LATHAM & WATKINS

Client Alert
Commentary

Latham & Watkins Benefits, Compensation & Employment Practice January 24, 2020 | Number 2583

# 10 Key Takeaways From the Section 162(m) Proposed Regulations

***Recently issued proposed regulations clarify changes made by the TCJA to the tax deductibility of executive compensation.***

Section 162(m) of the US Internal Revenue Code (the Code) as amended by the Tax Cuts and Jobs Act (TCJA) denies a tax deduction for compensation of more than US$1 million paid to certain executive officers of a publicly traded corporation (covered employees). This *Client Alert* examines the 10 key takeaways from the proposed regulations.[1]

### 1. More entities are covered by the deduction limitations than you think!

The proposed rules clarified which entities are covered by the Section 162(m) limitations. These entities include publicly traded partnerships taxed as corporations (generally not including publicly traded partnerships taxed as partnerships, such as master limited partnerships (MLPs)), foreign private issuers, privately held corporations, and S-corporations that have publicly traded debt. Additionally, if a privately held corporation has a partnership, limited liability company, or qualified subchapter S corporation that is disregarded from the corporation for tax purposes and such disregarded entity has publicly traded debt, then the privately held corporation will still be treated as being a publicly traded corporation and subject to the limitations of Section 162(m). Use of minority ownership interests in order to avoid a subsidiary from being disregarded for Section 162(m) purposes can be challenged by the IRS under the partnership tax anti-abuse rules.

### 2. Companies that are voluntary filers, voluntarily provide public disclosure, or are not subject to Exchange Act registration or reporting on the last day of the tax year are not subject to Section 162(m) limitations.

Only companies (or their disregarded subsidiaries) that, as of the last day of the company's tax year, are required to register securities under Section 12 of the Securities Exchange Act of 1934 (the Exchange Act) or are required to file reports under Section 15(d) of the Exchange Act are considered publicly traded for Section 162(m) purposes. Companies that voluntarily register securities, or voluntarily file public disclosure, are not covered by the deduction limitations of Section 162(m), including companies that are required to file public reports only in order to be listed on OTCBB. If, as of the last day of the company's tax year, a company's reporting requirements under the Exchange Act are suspended, or the company may deregister (but has not deregistered) under the Exchange Act, then it will not be treated as a publicly traded corporation for Section 162(m) purposes. Notably, the same analysis does not apply when determining whether a company is considered a publicly traded corporation under the Exchange Act.

Latham & Watkins operates worldwide as a limited liability partnership organized under the laws of the State of Delaware (USA) with affiliated limited liability partnerships conducting the practice in France, Hong Kong, Italy, Singapore, and the United Kingdom and as an affiliated partnership conducting the practice in Japan. Latham & Watkins operates in South Korea as a Foreign Legal Consultant Office. Latham & Watkins works in cooperation with the Law Office of Salman M. Al-Sudairi in the Kingdom of Saudi Arabia. Under New York's Code of Professional Responsibility, portions of this communication contain attorney advertising. Prior results do not guarantee a similar outcome. Results depend upon a variety of factors unique to each representation. Please direct all inquiries regarding our conduct under New York's Disciplinary Rules to Latham & Watkins LLP, 885 Third Avenue, New York, NY 10022-4834, Phone: +1.212.906.1200. © Copyright 2020 Latham & Watkins. All Rights Reserved.

## 3. REIT and Up-C executives are subject to the Section 162(m) deduction limitations

Under several rulings issued by the IRS prior to the enactment of TCJA, executives of publicly traded real estate investment trusts (REITs) typically were not subject to the prior deduction limitations of Section 162(m), because the REIT itself did not employ or pay the executives any compensation. REIT and Up-C executives are typically paid by a lower-tier operating partnership. The proposed regulations, however, overturn this prior guidance and apply the Section 162(m) deduction limitations to REITs and Up-C structures by treating as compensation paid to the covered employee the amount of the REIT/Up-C's distributive share of the deduction for compensation paid to a covered employee for services performed for the partnership. A similar result may also apply in some MLP structures (*e.g.*, if an MLP pays compensation to the covered employees of a publicly traded parent or sponsor corporation). This change is effective for tax years ending on or after December 20, 2019. However, in acknowledging this shift from prior IRS guidance, the proposed regulations provide transition relief for compensation paid pursuant to a written binding contract in effect on December 20, 2019, that is not materially modified thereafter.

## 4. Covered employees are not limited to those reported in the proxy or 10-K

Section 162(m) limitations apply only to compensation paid by a publicly traded corporation to its principal executive officer (PEO), principal financial officer (PFO), and the three most highly compensated executive officers (covered employees). The SEC rules for reporting compensation are used to calculate the compensation of an executive officer when determining who is one of the three most highly compensated executive officers. However, there are some differences in who is a covered employee under the SEC executive compensation disclosure rules:

- *Covered employees are determined based on the publicly traded corporation's tax year, which may not necessarily be the same as the corporation's fiscal SEC reporting year.* For instance, a corporation may have a short tax year due to a merger transaction. In that case, the covered employees would be determined by applying the SEC executive compensation rules for the short tax year. Human resources and payroll should be notified to the extent a corporation has a short tax year in order to facilitate the necessary data collection.

- *Once a covered employee, always and forever a covered employee of the publicly traded corporation, and of any successor publicly traded corporation, even after the employee terminates his or her employment.* However, there is an exception for a corporation that was a publicly traded corporation, became private, and then again becomes a publicly traded corporation. In that case, if the corporation is private for longer than three years after the due date of its federal tax return (disregarding any extensions) for the tax year it was previously a public company, then individuals who were covered employees when the corporation was previously a public company will not continue to be covered employees. However, if the corporation is private for less than that three-year period, then previously covered employees will return to being covered employees when the corporation again becomes a publicly traded corporation.

- *A publicly traded corporation can acquire new covered employees in transactions.* Under the proposed regulations, a publicly traded corporation will acquire the covered employees of another publicly traded corporation in acquisitions, including asset acquisitions when more than 80% of the assets of a publicly traded corporation are acquired and the target's covered employees become employed by the acquirer within 12 months of the acquisition. Similarly, a publicly traded corporation can acquire covered employees in a spin-off or other distribution transaction if the distributing company's covered employees become employed by the spun-off publicly traded corporation within 12 months of the distribution. As a result, public companies will need to expand their due diligence process to include information regarding covered employee status, including

private company transactions in which the private company may be or have been previously treated as a publicly traded company.

## 5. The deduction limitations cannot be avoided by having another entity pay the compensation

Under the proposed regulations, all members of an "affiliated group" under the Section 1504 of the Code (determined without regard to the exclusions for foreign corporations, S-corporations, REITs, regulated investment companies, insurance companies, or tax-exempt corporations under Section 1504(b)) are aggregated to determine whether or not a corporation is treated as a publicly traded corporation. However, the following rules apply to the determination of covered employees and the allocation of deductions among the group:

- If more than one corporation within the affiliated group is treated as a publicly traded corporation, then each publicly traded corporation will need to determine and apply the deduction limitations to its own covered employees based on its own separate PEO, PFO, and three most highly compensated employees, which may each be different.

- If more than one entity within the affiliated group pays compensation to a covered employee, then the compensation paid is aggregated to determine whether any compensation paid exceeds US$1 million. If the affiliate group pays compensation in excess of US$1 million, then the deduction limitation is proportionally applied to each entity based on the pro rata portion of the total compensation each entity paid. For example, PEO is a covered employee of Corporation A, a publicly traded corporation, and also performs services for Corporation B, which is a member of the affiliated group with Corporation A. Corporation A pays the PEO US$900,000 in 2020 and Corporation B pays the PEO US$1.5 million. PEO's total compensation from the affiliated group is US$2.4 million. By application of the aggregation rules, US$1.4 million (US$2.4 million– US$1 million) will not be deductible, with US$525,000 not deductible by Corporation A and US$875,000 not deductible by Corporation B.

## 6. The proposed regulations provide that foreign private issuers are subject to Section 162(m), but give little clarity on how foreign private issuers determine covered employees and the limitations on the deduction by US subsidiaries

Under the proposed regulations, foreign private issuers are now subject to Section 162(m), whether or not they are required to include a summary compensation table in their Exchange Act reports. Under prior IRS guidance before the enactment of TCJA, foreign private issuers were exempted from Section 162(m) limitations because they were not required to include a summary compensation table in their Exchange Act reports. Rather, foreign private issuers were able to rely on home country rules for compensation disclosures. Under the new rules, however, a foreign private issuer will be subject to the Section 162(m) limitations to the extent that it, or a subsidiary, takes a US tax deduction for compensation paid to covered employees. Foreign private issuers with US employees will need to determine if any of them are covered employees. Most foreign private issuers have not historically collected the information necessary to determine who the top three most highly compensated employees are under the Exchange Act rules, because most other countries usually only require individualized compensation disclosure for employees who are also directors, or may only require disclosure on an aggregated basis for all employees with executive officer positions. As a result, the Treasury Department has invited comments on whether a safe harbor would be appropriate for foreign private issuers that are not required to disclose compensation of their officers on an individual basis in their home countries. The proposed regulations currently indicate that the determination of covered employees is made based on the rules in effect under the executive compensation disclosure rules of the Exchange Act. Until further guidance is issued, since the rules of the

Exchange Act allow the application of home country rules to foreign private issuers, it should be appropriate for a foreign private issuer to use the same methodology for determining the amount included in any aggregated compensation disclosed in its Exchange Act filings for determining the three most highly compensated executive officers. Similarly, it should also be appropriate for a foreign private issuer to use any other reasonable application of the executive compensation disclosure rules of the Exchange Act to determine the total compensation paid to its executive offices and to determine the three most highly compensated executive officers. The proposed regulations are not clear on how the deduction limitation and allocation rules discussed above apply to a foreign private issuer when foreign members of the affiliated group also pay compensation to a covered employee.

### 7. Elimination of the transition rules for IPOs, spin-offs, or other newly publicly traded corporations

Prior to its amendment by TCJA, Section 162(m) did not apply for a post-IPO (or post-spin-off) transition period to companies that went public in connection with an initial public offering (IPO) or were spun-off. This transition period was eliminated by the proposed regulations for companies that become publicly held through an IPO after December 20, 2019. Companies with an IPO prior to that date may continue to rely on the old Section 162(m) transition rules. The proposed regulation, however, did not entirely clarify whether companies that became publicly held via a spin-off prior to December 20, 2019, will receive similar relief. Also, no transition rule applies to companies that become publicly traded corporations by reason of being required to register securities under Section 12 of the Exchange Act or becoming subject to the reporting requirements of Section 15(d) of the Exchange Act. In connection with the elimination of the post-IPO and post-spin-off transition periods, the proposed regulations also apply the Section 162(m) deduction limit to the tax year ending on or after the date the company becomes a publicly traded corporation. Thus, for example, compensation payable to covered employees of a company that becomes publicly held via an IPO will be subject to the Section 162(m) deduction limit for the entire year of the IPO, including the portion of the company's tax year prior to the IPO. Companies contemplating an IPO or the registration of public securities (*e.g.*, public debt) should assess whether the application of Section 162(m) to their compensation arrangements will require any additional disclosure in the registration and offering materials.

### 8. The existence of a clawback policy could result in a loss of grandfathering and the retroactive loss of a deduction

Compensation payable under written binding contracts in effect on November 2, 2017, that publicly held corporations are obligated to pay under applicable law (for example, state contract law) are sheltered from the new proposed regulations — unless they are materially modified. This is typically referred to as "grandfathering." The proposed regulations indicate that the application of a "clawback" or compensation recovery policy will result in the loss of grandfathering, whether or not the right to clawback is discretionary or enforced. This could result in a company retroactively losing a tax deduction taken in a prior year under the grandfathering exception. Companies should assess and discuss with their accountants whether or not a reserve should be taken against any potential lost tax deductions until the clawback no longer applies. Notably, the adoption of a clawback policy itself will not be a material modification as long as the clawback is conditioned upon the future occurrence of a condition or event that is objectively outside of the company's control (for example, a restatement of the company's financial statements or an employee's misconduct or felony conviction). Companies should thus be careful not to adopt any clawback policy that could retroactively apply to any grandfathered compensation.

### 9. Potential need to modify deferred compensation arrangements in 2020

A deferred compensation plan or arrangement can provide for deferrals until the year in which the company is allowed to deduct the compensation under Section 162(m). These types of arrangements were sometimes used prior to TCJA, because under the pre-TCJA rules an employee ceased to be a covered employee and subject to the deduction limitations following termination of employment. Under the post-TCJA rules, however, compensation deferred under such an arrangement may never become deductible or payable. The proposed regulations discuss allowing these types of arrangements to be modified and paid in 2020, and such modifications will not impact grandfathering status and/or violate the restrictions on acceleration of payments of deferred compensation under Section 409A of the Code. Companies should review their deferred compensation arrangements for any such provisions and should take appropriate action before December 31, 2020.

### 10. Compensation paid in another capacity or following termination of employment (even upon death) may not be deductible

Compensation payable to a covered employee for services, whether or not as an employee and whether reported on Form W-2 or Form 1099, is counted when determining the deduction limitations of Section 162(m). During employment, this includes compensation paid to a covered employee in a separate, non-executive capacity (such as directors' fees paid to the covered employee in addition to executive compensation). Following termination of employment, all compensation of a covered employee for services performed is counted in determining the deduction limitations of Section 162(m), including severance, directors' fees, and consulting fees received by the former employee, and death benefits paid to a beneficiary of a deceased former employee. Compensation paid under tax qualified plans, cafeteria plans under Section 125 of the Code, and tax-free benefits are not considered compensation subject to the deduction limitations.

## Effective Dates

The Section 162(m) proposed regulations are generally effective for taxable years beginning on or after December 20, 2019. There are several exceptions to the general effective date, however, including:

- The definition of covered employees generally applies for companies with a taxable year ending on or after September 10, 2018 (the date Notice 2018-68, which provided initial guidance on covered employees, was published).
- The allocation of partnership deduction rules with respect to REITs, Up-Cs, and MLPs generally apply with respect to tax years ending on or after December 20, 2019, but as detailed above in paragraph 3, are subject to a transition rule for compensation paid pursuant to a written binding contract in effect on December 20, 2019.
- The elimination of the post-IPO and post-spin-off transition rule generally applies to companies that become publicly held after December 20, 2019.
- The predecessor corporation rules will apply to corporate transactions closing after the final regulations are published.

The Treasury Department and the IRS have requested that comments on the Section 162(m) proposed regulations be submitted by February 28, 2020, and have scheduled a public hearing on the proposed regulations on March 9, 2020.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

**Robin L. Struve**
robin.struve@lw.com
+1.312.876.7632
Chicago

**Bradd L. Williamson**
bradd.williamson@lw.com
+1.212.906.1826
New York

**Juliet Rognlie**
juliet.rognlie@lw.com
+1.312.876.6547
Chicago

**You Might Also Be Interested In**

2020 Proxy Season: Considerations for Your Proxy Statement and Preparing for Your Annual Meeting (Webcast)

Designing and Administering Executive and Director Compensation in Today's Challenging Environment (Webcast)

Investment Funds: Sun Capital Reversal Offers Important Takeaways Regarding Portfolio Company Pension Liabilities

Key Compensation Items for the 2019 Proxy Season and Beyond

IRS Provides Initial Guidance on Section 162(m) Tax Reform Changes

US Tax Reform Resource Center

*Client Alert* is published by Latham & Watkins as a news reporting service to clients and other friends. The information contained in this publication should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, please contact the lawyer with whom you normally consult. The invitation to contact is not a solicitation for legal work under the laws of any jurisdiction in which Latham lawyers are not authorized to practice. A complete list of Latham's *Client Alerts* can be found at www.lw.com. If you wish to update your contact details or customize the information you receive from Latham & Watkins, visit https://www.sites.lwcommunicate.com/5/178/forms-english/subscribe.asp to subscribe to the firm's global client mailings program.

**Endnotes**

[1] In August 2018, the IRS released Notice 2018-68, providing initial guidance on changes to Section 162(m) made by TCJA. See the Latham & Watkins *Client Alert* on Notice 2018-68, ***available at*** https://www.lw.com/thoughtLeadership/lw-irs-provides-initial-guidance-on-section-162m-tax-reform-changes.