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Skadden

Executive Compensation and Benefits Alert

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IRS Issues Final Regulations Under Section 162(m)

Background

On December 18, 2020, the Treasury Department and the Internal Revenue Service (IRS) made long-awaited final regulations under Section 162(m)[1] publicly available. These regulations (Final Regulations) implement amendments made to Section 162(m) by the Tax Cuts and Jobs Act (the Act)[2] and largely conform to and finalize the proposed regulations published on December 20, 2019 (the Proposed Regulations), which expand the scope of Section 162(m)'s deduction limitation.[3]

Section 162(m) generally limits the deductibility of compensation paid to certain "covered employees" of a publicly held corporation to $1 million per year. Before the Act was implemented, payments of qualified performance-based compensation made to covered employees were exempt from the $1 million annual limitation. The Act eliminated the exemption for qualified performance-based compensation and expanded the scope of individuals who may qualify as covered employees subject to the limitation. However, the Act includes an important transition rule under which the changes made to Section 162(m) by the Act do not apply to compensation payable pursuant to a written binding contract that was in effect on November 2, 2017, that is not materially modified after that date. Arrangements that fall under the scope of such transition rule are "grandfathered."

The Final Regulations are largely consistent with the Proposed Regulations, other than with respect to certain material differences that are highlighted below. For a detailed overview of the impact of the Proposed Regulations on the Act's application to Section 162(m) that have largely been finalized by the Final Regulations, see our publication "Section 162(m): Proposed Regulations Expand Scope of Deduction Limitation."

The Extension of Grandfathered Stock Options or Stock Appreciation Rights in Compliance With Section 409A Does Not Invalidate Grandfathered Status

Generally, material modifications to nonqualified stock options (NSOs) and stock appreciation rights (SARs) that are otherwise grandfathered under the Act will result in the loss of grandfathered status. However, the Final Regulations permit the extension of the exercise period of otherwise grandfathered NSOs and SARs if the extension complies

[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. The Treasury Department and IRS' publication is available here. The official Final Regulations will be published in the Federal Register.

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

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

with Section 409A. Therefore, any extensions to a date no later than the earlier of the applicable NSO or SAR original expiration date or the 10th anniversary of the original grant date will not result in the loss of grandfathered status for NSOs and SARs otherwise grandfathered under the Act.

Distributive Shares of a Partnership's Deduction Are Factored Into a Public Company's Allowable Deduction for Covered Employees

The Proposed Regulations require a publicly held corporation that holds a partnership interest to take into account its distributive share of the partnership's deduction for compensation paid to the corporation's covered employees. Specifically, the corporation must aggregate such distributive share with the corporation's otherwise allowable deduction for compensation paid directly to the applicable employee in applying the deduction limitation under Section 162(m). This rule applies to any deduction for a taxable year ending on or after December 20, 2019. The Proposed Regulations provide transition relief by excluding compensation paid pursuant to a written binding contract in effect on December 20, 2019, that is not materially modified on or after that date.

The Final Regulations adopt the proposed rule but extend the effective date so that the limitations apply to the compensation paid to the covered employee by the partnership after December 18, 2020. The Final Regulations maintain an exclusion for compensation paid after that date, 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.

Account and Non-Account Balance Plans and Grandfathered Status

The Final Regulations also include detailed rules about grandfathered status for amounts payable under account and non-account balance nonqualified deferred compensation plans ("balance plans").

The balance plan rules in the Final Regulations are generally consistent with the balance plan examples in the Proposed Regulations. Overall, the amount that a corporation is obligated to pay pursuant to the terms of a balance plan in effect as of November 2, 2017, as determined under applicable law, is generally grandfathered. The Final Regulations address how this principle applies in various situations, such as when a balance plan may be frozen or terminated.

Notably, the Final Regulations newly specify:

- the method for determining lump sum value for non-account balance plans, noting that certain risks and contingencies should not be considered, including the likelihood that payments will not be made, and the possibility of future plan amendments and changes in the law; and
- the method for corporations to treat the account balance (for account balance plans) or lump sum value (for non-account balance plans) as of the plan's freeze or termination date (as applicable) as the grandfathered amount, regardless of when the amount is paid and whether it is credited with additional contributions, earnings or losses before payment.