IRS Issues Final Regulations Under Section 162(m)

December 23, 2020

On December 18, 2020, the IRS issued **final regulations** under Section 162(m) of the Internal Revenue Code to reflect certain changes that were made to Section 162(m) by the Tax Cuts and Jobs Act of 2017. The final regulations are generally consistent with the regulations proposed by the IRS in December 2019, except as described below.

What is Section 162(m) and how was it amended by the act?

Under Section 162(m), compensation paid to a publicly held corporation's "covered employees" that exceeds $1 million per year for any covered employee is non-deductible. Among other changes, the act amended Section 162(m) to expand the scope of covered employees and eliminate the qualified performance-based compensation exemption from the $1 million deduction limit.

The amended rules under Section 162(m) apply to taxable years beginning on or after January 1, 2018. However, the act provides transition relief under which certain compensation paid pursuant to a written binding contract in effect on November 2, 2017, will be grandfathered and not subject to the amended rules, provided that the contract is not materially modified on or after that date.

As discussed in our prior **Cooley alert**, the IRS provided extensive guidance on the amended rules in the form of proposed regulations in December 2019. The final regulations contain certain changes and clarifications to the proposed regulations and also provide guidance on certain issues that were not addressed by the proposed regulations. This alert focuses on certain key developments in the final regulations; however, the final regulations also contain guidance on rules for affiliated groups, disregarded entities and non-qualified deferred compensation arrangements.

What are the key developments in the final regulations?

The final regulations contain the following guidance, which is generally more favorable to corporations than the positions taken in or absent from the proposed regulations:

- **Clarification of reliance period exemption for newly public corporations:** The proposed regulations eliminated the exemption from the $1 million deduction limit previously available under Section 162(m) for certain compensation paid by newly public corporations for a certain period of time after the corporation became publicly held. The final regulations clarify that transition relief is available only for corporations that became publicly held *on or before* December 20, 2019. Accordingly, for any corporation becoming publicly held *after* December 20, 2019, the $1 million deduction limit would apply.
- **Update on grandfathered arrangements subject to clawback/forfeiture provisions:** The final regulations provide that a corporation's right to recover compensation paid to an individual only upon the future occurrence of a condition that is objectively outside of the corporation's control (e.g., pursuant to a contract with a clawback provision based on the restatement of financial statements or a forfeiture provision based on the individual's criminal wrongdoing) does not affect the determination of the amount of compensation that is grandfathered. This is the case regardless of whether the corporation exercises its discretion to recover any compensation in the event the condition arises. This position is more favorable to corporations than the one taken in the proposed regulations in the event the condition occurred, which limited the grandfathered amount to what the

corporation was obligated to pay under applicable law, regardless of whether the corporation chose to exercise its discretion to recover any compensation.

- **New guidance on extending the exercise period of grandfathered nonstatutory stock options and stock appreciation rights:** The final regulations provide that if a nonstatutory stock option or stock appreciation right is grandfathered, an extension of the exercise period will *not* be treated as a material modification and all compensation paid upon the exercise of the nonstatutory stock option or stock appreciation right will be grandfathered, provided that the extension complies with certain rules under Section 409A of the Internal Revenue Code.

When are the final regulations effective?

Generally, the final regulations apply to taxable years beginning on or after the date of publication in the Federal Register (with special applicability dates for certain limited exceptions). However, taxpayers may choose to apply the final regulations to any taxable year beginning after December 31, 2017, provided the taxpayer applies the final regulations in their entirety and in a consistent manner to that taxable year and all subsequent taxable years. Taxpayers were also permitted to rely on the proposed regulations until the applicability date of the final regulations, provided that taxpayers apply the proposed regulations consistently and in their entirety.

If you have any questions regarding the final regulations, please contact any member of the Cooley compensation & benefits group.

Key Contacts

Paula Holland London	pholland@cooley.com +44 (0) 20 7556 4250
Soo Kim New York	skim@cooley.com +1 212 479 6477
Blake Martell San Francisco	bmartell@cooley.com +1 415 693 2099

Barbara Mirza Santa Monica	bmirza@cooley.com +1 310 883 6465
Alessandra Murata Palo Alto	amurata@cooley.com + 1 650 843 5696
David Walsh Reston	dwalsh@cooley.com +1 703 456 8021