

December 28, 2020

Final Section 162(m) Rules Clarify Limits on Companies' Ability to Deduct Executive Pay

On December 18, 2020, just over one year after proposed regulations were released, the Internal Revenue Service (IRS) and the Department of the Treasury (Treasury) finalized regulations implementing the changes to Section 162(m) of the Internal Revenue Code made by the 2017 Tax Cuts and Jobs Act (TCJA). Section 162(m) generally disallows a tax deduction for compensation paid in excess of \$1 million in any taxable year to certain current and former executive officers (covered employees) of publicly held corporations. The TCJA expanded the scope of Section 162(m), and thus made more compensation nondeductible, by eliminating exceptions (most notably, for certain qualifying performance-based compensation) and by broadening the scope of entities and employees covered by Section 162(m). The proposed regulations issued by the IRS and Treasury in December 2019 fleshed out a number of the details of TCJA. The final regulations largely follow the proposed regulations, but further clarify or refine certain provisions. This Alert briefly summarizes several of the key clarifications and changes included in the final regulations.

- **Post-IPO Transition Relief for Newly Public Corporations Has Been Eliminated.** The pre-TCJA regulations under Section 162(m) included special transition relief for newly public corporations, which exempted compensation paid under arrangements that pre-dated the corporation's initial public offering and that were disclosed to prospective shareholders from Section 162(m)'s deduction limitations for a limited period following the initial public offering. The proposed regulations eliminated this transition relief for corporations that became publicly-traded after December 20, 2019. The final regulations retain the elimination of the transition relief set forth in the proposed regulations, and clarify that a subsidiary that is a member of an affiliated group may rely on the transition relief if the subsidiary became a separate public corporation on or before December 20, 2019.
- **"Predecessor" Rules Are Further Refined.** The proposed regulations significantly expanded the scope of individuals covered by Section 162(m) by providing that the term "covered employee" includes any individual who was a covered employee of any predecessor to a publicly held corporation. The final regulations generally take the same sweeping approach as the proposed regulations in determining what it means to be a predecessor of a publicly held corporation, but provide further rules and clarifications regarding certain transactions, including- spin-offs of subsidiaries. These rules are significant because the TCJA introduced the "once a covered employee, always a covered employee" rule, which means that if an executive of a corporation that is treated as a predecessor corporation remains employed or otherwise in service or becomes newly employed in connection with certain subsidiary spin-offs, his or her compensation may be wholly or partially nondeductible.
- **The Partnership "Distributive Share" Rules Are Clarified.** If a publicly held corporation owns an interest in a partnership and that partnership pays compensation to the publicly held corporation's covered employees, like the proposed regulations, the final 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 such employees. The final regulations clarify that the publicly held corporation's distributive share includes the partnership's deduction for a payment to the covered employee under Sections 707(a) or 707(c) of the Internal Revenue Code. Recognizing the prior lack of clarity in these rules, the final regulations provide that this distributive share rule only applies to deductions attributable to compensation paid after December 18, 2020. The final regulations also adopted the grandfather rule set forth in the proposed regulations, which provides that this rule does not apply to compensation paid pursuant to a written binding contract in effect on December 20, 2019 that is not thereafter materially modified.

- **Grandfathering Rules Further Clarified.** TCJA's changes to Section 162(m) do not apply to compensation provided under a written binding contract in effect on November 2, 2017 that has not been modified in any material respect on or after that date. The final regulations generally adopt the grandfathering provisions set forth in the proposed regulations, including the effect that negative discretion has on the ability to consider contracts grandfathered for purposes of Section 162(m), and they provide additional clarifications relating to stock options and SARs, investment alternatives and account and nonaccount balance plans.
 - **Extended Exercise Period Not a Material Modification.** The final regulations include a new provision that provides that, if compensation attributable to stock options or stock appreciation rights is grandfathered, an extension of the exercise period that complies with Section 409A of the Internal Revenue Code will not be treated as a material modification of such awards. The final regulations retain the provision found in the proposed regulations that the acceleration of vesting of a grandfathered stock option, stock appreciation right or restricted stock award is not treated as a material modification of that award.
 - **Substitution of Investment Alternative Not a Material Modification.** Where grandfathered amounts are subject to increase or decrease based on the performance of a predetermined actual investment, the final regulations provide that the addition or substitution of a predetermined actual investment or reasonable interest rate as an investment alternative for deferred amounts will not be treated as a material modification of such grandfathered arrangement.
 - **Application to Account and Nonaccount Balance Plans.** The final regulations include various examples illustrating the application of the grandfather rule to account and nonaccount balance nonqualified deferred compensation plans. The final regulations provide that the grandfathered amount under an account 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 an employee the account balance that is credited with earnings and losses and has no right to terminate or materially amend the plan, then the grandfathered amount would be the account balance as of November 2, 2017, plus any additional contributions and earnings and losses that the corporation is obligated to credit under the plan, through the date of payment. If instead the corporation has the right to terminate the plan, the grandfathered amount would be the account 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 in accordance with its terms. The final regulations include an analogous rule for nonaccount balance plans. For those plans, the grandfathered amount is the present value of the total benefit (lump sum value) 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 in accordance with its terms, determined based on the actuarial methods and assumptions provided in the plan in effect on November 2, 2017, if reasonable.

Applicability Dates

In general, the final regulations apply to compensation that is otherwise deductible for taxable years beginning on or after the date the regulations are published in the Federal Register, although there are special applicability dates for certain items, such as the elimination of the post-IPO transition rule and the partnership distributive share rules, discussed 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.