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Final Section 162(m) Rule Review: Identifying the Differences and Similarities from the Prior Guidance

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Published December 30, 2020, the final regulations under Section 162(m) of the Internal Revenue Code of 1986, as amended (the "Code") incorporate the Tax Cuts and Jobs Act ("TCJA") statutory amendments and effect certain other changes to the proposed regulations which were previously published in December 2019.

In our previous column,[1] we provided a summary of the history, purpose and impact of such rules based on the guidance then in

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effect. While there are some changes from and clarifications to the previous guidance, the final regulations retain the basic approach and structure of the proposed regulations.

This column will examine the final regulations in order to identify the differences from and similarities to the prior guidance. In addition, this column will review the IRS responses to the comments (including Wish Lists for changes and or clarifications to be included in the new guidance) that were received in response to the proposed regulations. This column also will highlight which concerns were addressed and which issues still may present compliance challenges for employers.

PUBLICLY HELD CORPORATION

Final Regulations Versus Previous Guidance: Section 162(m) of the Code limits deductions for "publicly held corporations" in certain circumstances. As amended by TCJA, Section 162(m)(2) of the Code defines the term "publicly held corporation" as any corporation that is an issuer[2] of securities that are required to be registered under Section 12 of the Securities and Exchange Act of 1934 ("Exchange Act"), or that is required to file reports under Section 15(d) of the Exchange Act. The final regulations mirror the proposed regulations through their adoption of rules that:

- Provide, for ease of administration, a corporation is a publicly held corporation if, as of the last day of its taxable year, its securities are required to be registered under Section 12 of the Exchange Act or it is required to file reports under Section 15(d) of the Exchange Act.

- Determine whether a publicly traded partnership, a corporation that owns an entity that is disregarded as an entity separate from its owner within the meaning of Section 301.7701-2(c)(2)(i), or an S corporation (including an S corporation parent of a qualified subchapter S subsidiary[3] ("QSub") is a publicly held corporation.[4]

- Confirm that a real estate investment trust ("REIT"),[5] that owns a qualified real estate investment trust subsidiary,[6] is a publicly held corporation if the QRS issues securities required to be registered under Section 12(b) of the Exchange Act, or is required to file reports under Section 15(d) of the Exchange Act.[7]

AFFILIATED GROUPS

Final Regulations Versus Previous Guidance: The final regulations followed the 162(m) regulations from 1995 and the proposed regulations providing that the term "publicly held corporation" includes an affiliated group of corporations ("AGC") (as defined in Section 1504 of the Code (determined without regard to Section 1504(b)).[8] These regulations provide:

- The term "publicly held corporation" includes an AGC that includes one or more publicly held corporations;
- A subsidiary corporation that meets the definition of publicly held corporation is separately subject to Section 162(m);
- An AGC includes a parent corporation that is privately held if one or more of its subsidiary corporations is a publicly held corporation; and
- An AGC may include more than one publicly held corporation as defined in Section 162(m)(2).[9]

Commenters' Wish List: A commentator to the proposed regulations suggested an AGC with more than one publicly held corporation should have only one set of covered employees for the AGC (instead of one set of covered employees for each separate publicly held corporation that is a member of the AGC).

Final Regulations Resolution: The final regulations did not adopt such suggestion. The preamble to the proposed regulations state this is because each corporation in an AGC is a separate taxpayer and Section 162(m)(3) provides that each taxpayer that is a publicly held corporation has its own set of covered employees. Instead, the final regulations remain consistent with the prior guidance by continuing to provide that, in an AGC, each corporation that is a publicly held corporation is separately subject to Section 162(m) and, therefore, has its own set of covered employees.[10]

FOREIGN PRIVATE ISSUERS

Final Regulations Versus Previous Guidance: The proposed regulations provided that a foreign private issuer[11] ("FPI") is a publicly held corporation if it is required to register securities under Section 12 of the Exchange Act or file reports under Section 15(d) of the

Exchange Act. The preamble to the final regulations points out that the legislative history to TCJA indicates that Congress intended Section 162(m) to apply to FPIs.[12]

Commenters' Wish List: In response to Notice 2018-68, a commenter suggested that the regulations provide that Section 162(m) does not apply to FPIs because FPIs are not required to disclose compensation of their officers on an individual basis under the Exchange Act, unless similar disclosure is required by their home country.[13] The assertion was "that determining compensation on an individual basis (in order to determine the three most highly compensated executive officers) would require the FPIs to expend significant time and money in adopting the necessary internal procedures to make the determination consistent with Exchange Act requirements that are inapplicable to them."

Proposed Regulations Resolution: Wishes denied; however, the preamble to the proposed regulations requested additional comments as to whether a safe harbor exemption from the definition of a publicly held corporation under Section 162(m) was appropriate for FPIs that are not required to disclose compensation of their officers on an individual basis in their home countries and, if so, how such a safe harbor could be designed.[14]

Commenters' Wish List: Commenters proposed exempting any FPI from the definition of publicly held corporation, unless the FPI is required to disclose compensation of its officers on an individual basis in its home country.

Final Regulations' Resolution: Wish denied. The preamble to the final regulations state this is because each corporation in an AGC is a separate taxpayer and Section 162(m)(3) provides that each taxpayer that is a publicly held corporation has its own set of covered employees. Instead, consistent with prior guidance, the final regulations provide that, in an AGC, each corporation that is a publicly held corporation is separately subject to Section 162(m) and, therefore, has its own set of covered employees.[15]

Commenters' Wish List: Commenters' suggested the final regulations exclude FPIs from the definition of publicly held corporation because determining compensation on an individual basis (in order to determine the three most highly compensated executive officers) requires extensive calculations consistent with executive compensation disclosure rules under the Exchange Act that are not applicable to FPIs. However, this request was not accompanied by any analysis supporting a safe harbor rule or addressing how a safe harbor could be designed and administered.

Final Regulations' Resolution: Wish denied. The preamble to the final regulations states this is because the scope of the exemption suggested for FPIs from the definition of publicly held corporation is inconsistent with the statutory language and the legislative history.

Instead, the final regulations adopt the rules set forth in the proposed regulations providing that a FPI is a publicly held corporation if it is required to register securities under Section 12 of the Exchange Act or file reports under Section 15(d) of the Exchange Act.[16]

COVERED EMPLOYEE

Final Regulations Versus Previous Guidance: As amended by TCJA, Section 162(m)(3) of the Code defines the term "covered employee" as an employee of the taxpayer if:

- The employee is the principal executive officer ("PEO") or principal financial officer ("PFO") of the taxpayer at any time during the taxable year, or was an individual acting in such a capacity;
- The total compensation of the employee for the taxable year is required to be reported to shareholders under the Exchange Act by reason of the employee being among the three highest compensated officers for the taxable year (other than the PEO and PFO);
- The individual was a covered employee of the taxpayer (or any predecessor) for any preceding taxable year beginning after December 31, 2016; or
- The employee's total compensation for the taxable year places the individual among the three highest compensated officers for the taxable year (other than any individual who is the PEO or PFO of the taxpayer at any time during the taxable year, or was an individual acting in such a capacity) even if the compensation of the officer is not required to be reported to shareholders under the Exchange Act.

The final regulations double down on the rules set forth in the proposed regulations providing that:

- A covered employee for any taxable year means any employee of the publicly held corporation who is among the three highest compensated executive officers for the taxable year, regardless of whether:
  - o The executive officer is serving as an executive officer at the end of the publicly held corporation's taxable year, and

  - The executive officer's compensation is subject to disclosure for the publicly held corporation's last completed fiscal year under the applicable SEC rules.

  (Note: the determination that an officer is a covered employee because the officer is one of the three highest compensated executive officers, even if the officer's compensation is not required to be disclosed under the SEC rules, is based on the flush language to Section 162(m)(3), the legislative history,[17] and the SEC executive compensation disclosure rules.[18])

- The amount of compensation used to identify the three most highly compensated executive officers is determined pursuant to the executive compensation disclosure rules under the Exchange Act, substituting the publicly held corporation's taxable year for references to the corporation's fiscal year for purposes of applying the disclosure rules under the Exchange Act.[19]

Commenters' Wish List: Commenters suggested that "with respect to the three highest compensated executive officers (other than the PEO and PFO), the term "covered employee" should include only executive officers whose compensation is required to be disclosed pursuant to the SEC executive compensation disclosure rules."

Final Regulations' Resolution: Wish denied. The preamble to the final regulations states that this is because such is inconsistent with the intent of Section 162(m)(3) providing that, "even if the compensation of an executive officer is not required to be reported to shareholders under the Exchange Act, the officer is a covered employee if the officer's total compensation for the taxable year, determined in accordance with the SEC disclosure rules, places the officer among the three highest compensated officers for the taxable year (other than the PEO and PFO)."[20]

Section 162(m)(3)(C) provides that the term "covered employee" includes any employee who was a covered employee of any predecessor of the publicly held corporation for any preceding taxable year beginning after December 31, 2016. The proposed regulations provide rules for determining the predecessor of a publicly held corporation for various corporate transactions. With respect to asset acquisitions, the proposed regulations provide that, if an acquirer corporation acquires at least 80 percent of the operating assets (determined by fair market value on the date of acquisition) of a publicly held target corporation, then the target corporation is a predecessor of the acquirer corporation.[21]

Commenters' Wish List: Clarify that the operating assets refer to gross operating assets instead of net operating assets.

Final Regulations' Resolution: Wish granted.[22]

The proposed regulations also provided rules for determining the covered employees of an owner of a disregarded entity, and an S corporation that owns a QSub. The final regulations adopt this approach.[23]

COVERED EMPLOYEES LIMITED TO EXECUTIVE OFFICERS

Final Regulations Versus Previous Guidance: Under the definition of "covered employee" in Section 162(m)(3) of the Code, as amended by TCJA, a PEO and PFO are covered employees by virtue of holding those positions or acting in those capacities. The three highest compensated officers (other than the PEO or PFO) are covered employees by reason of their compensation. Pursuant to Section 162(m)(3)(B) of the Code, the three highest compensated officers are determined based on the methods by which these officers are identified for purposes of the executive compensation disclosure rules under the Exchange Act. With respect to the three highest compensated officers for a taxable year, consistent with the disclosure rules under the Exchange Act, the proposed regulations provide that only an executive officer as defined in 17 CFR 240.3b-7 (Rule 3b-7),[24] which provides that "[e]xecutive officers of subsidiaries may be deemed executive officers of the registrant if they perform . . . policy making functions for the registrant" may qualify as a covered employee.[25]

Commenters' Wish List: Commenters suggested "an executive officer of a subsidiary may be a covered employee of the publicly held corporation that is the registrant only if the officer is also an officer of that publicly held corporation."

Final Regulations' Resolution: Wish denied. The preamble to the final regulations state this is because it is inconsistent with Rule 3b-7.[26]

COVERED EMPLOYEES AFTER SEPARATION FROM SERVICE

Final Regulations Versus Previous Guidance: Section 162(m)(3)(C), as amended by TCJA, provides that a covered employee includes "a covered employee of the taxpayer (or any predecessor) for any preceding taxable year beginning after December 31, 2016" and hence includes former employees. The preamble to the final regulations point out that the legislative history to TCJA provides that:

> [I]f an individual is a covered employee with respect to a corporation for a taxable year beginning after December 31, 2016, the individual remains a covered employee for all future years. Thus, an individual remains a covered employee with respect to compensation otherwise deductible for subsequent years, including for years during which the individual is no longer employed by the corporation and years after the individual has died.[27]

Prior guidance and the proposed regulations provided "that a covered employee identified for taxable years beginning after December 31, 2016, will continue to be a covered employee for all subsequent taxable years, including years during which the individual is no longer employed by the corporation and years after the individual has died."[28]

Commenters' Wish List: A commenter suggested that based on the statutory text of both Section 162(m) and Section 4960, which was enacted by TCJA, Congress intended the term "employee" in Section 162(m) to be limited to a current employee. This requested was supported by the following rationale:

- Section 4960(c)(2) provides, in relevant part, that "the term 'covered employee' means any employee (including any former employee)" and noted that the words "including any former employee" are absent from the definition of covered employee in Section 162(m)(3).

- Congress enacted Section 4960 of the Code and amended the definition of "covered employee" in Section 162(m) in the same legislation ("TCJA"), the absence of these words limits the definition of "covered employee" to a current employee for purposes of Section 162(m).

Final Regulations' Resolution: Wish denied. The preamble to the final regulations state that the final regulations adopt the proposed regulations without change based on the following counterpoints:

- Congress intended to apply both Section 162(m) and Section 4960 to current and former employees.

- Congress may accomplish the same objective in two separate legislative provisions without using identical statutory language.

- The reference to an employee in Section 162(m) provides no indication that the term "employee" is limited to a current employee, since a reference in the Code to an "employee" has frequently been interpreted in regulations as a reference to both a current and a former employee.[29]

- The legislative history to Section 162(m) makes clear that Congress intended the term "covered employee" to include a former employee.[30]

COVERED EMPLOYEES PERFORMING SERVICES FOR MORE THAN ONE AGC MEMBER

Final Regulations Versus Previous Guidance: As discussed above, a covered employee can be paid compensation during a taxable year by more than one publicly held corporation that are members of the same AGC. To address the uncertainty of this situation, the final regulations adopt the rules from the 1995 regulations and the proposed regulations that generally provide:

- That compensation[31] paid by all members of the AGC is aggregated and that any amount disallowed as a deduction by Section 162(m) is prorated among the payor corporations in proportion to the amount of compensation paid to the covered employee by each corporation in the taxable year.

- That the amount of the deduction that is disallowed for compensation paid to a covered employee is determined separately with respect to each payor corporation that is a publicly held corporation.

- That compensation paid by a member of an AGC that is not a publicly held corporation to an employee who is a covered employee of two or more other members of the AGC is prorated for purposes of the determining the deduction disallowance among the members that are publicly held corporations of which the employee is a covered employee.[32]

APPLICABLE EMPLOYEE REMUNERATION

Final Regulations Versus Previous Guidance: The term "applicable employee remuneration" with respect to any covered employee for any taxable year is define as the aggregate amount allowable as a deduction for the taxable year (determined without regard to

Section 162(m)) for remuneration for services performed by such employee (whether or not during the taxable year). Furthermore, such remuneration shall not fail to be applicable employee remuneration merely because it is includible in the income of, or paid to, a person other than the covered employee, including after the death of the covered employee.[33] In this area, there were no changes from the proposed to the final regulations as both include the following provisions:

- Use the term "compensation," for simplicity sake, instead of "applicable employee remuneration" wherever possible;
- Define compensation as the aggregate amount allowable as a deduction under Chapter 1 of the Code for the taxable year (determined without regard to Section 162(m)) for remuneration for services performed by a covered employee, whether or not the services were performed during the taxable year, and
- Indicate that compensation includes an amount that is includible in the income of, or paid to, a person other than the covered employee, including after the death of the covered employee.[34]

COMPENSATION PAID BY A PARTNERSHIP TO A COVERED EMPLOYEE

Final Regulations Versus Previous Guidance: The final regulations follow the proposed regulations with respect compensation paid to a "covered employees" to the extent the publicly held corporation is allocated a share of the deduction from a lower-tier partnership. The proposed regulations provided that a publicly held corporation that holds a partnership interest must take into account its distributive share of the partnership's deduction for compensation paid to the publicly held corporation's covered employees and aggregate that distributive share with the corporation's otherwise allowable deduction for compensation paid directly to that employee in applying the deduction limitation under Section 162(m).[35]

Commenters' Wish List: A commenter suggested that remuneration paid by a partnership should not be considered compensation for purposes of Section 162(m) because the partnership is neither a publicly held corporation nor a member of an AGC. The applicable comments suggest a reading of Section 162(m)(1) that services must be performed:

- In the employee's capacity as an employee, and
- For the publicly held corporation.

Final Regulations' Resolution: Wish denied. The preamble to the final regulations state this is because:

- Neither of the above-referenced requirements appear in the statute.
- Section 162(m) does not specifically limit the application of Section 162(m) in that manner. Rather, Section 162(m) applies to all compensation, which includes "all amounts allowable as a deduction . . . for remuneration for services performed by such employee (whether or not during the taxable year)."
- In addition, adoption of the Commenters' suggestion could lead to the use of partnerships as a method of avoiding application of Section 162(m), a result that the Treasury Department and IRS conclude is not intended by the statute.[36]

Commenters' Wish List: Commenters also suggested that remuneration paid by a partnership should be compensation for purposes of Section 162(m) only if the publicly held corporation has an 80 percent or greater interest in the partnership because the definition of an AGC requires 80 percent ownership by vote and value among the members of the AGC.

Final Regulations' Resolution: The preamble to the final regulations states that such wish was denied because in the view of the Treasury Department and the IRS, the proposed analogy to the AGC does not take into account different tax treatment of a partner in a partnership Versus a corporation that owns stock in another corporation. Although a consolidated group of corporations may obtain a tax result similar to a deduction flow through, a subsidiary's compensation deduction does not flow through to the parent corporation in a non-consolidated group of corporations.

In contrast, when a publicly held corporation is a partner in a partnership, a share of the partnership's items of income, gain, loss, and deduction generally is allocated to the publicly held corporation in accordance with partnership agreement, subject to Section 704 of the Code. Furthermore, that allocation may occur regardless of the level of ownership by the publicly held corporation.[37]

Final Regulations Versus Previous Guidance: Consistent with an example in the proposed regulations and incorporated into the final regulations, the final regulations clarify that the publicly held corporation's distributive share of the partnership's deduction for compensation paid by the partnership to a covered employee in connection with the performance of services includes the partnership's deduction for a payment to the covered employee for services under Section 707(a) or Section 707(c).[38]

Commenters' Wish List:

- A commenter requested clarification on the application of the rule that a publicly held corporation must take into account its distributive share of a partnership's compensation payment to the publicly held corporation's covered employee.

- The commenter also noted that this partnership rule results in a different application of Section 162(m) depending on whether a publicly held corporation's covered employee receives compensation for services from a partnership in which the publicly held corporation is a partner or from a corporate subsidiary of the partnership. Assuming the partnership is respected for U.S. federal income tax purposes, Section 162(m) generally would not apply to compensation paid to a publicly held corporation's covered employee by a corporate subsidiary of a partnership for services performed as an employee of the subsidiary because, in this circumstance, the corporate subsidiary would not be a member of the publicly held corporation's AGC.

Final Regulations' Resolution: According to the preamble of the final regulations:

- The Treasury Department and the IRS confirmed that the final regulations address only application of the Section 162(m) compensation deduction limitation to the publicly held corporation's distributive share of the payment.

- In recognition of the prior lack of clarity in this area, the proposed regulations provided a special applicability date for this rule, as well as limited transition relief applicable to arrangements in which a publicly held corporation holds a partnership interest.

  Specifically, to ensure that compensation agreements were not formed or otherwise structured to circumvent the rule regarding partnerships after publication of the proposed

> regulations and prior to the publication of the final regulations, the proposed regulations set forth a special applicability date that would apply the rule to any deduction for compensation paid by a partnership that is otherwise allowable for a taxable year ending on or after December 20, 2019 (the publication date of the proposed regulations), but would not apply the rule to compensation paid pursuant to a written binding contract in effect on December 20, 2019 that is not materially modified after that date.[39]

Commenters' Wish List: Commenters' requested additional transition relief for this rule as follows:

- A transition relief period of seven years from the date of publication of the final regulations.[40]
- That transition relief should apply for taxable years beginning before the publication of the final regulations.
- Transition relief for compensation arrangements in effect on December 22, 2017 (the date of TJCA enactment), regardless of whether the partnership is obligated to pay the amount of compensation under applicable law, which would provide for more expansive transition relief than set forth in the proposed regulations.

Final Regulations' Resolution: The preamble to the final regulations state that the transition relief for this definition of compensation must be designed to ensure that compensation agreements are not formed or otherwise structured to circumvent the proposed rules after publication of the proposed regulations and prior to the publication of the final regulations. In consideration of commenters' requests for additional transition relief, the final regulations modify the applicability date of the definition of compensation[41] to provide additional limited transition relief.

This revised compensation definition includes an amount equal to a publicly held corporation's distributive share of a partnership's deduction for compensation expense attributable to the compensation paid by the partnership after December 18, 2020, the date on which the final regulations were made publicly available on the IRS website at *http://www.irs.gov*. Because the date that the final regulations are made publicly available is prior to the date that they are published in the *Federal Register*, using the earlier date for the expiration of the additional transition relief is appropriate to ensure that compensation is not paid to circumvent the final regulations.

In addition, the final regulations continue to provide that this aspect of the definition of compensation does not apply to compensation paid after December 30, 2020 if the compensation is paid pursuant to a written binding contract that is in effect on December 20, 2019, and that is not materially modified after that date.[42]

COMPENSATION FOR SERVICES IN A CAPACITY OTHER THAN AS A COMMON LAW EMPLOYEE

Final Regulations Versus Previous Guidance: The final regulations follow the proposed regulations provide that compensation subject to Section 162(m) is not limited to compensation received as a common law employee, but also includes compensation received as a director or an independent contractor.

Commenters' Wish List: Commenters' suggested that compensation subject to Section 162(m) should include only compensation for services performed by a covered employee as an employee of the publicly held corporation. The rationale offered for this request was that because Section 162(m)(4)(A) uses the phrase "for remuneration for services performed by such *employee*" (emphasis added) in defining compensation subject to Section 162(m), only compensation for services provided as an employee is subject to Section 162(m).[43]

Final Regulations' Resolution: The preamble to the final regulations states that such wish was denied because while the statute may be read in the manner suggested by the commenters, there is nothing in the language that compels this reading, nor does the legislative history to the enactment of Section 162(m) suggest that compensation subject to Section 162(m) was intended to include only compensation for services as an employee. Section 162(m)(4)(A), which was not amended by TCJA, provides that:

> [T]he term "applicable employee remuneration" means, with respect to any covered employee for any taxable year, the aggregate amount allowable as a deduction under this chapter for such taxable year . . . for remuneration for services performed by such employee (whether or not during the taxable year).[44]

Commenters' Wish List: Section 162(m) does not apply to compensation for services as an independent contractor because by excluding from the definition of compensation payments that may be made only to an employee, Section 162(m)(4)(C) indicates that compensation subject to Section 162(m) is limited to compensation for services as an employee. Section 162(m)(4)(C) excludes from the definition of compensation: "(i) any payment referred to in so much of Section 3121(a)(5) as precedes subparagraph (E) thereof, and (ii) any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from gross income under this chapter."

Final Regulations' Resolution: Wish denied because the rules generally exclude from compensation contributions by an employer on an employee's behalf to certain types of qualified retirement plans and payments from those types of plans to the employee. Thus, contributions to these arrangements for which an employer would otherwise have a deduction available will not be treated as compensation and the deduction will not be limited by Section 162(m).

In addition, also excluded from compensation (and thus not limiting the compensation deduction) are certain employee benefits that would be excludible from the employee's income. These exclusions of benefit payments from the definition of "applicable employee remuneration" reflect only that an individual must be an active employee of the publicly held corporation (or a predecessor) at some point in order to become a covered employee, and that the individual typically would participate in these types of employee benefit arrangements as an employee (often continuing participation that started before the individual became a covered employee).

Importantly, the TCJA amendments to Section 162(m) changed the context in which the question as to whether non-employee compensation is subject to the deduction limitation is analyzed. Prior to TCJA, the Section 162(m) deduction limitation could be avoided by ensuring that any compensation in excess of $1,000,000 paid to a covered employee qualified as performance-based compensation or was paid to the covered employee after separation from service or after termination of the individual's status as a covered employee. For example, if a PEO ceased serving as PEO or as an executive officer but continued as an employee of the publicly held corporation for later taxable years, the former PEO could be compensated without taking into account the potential for a limitation on the deduction due to Section 162(m).

The TCJA amendment of Section 162(m) eliminates the exclusion from the deduction limitation for compensation paid after the individual is no longer a covered employee. Under the amended Section 162(m) rules, once an individual is identified as a covered employee, the individual continues to be a covered employee, and all compensation paid to that individual is subject to the deduction limitation, even after the individual is no longer employed by the publicly held corporation. As explained in the legislative history, this result was intended.[45]

Finally, granting the request that that Section 162(m) not apply to compensation for services as an independent contractor would lead to uncertainty and administrative burdens for both the taxpayer and the IRS, as well as to the potential for abusive arrangements structured to avoid the application of Section 162(m) to covered employees who have terminated employment (or who have purportedly terminated employment).

Given that the amendments to Section 162(m) no longer limit the deduction disallowance to taxable years in which a covered employee is employed on the last day of the taxable year, and the lack of statutory language or legislative history specifically indicating an intent to restrict the deduction limitation to compensation earned by the individual in the capacity as an employee, the Treasury Department and the IRS have determined that the more appropriate construction of the statutory language defining "applicable employee remuneration" is to include all compensation paid to a covered employee regardless of the capacity in which the covered employee performed services to earn that compensation.[46]

PRIVATELY HELD CORPORATIONS THAT BECOME PUBLICLY HELD

Final Regulations Versus Previous Guidance: The final regulations adopt:

- The rules set forth in the proposed regulations providing that, in the case of a privately held corporation that becomes a publicly held corporation, Section 162(m) limits the deduction for any compensation that is otherwise deductible for the taxable year ending on or after the date that the corporation becomes a publicly held corporation, and that a corporation is considered to become publicly held on the date that its registration statement becomes effective under the Securities Act or the Exchange Act;

- The proposed regulations provided that a privately held corporation that becomes a publicly held corporation on or before December 20, 2019, generally may rely on the transition rules provided in Section 1.162-27(f)(1) and (2) of the 1995 regulations.[47]

Commenters' Wish List: Commenters' suggested that the final regulations should continue to provide transition relief similar to that provided in Section 1.162-27(f)(1) and (2) of the 1995 regulations for privately held corporations that become publicly held after December 20, 2019 and (b) clarify that a subsidiary that is a member of an AGC may rely on transition relief provided in Section

1.162-27(f)(4) of the 1995 regulations if it becomes a separate publicly held corporation (for example, in a spin-off transaction) on or before December 20, 2019.

Final Regulations' Resolution: The preamble to the final regulations states that such while the clarification request in (b) was met, the transition relief for privately held corporations that become publicly held after December 20, 2019 was not granted based on the following rationale:

- Those sections of the 1995 regulations were formulated based on the legislative history to the enactment of Section 162(m) and were intended to permit a transition period to meet the shareholder approval requirement for qualified performance-based compensation so that the resulting compensation would not be subject to the deduction limitation under Section 162(m).

- Since TCJA eliminated the exclusion from the definition of compensation for qualified performance-based compensation, a transition period to accommodate a shareholder approval process is no longer needed.

- There is no indication in the language of the amended Section 162(m) or the legislative history to the amendments that the transition period was intended be extended even though the original basis for its adoption no longer exists.[48]

GRANDFATHER RULE

Summary of Prior Guidance: Section 13601(e) of TCJA generally provides that the amendments to Section 162(m) apply to taxable years beginning after December 31, 2017, but provides that those amendments do not apply to compensation that is payable pursuant to a written binding contract that was in effect on November 2, 2017, and that was not modified in any material respect on or after that date (the grandfather rule).[49] Under the 1993 grandfather rule, Section 162(m) did not apply to compensation payable under a written binding contract that was in effect on February 17, 1993, and that was not modified thereafter in any material respect before the compensation was paid. Section 1.162-27(h) provides guidance on the definitions of written binding contract and material modification for purposes of applying the 1993 grandfather rule. The proposed regulations adopted those definitions for purposes of the grandfather rule under Section 13601(e) of TCJA.

Final Regulations Versus Previous Guidance: The final regulations adopt the provisions of the proposed regulations that state that compensation is payable under a written binding contract that was in effect on November 2, 2017, only to the extent that the corporation is obligated under applicable law to pay the compensation if the employee performs services or satisfies the applicable vesting conditions. Section 162(m), as amended by TCJA, applies to any amount of compensation that exceeds the amount that applicable law obligates the corporation to pay under a written binding contract that was in effect on November 2, 2017. In addition, because the 1995 regulations continue to apply to deductions related to amounts of remuneration to which the grandfather rule applies, the 1995 regulations are retained as a separate section in the Treasury regulations under Section 162(m).[50]

Commenters' Wish List: A commenter suggested that a contract be treated as a written binding contract if an amount related to the compensation payable under the contract was accrued (or could have been accrued) as a cost under generally accepted accounting principles ("GAAP"), regardless of whether the corporation is obligated to pay the remuneration under applicable law.

Final Regulations' Resolution: The preamble to the final regulations state that this wish was not granted as no comments addressed the issues related to the formulation and adoption of such safe harbor discussed in the preamble to the proposed regulations. Such preamble questioned (i) if costs identified correlate with the statutory standard of being paid under a legally binding contract if, in fact, the employer was not necessarily bound to pay the amounts of compensation but rather was likely to pay them, and (ii) if the suggested safe harbor is an accounting standard based on financial statements audited by accountants and if such raised the potential for the IRS to audit for Section 162(m) purposes a corporation's "audited" financial statements, and challenges IRS examiners would have in applying GAAP principles.[51]

Commenters' Wish List: A commenter suggested that a safe harbor that would grandfather an amount of compensation paid pursuant to a compensation arrangement that satisfied the following three requirements on or before November 2, 2017:

- The arrangement was memorialized in some form of media (for example, presentation slides or spreadsheet);

- The arrangement was communicated to its participants (for example, disseminated in hard copy, electronically, or via presentation format); and

- Participants in the arrangement had a reasonable expectation that they were eligible to receive compensation pursuant to the arrangement.

Final Regulations' Resolution: The preamble to the final regulations state such wish was denied because this suggested safe harbor:

- Would require an intensive facts and circumstances analysis and raise administrative issues about how to determine the participants' expectations regarding the compensation arrangement and whether those expectations were reasonable; and

- Arguably is inconsistent with the statutory language that grandfathers an amount of compensation only if the corporation was obligated to pay it under applicable law pursuant to a written binding contract in effect on November 2, 2017, and not, for example, if an employee merely had a reasonable expectation of payment (without regard to the corporation's obligation under applicable law).[52]

COMPENSATION SUBJECT TO NEGATIVE DISCRETION

Final Regulations Versus Previous Guidance: The final regulations adopt the rule set forth in the proposed regulations providing that a provision in a compensation agreement that purports to provide the employer with the discretion to reduce or eliminate a compensation payment (negative discretion) is taken into account only to the extent the corporation has the right to exercise the negative discretion under applicable law (e.g., applicable state contract law). If a compensation arrangement allows the corporation to exercise negative discretion, compensation payable under the arrangement is not grandfathered to the extent the corporation is not obligated to pay it under applicable law.

Commenters' Wish List: A commenter suggested negative discretion provisions should be disregarded in determining whether compensation is grandfathered because numerous performance-based compensation arrangements provide corporations with such discretion.

Final Regulations' Resolution: The preamble to the final regulations indicated that given that practice of including negative discretion provisions in compensation arrangements is based on a well-known and longstanding regulatory provision, Congress could have provided for a grandfather rule that addressed performance-based compensation arrangements that include a negative discretion provision, but it did not. In contrast, the grandfather rule refers only to compensation paid pursuant to a legally binding contract in effect on the transition date. Thus, whether a performance-based compensation arrangement that includes a negative discretion provision is a legally binding contract is determined based on applicable law.[53]

Commenters' Wish List: A commenter suggested a corporation should be deemed not to have a right to exercise negative discretion if the terms of the agreement provide that the corporation may not exercise this discretion if doing so would result in the payment of compensation that would not be deductible by reason of Section 162(m).

Final Regulations' Resolution: The preamble to the final regulations state that whether a compensation agreement that includes a negative discretion provision of this sort would be a written binding contract that permitted the exercise of the negative discretion after the amendments to Section 162(m) or rather obligated the employer to pay the compensation because the Section 162(m) amendments negated the employer's ability to exercise the negative discretion must be determined based on applicable law. Accordingly, the final regulations do not provide a separate standard for purposes of applying the grandfather rule to compensation agreements that include this type of negative discretion provision (or any other type of negative discretion provision).[54]

RECOVERY OF COMPENSATION

Final Regulations Versus Previous Guidance: The final regulations address a publicly held corporation's right to recover compensation upon the occurrence in the future of a condition beyond its control. The proposed regulations provided that, if:

- The corporation is obligated or has discretion to recover compensation paid in a taxable year only upon the future occurrence of a condition that is objectively outside of the corporation's control, then the corporation's right to recovery is disregarded for purposes of determining the grandfathered amount for the taxable year; and

- Such condition occurs, then only the amount the corporation is obligated to pay under applicable law remains grandfathered, taking into account the occurrence of the condition.[55]

The preamble to the final regulations state that, after further consideration, the Treasury Department and the IRS recognized that the corporation's right to recover compensation is a contractual right that is separate from the corporation's binding obligation under the contract (as of November 2, 2017) to pay the compensation. Accordingly, the final regulations provide that the corporation's right to recover compensation does not affect the determination of the amount of compensation the corporation has a written binding contract to pay under applicable law as of November 2, 2017, whether or not the corporation exercises its discretion to recover any compensation in the event the condition arises in the future.[56]

ACCOUNT AND NON-ACCOUNT BALANCE PLANS

Final Regulations Versus Previous Guidance: The Final Regulations include rules about grandfathered status for amounts payable under account and non-account balance nonqualified deferred compensation plans that are generally consistent with the proposed regulations. The proposed regulations include examples illustrating the application of the grandfather rule to account and non-account balance nonqualified deferred compensation ("NQDC") plans. As described below, the final regulations generally adopt the same rules as the previous guidance but with some clarifications. The below sections discussion is limited to account balance plans because in each case the final regulations provide an analogous rule for non-account balance plans.[57]

Commenters' Wish List: Commenters' asked for clarification on the application of the grandfather rule to compensation payable under these plans.

Final Regulations' Resolution: The preamble of the final regulations state that "[t]he final regulations clarify the application of the grandfather rule to compensation payable under these plans by providing detailed rules and thus eliminate the need to retain certain examples in the final regulations. Specifically, with respect to an account balance plan, 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 the employee the account balance that is credited with earnings and losses and has no right to terminate or materially amend the contract, 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."

The preamble to the final regulations also provide that:

> If the terms of the account balance plan that is a written binding contract as of November 2, 2017, provide that the corporation may terminate the plan and distribute the account balance to

the employee, then the grandfathered amount is 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 (termination date). Furthermore, whether additional contributions and earnings and losses credited to the account balance after the termination date, through the earliest possible date the account balance could have been distributed to the employee, are grandfathered depends on whether the terms of the plan require the corporation to make those contributions or credit those earnings and losses through the earliest possible date the account balance could be distributed if it were terminated as of the termination date.

If the terms of the account balance plan provide that the corporation may not terminate the contract, but may discontinue future contributions to the account balance and distribute the account balance in accordance with the terms of the plan, then the grandfathered amount is the account balance determined as if the corporation had exercised the right to discontinue contributions on November 2, 2017 or, if later, the earliest permissible date the corporation could exercise that right in accordance with the terms of the plan (the freeze date). Furthermore, if the plan required the crediting of earnings and losses on the account balance after the freeze date through the payment date, then those earnings and losses credited to the grandfathered account balance are also grandfathered. Alternatively, whether the terms of the account balance plan provide that the corporation may terminate the plan or, instead, may discontinue future contributions, the corporation may elect to treat the account balance as of the termination date (or freeze date, if applicable) as the grandfathered amount regardless of when the amount is paid and regardless of whether it has been credited with earnings or losses prior to payment. The final regulations adopt this alternative grandfather rule that disregards earnings and losses in order to minimize the administrative burden of tracking the earnings, losses and new contributions (if made) on an account balance plan or the increase or decrease in a non-account balance benefit after November 2, 2017. With respect to an account balance plan, the Treasury Department and IRS understand that this grandfather rule may result in contributions made after November 2, 2017, not being subject to the Section 162(m) limitation if the contributions offset losses; however, the Treasury Department and IRS concluded that under many common arrangements the continuous separate tracking of earnings, losses, and contributions on the November 2, 2017, account balance through the payment date would be burdensome to administer while having a limited, if any, impact on the available deduction.[58]

ORDERING RULE FOR PAYMENTS CONSISTING OF GRANDFATHERED AND NON-GRANDFATHERED AMOUNTS DEDUCTIBLE FOR TAXABLE YEARS ENDING PRIOR TO DECEMBER 20, 2019

Final Regulations Versus Previous Guidance: The final regulations adopt the following ordering rule set forth in the proposed regulations for identifying the grandfathered amount when payment under a grandfathered arrangement is made in a series of payments: the grandfathered amount is allocated to the first otherwise deductible payment paid under the arrangement. If the grandfathered amount exceeds the payment, then the excess is allocated to the next otherwise deductible payment paid under the arrangement. This process is repeated until the entire grandfathered amount has been paid.

For example, assume an employer maintains a non-account balance NQDC plan (payable as an annuity) as of November 2, 2017, and that the grandfathered amount is $2,000,000. Further assume that additional benefits accrue under the plan after November 2, 2017, with the result that the employee's benefit is payable as an annual annuity of $1,500,000 commencing at the employee's retirement for the employee's life. Under the final regulations, the entire $1,500,000 paid in the first year is grandfathered. In the second year, only $500,000 of the $1,500,000 payment is grandfathered; the remaining $1,000,000 paid in the second year is not grandfathered.

For subsequent taxable years, none of the $1,500,000 payments are grandfathered.

Commenters' Wish List: Commenters suggested that for payments otherwise deductible for taxable years ending prior to the date the proposed regulations were published (i.e., December 20, 2019), it would be a reasonable good faith interpretation of the statute if the grandfathered amount were allocated to the last otherwise deductible payment or to each payment on a pro rata basis.

Final Regulations' Resolution: The preamble to the final regulations state the wish was granted with a condition as the final regulations permit the grandfathered amount to be allocated to the last otherwise deductible payment or to each payment on a pro rata basis for taxable years ending before December 20, 2019, provided that the ordering rule requiring the grandfathered amount to be allocated to the first otherwise deductible payment paid under the arrangement must be used for taxable years ending on or after December 20, 2019, regardless of the method used to allocate the grandfathered amount for taxable years ending prior to that date.[59]

GRANDFATHERED AMOUNT LIMITED TO A PARTICULAR PLAN OR ARRANGEMENT

Final Regulations Versus Previous Guidance: The final regulations provide that the grandfathered amount payable under a plan or arrangement applies solely to the amounts paid under that plan or arrangement. Regardless of whether all of the grandfathered amount is paid to the employee, no portion of that grandfathered amount may be treated as a grandfathered amount under any other separate plan or arrangement in which the employee is a participant. If, for example, all or a portion of a grandfathered amount is forfeited because the employee died before being paid the entire amount, then any unpaid portion of the grandfathered amount may not be applied as a grandfathered amount to payments under any other separate plan or arrangement in which the employee participated.[60]

MATERIAL MODIFICATION

Final Regulations Versus Previous Guidance: The final regulations adopt the rules set forth in the proposed regulations related to material modifications. These rules provide that a material modification occurs when a contract is amended to increase the amount of compensation payable to the employee. If a written binding contract is materially modified, it is treated as a new contract entered into as of the date of the material modification.[61] Accordingly, if a contract is materially modified, amounts received by an employee under the contract before the material modification are not affected, but amounts received after the material modification are treated as paid pursuant to a new contract, rather than as grandfathered.[62] The adoption of a supplemental contract or agreement that provides for increased compensation, or the payment of additional compensation, results in a material modification if the facts and circumstances demonstrate that the compensation under the supplement is paid on the basis of substantially the same elements or conditions as the compensation that is otherwise paid pursuant to the written binding contract.[63]

The final regulations make clear that if a written binding contract in effect on November 2, 2017, is subsequently modified to defer the payment of compensation, any compensation paid or to be paid that is in excess of the amount that was originally payable to the employee under the contract will not be treated as resulting in a material modification if the additional amount is based on either a reasonable rate of interest or a predetermined actual investment (whether or not assets associated with the original amount are actually invested therein) such that the amount payable by the employer at the later date will be based on the rate of interest or the actual rate of return on the investment (including any decrease, as well as any increase, in the value of the investment). However, the additional amount paid will not be treated as a grandfathered amount. Additionally, a modification of the contract after November 2, 2017, to offer an additional or substitute a predetermined actual investment as an investment alternative under the arrangement is not a material modification.[64]

Commenters' Wish List: Commenter's suggested that providing that the deferral of a grandfathered amount after November 2, 2017, but prior to September 10, 2018 (the publication date of Notice 2018-68), is not a material modification even if the earnings on the deferred amount are not based on either a reasonable rate of interest or a predetermined actual investment because taxpayers were not aware prior to the publication of the notice that this deferral would constitute a material modification.

Final Regulations' Resolution: The preamble to the final regulations states the wish was denied because the grandfather rule described in Section 13601(e) of TCJA and its legislative history, including the definition and the resulting impact of a material modification, is almost identical to the statutory language and legislative history to the grandfather rule provided when Section 162(m) was enacted in 1993. The 1995 final regulations interpreting the original grandfather rule in the 1993 legislation provided that a deferral of payment of compensation will not be treated as a material modification if any additional amount paid were determined based on a reasonable rate of interest or one or more predetermined actual investments, and there is no indication in the grandfather rule in Section 13601 of TCJA or its legislative history of an intent to adopt a different grandfather rule.[65]

EXTENSION OF AN EXERCISE PERIOD FOR A NON-STATUTORY STOCK OPTION

Commenters' Wish List: Commenters' asked if extending the exercise period for a non-statutory stock option[66] is a material modification.

Final Regulations' Resolution: The preamble to the final regulations state that the Treasury Department and the IRS recognize that, for bona fide business reasons, an employer may want to extend an exercise period of a stock option or a stock appreciation right ("SAR"). This often occurs when a stock option or SAR grant agreement provides that the exercise period will terminate immediately or within a short period following the employee's separation from service, but the employer later decides to waive that termination or otherwise extend the exercise period for some period of time upon the employee's separation from service. These concerns led to treating certain extensions of stock options or SARs as not being material modifications in the regulations under Section 409A. For the same reasons, the final regulations incorporate the Section 409A regulatory provisions and provide that, if compensation attributable to the exercise of a non-statutory stock option or a SAR is grandfathered and the exercise period of the option or SAR is extended, then all compensation attributable to the exercise of the option or the SAR is grandfathered if the extension complies with Section 1.409A-1(b)(5)(v)(C)(1).[67]

COORDINATION WITH SECTION 409A

Final Regulations Versus Previous Guidance: Section 409A addresses nonqualified deferred compensation arrangements, sets forth certain requirements that must be met to avoid current income inclusion, provides a 20 percent additional income tax on the amount includible in income,[68] and provides a second additional income tax based on the tax benefit received due to the deferral.[69] Recognizing that the TCJA amendments to Section 162(m) required coordination with the Section 409A rules in certain circumstances, the preamble to the proposed regulations provided that certain modifications would be made to the regulations under Section 409A and that taxpayers may rely on the preamble until this guidance is issued such as permitting companies to amend deferred compensation plan prior to December 31, 2020 to remove Section 162(m) payment delay provisions.[70]

Commenters' Wish List: Commenters suggested additional modifications to the rules and regulations under Section 409A to provide further coordination between Sections 162(m) and 409A.

Final Regulations' Resolution: The preamble to the final regulations state that no such modifications were adopted and that until guidance under Section 409A is issued, taxpayers may continue to rely on the preamble to the proposed regulations. The Treasury Department and the IRS will continue to consider whether additional guidance under Section 409A is appropriate.

APPLICABILITY DATES

General Applicability Date: Generally, the final regulations apply to taxable years beginning on or after December 30, 2020. However, taxpayers may choose to apply the final regulations to a taxable year beginning after December 31, 2017, provided the taxpayer applies the final regulations in their entirety and in a consistent manner to that taxable year and all subsequent taxable years.[71]

Special Applicability Dates: The final regulations include special applicability dates covering certain aspects of the following five provisions of the final regulations as follows:

- *Definition of covered employee:* Applies to taxable years ending on or after September 10, 2018 (i.e., publication date of Notice 2018-68), which provided guidance on this definition. Notice 2018-68 also provided that the Treasury Department and the IRS anticipate that the guidance in the notice will be incorporated into future regulations that, with respect to the issues addressed in the notice, will apply to any taxable year ending on or after September 10, 2018. The final regulations adopt the definition of covered employee in Notice 2018-68 as anticipated, and accordingly the definition of covered employee in the final regulations applies to taxable years ending on or after September 10, 2018. In recognition of the fact that the applicable rules,[72] related to a corporation whose fiscal year and taxable year do not end on the same date, were not addressed in Notice 2018-68 but were discussed initially in the proposed regulations, the final regulations provide that, for a corporation the fiscal and taxable years of which do not end on the same date, the rule requiring the determination of the three most highly compensated executive officers to be made pursuant to the rules under the Exchange Act applies to taxable years ending on or after December 20, 2019.[73]

- *Definition of predecessor of a publicly held corporation:* Apply to corporate transactions that occur on or after December 30, 2020. The final regulations also include a special applicability date for corporations that change from being a publicly held corporation to a privately held corporation, and, later, back to a publicly held corporation on or after December 30, 2020. If a corporate transaction occurs before December 30, 2020, then taxpayers may apply either the definition of predecessor of a publicly held corporation[74] or a reasonable good faith interpretation of the term "predecessor"[75] with respect to such transaction. However, with respect to any of the following corporate transactions occurring after December 20, 2019, and before, excluding target corporations from the definition of the term "predecessor" is not a reasonable good faith interpretation of the statute: (1) a publicly held target corporation the stock or assets of which are acquired by another publicly held corporation in a transaction to which Section 381(a) applies, and (2) a publicly held target corporation, at least 80 percent of the total voting power of the stock of which, and at least 80 percent of the total value of the stock of which, are acquired by a publicly held acquiring corporation (including an AGC). No inference is intended regarding whether the treatment of a target corporation as other than a "predecessor" in any other situation is a reasonable good faith interpretation of the statute.[76]

- *Definition of compensation:* The final regulations modify the proposed applicability date for the definition of compensation.[77] Under the final regulations, this definition of compensation includes an amount equal to the publicly held corporation's distributive share of a partnership's deduction for compensation expense only if the deduction is attributable to compensation paid by the partnership after December 18, 2020 (the date that the final regulations were made publicly available on the IRS website at *http://www.irs.gov*). However, the final regulations continue to provide a transition rule so that this aspect of the definition of compensation related to the distributive share of a partnership's deduction for compensation expense does not apply to compensation paid after December 30, 2020 if the compensation is paid pursuant to a written binding contract that is in effect on December 20, 2019, and that is not materially modified after that date.[78]

- *Application of Section 162(m) to a deduction for compensation otherwise deductible for a taxable year ending on or after a privately held corporation becomes a publicly held corporation:* Applies to corporations that become publicly held after December 20, 2019. A corporation that was not a publicly held corporation and then becomes a publicly held corporation on or before December 20, 2019, may rely on the transition relief[79] until the earliest of the events provided.[80] Furthermore, a subsidiary corporation that is a member of an AGC[81] may rely on the transition relief provided in Section 1.162-27(f)(4) if it becomes a separate publicly held corporation (whether in a spin-off transaction or otherwise) on or before December 20, 2019.[82]

- *Definitions of written binding contract and material modification:* Apply to taxable years ending on or after September 10, 2018, the publication date of Notice 2018-68, which provided guidance defining these terms. Notice 2018-68 also provided that the Treasury Department and IRS anticipated that the guidance in the notice would be incorporated into future regulations that, with respect to the issues addressed in the notice, would apply to any taxable year ending on or after September 10, 2018. Because the final regulations adopt the definitions of the terms "written binding contract" and "material modification" that were included in Notice 2018-68, the guidance on these definitions in the final regulations applies to taxable years ending on or after September 10, 2018. The rules provided in the final regulations for compensation paid from an account balance plan,[83] compensation paid as an annuity,[84] and payment delays[85] are applicable to taxable years beginning on or after December 30, 2020; however, taxpayers may choose to apply the final regulations, for taxable years beginning after December 31, 2017, and before December 30, 2020 provided the taxpayer applies the final regulations in their entirety and in a consistent manner.[86]

CONCLUSION

While the final 162(m) regulations generally remain consistent with the prior guidance on this topic, there are some differences from and clarifications to the past guidance. The IRS and Treasury have issued their responses to the various commenters' wish lists they received; granting a select few while providing their interpretation and analysis to explain why others were denied.

Accordingly, all publicly held corporations should now review this final 162(m) guidance to see how it may affect their corporation and top executives including whether their organization is covered by the rules, determining who is a "covered employee" and what contracts and compensation amounts are grandfathered under the final rules.

Corporations with executives who have grandfathered amounts will need to continue to separate such amounts from non-grandfathered amounts and administratively aggregate them with like amounts to ensure that there are no material modifications that would void their grandfathered status.

Finally, considering that much of the relief requested by commenters was not adopted in the final regulations, corporations should contact their legal, tax and employee benefit consultants in order to review their compensation practices and assist them in complying with the final rules.

NOTES

1. *See* our previous column, "Interim Section 162(m) Guidance: Days Dwindling for NQDC Plan Amendments to Delete Nondeductible Deferred Compensation Delays," 33 Benefits L.J. 4 (Winter 2020).

2. As defined in Section 3 of the Securities Exchange Act of 1934.

3. As defined in Section 1361(b)(3)(B)) of the Code.

4. As defined in Section 162(m)(2) of the Code.

5. As defined in Section 856(a) of the Code.

6. As defined in Section 856(a)(i)(2) of the Code.

7. *See* 85 Fed. Reg. 86482

8. Section 1504 of the Code generally defines an "affiliated group" as "(A) 1 or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if— (B) (i) the common parent owns directly stock meeting the requirements of paragraph (2) in at least 1 of the other includible corporations, and (ii) stock meeting the requirements of paragraph (2) in each of the includible corporations (except the common parent) is owned directly by 1 or more of the other includible corporations." Paragraph (2) provides that the ownership of stock of any corporation meets the requirements of this paragraph if it— (A) possesses at least 80 percent of the total voting power of the stock of such corporation, and (B) has a value equal to at least 80 percent of the total value of the stock of such corporation.

9. 85 Fed. Reg. 86482.

10. *Id.*

11. The term "foreign private issuer" is defined in 21 CFR 240.3b-4(c).

12. The preamble to the final regulations point out that the legislative history to TCJA provides that the amendment to the definition of publicly held corporation under Section 162(m) "extends the applicability of section 162(m) to include … all foreign companies publicly traded through ADRs." House Conf. Rpt. 115-466, 489 (2017). The Blue Book similarly states that "the provision extends the applicability of section 162(m) to include all foreign companies publicly traded through ADRs." Staff of the Joint Committee on Taxation, General Explanation of Public Law 11597 ("Blue Book"), at 261 (December 20, 2018). *See* 85 Fed Reg. 86482, 86483.

13. Before TCJA, the IRS ruled in several private letter rulings that Section 162(m), as in effect at that time, did not apply to FPIs because FPIs are not required to disclose compensation of their officers on an individual basis under the Exchange Act, and, therefore, did not have covered employees. A private letter ruling may be relied upon only by the taxpayer to whom the ruling was issued and does not constitute generally applicable guidance. *See* Section 11.02 of Revenue Procedure 2020-1, 2020-01 I.R.B. 144. TCJA amended Section 162(m) to provide that a requirement to disclose compensation is not determinative of whether an officer is a covered employee. *See* 85 Fed. Reg. 86483.

14. 85 Fed. Reg. 86483.

15. *Id.*

16. *Id.*

17. *See* House Conf. Rpt. 115-466, 489 (2017).

18. Item 402 of Regulation S-K, 17 CFR 229.402(a)(3).

19. *See* 85 Fed. Reg. 86483.

20. *Id.*

21. *See* 84 Fed. Reg. 70,362.

22. *See* 85 Fed. Reg. 86484.

23. *Id.*

24. *See* 17 CFR 240.3b-7 (Rule 3b-7).

25. *See* 85 Fed. Reg. 86484.

26. *Id.*

27. *Id. See* (House Conf. Rpt. 115-466, 489 (2017)). The Blue Book reiterated the legislative history in explaining the amended definition of covered employee. *See* Blue Book at p. 260.

28. *Id.*

29. *See* Section III. D of the preamble to the proposed regulations. For example, under Section 1.105-11(c)(3)(iii), the nondiscrimination rules of Section 105(h)(3) apply to former employees even though the Code uses only the term "employees."

30. *Id. See* House Conf. Rpt. 115-466, *supra*, at 489.

31. For simplicity, where possible, the final regulations use the term "compensation" instead of "applicable employee remuneration." These terms have the same meaning in the final regulations.

32. *See* 85 Fed. Reg. 86482.

33. *See* Section 162(m)(4)(F); 85 Fed. Reg. 86484.

34. *See* 85 Fed. Reg. 86484.

35. *See* 85 Fed. Reg. 86485; *see* Section IV.B of the preamble to the proposed regulations.

36. *See* 85 Fed. Reg. 86485.

37. *See* 85 Fed. Reg. 86485.

38. *Id.*

39. *See* 85 Fed. Reg. 86485.

40. This commenter also suggested a transition relief period of 10 years for taxpayers that, prior to the IRS first announcing the no-rule position on this issue in Revenue Procedure 2010-3, received private letter rulings providing that Section 162(m) did not limit the deduction of the publicly held corporation for compensation paid to a covered employee by a partnership in which the publicly held corporation held a partnership interest. The IRS announced the no-rule position in 2010 in Section 5.06 of Revenue Procedure 2010-3, 2010-1 I.R.B. 110, which provided that "[w]hether the deduction limit under § 162(m) applies to compensation attributable to services performed for a related partnership" was an area under study in which rulings or determination letters will not be issued until the IRS resolves the issue through publication

of a revenue ruling, revenue procedure, regulations, or otherwise. *See* 85 Fed. Reg. 86485.

41. *See* Treas. Reg. § 1.162-33(c)(3)(ii).

42. *See* 85 Fed. Reg. 86485.

43. *See* 85 Fed. Reg 86486. In suggesting that the statute should be read to exclude payments for services performed as an independent contractor from compensation subject to Section 162(m), commenters point to a private letter ruling issued in 1997 (PLR 9745002). In the letter ruling, based on the facts presented, the IRS ruled that, for purposes of Section 162(m), compensation excludes consulting fees for services performed by a covered employee as an independent contractor. A private letter ruling may be relied upon only by the taxpayer to whom the ruling was issued and does not constitute generally applicable guidance. *See* Section 11.02 of Revenue Procedure 2020-1, 2020-01 I.R.B. 144.

44. *See* 85 Fed. Reg. 86486.

45. *Id*. *See* House Conf. Rpt. 115-466, 489 (2017).

46. *See* 85 Fed. Reg. 86487.

47. As provided in Treas. Reg. § 1.162-27(f)(1) and (2) of the 1995 regulations (Specifically, a privately held corporation that becomes a publicly held corporation before December 20, 2019, may rely on the transition rules provided in Section 1.162-27(f)(1) until the earliest of the events described in Section 1.162-27(f)(2). As provided in the 1995 regulations, a corporation that is a member of an affiliated group that includes a publicly held corporation is considered publicly held and, thus, may not rely on the transition relief provided in Section 1.162-27(f)(1). *See* 85 Fed. Reg. 86487.

48. *See* 85 Fed. Ref. 86487.

49. The preamble to the final regulations, at 85 Fed. Ref. 86487, points out that:

> The text of section 13601(e) of TJCA is almost identical to the text of pre-TCJA section 162(m)(4)(D), which provided a transition rule in connection with the enactment of section 162(m) in 1993 (the 1993 grandfather rule). Under the 1993 grandfather rule, section 162(m) did not apply to compensation payable under a written binding contract that was in effect on February 17, 1993, and that was not modified thereafter in any material respect before the compensation was paid. Treas. Reg. Section 1.162-27(h) provides guidance on the definitions of written binding contract and material modification for purposes of applying the 1993 grandfather rule. The proposed regulations adopted those definitions for purposes of the grandfather rule under section 13601(e) of TCJA.

50. *See* 85 Fed. Ref. 86487.

51. *See* 85 Fed. Ref. 86488.

52. *Id*.

53. *Id*.

54. *Id*.

55. *See* 85 Fed. Reg. 86488.

56. *Id*.

57. *See* 85 Fed. Reg. 86488, 86489.

58. *See* 85 Fed. Ref. 86489.

59. *Id.*

60. *Id.*

61. *See* 85 Fed. Ref. 86489, 8649.

62. *Id.*

63. *Id.*

64. *See* 85 Fed. Ref. 86487.

65. Treas. Reg. Section 1.162-27(h)(iii)(B) provides that:

> If the contract is modified to defer the payment of compensation, any compensation paid in excess of the amount that was originally payable to the employee under the contract will not be treated as a material modification if the additional amount is based on either a reasonable rate of interest or one or more predetermined actual investments (whether or not assets associated with the amount originally owed are actually invested therein) such that the amount payable by the employer at the later date will be based on the actual rate of return of the specific investment (including any decrease as well as any increase in the value of the investment).

66. A non-statutory stock option is an option other than an incentive stock option described in Section 422 of the Code or a stock option granted under an employee stock purchase plan described in Section 423 of the Code.

67. Section 1.409A-1(b)(5)(v)(C)(1) describes the following requirements for an extension: (1) at the time of the extension, the exercise price is greater than the underlying stock's fair market value and (2) the exercise period is extended to a date no later than the earlier of the latest date upon which the stock right could have expired by its original terms or the 10th anniversary of the original date of grant.

68. *See* Section 409A(a)(1)(B)(i)(II) of the Code.

69. *See* Section 409A(a)(1)(B)(i)(I) of the Code.

70. *See* 85 Fed. Ref. 86490.

71. *See* Section 7805(b)(7) of the Code.

72. *See* Section 1.162-33(c)(2)(i)(B).

73. *See* 85 Fed. Ref. 86491.

74. *See* Treas. Reg. § 1.162-33(c)(2)(ii).

75. *See* Section 162(m)(3)(C).

76. *See* 85 Fed. Ref. 8649.

77. *See* Treas. Reg. § 1.16233(c)(3)(ii).

78. *See* 85 Fed. Ref. 86491.

79. *See* Treas. Reg. § 1.162-27(f)(1).

80. *See* under § in Section 1.162-27(f)(2).

81. *See* under Section 1.162-27(c)(1)(ii)).

82. *See* 85 Fed. Ref. 86491.

83. *See* under (cf. Section 1.162-33(g)(1)(v)).

84. *See* under (cf. Section 1.162-33(g)(1)(vi)).

85. *See* under (cf. Section 1.162-33(g)(1)(vii)).

86. *See* 85 Fed. Ref. 86491.

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