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Labor and Employment Alert: 162(m) Regulations Proposed

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Overview

The Tax Cuts and Jobs Act generally eliminated the exception to the $1M deduction cap imposed under Code Section 162(m). We previously wrote about these changes in our alerts on 1/8/2018 (describing the TCJA) and on 8/22/2018 (describing IRS Notice 2018-68). On December 20, 2019, proposed regulations were issued. In many respects, the proposed regulations follow the structure of Notice 2018-68. This alert summarizes some of the nuances in the proposed regulations that public companies should evaluate.

What companies are subject to the deduction limit?

Any entity that is taxed as a corporation (including S-corporations, certain publicly traded partnerships, disregarded entities, and foreign corporations) is subject to the deduction limitation for a year if, on the last day of the taxable year, that company (a) has issued securities that are required to be registered under Section 12 of the Exchange Act *(whether or not the securities are actually registered)*, or (b) is required to file reports under Section 15(d) of the Exchange Act *(whether or not the reports are actually filed)*.

Vorys comment: It is important to note that the deduction limitation is based on whether registration and/or filing is required. This means that some companies with SEC registrations and/or reports may not be subject to the deduction limit (because their registration/reports are not legally required) and others with no publicly reported information may actually be subject to the deduction limit (because the company actually was required to register or report).

It doesn't matter where the public company is on the company organization chart, once there is a company that should have registered or filed reports, the deduction limit applies to all compensation paid by any company in the affiliated group of companies to a covered employee, with one exception described below (see *How is the deduction allocated among companies in an affiliated* *group?)*

If during a year the company ceases to be ***required*** to register their outstanding securities (even if the company does not actually terminate their registration during the year) and is not required to file reports under section 15(d), the deduction limit ceases to apply to that company.

The proposed regulations clarify that if no company in an affiliated group is "public" under this standard on the last day of a tax year, the deduction limit doesn't apply for that year.

How is the deduction allocated among companies in an affiliated group?

The deductible amount is generally allocated among the affiliated companies in proportion to that company's share of the compensation paid to the covered employee. Here is an example of the allocation between affiliated companies. This example is the same regardless of which company is the applicable public company.

Pay

Nondeductible

Deductible

Company A

$2,100,000

$1,400,000 =

$2.1M * ($3M - $1M) / $3M

$700,000

Company B

$900,000

$600,000 =

$900K * ($3M - $1M) / $3M

$300,000

Total

$3,000,000

$2,000,000

$1,000,000

There is an exception to that general rule. If there are two (or more) SEC reporting companies in an affiliated group and the same person is a covered employee for both companies, the pay from each of the reporting companies is disregarded when applying the limit for the other reporting company. Here is an example of the allocation when both A and B are related public companies.

Pay

Nondeductible

Deductible

Company A*

$2,100,000

$1,100,000 =

$2.1M * ($2.1M - $1M) / $2.1M

$1,000,000

Company B*

$900,000

$0 [$900K is not more than $1M]

$900,000

Total

$3,000,000

$1,100,000

$1,900,000

Note that pay from the other affiliated group members still count toward both limits. Here is an example of the allocation where A is publicly traded, B and C both have public debt, and the employee is a covered employee of A and B but not of C.

Pay

Nondeductible

Deductible

Company A*

$1,500,000

$785,714 =

$1.5M * ($1.5M + $600K - $1M) / ($1.5M + $600K)

$714,286

Company B*

$900,000

$300,000 =

$900K * ($900K + $600K - $1M) / ($900K + $600K)

$600,000

Company C

$600,000

$314,285 + $200,000 = $514,285

$600K * ($1.5M + $600K - $1M) / ($1.5M + $600K)

$600K * ($900K + $600K - $1M) / ($900K + $600K)

$85,715

Total

$3,000,000

$1,599,999

$1,400,001

As you see from these examples, although having more than one public company in an organization chart can trigger a loss of deduction for more people (because each company will have a list of covered employees), the actual total deduction may be increased for a person who is a covered employee for both companies and who is paid by both companies.

Vorys comment: For companies that have public subsidiaries, it may be tempting to restructure compensation to attempt to maximize the deduction. Be warned, the preamble to the proposed regulations indicate that the IRS intends to use their anti-abuse authority to address situations that they find abusive.

Who is a covered employee?

As you may recall, the covered employee definition generally triggers a permanent taint for anyone who serves as the principal executive officer (PEO), the principal financial officer (PFO) and the top 3 highest paid executive officers at any time during a taxable year. There are numerous situations where this list will not line up with the individuals disclosed on the summary compensation table.

Vorys comment: We recommend that compensation committee adopt a resolution after the end of each tax year that lists the covered employees for that tax year (and the applicable prior years). Remember that the test applies for each tax year and this could result in multiple lists during a fiscal year.

As described above, once a person becomes a covered employee, the aggregate of all pay from all companies within the affiliated group that is payable to that covered employee is subject to the deduction limit if there is any company within the group that is required to be registered or is required to file. This includes compensation paid by any company in the affiliated group (a) for services as a director, employee, independent contractor, partner or in any other capacity; (b) for current or past services; and (c) whether paid to the covered employee or to someone else (including a former spouse or a beneficiary).

Vorys comment: Data tracking across all affiliates will be important.

The proposed regulations also clarify (with 31 examples) when a company inherits people that were on someone else's list of covered employees. Note, the covered employee also remains on the original company's list.

- Companies resulting from corporate reorganizations and mergers inherit the full list of covered employees.
- Companies formed by a spin-off of stock inherit only the covered employees who perform services for the new company (or its affiliates) within the 24 month period spanning the spin-off date.
- Companies that purchase at least 80% of the operating assets of a target (based on the acquisition date fair market value) inherits only the covered employees on target's list who work for the acquirer during the 24 month period spanning the asset acquisition date. The regulations specifically comment that a seller's acquisition of other assets to push the purchase below this threshold will not be effective.
- If a public company is no longer required to register or file reports and therefore ceases to be public for purposes of these rule, that company's list of covered employees will become irrelevant 36 months after the tax return due date (without extension) for the year in which the company went private and deductions will not be limited for payments made to the former covered employees (unless they become a covered employee again in the future). If, however, the company goes public again, or is acquired by another public company, before the end of this 36 month period, the deduction limits apply to compensation paid to the original list of covered employees as well as any new covered employees.

- You can't break the taint by intervening transactions.

How do 162(m) and 280G interact?

Any amount that is non-deductible under Code Section 280G reduces the $1M amount that would otherwise be deductible under Code Section 162(m).

Vorys comment: This makes 280G cutback provisions even more important. Provisions that only cut back if the employee would realize less after taxes may result in a nominal increase in the net amount realized by an executive in a change in control transaction, but that typically minor increase often comes at the cost of a large lost corporate deduction.

What about grandfathering?

Compensation that is payable pursuant to a written binding contract that was in effect on November 2, 2017 are taxed under the old rules.

For example, if on November 2, 2017, the covered employee held a performance based award that contained the typical negative discretion provision, but the applicable state law would apply a limitation on that discretion, the company could treat that portion of the award that could not have been unilaterally forfeited as grandfathered and deductible under the old rules.

Where a portion of a benefit is grandfathered, the first dollars paid will be applied against the grandfathered benefit and then, after all grandfathered amounts have been paid, the new rules would apply to the non-grandfathered amounts.

Vorys comment: Just because an amount is grandfathered doesn't mean that it is deductible. For example, grandfathered severance would still count against the $1M deduction limit.

If a contract can be terminated, it is only grandfathered for the period between November 2, 2017 and the earliest date that the termination would have been effective if notice of termination had been given on that date. In addition, earnings on account balances generally are only grandfathered through November 2, 2018, on the theory that the company could have terminated the plan and frozen earnings, so the employee would not have had a contractual right to earnings more than 12 months after a potential November 2, 2017 plan termination date.

The existence of a clawback right will not trigger a loss of grandfathered status until the event that triggers the clawback occurs. However, in the unlikely event that a clawback right is triggered, whether or not the company is able to recover any amount, the portion of the benefit that would be subject to the clawback right would not be grandfathered. For example, if an employee's contract would provide a right to a bonus of $2M, subject to clawback, and the company's past practice would expect that the company would have a binding obligation to pay $500K if the clawback right were triggered, the bonus deduction would be reduced by (a) any amount actually recovered by the company, (b) $500K of the net bonus paid would be analyzed under the old Regulation Section 1.162-27 and (c) the rest of the net bonus paid would be analyzed under the new Regulation Section 1.162-33.

A material modification of a grandfathered compensation arrangement will trigger a prospective loss of grandfathered status, but will not affect deductions for prior years.

Changes that are material modifications

Changes that are not material modifications

Acceleration of benefit payments *without* a present value discount

Acceleration of benefit payments *with* a present value discount

Delay of benefit payments if additional earnings *exceed* a reasonable rate of interest or the return on a predetermined actual investment

Delay of benefit payments if additional earnings are based on a reasonable rate of interest or the return on a predetermined actual investment

Additional compensation based on the same terms (other than reasonable cost-of-living increases)

Reasonable cost of living increases

Failure to exercise negative discretion

Accelerating vesting (even if that accelerates payment without a discount for early payment)

Adding a new type of compensation

Each benefit under a grandfathered arrangement is evaluated separately. For example, if an employment agreement provided for base pay, a discretionary bonus, and severance based on a multiple of the base pay plus bonus, the company would need to evaluate whether the contract was a binding obligation to pay each of these types of compensation.

The following example assumes that on November 2, 2017, a covered employee had an employment agreement that had a term through June 1, 2021, with automatic extensions:

On 11/2/2017

Treatment before 6/1/2021 (when the term in place on 11/2/2017 would have expired), deductibility analyzed under 1.162-27

UNLESS… (in which case 1.162-33 applies)

Base salary

So long as raises have been reasonable

Any raise was unreasonable

Raises

Always analyzed under 1.162-33

Discretionary bonus

Always analyzed under 1.162-33

Portion of severance

Based on 11/2/2017 base salary

So long as raises have been reasonable

Any raise was unreasonable

Based on Raises

Always analyzed under 1.162-33

Based on a bonus paid before 11/2/2017

Always

Based on a discretionary bonus paid after 11/2/2017

Always analyzed under 1.162-33

Coordination with Code Section 409A

The preamble to the proposed regulations contain two important topics. Some plans and employment agreements provided that compensation that was not expected to be deductible must be automatically deferred and be payable in the year following the individual's termination of employment. Treasury Regulation Section 1.409A-2(b)(7)(i) provided that payment may be delayed past the designated payment date to the extent that the company reasonably anticipates that the payment would not be deductible due to Code Section 162(m) if it was paid when originally scheduled. Importantly, that regulation required that all schedule payments must be delayed.

The preamble indicated that the regulations under 409A will be amended to allow companies to delay scheduled payments of grandfathered amounts (to preserve the deduction on those amounts) without delaying payment on non-grandfathered amounts.

In addition, the preamble indicated that companies would be given until December 31, 2020 to adopt amendments to deferred compensation arrangements that required deferral until the amount would be deductible. Any payment that would have been payable prior to December 31, 2020 but for the deduction limitation must be paid no later than December 31, 2020.

Vorys comment: Companies should review their deferred compensation arrangements to confirm whether amendments should be adopted.