</th>
<th>Tax Year for Calendar Year Taxpayers</th>
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<tbody>
<tr>
<td>Notice 2018-68 rules for covered employees and grandfathering</td>
<td>Tax years ending on/after 9/10/18</td>
<td>2019</td>
</tr>
<tr>
<td>Identifying 3 highest compensated executive officers when tax year is</td>
<td>Reg text: Tax years ending on/after 12/20/19</td>
<td>2019</td>
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<td>different from fiscal year</td>
<td>Preamble: Tax years beginning on/after 12/20/19</td>
<td>2020</td>
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<tr>
<td>Distributive share of partnership compensation deduction</td>
<td>Tax years ending on/after 12/20/19</td>
<td>2019</td>
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<td>IPO transition rule repealed</td>
<td>Reg text: Becoming publicly held on/after 12/20/19</td>
<td>Depends</td>
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<td>Predecessor corporation rules for identifying covered employees</td>
<td>Transactions on/after publication of FINAL regulations</td>
<td>Depends</td>
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<td>Public to private to public 36-month cooling off period</td>
<td>Becoming publicly held again on/after publication of FINAL regs</td>
<td>Depends</td>
</tr>
<tr>
<td>All other rules</td>
<td>Tax years beginning on/after publication of FINAL regulations</td>
<td>?</td>
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Statutory Grandfather Rules

• All TCJA amendments do not apply to grandfathered compensation—amounts paid pursuant to a:
  – Written binding contract
  – In effect on November 2, 2017
  – Not materially modified on/after that date

• Analogous to OBRA 1993 statutory grandfather rules
Notice 2018-68 Grandfather Rules

• Based on grandfather rules in 1995 final regulations
• Emphasize the requirement that there be a legal obligation to pay if services are performed
  – No grandfathering to the extent the corporation retains negative discretion
  – Defined contribution plan examples
• Material modification: increase greater than a reasonable COLA in compensation based on substantially the same elements and conditions
Proposed Regulations Grandfather Rules

• Clarifications of Notice 2018-68
  – Earnings on deferred compensation
  – Nonaccount balance plans
  – Severance pay

• New proposed rules
  – Acceleration of vesting is not a material modification
  – Grandfathered-first ordering rule
  – Clawbacks
Coordination with section 409A
Section 409A

- Subject to conditions, existing section 409A regulations allow a service recipient to delay payment of nonqualified deferred compensation if it reasonably believes section 162(m) would disallow its deduction.
- Preamble to proposed section 162(m) regulations states an intention to modify the section 409A regulations in the future to reflect TCJA amendments to section 162(m):
  - Permit bifurcation of grandfathered and non-grandfathered amounts (only delay payment of grandfathered amounts)
  - Plan amendments may or may not be required
    - If required, there is a December 31, 2020, deadline
- Taxpayers may rely on these rules for tax years beginning after December 31, 2017, through issuance of intended proposed section 409A regulations.