Bloomberg Tax

Tax Management
Compensation Planning Journal™

Section 162(m): Proposed Regulations Expand Scope of Deduction Limitation

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BACKGROUND

Section 162(m)[1] generally limits publicly held corporations to annual $1 million deductions for compensation paid to each of certain covered employees. Section 162(m) was added to the I.R.C. as part of the Omnibus Budget Reconciliation Act of 1993,[2] with final regulations adopted in 1995. In 2017, amendments were made to §162(m) as part of the Tax Cuts and Jobs Act (the Act),[3] including amendments to the definitions of ''publicly held corporation,'' ''covered employee'' and ''applicable employee remuneration.'' The Act also introduced a transition rule for compensation arrangements already in effect, known as the ''grandfather rule.''[4] The amendments introduced by the Act were further clarified via Notice 2018-68 and the recent proposed regulations issued on December 20, 2019 (Proposed Regulations).[5] This article examines the impact of these recent proposed regulations on the Act's application to §162(m).

Most significantly, the Act eliminated the exception from the application of §162(m) for performance-based compensation, which was the widely utilized exception that resulted in the very limited applicability of the §162(m) limitation in actual practice. In addition, the Act made material changes to other §162(m) provisions. This article will cover the notable amendments to §162(m) clarified by the Proposed Regulations, including the following: (a) the general expansion of the definition of ''publicly held corporation;'' (b) the specific inclusion of publicly traded partnerships, certain members of affiliated groups, disregarded entities, qualified sub chapter S subsidiaries and foreign private issuers, in the definition of ''publicly held corporation;'' (c) the expansion of the definition of ''covered employee;'' (d) the expansion of the definition of ''applicable employee remuneration'' and conversion to the term ''compensation;'' (e) elimination of the transition rule for newly public companies; (f) applicability dates and the grandfather rule; and (g) coordination with §409A.

PUBLICLY HELD CORPORATION

Prior to the Act, a ''publicly held corporation'' meant any corporation that issued common equity securities that are required to be registered under §12 of

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[1] All section references herein are to the Internal Revenue Code of 1986, as amended (the ''Code''), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[2] Pub. L. No. 103-66.

[3] Pub. L. No. 115-97, 131 Stat. 2054, 2155 (2017).

[4] Pub. L. No. 115-97, 131 Stat. 2054, 2156 (2017).

[5] REG–122180–18, 84 Fed. Reg. 70,356 (Dec. 20, 2019).

the Securities Exchange Act of 1934 (Exchange Act). Effective for taxable years beginning after December 31, 2017, the Act amended the definition to include any issuer of any class of securities that are required to be registered under §12[6] of the Exchange Act, thereby eliminating any distinction between different classes of securities, or any issuer that is required to file reports under §15(d) of the Exchange Act.[7] Thus, for example, companies with publicly traded debt, are now subject to §162(m). The characterization, however, does not apply if the issuer is not a ''publicly held corporation'' as of the last day of the taxable year.

The Proposed Regulations specify that C corporations and S corporations would qualify as publicly held corporations for purposes of §162(m) to the extent they offer securities that are required to be registered under §12 of the Exchange Act or are required to file reports under §15(d) of the Exchange Act. In addition to the above, the Proposed Regulations include within the definition of publicly held corporation, certain publicly traded partnerships, affiliated groups, disregarded entities, qualified sub chapter S subsidiaries, and foreign private issuers, as described below.

Publicly Traded Partnerships

The Proposed Regulations provide that publicly traded partnerships are publicly held corporations to the extent the partnership is treated as a corporation under §7704. Although deemed a publicly held corporation, this provision may have limited applicability due to the gross income exception of §7704(c)(2).

Affiliated Groups

While the Proposed Regulations follow the general rule of the 1995 final regulations by including §1504 affiliated groups of corporations,[8] the Proposed Regulations go beyond the general rule to significantly change the application of §162(m) to affiliated groups, as described below. All members of an affiliated group of corporations are considered publicly held if any member of the group is publicly held and includes privately held parent entities. 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 §162(m) and the affiliated group as a whole is also subject to §162(m). For example, if a publicly held corporation is a wholly owned subsidiary of another publicly held corporation, which is a wholly owned subsidiary of a privately held corporation, the two subsidiaries are separately subject to §162(m), and all three corporations are members of an affiliated group that is subject to §162(m). Moreover, each subsidiary has its own set of covered employees (although it is possible that the same individual may be a covered employee of both subsidiaries).

In the event that a covered employee of one of the entities in the affiliated group receives compensation from more than one entity of the affiliated group, the compensation paid by the entities is aggregated, except for compensation paid by another publicly held corporation in the affiliated group. Compensation paid to a covered employee of multiple publicly held corporations in the same affiliated group by such publicly held corporations will separately apply against the $1 million deduction limitation for each publicly held corporation. If any amounts exceed the limitation and are denied a deduction, the amount must be prorated among the separation corporations proportionally.

The Proposed Regulations provide the following adapted example,[9] Employee, a covered employee of Corporation A, performs services and receives compensation from Corporations A and B, members of an affiliated group of corporations. Corporation A, the parent corporation, is a publicly held corporation. Corporation B is a direct subsidiary of Corporation A and is a privately held corporation. The total compensation paid to Employee from all affiliated group members is $3,000,000 for the taxable year, of which Corporation A pays $2,100,000 and Corporation B pays $900,000. Because the compensation paid by all affiliated group members is aggregated for purposes of §162(m)(1), $2,000,000 of the aggregate compensation paid is nondeductible. Corporations A and B each are treated as paying a ratable portion of the nondeductible compensation. Thus, two thirds of each corporation's payment will be nondeductible. Corporation A has a nondeductible compensation expense of $1,400,000 ($2,100,000 × $2,000,000/$3,000,000). Corporation B has a nondeductible compensation expense of $600,000 ($900,000 × $2,000,000/$3,000,000).

DREs and QSubs

Ownership of a disregarded entity (DRE) or a qualified subchapter S subsidiary (QSUB) can expose

[6] Section 12(b) of the Exchange Act details the information required to list on a national securities exchange. Section 12(g) of the Exchange Act requires issuers with total assets that exceed $10,000,000 and a class of securities held by 2,000 or more persons or 500 who are not accredited investors.

[7] Section 15(d) of the Exchange Act requires reporting when securities are offered in a transaction subject to the Securities Act of 1933 and the registration statement has become effective.

[8] Section 1504 includes an 80% ownership threshold for purposes of determining whether an entity is part of an affiliated group.

[9] Prop. Reg. §1.162-33(c)(1)(v)(O) *Ex.* 15.

ISSN 0747-8607

the corporate owner of such an entity to the §162(m) limitation for compensation paid to covered employees if the DRE or the QSUB issues securities that are required to be registered under §12(b) of the Exchange Act or is required to report under §15(d) of the Exchange Act. The Proposed Regulations include the owners of such DREs or QSUBs within the definition of publicly held corporations. The IRS determined that the corporate owner of the DRE or QSUB will be treated as issuing the securities directly, since both DREs and QSubs are not treated as separate from their entity owners.

Foreign Private Issuers

Prior to the Act, foreign private issuers (FPIs) were not subject to the §162(m) limitation. In several private letter rulings, the IRS concluded that FPIs were not subject to §162(m) because they were not required to file a summary compensation table under the Exchange Act.[10] The Proposed Regulations, however, provide that corporations subject to §162(m) include foreign private issuers that meet the new definition of a publicly held corporation (even if not subject to the executive compensation disclosure rules of the Exchange Act), including those FPIs with publicly traded American Depositary Receipts.

COVERED EMPLOYEE

Section 162(m) limits the deduction for compensation paid to covered employees (Covered Employees). Before 2018, a Covered Employee generally included the CEO of the publicly held corporation, if employed as of the last day of the taxable year, and the three highest-compensated officers whose compensation for the given tax year was required to be reported. The Act includes any employee of the publicly held corporation who was the CEO or CFO at any time during the taxable year (including individuals acting in such capacities), any employee who is among the three highest-compensated officers for the taxable year whose compensation is required to be reported, and any employee of the publicly held corporation who was a Covered Employee for any taxable year beginning after December 31, 2016 (including in respect of service at a predecessor company).

Notice 2018-68 provides that the Covered Employee does not need to be employed at year-end, and that whether the Covered Employee's compensation is required to be disclosed for the last completed fiscal year under the securities rules is irrelevant. As a result, it is possible for individuals who are not listed as named executive officers in the annual proxy statement to be Covered Employees.

Under the Act, if an individual is a Covered Employee for a taxable year beginning after December 31, 2016, that individual will be a Covered Employee indefinitely. Notice 2018-68 clarifies that Covered Employees identified for the taxable year beginning in 2017 in accordance with the pre-Act rules for identifying Covered Employees will continue to be Covered Employees for all taxable years beginning in 2018 and beyond.

Under the Proposed Regulations and Notice 2018-68, Covered Employees are limited to executive officers of a publicly held corporation and executive officers of a DRE or QSUB owned by a publicly held corporation, to the extent they perform policy making functions for the publicly held corporation. In addition, under the Proposed Regulations, a Covered Employee includes any employee who was a Covered Employee of any "predecessor of a publicly held corporation."[11] The Proposed Regulations indicate that a publicly held corporation is a predecessor to itself if, after becoming privately held, it becomes a publicly held corporation again for a taxable year ending before the 36-month anniversary of the due date for the corporations federal income tax return for the last taxable year for which the corporation was publicly held.[12] They also state that a predecessor of a publicly held corporation will include (i) a publicly held corporation that is acquired or that is the transferor corporation in a corporate reorganization under §368(a)(1); (ii) a publicly held corporation that distributes or exchanges the stock of one or more controlled corporations in a transaction under §355(a)(1); (iii) a publicly held corporation that becomes a member of an affiliated group, pursuant to the Proposed Regulations; and (iv) if an acquiror corporation or a member or members of an affiliated group acquire 80% or more of the operating assets (by fair market value) of a target that is a publicly held corporation, then the target is a predecessor.[13] The result of this is that in most cases, Covered Employees of a public target will continue to be Covered Employees of public buyer indefinitely.

COMPENSATION

Compensation, for §162(m) purposes (Compensation), is the aggregate amount paid to the executive,

[10] See generally the following PLRs 201103008, 200916012, 200419013, 200406013, and 200021050.*But see* §11.02 of Rev. Proc. 2020-1 (reiterating that PLRs do not constitute generally applicable guidance).

[11] Prop. Reg. §1.162-33(c)(2)(i)(C).

[12] Prop. Reg. §1.162-33(c)(2)(ii)(A).

[13] Prop. Reg. §1.162-33(c)(2)(ii)(B)-§1.162-33(c)(2)(ii)(E).

ISSN 0747-8607

for services performed as a Covered Employee (regardless of whether performed during the taxable year) that is allowed as a deduction by the corporation for the taxable year (determined without regard to the $1 million limit imposed by §162(m)). The $1 million deduction limit applies to the taxable year in which the deduction would otherwise be taken by the corporation. For example, the deduction is generally taken in the year in which a bonus is paid, in the year in which an option is exercised, in the year in which restricted stock vests (unless a timely §83(b) has been made), and the year in which restricted stock units are settled. In addition, the $1 million deduction limit is not reduced where an employer that is newly formed as a result of a spin-off has a short taxable year.[14]

The Act expanded Compensation to include commissions and performance-based compensation, as well as payments made to beneficiaries of Covered Employees, certain payments made by a partnership to Covered Employees and payments made to a Covered Employee through a non-employee position (e.g., as a director or advisor). In addition, the Joint Explanatory Statement indicates that Compensation does not fail to be Compensation with respect to a Covered Employee merely because the Compensation is includible in the income of, or paid to, another individual, such as compensation paid to a beneficiary after the Covered Employee's death, or to a former spouse of the Covered Employee pursuant to a domestic relations order.[15]

With respect to partnerships, the Proposed Regulations provide that §162(m) applies to the Compensation that a Covered Employee receives from a partnership in which the publicly held corporation has an ownership interest for services the Covered Employee performs for the partnership.[16] The Proposed Regulations provide that if a publicly held corporation is a corporate partner in a partnership, and is allocated a distributive share of the partnership's deduction for Compensation paid by the partnership, the allocated distributive share of the deduction is subject to §162(m) even though the publicly held corporation did not directly pay the Compensation to the Covered Employee.[17] This new provision will impact taxpayers with "Up-C" and "Up-REIT" partnership structures. The revised rule applies for any deduction for Compensation that is otherwise allowable for a taxable year ending on or after December 20, 2019, but does not apply to Compensation paid pursuant to a written binding contract in effect on December 20, 2019, that is not materially modified after such date.

IPO TRANSITION RULE

Prior to the Act, §162(m) provided transition relief rules for Compensation paid by private companies that later become publicly held corporations. The Proposed Regulations eliminate the transition relief for companies that become publicly held after December 20, 2019.

For corporations that become publicly held corporations on or before December 20, 2019, Compensation paid according to a compensation plan or agreement that existed during the period in which the corporation was not publicly held is excluded from the annual deduction limit. However, in the case of a corporation that becomes a publicly held corporation in connection with an initial public offering (IPO), this exception for newly public companies applies only to the extent that the prospectus accompanying the IPO disclosed information concerning those plans or agreements that satisfied all applicable securities laws then in effect. A corporation that is a member of an affiliated group that includes a publicly held corporation is considered publicly held and, therefore, cannot rely on this exception.

In addition, a corporation that is a member of an affiliated group that includes a publicly held corporation is considered publicly held and is not permitted to rely on the exception for companies that become publicly held corporations. Instead, if such a subsidiary becomes a separate publicly held corporation on or before December 20, 2019, the exception may apply and any Compensation paid to covered employees of the new publicly held corporation may satisfy the exception for performance-based compensation, if the former performance-based compensation rules were satisfied before the subsidiary became a publicly held corporation or the former "transition period" requirements are satisfied.

APPLICABILITY DATES

The date that the final regulations have been published under §162(m) is generally the date that the Proposed Regulations apply and become effective, but certain other dates apply for specific provisions and rules. The definition of Covered Employees and the applicability of the grandfathering rules apply for taxable years ending on or after September 10, 2018. Provisions regarding identification of the three highest-compensated officers when the taxable year is different from the fiscal year apply for taxable years *ending* on or after December 20, 2019, according to the text of the Proposed Regulations and for taxable years *beginning* on or after December 20, 2019, according to the preamble to the Proposed Regula-

[14] PLR 9810024.

[15] H.R. Rep. No. 115-466 at 489-90 (2017), *available at* https://www.congress.gov/115/crpt/hrpt466/CRPT115hrpt466.pdf.

[16] Prop. Reg. §1.162-33(c)(3)(ii).

[17] Prop. Reg. §1.162-33(c)(3)(ii).

ISSN 0747-8607

tions.[18] The IPO transition rule is repealed for corporations that become publicly held corporations *on or after* December 20, 2019. With respect to the rules regarding Compensation relating to distributive shares of partnership compensation deductions, the new rules apply to taxable years ending on or after December 20, 2019.

GRANDFATHER RULES

The Act generally does not apply retroactively (i.e., it only applies to taxable years beginning after December 31, 2017) and it does not apply to amounts paid pursuant to a written binding contract that was in effect on November 2, 2017, and that was not materially modified on or after such date, known as the ''Grandfather Rules'' herein. The Proposed Regulations generally follow Notice 2018-68 with respect to the Grandfather Rules, including in its adoption of the definitions of ''written binding contract'' and ''material modification'' from Reg. §1.162-27(h).

Written Binding Contract

Compensation is payable under a written binding contract that was in effect on November 2, 2017, if the publicly held corporation was and is obligated under applicable law (including state law) to make payment under the terms of the contract if the Covered Employee performs services or satisfies applicable vesting conditions. Thus, if there is no obligation under applicable law to make payments under the contract even if the Covered Employee performs services or satisfies the applicable vesting conditions, those amounts would not be considered paid under a written binding contract for purposes of the Grandfather Rules and would be subject to the §162(m) limitation. Negative discretion, therefore, would eliminate the relief provided by the Grandfather Rules for those amounts subject to negative discretion even if the negative discretion was never exercised.

For example, a Covered Employee serves as the CEO of corporation A for the 2017 and 2018 taxable years. On February 1, 2017, corporation A establishes a bonus plan, under which the Covered Employee will receive a cash bonus of $1,500,000 if a specified performance goal is satisfied. The compensation committee retains the negative discretion, if the performance goal is met, to reduce the bonus payment to no less than $400,000 if, in its judgment, other subjective factors warrant a reduction. On November 2, 2017, under applicable law which takes into account corporation A's ability to exercise negative discretion, the bonus plan established on February 1, 2017, constitutes a written binding contract to pay $400,000. On March 1, 2018, the compensation committee certifies that the performance goal was satisfied but exercises its discretion to reduce the award to $500,000. On April 1, 2018, corporation A pays $500,000 to the Covered Employee. Because the February 1, 2017 plan is a written binding contract to pay the Covered Employee $400,000 if the performance goal is satisfied, the §162(m) limitation does not apply to the deduction for the $400,000 portion of the $500,000 payment. Furthermore, the failure of the compensation committee to exercise its discretion to reduce the award further to $400,000, instead of $500,000, does not result in a material modification of the contract. The deduction for the $400,000 payment is not subject to §162(m) because the payment is considered qualified performance-based compensation. The deduction for the remaining $100,000 of the $500,000 payment is, however, subject to §162(m) and does not qualify for exemption under the Grandfather Rules.[19]

Clawback agreements would typically qualify as written binding contracts as long as the publicly held corporation has no discretion or only has discretion to recover Compensation upon the occurrence of some event or condition outside its control. If so, the right to recover the amount is disregarded for purposes of determining the grandfathered amount for the taxable year.

In addition, the Proposed Regulations maintain existing guidance with respect to how Compensation amounts in account and non-account balance plans are treated for purposes of the transition rule. The Proposed Regulations provide that only the amount of Compensation under such plans that a company was obligated to pay under applicable law on November 2, 2017, is grandfathered under the rule, as noted above.[20] Benefits accruing under account or non-account balance plans after November 2, 2017, are not grandfathered. Furthermore, any earnings credited on grandfathered amounts under such plans after November 2, 2017, are grandfathered only if the corporation is obligated to pay the earnings under applicable law pursuant to a written binding contract in effect on November 2, 2017, but are not grandfathered if (as is typical) the company retains the right to amend the plan at any time to stop or reduce earnings under such plan.

Material Modification

The Proposed Regulations provide that a ''material modification'' occurs if a contract is amended to (i) in-

[18] See Prop. Reg. §1.162-33(h)(2)(ii)(A) and §VII.B. of the preamble to the proposed regulations.

[19] *See generally* Prop. Reg. §1.162-33(g)(3)(xvi) *Ex.* 16.

[20] *See generally* Prop. Reg. §1.162-33(g)(1), §1.162-33(g)(3)(xiii), §1.162-33(g)(3)(xv).

ISSN 0747-8607

crease the amount of Compensation payable to the employee; (ii) accelerate the payment of Compensation, unless the amount of Compensation paid is discounted to reasonably reflect the time value of money; or (iii) defer the payment of Compensation, to the extent any additional amount in excess of the original amount payable is not based on applying a reasonable rate of interest or the rate of return on a predetermined actual investment (including any decrease, as well as any increase, in the value of the investment, and regardless of whether assets associated with the amount originally owed are actually invested therein).[21] The Proposed Regulations, however, exclude vesting acceleration from the definition of a ''material modification,'' even where acceleration of vesting results in acceleration of payment. Acceleration of payment of even vested equity awards is also not a material modification.

Adoption of a supplemental contract or agreement that provides for increased Compensation, or the payment of additional Compensation, is a material modification if the facts and circumstances provide that the additional Compensation is based on substantially the same elements or conditions as the Compensation that is otherwise paid pursuant to the written binding contract, excluding any increase that is equal to a reasonable cost of living adjustment. In addition, failing to exercise negative discretion does not act as a material modification of a written binding contract.

The Proposed Regulations also provide guidance on the application of the transition rule and the material modification rule to severance arrangements. The Proposed Regulations generally limit the amount grandfathered under a severance arrangement to the amount that was actually payable pursuant to a written binding contract in effect on November 2, 2017. Severance payable under such a contract is grandfathered only if the amount of severance is based on compensation elements the company is obligated to pay under the contract. Each element of the severance calculation is analyzed separately in determining the amount grandfathered.

For example, on October 2, 2017, a corporation executes a 5-year employment agreement with an employee to serve as its CEO for an annual salary of $2,000,000. The agreement provides for severance upon termination without cause during the employment agreement term equal to two times the sum of his base salary plus discretionary bonus (if any) which was paid within twelve months prior to termination. The company pays a discretionary bonus of $1 million on November 1, 2017. It then pays another discretionary bonus of $1 million on November 1, 2018. Under applicable law, the agreement constitutes a written binding contract in effect on November 2, 2017, to pay $4,000,000 (two times employee's $2,000,000 annual salary) if the corporation terminates the employee's employment without cause prior to October 2, 2022 (the term of the agreement), and an additional $2,000,000 (two times employee's $1,000,000 bonus paid on November 1, 2017) if the corporation terminates the employee's employment without cause prior to November 1, 2018 (twelve months after payment of the bonus paid on November 1, 2017).

Scenario 1 – corporation terminates employee without cause on June 1, 2018. The employee is entitled to severance of $6,000,000 of which $4,000,000 relates to salary and $2,000,000 relates to the bonus paid on November 1, 2017. The entire $6,000,000 payment is grandfathered.

Scenario 2 – corporation terminates employee without cause on June 1, 2019. The employee is entitled to severance of $6,000,000 of which $4,000,000 relates to salary and $2,000,000 relates to the bonus paid on November 1, 2018. The $4,000,000 portion of the severance which relates to salary is grandfathered. The remaining $2,000,000 portion of severance that relates to the discretionary bonus paid after November 2, 2017, and as to which bonus no legally binding right existed on November 2, 2017, is not grandfathered.

INTERACTION WITH SECTION 409A

Section 409A addresses nonqualified deferred compensation (NQDC) arrangements and contains certain requirements that must be met to avoid current income inclusion and additional tax. Section 409A permits delaying payment under such an arrangement to the extent the company reasonably anticipates that, if the payment were made as scheduled, the company's deduction with respect to the payment of Compensation would be limited due to §162(m). Plans and compensation arrangements that utilize this rule either give discretion to the company to delay the payment or require the company to delay the payment if the company believes a deduction would be disallowed under §162(m).

Prior to the Act, because a Covered Employee in one taxable year would not necessarily remain a Covered Employee in a subsequent taxable year, the delay of payment would last until the employee would no longer be a Covered Employee, as in the case of the employee's separation from service. The Act, however, amended the definition of Covered Employee to provide that a Covered Employee in one taxable year would remain a Covered Employee in any subsequent taxable year, which may result in a significant delay

[21] Prop. Reg. §1.162-33(g)(2)(i).

ISSN 0747-8607

before the payment becomes deductible or the payment may never become deductible.[22]

The Proposed Regulations provide guidance to address this scenario. Where the company has discretion under a plan or arrangement to delay a payment if the company believes that the deduction will be disallowed under §162(m), the Proposed Regulations allow the company to delay the payment of grandfathered amounts without delaying the payment of non-grandfathered amounts. Where a company is required under a plan or arrangement to delay payment if the company believes that the deduction with respect to the payment will be disallowed under §162(m), the Proposed Regulations allow the plan or arrangement to be amended to remove the provision requiring the company to delay payment. If such amendment is made no later than December 31, 2020, the amendment will not result in an impermissible acceleration of payment under §409A. Such amendment may apply only to non-grandfathered amounts, while payment of grandfathered amounts may continue to be delayed.

[22] Pub. L. No. 115-97, 131 Stat. 2054, 2156 (2017).

CONCLUSION

Although the Proposed Regulations incorporate much of the guidance provided by Notice 2018-68, they materially expand the scope of §162(m) beyond what was provided in that interim guidance. Employers and their advisors should pay close attention to the applicability dates because a significant portion of the new rules apply even prior to the publication of the final regulations. Employers, including public companies, publicly traded partnerships, affiliate groups, companies considering going public, DREs, and QSubs should consider and review the impact of the Act.

ISSN 0747-8607