December 23, 2019

Proposed Section 162(m) Rules Would Make More Post-IPO and Public Company Transaction-Based Executive Pay Nondeductible

The trend toward limiting U.S. federal income tax benefits associated with public company executive pay continues. The latest effort came last week, when the Treasury Department proposed new regulations implementing changes to Section 162(m) of the Internal Revenue Code (Code) made by 2017's "Tax Cuts and Jobs Act" (TCJA). One of the most important aspects of the TCJA's reforms to Section 162(m) and the newly proposed regulations is the impact on companies undergoing significant corporate transactions, such as initial public offerings (IPOs) and M&A transactions involving public companies, adding new complexities and considerations for companies and investors.

Section 162(m) operates by eliminating tax deductions associated with executive compensation above $1 million in any taxable year for certain current and former top executives ("covered employees") of "publicly held corporations." The TCJA expanded the scope of Section 162(m), and thus made more compensation nondeductible, by eliminating exemptions (most notably, the one for performance-based pay) that previously enabled full deductibility for key components of executive pay packages and by broadening the meaning of "publicly held corporation" and "covered employee." The proposed regulations flesh out several key details related to those changes.

Key Takeaways from the Proposed Regulations

- **The Post-IPO Transition Relief for Newly-Public Companies Has Been Eliminated**. The existing regulations under Section 162(m) provide a special transition rule for companies that have gone public. Under the transition rule, executive pay pursuant to plans and agreements that pre-date the Company's initial public offering and that are disclosed to prospective shareholders are exempt from Section 162(m) for a certain period following the initial public offering as long as those arrangements are not materially modified. This transition rule could often afford newly public companies more than three years of relief from the restrictions of Section 162(m) (and stock options and certain other awards granted during that window might remain outstanding and fully deductible for additional years). The proposed regulations preserve the existing rule for companies that went public on or before December 20, 2019, but eliminate it for companies that go public after that date.

- **"Predecessor" Rules Will Make More Pay Nondeductible**. Section 162(m) applies to any individual who was a covered employee of a publicly held corporation ***or any predecessor*** of a publicly held corporation for a preceding taxable year. The proposed regulations take a sweeping approach to determining what it means to be a "predecessor of a publicly held corporation." These rules are significant because the TCJA introduced the "once a covered employee, always a covered employee" requirement, which means that if executives of a predecessor company remain employed or otherwise in service or receive transition or exit packages, their compensation may be wholly or partially nondeductible.

    - **Public Company M&A Transactions**. Where a publicly held corporation is acquired in a stock transaction or substantially all of its assets (at least 80%) are acquired by another publicly held corporation, covered employees of the target will become covered employees of the acquirer. These rules would be applied cumulatively, so a target corporation would include its predecessors (and any of their respective predecessors).

    - **Spin-Off Transactions**. A publicly held distributing corporation will be considered a predecessor to the publicly held "SpinCo" with respect to a covered employee of the distributing corporation hired by the "SpinCo" within 12 months before or after the spinoff.

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- **Publicly Held → Privately Held → Publicly Held**. Under the proposed regulations, a publicly held corporation can be a predecessor to itself when, after becoming privately held, it becomes a publicly held corporation again in a taxable year ending prior to the 36-month anniversary of the due date for the corporation's U.S. federal income tax return for the last taxable year for which the corporation was previously public.

- **Go Private Transactions**. Many "go private" transactions in which publicly held corporations are acquired by private equity funds or other non-publicly traded acquirers result in a short taxable year for the target that ends on the closing. The proposed regulations make clear that compensation for this short taxable year in which the target was a publicly held corporation would be subject to Section 162(m). The result is that the deductibility associated with often substantial transaction-based pay to executives in such transactions (e.g., option or RSU cash-outs) would now be sharply curtailed or eliminated.

- **Interaction with Section 280G**. A collateral impact of broadening the applicability of Section 162(m)'s deduction limitations is that, in some situations, Section 280G of the Code would become less significant (e.g., a deduction that might otherwise be lost under Section 280G absent mitigation may nonetheless be lost under Section 162(m)). As under existing rules, "excess parachute payments" under Section 280G reduce the $1 million threshold for Section 162(m)'s deduction limitation to apply.

- **Partnership "Distributive Share" Rules May Impact Up-C/UpREIT Structures**. If a publicly held corporation owns an interest in a partnership, the proposed regulations provide that, in applying Section 162(m)'s limitations, the publicly held corporation must take into account its distributive share of the partnership's deduction for compensation paid to the publicly held corporation's covered employees. This change could impact compensation deductions for publicly held companies and real estate investment trusts (REITs) employing "up-C" or "upREIT" structuring. This rule applies to deductions for compensation that is otherwise allowable for a taxable year ending on or after December 20, 2019.

Other Matters Addressed

- **Grandfathering Rules**. TCJA's reforms to Section 162(m) do not apply to compensation provided pursuant to a written binding contract in effect on November 2, 2017 that has not been materially modified on or after that date. Like prior IRS guidance, the proposed regulations provide that the presence of negative discretion in preexisting contracts, even if not used, would prevent grandfathering unless the exercise of that contractual negative discretion was limited under applicable law (such as state contract law). The proposed regulations otherwise provide a number of specific examples of the application of the grandfathering rules in particular contexts.

    - **Equity Acceleration**. Notably, a modification of an otherwise grandfathered award of restricted stock or exempt stock option or stock appreciation right to provide accelerated vesting would not be considered a material modification.

    - **Account and Nonaccount Balance Plans**. The proposed regulations generally maintain existing IRS guidance that the amount grandfathered under an account or nonaccount balance plan is the amount that the corporation is obligated to pay under applicable law on November 2, 2017, with future earnings or additional benefit accruals, as applicable, generally not grandfathered.

- **Expansion of "Publicly Held Corporation" Definition**. TCJA's amendments to Section 162(m) expanded the definition of "publicly held corporation" to pick up a broader array of corporations that make public filings with

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the Securities and Exchange Commission, and the proposed regulations further provide detail on which companies will be subject to this section.

- **Debt Issuers**. Issuers of publicly traded debt are now considered "publicly held corporations." The proposed regulations provide that this is the case even if the issuer is otherwise a disregarded entity for U.S. federal income tax purposes.
- **Foreign Private Issuers (FPIs)**. Since an FPI may offer or list its securities (often in the form of American Depositary Receipts (ADRs)) in the United States, the FPI may be required to register its deposited securities under Section 12 of the Securities Exchange Act of 1934. In such instances, the FPI will be considered a publicly held corporation.
- **Affiliated Groups**. The proposed regulations provide detailed rules for determining covered employees and allocating their compensation in affiliated groups that include more than one "publicly held corporation" within the affiliated group (e.g., where a parent entity has publicly traded equity securities and a subsidiary has publicly traded debt securities).

Effective Dates

In general, these regulations would apply to compensation that is otherwise deductible for taxable years beginning on or after the date that the final rules are published, although there are some notable exceptions, such as the elimination of the post-IPO transition rule and the requirement to take into account partnership distributive shares, as described above.

Please contact your usual Ropes & Gray advisor or any member of the executive compensation & employee benefits group if you would like to discuss these issues.

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