



TaxNewsFlash

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KPMG report: Final regulations, section 162(m) deduction limitation on executive compensation

The IRS on December 18, 2020, posted to its website a version of final regulations (T.D. 9932) under section 162(m) limiting the deduction for compensation paid for covered employees.

The [final regulations](#) [PDF 507 KB] (109 pages) considered taxpayer comments to the proposed regulations (December 2019) in a number of areas, including defined terms, grandfathering and applicability dates, ordering, and coordination with related rules. While the final regulations substantially adopt the regulations as proposed, there are several modifications and clarifications.

This report highlights the changes made in the final regulations.

Publicly held corporation

- The final regulations generally tracked the proposed regulations' definition of publicly held corporation and clarified that a real estate investment trust (REIT) that owns a qualified REIT subsidiary (also known as QRS) is a publicly held corporation if the QRS issues securities required to be registered under section 12(b) of the Securities Exchange Act of 1934 (Exchange Act), or is required to file reports under section 15(d) of the Exchange Act.
- The final regulations adopt the rules in the proposed regulations providing that a foreign private issuer (FPI) is a publicly held corporation if it is required to register securities under section 12 of the Exchange Act or file reports under section 15(d) of the Exchange Act, declining to adopt suggestions from commenters recommending additional safe harbors and exemptions to exclude certain FPIs from the definition of publicly held corporation. The focus on a "requirement" here will naturally focus on the determinations of Security and Exchange Commission (SEC) counsel.

Affiliated group

- The final regulations adopt rules addressing situations in which a covered employee of a publicly held corporation performs services for other members of the affiliated group. Under the final rule, compensation paid by all members of the affiliated group is aggregated and any amount disallowed

as a deduction by section 162(m) is prorated among the payor corporations. When a covered employee is paid by more than one publicly held corporation that are members of the same affiliated group, the amount of the deduction that is disallowed is determined separately with respect to each payor corporation that is a publicly held corporation. The final regulations clarify that compensation paid by a member of an affiliated group that is **not** a publicly held corporation to an employee who is a covered employee of two or more other members of the affiliated group is prorated for purposes of the determining the deduction disallowance among the members that are publicly held corporations of which the employee is a covered employee.

Covered employee

- The statute provides that the term “covered employee” includes covered employees of a predecessor of the publicly held corporation for a preceding tax year beginning after December 31, 2016. Among other definitions of predecessor, the proposed regulations provided that if an acquiror corporation acquires at least 80% of the operating assets of the publicly held target corporation, then the target corporation is a predecessor of the acquiror. The final regulations maintain that rule and clarify that the operating assets refer to gross operating assets instead of net operating assets.

Applicable employee remuneration

- The final regulations choose to use the term compensation instead of applicable employee remuneration when possible. Compensation means the aggregate amount allowable as a deduction for the tax year for remuneration for services performed by a covered employee whether or not the services were performed during the tax year. The final regulations provide that compensation includes an amount that is includible in the income of or paid to a person other than the covered employee, including after the death of the covered employee, consistent with section 162(m)(4)(F).
- **Umbrella partnership C corporation (Up-C) arrangements and similar when partnership is within the umbrella of a public corporation:**
 - The final regulations modify the applicability date of the definition of compensation related to partnerships to provide additional transition relief. The definition of compensation includes an amount equal to a publicly held corporation’s distributive share of a partnership’s deduction for compensation expense attributable to the compensation paid by the partnership after December 18, 2020. This is the date the final regulations were made publicly available, but prior to the date published in the Federal Register to ensure taxpayer’s do not pay out compensation to circumvent the final regulations. However, the final regulations also continue to provide that this definition of compensation does not apply to compensation paid after date of publication in the Federal Register 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 after that date.
 - Assuming the partnership is respected for U.S. federal income tax purposes, section 162(m) generally would not apply to compensation paid to a publicly held corporation’s covered employee by a corporate subsidiary of a partnership for services performed as an employee of the subsidiary because, in this circumstance, the corporate subsidiary would not be a member of the publicly held corporation’s affiliated group

Privately held corporations that become publicly held (including IPO exception)

- The final regulations adopt the transition relief in the proposed regulations that a privately held corporation that becomes a publicly held corporation on or before December 20, 2019, generally

may rely on the transition rules provided in section 1.162-27(f)(1) and (2) of the 1995 regulations. The final regulations clarify that a subsidiary that is a member of an affiliated group may rely on transition relief provided in section 1.162-27(f)(4) of the 1995 regulations if it becomes a separate publicly held corporation (such as in a spin-off) on or before December 20, 2019.

Grandfather rule

- **Recovery of compensation:** Treasury and the IRS reconsidered the approach provided in the proposed regulations regarding the recovery of compensation when the corporation is obligated or has discretion to recover compensation paid in a tax year upon a future occurrence of a condition outside the corporation's control. The corporation's right to recover compensation is a contractual right that is separate from the corporation's binding obligation under the contract (as of November 2, 2017) to pay the compensation. The final regulations provide a corporation's right to recover compensation does not affect the determination of the amount of compensation the corporation has a written binding contract to pay under applicable law as of November 2, 2017, whether or not the corporation exercises its discretion to recover any compensation in the event the condition arises in the future.
- **Account and nonaccount balance plans:**
 - **Grandfathered amount**—The final regulations clarify the application of the grandfather rule to compensation and earnings payable under grandfathered plans. For an account balance plan, the final regulations provide that the grandfathered amount under an account balance plan is the amount the corporation is obligated to pay pursuant to the terms of the plan as of November 2, 2017.
 - **Corporation cannot termination plan**—If the corporation is obligated to pay the employee the account balance that is credited with earnings and losses and has no right to terminate or materially amend the contract, then the grandfathered amount is the account balance on November 2, 2017, plus any additional contributions and earnings and losses that the corporation is obligated to credit under the plan through the date of payment.
 - **Right to terminate plan**—However, if the corporation may terminate the plan and distribute the account balance to the employee, then the grandfathered amount is the account balance as if the corporation had terminated on November 2, 2017, or if later, the earliest possible date the plan could be terminated. Earnings and losses that are credited to the account after the termination through the earliest possible date the account balance could have been distributed are grandfathered if the terms of the plan require the contribution or credit of those earnings and losses through the earliest possible date the account balance could be distributed if the plan were terminated.
 - **Right to freeze plan**—If the terms of the account balance plan provide the corporation may **not** terminate the plan, but may discontinue future contributions, then the grandfathered amount is the account balance determined as if the corporation had exercised the right to discontinue contributions on November 2, 2017, or if later, the earliest permissible date the corporation could exercise that right under the plan (freeze date). If the plan required crediting of earnings and losses on the account balance after the freeze date through the payment date, then those earnings and losses credited to the grandfathered account are also grandfathered.
 - **Election**—If the terms of the plan provide the corporation may terminate or freeze contributions, the corporation may elect to treat the balance as the termination date or freeze date as the grandfathered amount regardless of when the amount is paid and regardless of whether it has been credited with earnings or losses prior to the payment.

- Analogous rules are provided for nonaccount balance plans.
- **Ordering rules:** In response to a commenter suggestion, the final regulations permit the grandfathered amount to be allocated to the last otherwise deductible payment or to each payment on a pro rata basis for tax years ending before December 20, 2019. However, the ordering rule requiring the grandfathered amount to be allocated to the first otherwise deductible payment under the arrangement must be used for tax years ending on or after December 20, 2019, regardless of the method for allocating prior to that date.
- **Limited to particular plan or arrangement:** The grandfathered amount payable under a plan or arrangement applies **solely** to the amounts paid under that plan or arrangement. Regardless of whether all of the grandfathered amount is paid to the employee, no portion of the grandfathered amount may be treated as a grandfathered amount under any separate plan or arrangement.
- **Material modification:**
 - The final regulations provide that a modification of the contract after November 2, 2017, to offer an additional predetermined actual investment or substitute a predetermined actual investment as an investment alternative under the arrangement is **not** a material modification.
 - Subsequent deferral will not be treated as resulting in a material modification if any additional amount is based on either a reasonable rate of interest or a predetermined actual investment; **however**, the additional amount will not be treated as grandfathered.
- **Coordination with section 409A:** The final regulations incorporate the section 409A regulatory provisions and provide that if compensation attributable to the exercise of a non-statutory stock option or a stock appreciation right (SAR) is grandfathered and the exercise period of the option or SAR is extended, then all compensation attributable to the exercise of the option or the SAR is grandfathered if the extension complies with Reg. section 1.409A-1(b)(5)(v)(C)(1). Until final guidance under section 409A is issued, taxpayers may continue to rely on the preamble to the proposed regulations.

Applicability dates

- The final regulations apply to tax years beginning on or after the date of publication in the Federal Register. Taxpayers may choose to apply the final regulations to a tax year beginning after December 31, 2017, provided the taxpayer applies the final regulations in their entirety and in a consistent manner to that tax year and all subsequent tax years.
- Taxpayers may **not** rely on Notice 2018-68 for tax years ending on or after December 20, 2019, the publication date of the proposed regulations

Special applicability dates

- **Definition of covered employee:** Applies to tax years ending on or after September 10, 2018, the publication date of Notice 2018-68; **however**, for a corporation the fiscal and tax years of which do not end on the same date, the rule requiring the determination of the three most highly compensated executive officers to be made pursuant to the rules under the Exchange Act applies to tax years ending on or after December 20, 2019.

- **Definition of predecessor of a publicly held corporation:** Applies to corporate transactions that occur on or after the date the final regulations are published in the Federal Register; corporations that change from being a publicly held corporation to a privately held corporation, and later, back to a publicly held corporation on or after the date the final regulations are published in the Federal Register.
 - If a corporate transaction occurs **before** the date the final regulations are published in the Federal Register, then taxpayers may apply either the definition of predecessor of a publicly held corporation in section 1.162-33(c)(2)(ii) of these final regulations or a reasonable good faith interpretation of the term “predecessor” in section 162(m)(3)(C) with respect to such transaction. However, excluding the target corporations from the definition “predecessor” is not a reasonable good faith interpretation if: (1) a publicly held target corporation the stock or assets of which are acquired by another publicly held corporation in a transaction to which section 381(a) applies; and (2) a publicly held target corporation, at least 80% of the total voting power of the stock of which, and at least 80% of the total value of the stock of which, are acquired by a publicly held acquiring corporation (including an affiliated group).
- **Definition of compensation:** The definition of compensation under Reg. section 1.162-33(c)(3)(ii) includes an amount equal to the publicly held corporation’s distributive share of a partnership’s deduction for compensation expense only if the deduction is attributable to compensation paid by the partnership after December 18, 2020. However, this definition does not apply to compensation paid after the date of publication in the Federal Register 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 after that date.
- **Application of section 162(m) to a deduction for compensation otherwise deductible for a tax year ending on or after a privately held corporation becomes a publicly held corporation:** Applies to corporations that became publicly held after December 20, 2019. A corporation that becomes a publicly held corporation **on or before** December 20, 2019, may rely on the transition relief provided in section 1.162-27(f).
- **Definitions of written binding contract and material modification:** Apply for tax years ending on or after September 10, 2018, the publication date of Notice 2018-68. The rules for compensation paid from an account balance plan, compensation paid as an annuity, and payment delays are applicable to tax years beginning on or after the date of publication in the Federal Register.

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