IRS Issues Proposed Regulations under Section 162(m)

December 23, 2019

On December 16, 2019, the IRS issued proposed regulations under Section 162(m) of the Internal Revenue Code, which were published in the Federal Register on **December 20, 2019**. The proposed regulations provide highly anticipated guidance clarifying the substantial changes made to Section 162(m) by the Tax Cuts and Jobs Act (TCJA) and the initial guidance provided by the IRS in **Notice 2018-68** that was issued in August 2018.[1]

As further described below, the proposed regulations, including the accompanying preamble, generally have the effect of limiting the tax deductibility of a public company's compensation arrangements. The key takeaways from the proposed regulations include the following:

- elimination of the three-year and one-year transition period previously afforded to companies that become publicly held through an initial public offering or spin-off, respectively (often referred to as the "IPO grandfather" and the "spin-off grandfather"); however, in doing so, the proposed regulations permit companies that IPOed before December 20, 2019 to continue to rely on the IPO grandfather (it is not entirely clear whether the proposed regulations extend this transition rule to the spin-off grandfather);

- application of Section 162(m) to foreign private issuers, even if the company is not required to comply with the SEC's proxy disclosure rules;

- addition of predecessor rules that will need to be carefully analyzed by a public company acquirer in connection with any corporate transaction to ensure that it is properly continuing the covered employee status of employees acquired in the transaction;

- clarification that the existence of a "clawback" right on grandfathered amounts (whether or not discretionary) does not preclude grandfathered treatment unless and until the event triggering a clawback occurs;

- clarification that the accelerated vesting of grandfathered amounts (cash or equity) does not result in a material modification causing a loss of grandfathered status (however, the accelerated payment of grandfathered amounts may still result in a material modification);

- confirmation that any compensatory amounts (including earnings credited on deferred compensation and severance payments) are only grandfathered to the extent the public company is obligated to pay such amounts as of November 2, 2017 under applicable law (*e.g.*, state contract law) pursuant to a written binding contract (and, in the case of severance, analyzing each component of the severance arrangement separately);

- confirmation that the SEC proxy disclosure rules are used for purposes of identifying covered employees, even in the relatively unusual circumstances where a company's fiscal and taxable years are not aligned; and

[1] For a summary of the TCJA's changes to Section 162(m), see our **memorandum** from January 31, 2018. In addition, for a summary of the initial guidance on the TCJA's changes to Section 162(m) previously issued by the IRS in Notice 2018-68, see our **memorandum** from August 27, 2018.

- confirmation that amendments to nonqualified deferred compensation arrangements that require a mandatory delay of scheduled payments until they are deductible under Section 162(m) will not be considered a material modification for purposes of the grandfather rule nor result in an impermissible acceleration of payment under Section 409A of the Code, if (1) the amendment is made no later than December 31, 2020 and (2) if the company would have been required to make a payment under such amended arrangement prior to December 31, 2020, the payment is made no later than December 31, 2020.

Generally, the proposed regulations are effective for taxable years beginning on or after the publication date of the final regulations, with a few exceptions which we note in further detail below.[2]

This memorandum generally addresses the above described key takeaways from the proposed regulations, but, given their detailed nature, it does not purport to address all aspects of the proposed regulations. The proposed regulations also contain a number of examples that are intended to clarify aspects of the regulations, a few of which we discuss below.[3]

Elimination of Transition Period for Newly Public Companies

Under old 162(m), the $1 million deduction limitation does not apply to compensation paid pursuant to a compensatory arrangement that existed when the company was not publicly held so long as the arrangement is disclosed to investors in connection with the going public transaction. This transition period generally lasts until the first shareholder meeting that occurs after the third calendar year that a company becomes publicly held in connection with an initial public offering (IPO) and the first calendar year after a company becomes publicly held as the result of a spin-off. In each case, the transition period will end if the arrangement is materially modified, depleted or terminated prior to the applicable end date.

Old 162(m) also exempts any compensation received—even after the expiration of the transition period—pursuant to the exercise of a stock option or stock appreciation right, or the vesting of restricted property (but not a restricted stock unit or performance stock unit), as long as the grant occurred during the transition period.

Q1: Do the proposed regulations maintain the IPO and spin-off grandfather provided under old 162(m)?

A1: No.

The proposed regulations eliminate the IPO and spin-off grandfather provided under old 162(m) and apply the Section 162(m) deduction limit to any compensation that is otherwise deductible for the taxable year ending on or after the date the company becomes a publicly held corporation.

Q2: Does this mean that a newly public company may be disallowed a tax deduction for compensation that was paid to covered employees when the company was privately held?

A2: Yes.

For example, a company that completes its IPO on December 18, 2020 and is a calendar year taxpayer will be subject to the Section 162(m) deduction limit for the taxable year ending December 31, 2020, even though the company was privately held for the bulk of the taxable year.

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[2] The guidance provided in Notice 2018-68 may generally no longer be relied upon for taxable years ending on or after December 20, 2019.

[3] This memorandum refers to Section 162(m) as in effect prior to the TCJA as “old 162(m),” and following the TCJA as “new 162(m).”

Q3: Is there a transition period for the elimination of the IPO grandfather and/or spin-off grandfather?

A3: Generally, yes.

The proposed regulations apply only to companies that become publicly held corporations on or after December 20, 2019. A company that became a publicly held corporation through an IPO prior to December 20, 2019 may continue to rely on the old 162(m) IPO grandfather.

However, the proposed regulations are not entirely clear as to whether a company that became a publicly held corporation prior to December 20, 2019 as a result of a spin-off may continue to rely on the old 162(m) spin-off grandfather.

Expansion of "Publicly Held Corporation" Definition

Prior to the enactment of the TCJA, the Section 162(m) deduction limit generally only applied to covered employees of companies with publicly traded equity securities. The TCJA expands the scope of the "publicly held corporation" definition (*i.e.*, the companies subject to Section 162(m)) to include companies that issue any securities (not just equity securities) required to be registered under Section 12 of the Securities Exchange Act of 1934 or companies required to file reports under Section 15(d) of the Exchange Act (*e.g.,* Forms 10-Q, 10-K and 20-F).

The proposed regulations provide additional clarification on the companies that are subject to Section 162(m).

Q4: Is a foreign private issuer (FPI) subject to Section 162(m), even if the FPI's Exchange Act reports do not contain a summary compensation table[4]?

A4: Yes.

An FPI that otherwise satisfies the "publicly held corporation" definition is subject to Section 162(m), regardless of whether it is required to include a summary compensation table in its Exchange Act reports (or, if it is required to include a summary compensation table, regardless of whether the employees appear in the summary compensation table).

The preamble explicitly rejects IRS guidance under old 162(m), which indicated that an FPI would not be subject to Section 162(m) if it was not required to include a summary compensation table in its Exchange Act reports, noting that the covered employees of an FPI can still be determined under the SEC proxy disclosure rules for Section 162(m) purposes even if a summary compensation table is not required for SEC disclosure purposes.

As a practical matter, this means that FPIs will be required to determine who their covered employees will be under the SEC's disclosure rules applicable to U.S. companies. However, this will not be the case to the extent that the FPI does not take a U.S. tax deduction with respect to the compensation paid to its executive officers.

Q5: Is a company subject to Section 162(m) if it registers securities or files reports under the Exchange Act, even though it is not required by the Exchange Act to do so?

A5: Presumably not.

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[4] The "summary compensation table" is a disclosure provided in tabular format that is required to be included in certain public companies' Exchange Act reports that sets forth the annual total compensation of each of the company's named executive officers in accordance with SEC rules.

Whether registration under the Exchange Act is required by rules other than those of the Exchange Act is irrelevant to the “publicly held corporation” determination. For example, a company is not a “publicly held corporation” because it continues to have its class of equity securities voluntarily registered under Section 12 of the Exchange Act or because it is required by the Over the Counter Bulletin Board (OTCBB) to register with the SEC and to be current in its reporting obligations to have its securities quoted on the OTCBB.

Although the proposed regulations do not specifically address, for example, a company that voluntarily files annual Forms 10-K and quarterly Forms 10-Q to retain access to the U.S. capital markets or because it has entered into a credit agreement under which it has agreed to file these reports, the operative question seems to be whether the requirement to register securities or file reports stems from the Exchange Act itself.

Q6: How do the proposed regulations treat affiliated companies?

A6: A “publicly held corporation” includes affiliated groups of corporations.

If an affiliated group includes two or more publicly held corporations, each publicly held corporation is separately subject to Section 162(m) and the affiliated group as a whole is subject to Section 162(m). A private company may be part of an affiliated group subject to Section 162(m) if a subsidiary of the private company issues securities required to be registered under Section 12(b) of the Exchange Act or is required to file reports under Section 15(d) of the Exchange Act.

Q7: When does a company determine whether it is a “publicly held corporation” for purposes of Section 162(m)?

A7: The proposed regulations follow the same approach as the final regulations under old 162(m) and provide that the determination as to whether a company is a “publicly held corporation” is made as of the last day of the company’s taxable year.

For example, if a company with a calendar year taxable year was required to file reports under Section 15(d) of the Exchange Act at some point during 2020, but its obligation to file reports was automatically suspended as of December 31, 2020, the company is <u>not</u> a “publicly held corporation” (and, therefore, not subject to the Section 162(m) deduction limit) for the 2020 taxable year.

Covered Employees

The TCJA broadens the group of “covered employees” whose compensation is subject to the $1 million deduction limit under Section 162(m), and Notice 2018-68 provided guidance on how to identify covered employees.

The definition of covered employees under new 162(m) includes the following individuals:

- anyone who served as the principal executive officer (PEO) or principal financial officer (PFO) at any time during the taxable year;
- the three highest compensated executive officers (other than the PEO or PFO), determined under SEC rules, regardless of whether (1) they served as an executive officer at the end of the taxable year and (2) the executive officer’s compensation is required to be disclosed under SEC rules; and
- any individual who was a covered employee, including of a predecessor company, at any point during a taxable year beginning on or after January 1, 2017, even after the employee terminates employment.

The proposed regulations generally confirm the guidance provided by Notice 2018-68 and provide additional guidance on the identification of covered employees.

Q8: Will covered employees of a public company that is acquired by another public company in a corporate reorganization become covered employees of the acquirer?

A8: Yes.

If a public company is acquired by another public company in a stock or asset reorganization under Section 368(a)(1) of the Code, then the target company's covered employees will become covered employees of the acquirer.

Given that many corporate transactions are structured in this manner, public company acquirers will need to ensure that they are properly continuing the covered employee status of the employees acquired in the transaction.

Q9: If a public parent company "spins off" a public subsidiary to its shareholders, will a covered employee of the public parent be a covered employee of the spin-off public subsidiary?

A9: It depends.

If a public parent company distributes the stock of a public subsidiary to its shareholders in a distribution or exchange qualifying under Section 355(a)(1) of the Code, a covered employee of the parent company will be a covered employee of the spin-off public subsidiary if the employee commences providing services for the public subsidiary within the period beginning 12 months before and ending 12 months after the distribution.

In addition, the employee will also remain a covered employee of the distributing company for all subsequent taxable years under new 162(m).

Q10: If a public company is acquired by another public company in an asset deal, will a covered employee of the target company become a covered employee of the acquirer?

A10: It depends.

If at least 80% of the operating assets of a public target company (determined by fair market value on the acquisition date) are acquired by another public company (aggregating all acquisitions made within a 12-month period), then a covered employee of the target company will become a covered employee of the acquirer if the employee commences providing services for the acquirer within the period beginning 12 months before and ending 12 months after the transaction.

Q11: Will a covered employee of a public company that goes private return to covered employee status if the company again becomes a public company?

A11: It depends.

A covered employee will return to covered employee status if the company becomes public again for a taxable year ending before the 36-month anniversary of the due date for its federal income tax return (disregarding any extensions) for the last taxable year for which it was previously a public company. If the company becomes public again after that date, then its list of covered employees starts fresh.

For example, assume a company (with a calendar year taxable year) is publicly held for its 2021 taxable year and that it is privately held for its 2022 and 2023 taxable years. The company then becomes publicly held again during 2024. Because the company became publicly held again for a taxable year before April 15, 2025 (the 36-month anniversary of the due date for its federal income tax return for 2021), the company's covered employees for its 2024 taxable year will include its covered employees who existed when it was a public company in 2021.

Q12: What happens to an individual's status as a covered employee in a corporate transaction where one or both of the parties are not publicly traded at the time of the transaction?

A12: It depends on the circumstances, as follows:

- Private Target / Public Acquirer: If the target company was previously a public company, but at the time of the transaction it is not public and the acquirer is a public company, an individual who was a covered employee of the target company from when it was a public company will become a covered employee of the acquirer if the transaction occurs during a taxable year ending prior to the 36-month anniversary of the due date for the target company's federal income tax return (disregarding any extensions) for the last taxable year for which it was previously a public company.

- Public Target / Private Acquirer: If the acquirer was previously a public company, but at the time of the transaction it is not public and the target company is a public company, a covered employee of the target company will become a covered employee of the acquirer if the acquirer subsequently becomes a public company for a taxable year ending prior to the 36-month anniversary of the due date for the target company's federal income tax return (disregarding any extensions) for the last taxable year in which the transaction is taken into account.

- Private Target / Private Acquirer: If the target company was previously a public company, but at the time of the transaction it is not public and the acquirer is also not a public company, an individual who was a covered employee of the target company from when it was a public company will become a covered employee of the acquirer if the acquirer subsequently becomes a public company for a taxable year ending prior to the 36-month anniversary of the due date for the target company's federal income tax return (disregarding any extensions) for the last taxable year for which it was previously a public company.

Q13: Does a public company with different fiscal and taxable years need to separately track its named executive officers for SEC disclosure and covered employees for Section 162(m) purposes?

A13: Yes, although this is a relatively uncommon scenario.

Although Section 162(m) applies the SEC proxy disclosure rules for determining covered employees, for SEC proxy disclosure purposes, the applicable measurement period is the company's fiscal year, while the applicable Section 162(m) measurement period is the company's taxable year.

If these periods are not aligned, then the company is required under new 162(m) to maintain separate tracks for determining its named executive officers for its proxy disclosure and its covered employees for Section 162(m). In these circumstances, the SEC proxy disclosure rules will be applied to identify the Section 162(m) covered employees by using the taxable year in place of the fiscal year.

For example, if a public company's 2020 fiscal year is the 2020 calendar year, but its 2020 taxable year runs from July 1, 2019 to June 30, 2020, then the three most highly compensated executive officers for:

- Section 162(m) covered employee purposes are determined for the taxable year ending June 30, 2020 by applying the SEC executive compensation disclosure rules for the period from July 1, 2019 to June 30, 2019; and

- SEC disclosure purposes are determined for the fiscal year ending December 31, 2020 by applying the SEC proxy disclosure rules for the period from January 1, 2020 to December 31, 2020.

Q14: Does a public company need to determine its covered employees for a short tax year?

A14: Yes.

If a public company has a short tax year as the result of a corporate transaction, then it will need to apply the same rules for determining its covered employees for the short tax year that apply for full tax years. As a result, any individual determined to be a covered employee for a short tax year will continue to be a covered employee for all subsequent tax years, including for a successor company as discussed below.

Q15: Can an executive officer of a partnership that is a subsidiary of a public company be a covered employee?

A15: Yes.

As a general matter, the SEC proxy disclosure rules apply only to executive officers, and therefore only a company's executive officers will be covered employees. The SEC rules deem an executive officer of a subsidiary to be an executive officer of the public company parent if the officer performs policy making functions for the public company. Accordingly, an executive officer of a partnership subsidiary who performs a policy making function for its public company parent will be a covered employee of the public parent if the officer is one of the three highest compensated executive officers of the public parent for the public parent's taxable year.

Q16: What compensation paid to a covered employee is subject to the deduction limit under new 162(m)?

A16: Generally, the aggregate amount of all compensation paid to a covered employee that the company is allowed to take as a tax deduction under Chapter 1 of the Code for the taxable year for services performed by the covered employee in any capacity, even if the services were performed in a different taxable year, is subject to the deduction limit under Section 162(m).

Q17: What about compensation paid to a covered employee in a non-executive officer capacity (including after a termination of employment)?

A17: Tax deductions for compensation paid to a covered employee for services performed outside of the covered employee's capacity as an executive officer are subject to the deduction limit under Section 162(m).

For example, if a public company's CEO also serves as a director and receives board fees, the board fees will be included in the CEO's compensation for purposes of Section 162(m).

In addition, if a covered employee returns to provide services to the public company in any capacity (including as an employee, a director or independent contractor) after a termination of employment for any reason, any deduction for the compensation paid in respect of those services will be subject to the limitations under Section 162(m).

Q18: What about amounts paid to other individuals (*e.g.*, beneficiaries) for services performed by the covered employee?

A18: Tax deductions for compensation paid to a person other than the covered employee for services performed by the covered employee are subject to the deduction limits under Section 162(m). This would include, for example, death benefits paid to a covered employee's beneficiaries.

Q19: What about compensation paid by a partnership to a covered employee?

A19: In a change from prior IRS guidance, a covered employee's compensation will include an amount equal to the public company partner's distributive share of a partnership's deduction for any compensation expense attributable to the compensation paid by the partnership to the covered employee for services performed by the covered employee for the partnership.

Q20: When does the proposed regulations' guidance on the definition of a covered employee become effective?

A20: Taxable years ending on or after September 10, 2018, subject to the following special timing rules:

- The rules regarding predecessors are proposed to apply to corporate transactions for which all events necessary for the transaction occur on or after the publication date of the final regulations. Until final regulations are published, taxpayers may rely on the proposed regulations or a reasonable good faith interpretation of the term "predecessor".
- For companies whose fiscal and taxable years do not end on the same date, the proposed rule requiring the determination of the three most highly compensated executive officers pursuant to SEC rules is proposed to apply to taxable years beginning on or after December 20, 2019.
- The rules relating to the application of Section 162(m) to a public company's distributive share of a partnership's deduction for compensation paid to a covered employee is proposed to apply to taxable years ending on or after December 20, 2019, with a transition rule for compensation under a written binding contract in effect on that date that is not later materially modified.

Grandfathered Arrangements

The TCJA provides that a "written binding contract" in effect on November 2, 2017 is "grandfathered" from new 162(m), unless and until it is materially modified or renewed (commonly referred to as the "grandfather rule"). Notice 2018-68 provided clarification on a number of aspects of the grandfather rule, including:

- compensation is payable under a written binding contract in effect on November 2, 2017 only if the public company is obligated under applicable law (*e.g.*, state contract law) to pay the compensation to the employee as of such date (and any negative discretion retained by the public company to reduce compensation otherwise payable may result in such compensation not being grandfathered); and
- a material modification to a written binding contract occurs when the contract is amended to increase the amount of compensation payable to the employee (other than an amount equal to or less than a reasonable cost-of-living increase), with amounts paid after such modification being subject to new 162(m).

The proposed regulations generally confirm the guidance on the grandfather rule provided by the IRS in Notice 2018-68 and also provide additional guidance and clarifications on certain key aspects of the grandfather rule.

Q21: Does the existence of a clawback right preclude grandfathered status?

A21: No.

The mere existence of a company's potential "clawback" right to recover compensation (whether on a mandatory or discretionary basis) is disregarded for purposes of determining the grandfathered status of compensation (*i.e.*, it is not treated as negative discretion), provided that the clawback right may only be triggered upon the future occurrence of a condition or event that is objectively outside of the company's control (*e.g.*, a restatement of the company's financial statements or the employee's misconduct or felony conviction).

Q22: Does the triggering of a clawback right result in the loss of grandfathered status?

A22: It depends.

If the condition giving rise to the clawback right does occur, only the amount that the company was obligated to pay under applicable law (*i.e.*, the amount that is not subject to the clawback) as of November 2, 2017 remains grandfathered, regardless of whether the company actually exercises its clawback right. If the company's clawback right is discretionary, the amount the company was obligated to pay under applicable law as of November 2, 2017 will be determined based on the company's ability to exercise discretion and its past exercise of such discretion.

If the condition giving rise to the clawback right does not occur, then the entire amount remains grandfathered.

Q23: Are earnings credited on grandfathered amounts also grandfathered?

A23: Earnings credited after November 2, 2017 on grandfathered amounts (including pre-existing deferrals) are grandfathered only if the company was obligated to pay the earnings as of November 2, 2017 under applicable law pursuant to a written binding contract.

For example, if a company was obligated as of November 2, 2017 to continue to credit earnings for amounts in a nonqualified deferred compensation plan during a 12-month period after terminating the plan, then those earnings would be grandfathered.

Relatedly, to the extent the company retains the right under applicable law to prospectively amend an arrangement at any time to either stop or reduce future credits (including earnings), only those payments and earnings that the company was obligated to pay as of November 2, 2017 are grandfathered (*i.e.*, the credited amount (including earnings) it could not reduce as of such date).

Q24: What about earnings credited on grandfathered amounts deferred after November 2, 2017?

Q24: If an employee defers a grandfathered amount after November 2, 2017 (e.g., pursuant to a new deferral election), the earnings on such deferred grandfathered amounts will only be grandfathered if, as of November 2, 2017, the company was obligated under the terms of the written binding contract to provide the deferral election and to pay the earnings on the deferred amount under applicable law.

Q25: Are payments under a non-account balance plan eligible for the grandfather rule?

A25: Payments under a non-account balance plan (e.g., a plan that calculates payments based on the participant's final salary and years of service, such as a supplemental executive retirement plan) are generally grandfathered only up to the amount that the company was obligated to pay under applicable law as of November 2, 2017 pursuant to a written binding contract.

Accordingly, amounts payable under a non-account balance plan are eligible for the grandfather rule only up to the amount attributable to service and compensation that the company was obligated to pay to the employee as of November 2, 2017. For example, if the company has the right to prospectively reduce or eliminate future benefit accruals at any time, amounts payable under the non-account balance plan attributable to salary increases or years of service accumulated after November 2, 2017 would not be grandfathered.

Q26: Do investment election changes result in a material modification?

A26: No.

An employee may make changes to investment elections applicable to the employee's grandfathered amounts (*e.g.*, under a deferred compensation plan) on a prospective basis and it will not constitute a material modification.

Q27: Is severance payable pursuant to a written binding contract eligible for the grandfather rule?

A27: Severance payable under a written binding contract is grandfathered only to the extent the company was, as of November 2, 2017, obligated under applicable law to pay both (1) the underlying compensation components used to calculate severance (e.g., base salary, bonus) and (2) the severance amounts.

Q28: What about changes in the underlying severance components made after November 2, 2017?

A28: Only the amount of severance the company would have been required to pay if the employee had been terminated as of November 2, 2017 is grandfathered.

For example, if the amount of a severance payment under a written binding contract is calculated based on a multiple of the employee's base salary, only the portion of the severance payment determined based on the employee's base salary entitlement in effect as of November 2, 2017 under a written binding contract will be grandfathered, and any increase in severance as a result of discretionary base salary increases after November 2, 2017 will not be grandfathered.

Q29: Is a severance payment based on a variable compensation component eligible for the grandfather rule?

A29: If a severance payment is based on two or more components, each component of the severance formula must be analyzed separately to determine whether, under applicable law, the company was obligated to pay that portion as of November 2, 2017 under a written binding contract.

The examples provided by the proposed regulations indicate that, where a component of a severance formula is the amount of a discretionary bonus paid to the employee prior to the employment termination date, the portion of the severance payment attributable to the underlying discretionary bonus component will only be grandfathered if that discretionary bonus was paid to the employee <u>before</u> November 2, 2017. If the underlying discretionary bonus used to calculate the severance payment was paid to the employee <u>after</u> November 2, 2017, then the portion of the severance payment attributable to that bonus would not be grandfathered because the company was not obligated to pay that portion of the severance amount as of November 2, 2017 (since the discretionary bonus amount was not yet fixed and paid).

As a practical matter, as a result of these rules, the grandfathered status of severance obligations calculated with reference to discretionary payments in this manner will burn off over time.

Q30: What about severance payments based on target annual bonus opportunities?

A30: While the proposed regulations do not expressly address severance payments that are based on target annual bonus opportunities, the proposed regulations seem to imply that, if the company was obligated to pay a specified target annual bonus opportunity to the employee pursuant to a written binding contract in effect on November 2, 2017, then the portion of the severance attributable to the specified target bonus opportunity should be grandfathered (even if the actual annual bonus payable to the employee for any applicable performance year may ultimately be more or less than the target bonus opportunity based on actual performance or if the actual bonus is actually paid after November 2, 2017).

However, for any target bonus opportunity expressed as a percentage of the employee's base salary, the proposed regulations seem to also imply that the portion of the severance attributable to the target bonus opportunity that may be grandfathered will be based only on the employee's base salary in effect as of November 2, 2017 (and any increase in severance attributable to an increase in a covered employee's target bonus opportunity due to a discretionary increase of the employee's base salary after November 2, 2017 will likely not be grandfathered).

Q31: Does accelerating the <u>vesting</u> of grandfathered arrangements result in a material modification?

A31: No.

A modification to a grandfathered arrangement (cash or equity compensation arrangements) to accelerate the <u>vesting</u> of the compensation or that results in the lapse of a substantial risk of forfeiture is not considered a material modification.

Q32: What about accelerating <u>payment</u> dates?

A32: Accelerating the timing of the <u>payment</u> of grandfathered amounts will be considered a material modification (unless the payment is discounted to reasonably reflect the time value of money).

However, for arrangements whose existing terms provide for payment of the compensation keyed off of the vesting date, the acceleration of the vesting date (and the resulting earlier payment date) will not result in a material modification.

For example, if the terms of a grandfathered arrangement provide that compensation will vest on February 13, 2021 and be paid within 30 days after the vesting date, the acceleration of the vesting date to February 13, 2020 and the resulting payment of the compensation within 30 days after the new vesting date does not result in a material modification (even though the payment date is now earlier than the initially scheduled payment date) because the payment is being made in accordance with its original terms.

By way of another example, assume that the terms of a grandfathered arrangement provide that compensation will vest on July 1, 2021 and be paid on September 30, 2023. If the vesting date is accelerated to July 1, 2020 and the payment date remains September 30, 2023, then no material modification will be deemed to occur. If, however, in connection with the acceleration of the vesting date, the payment date is accelerated to September 30, 2022, then that would result in a material modification causing a loss of grandfathered status because the original terms of the agreement specified a payment date (that was not keyed off the vesting date).

Q33: Do the proposed regulations address the coordination rules between Section 162(m) and Section 409A?

A33: Yes.

The preamble to the proposed regulations addresses the coordination rules between Section 162(m) and Section 409A (which governs the taxation of nonqualified deferred compensation). Under Section 409A, a company is permitted to delay the payment of nonqualified deferred compensation past the scheduled payment date to the extent the company reasonably anticipates that, if the payment were to be made as scheduled, the payment would not be tax-deductible under Section 162(m).

A company may delay the scheduled payment of grandfathered amounts in accordance with the coordination rules under Section 409A, without also delaying the payment of non-grandfathered amounts. The delay of the grandfathered amounts will not be treated as a subsequent deferral election under Section 409A. The preamble seems to permit these amendments even for amounts that have already been delayed under the Section 409A coordination rules.

Q34: What about amendments to plans that require a mandatory delay of scheduled payments until they are deductible under Section 162(m)?

A34: The preamble provides that if a nonqualified deferred compensation arrangement is amended to remove a provision that expressly requires the company to delay a deferred compensation payment if the company reasonably believes the scheduled payment will not be deductible under Section 162(m), the amendment will not be considered a material modification for purposes of the grandfather rule, nor will it result in an impermissible acceleration of payment under Section 409A, if (1) the amendment is made no later than December 31, 2020 and (2) if the company would have been required to make a payment under such amended arrangement prior to December 31, 2020, the payment is made no later than December 31, 2020.

Q35: When will taxpayers be permitted to rely on this preamble guidance for Section 409A purposes?

A35: The preamble indicates that the IRS and the Treasury Department intend to incorporate the above guidance into the regulations under Section 409A, and that taxpayers may rely on this guidance for any *taxable year beginning after December 31, 2017 until the issuance of the proposed regulations under Section 409A.*

Q36: When does the proposed regulations' guidance on the grandfather rule become effective?

A36: Taxable years ending on or after September 10, 2018.

Next Steps

Comments on the proposed regulations are due by February 18, 2020 and a public hearing has been scheduled for March 9, 2020.

The IRS and the Treasury Department have requested general comments on all aspects of the proposed regulations and, in particular, have invited comments on the following:

- whether a safe harbor is appropriate for determining the three highest compensated executive officers of an FPI that is not required to publish a summary compensation table in its SEC filings;
- whether rules similar to partnership rules under Section 162(m) should apply to trusts; and
- the administrative practicability of a safe harbor for establishing whether an arrangement is a written binding contract for purposes of the grandfather rule based on whether the compensation payable under the arrangement was accrued (or could have been accrued) as a cost under Generally Accepted Accounting Principles (GAAP).

A timeline of key dates relating to the proposed regulations is set forth below.

9/10/2018	12/20/2019	2/18/2020	3/9/2020	12/31/2020
Effectiveness of grandfather and covered employee guidance	Publication of proposed regulations Cutoff date for IPO grandfather	Due date for comments on the proposed regulations	Scheduled public hearing on the proposed regulations	Deadline for making amendments and payments under Section 409A coordination rule guidance

At this stage, and in light of the unfavorable nature of the guidance provided by the proposed regulations to taxpayers, we recommend that public companies, FPIs, companies planning an IPO or spin-off and companies that have recently undergone an M&A transaction (or are contemplating doing so), review the proposed regulations in order to assess its impact on the potential tax deductibility of their compensation arrangements.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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