

# Executive Compensation, Employee Benefits and ERISA Alert

**Akin Gump**  
STRAUSS HAUER & FELD LLP

## IRS Issues Final Regulations Regarding Certain Employee Remuneration in Excess of \$1 Million Under Section 162(m) of the Code

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Section 162(m) of the Internal Revenue Code of 1986 (as amended, the “Code”) imposes a \$1 million deductibility limit on compensation paid by “publicly held corporations” to “covered employees.” As reported in our [previous client alert](#) published on January 8, 2018, in December 2017, the Tax Cuts and Jobs Act (the “TCJA”) made numerous changes to the Code Section 162(m) deduction limitation, including repealing key exceptions for commissions and qualified performance-based compensation, expanding the definition of “covered employee” and extending the applicability of Code Section 162(m) to certain corporations, even if the stock is not publicly traded.

On August 21, 2018, the IRS issued Notice 2018-68 (the “Notice”), which provided guidance on the amended rules for identifying covered employees and the operation of the grandfather rule, including when a contract will be considered materially modified so that it is no longer grandfathered (discussed below). On December 20, 2019, the IRS published proposed treasury regulations (the “Proposed New Section 162(m) Rules”) and, in connection with the issuance of the Proposed New Section 162(m) Rules, the IRS advised that taxpayers would not be permitted to rely on the Notice for tax years ending on or after December 20, 2019. On December 18, 2020, the IRS released final regulations (the “New Section 162(m) Rules”) implementing the amendments made to Code Section 162(m) by the TCJA and finalizing the Proposed New Section 162(m) Rules.

### Overview of Key Issues in New Section 162(m) Rules

The New Section 162(m) Rules, which generally retain the basic approach and structure of the Proposed New Section 162(m) Rules with certain revisions (including revised examples), are generally effective for tax years beginning on or after December 30, 2020 (the date of publication in the Federal Register) (the “Final Publication Date”); however, there are certain exceptions to this general effective date, including those noted below, and taxpayers may choose to apply the New Section 162(m) Rules to a tax year beginning after December 31, 2017, as long as they apply

### Contact Information

If you have any questions regarding this alert, please contact the Akin Gump lawyer with whom you usually work or

**Bruce E. Simonetti**

Partner  
[bsimonetti@akingump.com](mailto:bsimonetti@akingump.com)  
New York  
+1 212.872.8023

**Rolf Zaiss**

Partner  
[rzaiss@akingump.com](mailto:rzaiss@akingump.com)  
New York  
+1 212.872.1050

**Aimee M. Adler**

Partner  
[aadler@akingump.com](mailto:aadler@akingump.com)  
New York  
+1 212.872.8060

**Michael Gerald**

Senior Counsel  
[mgerald@akingump.com](mailto:mgerald@akingump.com)  
Los Angeles  
+1 213.254.1206

**Aaron S. Farovitch**

Associate  
[afarovitch@akingump.com](mailto:afarovitch@akingump.com)  
New York  
+1 212.872.8092

them in their entirety and in a consistent manner to that tax year and all subsequent tax years.

Changes to Code Section 162(m) made by the TCJA and the New Section 162(m) Rules primarily focus on the entities, individuals and compensation subject to Code Section 162(m) and include, among other things, the following:

- **Expanded definition of “publicly held corporation.”** The definition of a “publicly held corporation” not only includes any corporation that issues common equity securities required to be registered under Section 12 of the Securities Exchange Act of 1934 (as amended, the “Exchange Act”), but now also includes any corporation that issues any class of securities (debt or equity, preferred or common) that are required to be registered under Section 12 of the Exchange Act and any corporation that is required to file reports under Section 15(d) of the Exchange Act, as determined as of the last day of the corporation’s tax year.
  - Now more entities may be subject to the \$1 million deduction limitation, including foreign private issuers, publicly traded partnerships that are treated as corporations under Code Section 7704, parent entities of disregarded entities, qualified real estate investment trust subsidiaries and S corporations, including qualified subchapter S subsidiaries.
- **Modification of “affiliated group” rules.** The New Section 162(m) Rules also modified the rules on affiliated groups. Under the treasury regulations that were issued on December 20, 1995 (the “Old Section 162(m) Rules”), an affiliated group did not include any subsidiary-member of the group that itself was a publicly held corporation.
  - Under the New Section 162(m) Rules, in the case of an affiliated group that includes two or more publicly held corporations, each member of the affiliated group that is a publicly held corporation is separately subject to the deduction limitation and has its own set of covered employees, and the affiliated group as a whole is subject to the deduction limitation. When an individual is a covered employee of more than one publicly held corporation in the same affiliated group, a separate determination is made as to whether compensation paid by each such member exceeds the \$1 million deduction limitation.
  - If a covered employee of one member of an affiliated group is paid compensation in a tax year by more than one member of the affiliated group, compensation paid by each member of the affiliated group is aggregated with the compensation paid by all other members of the affiliated group (excluding compensation paid by any other publicly held corporation in the affiliated group of which the individual is also a covered employee).
  - Any amount disallowed as a deduction must be pro-rated among the payor corporations (excluding any other publicly held payor corporation of which the individual is also a covered employee) in proportion to the amount of compensation paid to the covered employee by each payor corporation in the tax year.<sup>1</sup>
  - In addition, under the New Section 162(m) Rules, an affiliated group includes a privately held parent corporation and its publicly held subsidiary.

- **Expanded definition of “covered employee”; predecessor entities.**
  - The definition of a “covered employee” was expanded and now includes:
    - Any individual who serves as the principal executive officer (PEO) or the principal financial officer (PFO) of the publicly held corporation serving at any time during the corporation’s tax year, including individuals acting in either such capacity.
    - The three highest compensated executive officers of the publicly held corporation (other than the PEO or PFO or an individual acting in such capacity), regardless of whether the executive officer is serving at the end of the corporation’s tax year and regardless of whether the executive officer’s compensation is subject to disclosure for the last completed fiscal year under the executive compensation disclosure rules under the Exchange Act.
    - Any individual who was a covered employee of the publicly held corporation (or any predecessor) for any preceding tax year beginning after December 31, 2016.
  - The New Section 162(m) Rules include numerous examples illustrating how to determine covered employees under the expanded definition.
  - Employment on the last day of the publicly held corporation’s tax year is no longer a requirement for an individual to be considered a covered employee.
  - The concept of “once a covered employee, always a covered employee” was introduced by the TCJA and the New Section 162(m) Rules provide that any individual who was a covered employee for a publicly held corporation’s tax year beginning after December 31, 2016 will forever be a covered employee of that corporation.
  - This expanded definition generally applies to tax years ending on or after September 10, 2018 (the publication date of the Notice) (the “Notice Publication Date”) and, with respect to corporations that have fiscal and tax years that 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 rules under the Exchange Act applies to tax years ending on or after December 20, 2019.
  - The New Section 162(m) Rules describe predecessor corporations in the context of various types of corporate transactions and include multiple examples of the application of these rules. Subject to certain exceptions outlined in the New Section 162(m) Rules, in general, if a corporate transaction occurs before the Final Publication Date, then taxpayers may apply either the definition of predecessor in the New Section 162(m) Rules or a reasonable good faith interpretation of the term “predecessor” in Code Section 162(m)(3)(c).
  - Covered employees of predecessors remain subject to the \$1 million deduction limitation under the New Section 162(m) Rules. Accordingly, there are circumstances in which a publicly traded corporation can acquire additional covered employees.
  - In addition, under the New Section 162(m) Rules, a publicly held corporation is considered a predecessor if it becomes a privately held corporation, and again becomes a publicly held corporation for a tax year ending before the 36-month

anniversary of the due date for the corporation's tax return (disregarding any extensions) for the last tax year for which the corporation was previously publicly held. This rule applies to any publicly held corporation that becomes a privately held corporation for a tax year beginning after December 31, 2017, and subsequently again becomes a publicly held corporation on or after the Final Publication Date.<sup>2</sup>

- **Expanded definition of “applicable employee remuneration.”** The concept that the \$1 million deduction limitation applied to “applicable employee remuneration” paid to covered employees was replaced with the concept that it applies to “compensation” paid to covered employees. Subject to certain exceptions, the term “compensation” under the New Section 162(m) Rules means the aggregate amount allowable as a deduction to the publicly held corporation under the Code for the tax year (determined without regard to Code Section 162(m)) for remuneration for services performed by a covered employee, whether or not the services were performed during the tax year and includes amounts includible in the income of, or paid to, a person other than the covered employee, including after the death of the covered employee, for services performed by the covered employee.
  - Based on the new definitions of “covered employee” and “compensation,” more remuneration is now subject to the \$1 million deduction limitation, including remuneration such as board of director fees, compensation paid to a former covered employee no longer providing services as an executive officer, and payments made to non-employees on the covered employee's behalf (such as beneficiaries).
- **Change in position on compensation paid by a partnership to a covered employee.** Under prior IRS guidance, reasonable compensation paid from a lower-tiered partnership to partnership employees who were covered employees was not subject to the Code Section 162(m) deduction limitation because the corporation itself did not employ or pay the executives any compensation. Under the New Section 162(m) Rules, when a publicly held corporation is a partner in a partnership and the partnership pays compensation for services performed for the partnership to one of the corporation's covered employees, the publicly held corporation must take into account its distributive share of a partnership's deduction for compensation paid after December 18, 2020 to the corporation's covered employee in determining the amount allowable to the corporation as a deduction under Code Section 162(m). However, in acknowledging the shift in position, the New Section 162(m) Rules provide transition relief for compensation paid after the Final Publication Date pursuant to a written binding contract in effect on December 20, 2019 that is not materially modified thereafter.
- **Elimination of IPO transition rule.** The New Section 162(m) Rules eliminate the “IPO transition rule” that permitted privately held corporations that become publicly held from immediately becoming subject to the \$1 million deduction limitation in regards to pre-existing agreements. Such change generally applies to corporations that became publicly held after December 20, 2019. A privately held corporation that became publicly held on or before December 20, 2019 may rely on the transition relief provided in the Old Section 162(m) Rules.<sup>3</sup>
- **Grandfather rule.** The TCJA and the New Section 162(m) Rules provide transition relief for compensation payable pursuant to a written binding contract that was in effect on November 2, 2017 and not materially modified on or after that date.

Consistent with the Notice and the Proposed New Section 162(m) Rules, the IRS retained its narrow interpretation of the grandfather provision in the New Section 162(m) Rules and provided additional guidance on its application in various contexts (e.g., compensation paid from account and non-account balance plans). The New Section 162(m) Rules contain numerous examples of situations that may or may not affect the grandfather rule and provide generally that, subject to certain specific exceptions, the grandfather rule applies to tax years ending on or after the Notice Publication Date.

- Compensation that is payable under a “written binding contract” that was in effect on November 2, 2017 and was not “materially modified” on or after that date is “grandfathered” and remains subject to the Old Section 162(m) Rules. The amount of compensation that is grandfathered under such an agreement is only that amount which the corporation is obligated to pay to the employee under applicable law (e.g., state law). Therefore, depending on state law, negative discretion within an agreement may cause little to none of the compensation payable to be grandfathered.
  - The New Section 162(m) Rules provide that a corporation’s right to recover compensation under a written binding contract does not affect the determination of the amount of compensation the corporation is obligated to pay under applicable law as of November 2, 2017, whether or not the corporation exercises its discretion.
  - If a corporation can terminate or cancel a written binding contract without the employee’s consent after November 2, 2017 and without terminating the employee’s employment, the contract is treated as renewed as of the earliest date such termination or cancellation would be effective, and is subject to the New Section 162(m) Rules.
- A material modification occurs when a contract is amended to increase the amount of compensation payable to an employee. It is treated as a new contract entered into as of the date of the material modification. Therefore, amounts received by an employee under the contract before the material modification are not affected (i.e., remain grandfathered), but amounts received after the material modification are treated as paid pursuant to a new contract and are subject to the New Section 162(m) Rules.
- The New Section 162(m) Rules provide that the following amendments are not material modifications:
  - Accelerating the payment of compensation if the amount of compensation paid is discounted to reasonably reflect the time value of money.
  - Deferring a portion of the compensation if any additional compensation paid or to be paid under the contract is based on applying to the amount originally payable either a reasonable rate of interest or the rate of return on a predetermined actual investment (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 reasonable rate of interest or the actual rate of return on the predetermined actual amount (including any decrease as well as any increase in the value of the investment).<sup>4</sup>

<sup>1</sup> The New Section 162(m) Rules clarify that the amount of compensation treated as paid by a payor corporation that is not a publicly held corporation is determined by prorating the amount actually paid by that payor corporation in proportion to the total amount paid by all of the publicly held corporations of which the individual is a covered employee.

<sup>2</sup> The definition of "predecessor" for purposes of this rule does not apply to any publicly held corporation that became a privately held corporation for a tax year beginning before January 1, 2018, with respect to the earlier period as a publicly held corporation; or a publicly held corporation that becomes a privately held corporation for a tax year beginning after December 31, 2017, and, subsequently again becomes a publicly held corporation before the Final Publication Date.

<sup>3</sup> The New Section 162(m) Rules clarify that a subsidiary corporation that is a member of an affiliated group may rely on the transition relief provided in the Old Section 162(m) Rules if it became a separate publicly held corporation (whether in a spin-off transaction or otherwise) on or before December 20, 2019.

<sup>4</sup> If compensation attributable to the exercise of a non-statutory stock option or a stock appreciation right (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 the applicable treasury regulations under Code Section 409A.

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