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Proposed Code Section 162(m) Regulations
Some Things Old, Some Things New

The proposed Code Section 162(m) regulations were published in the Federal Register on December 20, 2019. The proposed regulations are extensive and cover a good amount of new ground. Find our prior analysis on 162(m) here. Here are some of the highlights of the proposals:

1. The covered employee "once-always" rule. The proposed regulations retain the broad "once always" interpretation from the 2018 notice to the effect that any employee who is a "covered employee" from the 2017 tax year remains a "covered employee" for all tax years thereafter, even after the individual ceases all employment with the employer. We filed a *comment letter* on this issue and argued that the statute only applies to compensation payable in years while individuals are current employees. While the IRS did not adopt our suggestions and is unlikely to do so in the final regulations, we continue to believe that a strong argument can be made that Section 162(m) does not apply to payments to former employees, and that refund claims might be worth pursuing in appropriate circumstances.

2. Grandfather rule for multi-year incentive arrangements. The proposed regulations do not move the needle on the scope of the grandfather rule and the "negative discretion issue." It still comes down to whether there is a valid contract under state law. We have analyzed case law in a number of states, and the presence of a "negative discretion" clause does not always negate the creation of a valid contract. In our view, many companies have been overly conservative in concluding that a standard "negative discretion" clause knocks a plan out of the Section 162(m) grandfather.

3. Grandfather rule for nonqualified deferred compensation plans. Nonqualified deferred compensation is not deductible by an employer until the benefit is paid and taxed to the employee. Because grandfathered deferred compensation remains subject to the pre-TCJA law, any grandfathered deferred compensation paid to a covered employee after termination of employment is not subject to the 162(m)-deduction limit. Accordingly, it is important to determine the scope of any grandfather for these plans – in particular, whether the grandfather just applies to November 2, 2017 plan amounts, or whether the grandfather also extends to future earnings on any grandfathered amount.

Nonqualified plan deferrals are usually subject to a plan-imposed "anti-cutback" protection, so most deferred compensation plans involve binding contracts that are grandfathered. As for future earnings, the 2018 IRS guidance focused on the scope of any plan amendment right that might eliminate the right to future earnings – if the company retained the right to eliminate future earnings by the power to amend the plan, then the right to any future earnings was not covered by the grandfather.

The proposed regulations expand on the plan amendment analysis and focus in particular on any reserved right to terminate a plan as something that could limit the scope of the grandfather. Since plans subject to Code Section 409A only can be terminated 12 months after a termination decision is authorized, the proposed regulations suggest that earnings on November 2, 2017 balances are only grandfathered up to November 2, 2018, the earliest date that liquidating plan distributions could be made under a Code Section 409A if a plan were terminated on November 2, 2017.

The proposed regulations, however, fail to take into account large body of case law dealing with ERISA "top hat" plans that may restrict a company's right to amend or terminate a plan. Many plans have not taken these authorities into consideration in fashioning plan termination provisions, but these authorities may provide the basis for extending the grandfather to future plan earnings without tying the company's hands in practical terms.

The proposed regulations also provide that the first dollars paid out are considered to be the grandfathered amount, which is generally (but not always) a favorable rule for taxpayers.

4. Compensation subject to the limit. The proposed regulations provide that non-deductible compensation includes compensation paid for work other than as an employee, such as director fees and consulting fees. This interpretation involves a change in the IRS position even though the 2017 legislation did not change the definition of compensation. The preamble to the proposed regulation incorrectly states that non-employee compensation has always been subject to the 162(m) limitation. In fact, a different IRS position was articulated in PLR 9745002 (11/7/97). The IRS concluded that director's fees and consulting fees were not subject to the deduction limitation because they were not paid with respect to employment – in that case a covered employee terminated employment and returned to employment in the same year and received the independent contractor pay attributable to the break-in-service. The treatment of consulting fees is an issue that companies may want to address in comments on the proposed regulation. Even if the IRS sticks with the interpretation set out in the proposed regulations, there may be ways to structure consulting arrangements to avoid the deduction denial.

5. Disregarded entities. The proposed regulation ignores any entity that is disregarded for tax purposes, even if that entity issues securities of the type that brings the Section 162(m) limitation to bear. This rule will affect companies with lower tier financing subsidiaries that issue publicly-traded debt securities. If the issuing subsidiary is a disregarded entity, the proposed regulation treats the next corporation up the chain as the publicly-traded company whose "covered employees" are subject to the deduction limit. The new proposal also affects partnerships whose partners are a corporation. The regulation would reverse four private rulings that held that Section 162(m) does not apply to compensation paid by an operating partnership – the proposed regulation attributes the disregarded entity activity to the corporate partners. The corporate-owned partnership structure has been widely utilized in the REIT industry.

6. Covered employee SEC disconnect. The proposed regulation retains the disconnect between the SEC proxy reporting requirements and the Section 162(m) definition of "covered employees." The disconnect is because the IRS rule applying to the three highest paid officers other than the CEO and CFO does not require year-end employment.

7. 409A plans delaying payout. Some 409A plans include provisions delaying payouts in order to stay under the $1 million per year cap. With the IRS position applying Section 162(m) to terminated employees and the broad "once-always" covered employee rule, a Section 162(m) delay provision could delay 409A payments for years. To remedy this, the proposed regulation allows 409A plans to be amended any time before December 31, 2020 to remove a Section 162(m) delay provision.

8. Predecessor entities. The definition of "covered employee" extends to "covered employees" of predecessor employers and the proposed regulations flesh out the types of merger and acquisition transactions that will give rise to predecessor status. The proposed regulation addresses corporate reorganization, corporate divisions (spin offs), stock acquisitions, and asset acquisitions. The regulation provides that employees of a privately-held company retains "covered employee" status for a period of time if the corporation previously was subject to Section 162(m) and that the covered employee status would come back into play if the privately-held company subsequently is acquired by a publicly-held company.

Contact us. If you have questions, please contact Kevin O'Brien, Spencer Walters, or any other member of our Benefits & Compensation practice.