Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

# 4 Steps For Public Cos. Subject To New Executive Pay Rules

By **Samuel Krause and Teresa Abney** (January 14, 2021, 5:07 PM EST)

The Internal Revenue Service recently issued final regulations regarding the caps for deducting employee compensation. In 2017, Congress expanded the rule that publicly held companies cannot deduct more than $1 million in compensation paid to a covered employee, and these new regulations implement that rule.

Samuel Krause

In light of these regulations, we recommend employee benefit and tax executives consider four tasks. Before discussing those tasks, we will provide a brief overview of the rule.

**Overview of Executive Compensation Cap**

Under Internal Revenue Code Section 162(m), publicly held corporations cannot deduct more than $1 million in compensation paid to covered employees.[1] Before 2017, commission-based and qualified performance-based compensation was excluded from the $1 million cap. Accordingly, many companies structured pay agreements to provide for $1 million base pay plus significant incentive pay.

Teresa Abney

In 2017, as part of the Tax Cuts and Jobs Act, Congress significantly expanded the scope of Section 162(m).[2] The new Section 162(m) applies to more executive officers and commission- and qualified-based compensation are now subject to the $1 million cap.

On Dec. 18, 2020, the IRS announced the final Section 162(m) regulations. Although the final regulations are largely the same as the proposed regulations released in December 2019, there are some key variations.

In light of the final regulations, we suggest employee benefit and tax executives take the following four steps to mitigate any surprises from the new rule.

**1. Identify who is a covered employee.**

Publicly held corporations need to identify their covered employees under the new rule. A covered employee now includes (1) the principal executive officer, (2) principal financial officer, (3) three highest compensated executive officers — in addition to the chief executive officer and chief financial officer, and (4) any employee who was a covered employee after Dec. 31, 2016. Employers should consider a few key issues when evaluating who is a covered employees.

First, the covered employee is no longer determined at the end of the taxable year — the term includes anyone who is the CEO or CFO anytime during the year. Similarly, for purposes of determining the three highest compensated executive officers, the officer does not have to be serving at the end of the corporation's taxable year.

Plus, covered employees include anyone who served as the acting CEO or CFO. Thus, if a company's CEO retires, an acting CEO serves for two months, and a new CEO is hired, then all three of those employees would be covered employees. This is a significant change from the prior rule that ensured there would be only one CEO treated as a covered employee.

Second, for the purpose of the three highest compensated officers, it does not matter whether the corporation must disclose the officer's compensation pursuant to the the U.S. Securities and Exchange Commission's disclosure rules. After the IRS released the proposed Section 162(m) regulations last year, commenters suggested such a rule. However, in the preamble to the final regulations, the IRS states that such a rule would be contrary to the statute and legislative intent.

Third, covered employee status is now permanent. Covered employees includes anyone who has been a covered employee after Dec. 31, 2016. The final regulations state that once an employee is a covered employee they are a covered employee for all subsequent taxable years, even if the employee is no longer employed by the corporation or if the employee has died.

The new definition of covered employee greatly expands the number of employees subject to the compensation cap and, as discussed below, the new permanent-status rule undoes a lot of the tax planning that went into executive compensation agreements.

**2. Identify compensation agreements subject to the grandfather rule.**

When Congress amended Section 162(m), it created a grandfather rule for compensation paid pursuant to agreements already in place. That is, compensation agreements protected by the grandfather rule are not subject to the amended Section 162(m).

Employers should ensure that they have identified the agreements subject to the grandfather rule so they ensure old Section 162(m) is applied to that compensation and they can take steps, if possible, to ensure the agreements stay covered by the old rule.

The grandfather rule applies if (1) the agreement is in writing, (2) the agreement was in effect on Nov. 2, 2017, and (3) the agreement has not been materially modified since then. The key issue for employers is the third requirement — that the agreement is not materially modified.

If an agreement is amended to increase the compensation paid, that is a material modification and the agreement is no longer protected by the grandfather rule. Before a corporation modifies a compensation agreement with a covered employee, it will want to consider the tax consequences of making the compensation agreement subject to the new Section 162(m) rules.

There a couple of nuances in the grandfather rule employers should review. First, the final regulations provide that a negative discretion provision is taken into account only to the extent that the corporation has the right to exercise the provision under applicable law — e.g., state contract law.

A negative discretion provision allows an employer to reduce or eliminate the compensation payable under the agreement. If a compensation agreement allows the corporation to exercise negative discretion, compensation payable under the agreement is not grandfathered to the extent the corporation is not obligated to pay it under applicable law.

Second, the final regulations provide that an agreement can qualify for the grandfather rule even if the employer has a recovery right. Many executive compensation agreements provide that the employer is able — or even obligated — to recover compensation paid if a certain future event occurs — e.g., the executive's criminal wrongdoing or a restatement of the corporation's financial statements.

In the proposed regulations, the IRS excluded from the grandfather rule any agreement that gave the corporation the right to recover compensation contingent on events outside the corporation's control. However, in a taxpayer favorable move, the IRS changed its position in the final regulations. Accordingly, a corporation's right to recover compensation does not impact whether the compensation agreement qualifies for the grandfather rule.

Third, Section 409A's rule permitting the extension of stock options and stock appreciation rights is imported into the final regulation to exclude such extensions from the definition of material modification for purposes of the grandfather rule, if the extension complies with Treasury Regulation Section 1.409A-1(b)(5)(v)(C)(1).[3]

Under the final regulations, if compensation attributable to the exercise of a nonstatutory stock option or a stock appreciation right is grandfathered, and the exercise period of the option or stock appreciation right is extended, then compensation attributable to the exercise of the option or stock appreciation right is grandfathered.

Therefore, the final regulations will not treat an extension as a material modification if, at the time of the extension, the exercise price is greater than the underlying stock's fair market value, and the exercise period is extended to a date no later than the earlier of the latest date upon which the stock right could have expired by its original terms or the 10th anniversary of the original date of grant.

**3. Reconsider deferred compensation payment agreements.**

Before Congress amended Section 162(m) as part of TCJA, employers and officers frequently entered into deferred compensation agreements. That is, the employer would defer paying the officer until the officer was no longer a covered employee — e.g., the individual was no longer within the top-paid group or employment terminated — and, thus, the compensation was deductible.

However, since Section 162(m) was amended to make covered-employee status permanent, a payment that was subject to an employer-deductibility delay might never become payable.

In the proposed regulations, the IRS allowed amended deferred compensation plans to remove the required delay by Dec. 31, 2020, and indicated that the IRS intended to amend the Section 409A regulations to permit such plans to be amended to remove the required delay no later than Dec. 31, 2020. Commenters hoped the IRS would provide an additional extension in the final regulations.

Unfortunately, the final regulations do not provide an extension of the Dec. 31, 2020, deadline or any further guidance thereon. If a corporation did not amend their deferred compensation agreements before the deadline, it will need to consider whether paying the amount will trigger tax problems under Section 409A.

In the future, employers will want to reconsider deferred compensation payment agreements given that the deferred compensation will never be deductible.

**4. Learn new rules for IPOs and corporate acquisitions.**

Given the new executive compensation rules, we also suggest that employee benefit and tax executives consider Section 162(m)'s impact on initial public offerings and corporate acquisitions.

Under the old Section 162(m) regulations, the IRS had a transition rule for privately-held companies going public. Under the transition rule, compensation paid pursuant to agreements in place before the IPO — and disclosed to the new shareholders — were exempt from Section 162(m) for a certain time period after the IPO.

This delay allowed time for the newly-public corporations to revise their compensation agreements — e.g., reclassify salary as deductible performance-based compensation — and obtain shareholder approval of the modifications. Commenters requested that the IRS adopt a similar rule in the regulations.

The IRS declined to do so; it stated corporations did not need time to transition salary compensation to performance-based compensation because performance-based compensation is no longer deductible. Although this is true, there is still concern that new shareholders will be penalized for compensation earned and paid before the IPO — e.g., a corporation that goes public in December 2021 won't be able to deduct a bonus that was paid in January 2021 for the executive's 2020 performance.

Although the IRS did not provide a transition rule, one change made in response to a comment was to the rules covering corporate acquisitions. Specifically, the final regulations deviate from the proposed regulations in providing clarification that "operating assets" refers to gross operating assets instead of net operating assets.

This guidance provides a useful clarification to the position taken in the proposed regulations — also included in the final version — that if an acquiring corporation acquires at least 80% of the operating assets — determined by fair market value on the date of acquisition — of a publicly held target corporation, then the target corporation is a predecessor of the acquiring corporation.

**Conclusion**

Now that the final Section 162(m) regulations are published, employee benefit and tax executives at publicly held corporations should ensure they know their covered employees and key compensation agreements subject to the executive compensation cap.

---

*Samuel Krause is senior counsel and Teresa Abney is counsel at Crowell & Moring LLP.*

*information purposes and is not intended to be and should not be taken as legal advice.*

[1] Internal Revenue Code Section 162(m).

[2] Tax Cuts and Jobs Act, 115 P.L. 97.

[3] Internal Revenue Code Section 409A; Treasury Regulation § 1.409A-1(b)(5)(v)(C)(1).