

**DEPARTMENT OF THE TREASURY****Internal Revenue Service****26 CFR Part 1**

[REG–122180–18]

RIN 1545–BO95

**Certain Employee Remuneration in Excess of \$1,000,000 Under Internal Revenue Code Section 162(m)****AGENCY:** Internal Revenue Service (IRS), Treasury.**ACTION:** Notice of proposed rulemaking and notice of public hearing.

**SUMMARY:** This document sets forth proposed regulations under section 162(m) of the Internal Revenue Code (Code), which limits the deduction for certain employee remuneration in excess of \$1,000,000 for federal income tax purposes. These proposed regulations implement the amendments made to section 162(m) by the Tax Cuts and Jobs Act. These proposed regulations would affect publicly held corporations. This document also provides a notice of a public hearing on these proposed regulations.

**DATES:** Written or electronic comments must be received by February 18, 2020. Outlines of topics to be discussed at the public hearing scheduled for March 9, 2020, at 10 a.m. must be received by February 18, 2020.

**ADDRESSES:** Submit electronic submissions via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (indicate IRS and REG–122180–18) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment received to its public docket, whether submitted electronically or in hard copy. Send hard copy submissions to: CC:PA:LPD:PR (REG–122180–18), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–122180–18), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC 20224.

**FOR FURTHER INFORMATION CONTACT:** Concerning these proposed regulations, Ilya Enkichev at (202) 317–5600; concerning submissions of comments, the hearing, and/or being placed on the building access list to attend the

hearing, Regina Johnson at (202) 317–6901 (not toll-free numbers) or [fdms.database@irs.counsel.treas.gov](mailto:fdms.database@irs.counsel.treas.gov).

**SUPPLEMENTARY INFORMATION:****Background**

This document sets forth proposed amendments to the Income Tax Regulations (26 CFR part 1) under section 162(m). Section 162(m)(1) disallows the deduction by any publicly held corporation for applicable employee remuneration paid with respect to any covered employee to the extent that such remuneration for the taxable year exceeds \$1,000,000. Section 162(m) was added to the Code by section 3211(a) of the Omnibus Budget Reconciliation Act of 1993, Public Law 103–66. Proposed regulations under section 162(m) were published in the **Federal Register** on December 20, 1993 (58 FR 66310) (1993 proposed regulations). On December 2, 1994, the Treasury Department and the IRS issued amendments to the proposed regulations (59 FR 61884) (1994 proposed regulations). On December 20, 1995, the Treasury Department and the IRS issued final regulations under section 162(m) (TD 8650) (60 FR 65534) (final regulations).

Section 162(m) was amended by section 13601 of the Tax Cuts and Jobs Act (TCJA) (Pub. L. 115–97, 131 Stat. 2054, 2155 (2017)). Section 13601 of TCJA amended the definitions of covered employee, publicly held corporation, and applicable employee remuneration in section 162(m). Section 13601 also provided a transition rule applicable to certain outstanding compensatory arrangements (commonly referred to as the grandfather rule).

On August 21, 2018, the Treasury Department and the IRS released Notice 2018–68 (2018–36 I.R.B. 418), which provides guidance on certain issues under section 162(m). Specifically, the notice provides guidance on the amended rules for identifying covered employees. Furthermore, the notice provides guidance on the operation of the grandfather rule, including when a contract will be considered materially modified so that it is no longer grandfathered. Notice 2018–68 requested comments on the following issues:

- The application of the definition of publicly held corporation to foreign private issuers, including the reference to issuers that are required to file reports under section 15(d) of the Securities Exchange Act of 1934,
- the application of the definition of covered employee to an employee who was a covered employee of a

predecessor of the publicly held corporation,

- the application of section 162(m) to corporations immediately after they become publicly held either, through an initial public offering or a similar business transaction, and

- the application of the Securities and Exchange Commission (SEC) executive compensation disclosure rules for determining the three most highly compensated executive officers for a taxable year that does not end on the same date as the last completed fiscal year.

In drafting these proposed regulations, the Treasury Department and the IRS have considered all comments received on the notice. See § 601.601(d)(2)(ii)(b). Commenters noted that the many examples in Notice 2018–68 were helpful in illustrating the guidance in the notice. In light of these comments, the Treasury Department and the IRS have included numerous examples in these proposed regulations to illustrate the proposed rules.

**Explanation of Provisions***I. Overview*

Section 13601 of TCJA significantly amended section 162(m). This document adds a section to the Income Tax Regulations (26 CFR part 1) to reflect these amendments. The amended section 162(m) applies to taxable years beginning after December 31, 2017, except to the extent the grandfather rule applies. Because the final regulations continue to apply to deductions related to amounts of remuneration that are grandfathered, the final regulations are retained as a separate section in the Income Tax Regulations under section 162(m).

*II. Publicly Held Corporation**A. In General*

Section 162(m)(2) defines the term “publicly held corporation.” Before the amendments made by section 13601(c) of TCJA, section 162(m)(2) defined publicly held corporation as any corporation issuing any class of common equity securities required to be registered under section 12 of the Securities Exchange Act of 1934 (Exchange Act). In defining a publicly held corporation, § 1.162–27(c)(1) adds that whether a corporation is publicly held is determined based solely on whether, as of the last day of its taxable year, the corporation is subject to the reporting obligations of section 12 of the Exchange Act.

Section 13601(c) of TCJA amended the definition of publicly held corporation in section 162(m)(2) to

provide that the term means any corporation which is an issuer (as defined in section 3 of the Exchange Act) the securities of which are required to be registered under section 12 of the Exchange Act, or that is required to file reports under section 15(d) of the Exchange Act. Thus, section 13601(c) of TCJA expanded the definition of publicly held corporation in two ways to include: (1) A corporation with any class of securities (rather than only a class of common equity securities) that is required to be registered under section 12 of the Exchange Act, and (2) a corporation that is required to file reports under section 15(d) of the Exchange Act.

The proposed regulations similarly define a publicly held corporation as any corporation that issues securities required to be registered under section 12 of the Exchange Act or that is required to file reports under section 15(d) of the Exchange Act. Unlike the final regulations, the proposed regulations do not focus on whether the corporation is subject to the reporting obligations of section 12 of the Exchange Act. Rather, tracking the statutory text as amended, the proposed regulations focus on whether a corporation's securities are required to be registered under section 12, or whether a corporation is required to file reports under section 15(d).

Consistent with the statutory expansion of section 162(m), Congress provided in the legislative history to TCJA that the definition of a publicly held corporation "may include certain additional corporations that are not publicly traded, such as large private C or S corporations." H. Rep. 115-466, at 490 (2017) (Conf. Rep.). See also Staff of the Joint Committee on Taxation, General Explanation of Public Law 115-97 (Blue Book), at 261 (December 20, 2018). As a result, these proposed regulations make clear that an S corporation (as defined in section 1361(a)(1)) would qualify as a publicly held corporation if it (1) issues securities required to be registered under section 12(b) of the Exchange Act, or (2) is required to file reports under section 15(d) of the Exchange Act (for example, because the S corporation has issued publicly traded debt). See Proposed § 1.162-33(c)(1)(i). Accordingly, the proposed regulations also provide that an S corporation parent of a qualified subchapter S subsidiary (as defined in section 1361(b)(3)(B)) (QSub) that issues securities required to be so registered, or is required to file such reports, likewise would qualify as a publicly held corporation. See part II.G of this

Explanation of Provisions section. See also Proposed § 1.162-33(c)(1)(iv).

For ease of administration, the proposed regulations follow the approach in the final regulations and use the last day of a corporation's taxable year to determine whether it is publicly held. Accordingly, the proposed regulations provide that a corporation is publicly held if, as of the last day of its taxable year, its securities are required to be registered under section 12 of the Exchange Act or it is required to file reports under section 15(d) of the Exchange Act.

A corporation is required to register its securities under section 12 of the Exchange Act in two circumstances. First, section 12(b) of the Exchange Act requires a corporation to register its securities in order to list them for trading on a national securities exchange (15 U.S.C. 78l(b)). Second, section 12(g) of the Exchange Act requires an issuer with total assets exceeding \$10 million to register a class of equity securities that is held of record by either 2,000 or more persons, or 500 or more persons who are not accredited investors (as that term is defined by the SEC) (15 U.S.C. 78l(g)).<sup>1</sup>

A corporation is required to file reports under section 15(d) of the Exchange Act when it offers securities for sale in a transaction subject to the registration requirements of the Securities Act of 1933 (Securities Act) and its registration statement is declared effective by the SEC. A corporation's section 15(d) filing obligation is automatically suspended when certain statutory requirements are met, and a corporation that meets other requirements established by rule may file a form with the SEC to suspend its section 15(d) filing obligation.<sup>2</sup> A commenter suggested that a corporation should not be considered publicly held if its obligation to file reports under section 15(d) of the Exchange Act is suspended. The proposed regulations adopt this suggestion.

In defining the term publicly held corporation under pre-amended section 162(m)(2), the final regulations included

<sup>1</sup> In the case of an issuer that is a bank, savings and loan holding company, or bank holding company, section 12(g) of the Exchange Act requires registration if the issuer has assets exceeding \$10 million and a class of equity securities held of record by 2,000 or more persons. See Exchange Act Rule 12g-1 (17 CFR 240.12g-1) regarding the requirements of section 12(g) generally, and Exchange Act Rule 12g5-1 (17 CFR 240.12g5-1) for determining record ownership of securities for purposes of Exchange Act sections 12(g) and 15(d).

<sup>2</sup> See Exchange Act Section 15(d) (15 U.S.C. 78o(d)), and Exchange Act Rules 15d-6 (17 CFR 240.15d-6) and 12h-3 (17 CFR 240.12h-3).

examples illustrating whether a corporation, as of the last day of its taxable year, is subject to the reporting obligations of section 12 of the Exchange Act. Similarly, these proposed regulations include examples illustrating when a corporation, as of the last day of its taxable year, is either required to file reports under section 15(d) of the Exchange Act or required to register its securities under section 12 of the Exchange Act. Even though the examples in these proposed regulations illustrate the application of the Securities Act and the Exchange Act and the rules thereunder (17 CFR part 240) for purposes of section 162(m), the examples are not intended to provide any guidance on how an issuer should apply the requirements of the Securities Act, the Exchange Act, and the rules thereunder (17 CFR part 240). Questions regarding those requirements should be directed to the SEC.

#### B. Subsidiaries That File Reports Under Section 15(d) of the Exchange Act

Pursuant to the definition of publicly held corporation in the proposed regulations, a corporation is publicly held if, as of the last day of its taxable year, it is required to file reports under section 15(d) of the Exchange Act. A commenter suggested that if a wholly-owned subsidiary corporation of a publicly held corporation subject to section 162(m) is required to file reports under section 15(d) of the Exchange Act, then it should not be considered a publicly held corporation separately subject to section 162(m) because its parent corporation is already subject to section 162(m). According to the commenter, to consider the subsidiary a publicly held corporation would result in two sets of covered employees—one for the parent corporation and one for the subsidiary corporation. The commenter was concerned that there would be too many covered employees for the group of corporations. The proposed regulations do not adopt this suggestion because not treating the subsidiary corporation as a separate publicly held corporation is inconsistent with the text of amended section 162(m)(2), which defines a publicly held corporation as a corporation that is required to file reports under section 15(d) of the Exchange Act. This conclusion is consistent with the affiliated group rule in the final regulations (which is retained in these proposed regulations and discussed in section II.E of this preamble) providing that a publicly held subsidiary is separately subject to section 162(m) and, therefore, has its own set of covered employees.

### C. Foreign Private Issuers

Foreign issuers<sup>3</sup> may access the U.S. capital markets to raise capital or establish a trading presence for their securities. There are specific rules under the Federal securities laws that apply if a foreign issuer meets the regulatory definition of “foreign private issuer” (FPI). “Foreign private issuer” is defined in 21 CFR 240.3b–4(c). A foreign private issuer is any foreign issuer other than a foreign government, except for an issuer that has (1) more than 50% of its outstanding voting securities held of record by U.S. residents and (2) any of the following: (i) A majority of its officers and directors are citizens or residents of the United States, (ii) more than 50% of its assets are located in the United States, or (iii) its business is principally administered in the United States.

A FPI may access the U.S. capital markets or establish a trading presence in the U.S. by offering or listing its securities, often in the form of American Depositary Receipts (ADRs). An ADR is a negotiable certificate that evidences ownership of a specified number (or fraction) of the FPI’s securities held by a depository (typically, a U.S. bank). Depending on the FPI’s level of participation in the U.S. capital market or trading presence, the FPI may be required to register its deposited securities (underlying the ADRs) under section 12 of the Exchange Act.

Commenters recommended that the proposed regulations provide that section 162(m) does not apply to FPIs. Before TCJA, the IRS ruled in several private letter rulings that section 162(m) does not apply to FPIs because FPIs are not required to file a summary compensation table pursuant to the reporting obligations under the Exchange Act.<sup>4</sup> The rationale of the rulings is that section 162(m) does not apply to FPIs because they do not have covered employees as a result of not being required to file a summary compensation table with the SEC. Commenters suggested that section 162(m) should continue to be inapplicable to FPIs because they are not required to disclose compensation of their officers on an individual basis under the Exchange Act, unless that disclosure is required by their home

country. The commenters asserted that determining compensation on an individual basis (in order to determine the three most highly compensated executive officers) would require the FPIs to expend significant time and money in adopting the necessary internal legal and compliance procedures to comply with the Exchange Act requirements that are otherwise inapplicable to them.

The proposed regulations do not adopt the recommendation to exclude FPIs from the application of section 162(m). Pursuant to the definition of publicly held corporation in amended section 162(m)(2), a FPI is a publicly held corporation if it is required either to register its securities under section 12 of the Exchange Act or to file reports under section 15(d) of the Exchange Act. The legislative history to TCJA indicates that Congress intended for section 162(m) to apply to FPIs.<sup>5</sup> Furthermore, the rationale of the private letter rulings, which conclude that section 162(m) does not apply to FPIs because they are not required to file a summary compensation table, is inconsistent with the definition of covered employee in amended section 162(m)(3). As discussed in section III of this preamble, under the definition of covered employee as amended by TCJA, a publicly held corporation has covered employees regardless of whether it is required to file a summary compensation table, and regardless of whether the employees appear on a summary compensation table that is filed. Accordingly, the proposed regulations do not adopt the suggestion to exclude FPIs from the application of section 162(m). The proposed regulations include examples illustrating when a FPI is a publicly held corporation. Because the calculation of compensation to determine the three highest compensated executive officers for a taxable year is made in accordance with the SEC executive compensation disclosure rules under the Exchange Act, the Treasury Department and the IRS request comments on whether a safe harbor for that determination is appropriate for FPIs that are not required to disclose compensation of their officers on an individual basis in

their home countries and, if so, how that safe harbor should be designed.

### D. Publicly Traded Partnerships

Partnerships may issue equity interests that are required to be registered under section 12 of the Exchange Act because they are traded on an established securities market. These partnerships are known as publicly traded partnerships (PTPs). Under section 7704(a), a PTP generally is treated as a corporation for purposes of the Code, unless its gross income meets the requirement of section 7704(c)(2). Stakeholders have asked whether a PTP that is treated as a corporation under that provision would be considered a publicly held corporation. As described in the preamble to the 1993 proposed regulations, stakeholders previously raised this issue:

Questions have arisen as to the application of section 162(m) to certain master limited partnerships whose equity interests are required to be registered under the Exchange Act and that, beginning in 1997, may be treated as corporations for Federal income tax purposes. Whether these partnerships would be publicly held corporations within the meaning of section 162(m) and, if so, the manner in which they would satisfy the exception for performance-based compensation is currently under study and is not addressed in these proposed regulations. If necessary, guidance as to the application of section 162(m) to these entities will be provided in the future.

(58 FR 66310, 66311). The Treasury Department and the IRS have concluded that, for purposes of section 162(m), a PTP that is treated as a corporation under section 7704 (or otherwise) is a publicly held corporation if, as of the last day of its taxable year, its securities are required to be registered under section 12 of the Exchange Act or it is required to file reports under section 15(d) of the Exchange Act. A PTP that is not treated as a corporation for Federal tax purposes (for example, because it satisfies the gross income requirement under section 7704(c)(2) and is not otherwise treated as a corporation for Federal tax purposes) is not a publicly held corporation for purposes of section 162(m).

### E. Affiliated Groups

In defining the term “publicly held corporation,” § 1.162–27(c)(1)(ii) provides that a publicly held corporation includes an affiliated group of corporations, as defined in section 1504 (determined without regard to section 1504(b)). The proposed regulations retain this rule with a modification described below. Because an affiliated group may include more

<sup>3</sup> The term “foreign issuer” means any issuer which is a foreign government, a national of any foreign country or a corporation or other organization incorporated or organized under the laws of any foreign country. 21 CFR 240.3b–4(b).

<sup>4</sup> A private letter ruling may be relied upon only by the taxpayer to whom the ruling was issued, and does not constitute generally applicable guidance. See section 11.02 of Revenue Procedure 2019–1, 2019–01 I.R.B. 157.

<sup>5</sup> The legislative history to TCJA provides that the amendment to the definition of publicly held corporation under section 162(m) “extends the applicability of section 162(m) to include . . . all foreign companies publicly traded through ADRs.” House Conf. Rpt. 115–466, 489 (2017). The Blue Book similarly states that “the provision extends the applicability of section 162(m) to include all foreign companies publicly traded through ADRs.” Blue Book at page 261.

than one publicly held corporation, § 1.162–27(c)(1)(ii) provides that an affiliated group of corporations does not include any subsidiary that is itself a publicly held corporation. In that case, pursuant to the final regulations, the publicly held subsidiary and its subsidiaries (if any) are separately subject to section 162(m). Therefore, the parent corporation that is a publicly held corporation and the publicly held subsidiary each has its own set of covered employees. However, the final regulations do not specifically address the situation in which a parent corporation is privately held and the subsidiary is publicly held. Because the amended definition of publicly held corporation includes a corporation that is required to file reports under section 15(d) of the Exchange Act, this type of affiliated group may be more common post-TCJA. Accordingly, unlike the final regulations, which provide that a publicly held subsidiary is excluded from an affiliated group, with the result that a privately held parent is not part of an affiliated group with its publicly held subsidiary, these proposed regulations provide that an affiliated group includes a parent corporation that is privately held and its subsidiary that is publicly held. Furthermore, because an affiliated group of corporations is determined without regard to section 1504(b), an affiliated group may also include a domestic parent corporation that is publicly held and its foreign subsidiary that is not publicly held.

A covered employee of a publicly held corporation may also perform services for another member of the affiliated group. In these situations, § 1.162–27(c)(1)(ii) provides that

[i]f a covered employee is paid compensation in a taxable year by more than one member of an affiliated group, compensation paid by each member of the affiliated group is aggregated with compensation paid to the covered employee by all other members of the group. Any amount disallowed as a deduction by this section must be prorated among the payor corporations in proportion to the amount of compensation paid to the covered employee by each such corporation in the taxable year.

The proposed regulations retain this rule and include additional rules addressing the proration of the deduction disallowance in situations in which a covered employee is paid compensation in a taxable year by more than one publicly held corporation in an affiliated group. Under these rules, the amount disallowed as a deduction is determined separately with respect to each publicly held payor corporation of which the individual is a covered employee. Accordingly, in determining

the deduction disallowance with respect to compensation paid to a covered employee by one publicly held payor corporation of an affiliated group, compensation paid to the covered employee by another publicly held payor corporation of the affiliated group (of which the individual is also a covered employee) is not aggregated for purposes of the deduction disallowance proration.

#### F. Disregarded Entities

Generally under § 301.7701–2(c)(2)(i), a business entity that has a single owner and is not a corporation under § 301.7701–2(b) is disregarded as an entity separate from its owner for Federal tax purposes (disregarded entity). All of the activities of a disregarded entity are therefore treated in the same manner as a sole proprietorship or as a branch or division of its owner under § 301.7701–2. Section 301.7701–2(c)(2)(iv) provides that § 301.7701–2(c)(2)(i) does not apply to taxes imposed under Subtitle C—Employment Taxes and Collection of Income Tax (Chapters 21, 22, 23, 23A, 24, and 25 of the Code). Because section 162(m) is in Subtitle A, the general rule in § 301.7701–2(c)(2)(i) applies for purposes of section 162(m).

Nonetheless, a disregarded entity that is owned by a privately held corporation may be an issuer of securities that are required to be registered under section 12(b) of the Exchange Act or may be required to file reports under section 15(d) of the Exchange Act. The Treasury Department and the IRS have concluded that, for purposes of section 162(m), a corporation that is the owner of a disregarded entity is treated as issuing any securities issued by its disregarded entity. Accordingly, if a disregarded entity that is owned by a privately held corporation is an issuer of securities that are 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, these proposed regulations treat the privately held corporation as a publicly held corporation for purposes of section 162(m).

The Treasury Department and the IRS are aware that a corporation could form a partnership with a minority partner in an attempt to circumvent the proposed rules treating a corporation that wholly owns a disregarded entity that issues certain securities as a publicly held corporation for purposes of section 162(m). In these circumstances, the corporation may be treated as a publicly held corporation by reason of the application of § 1.701–2 or other federal income tax principles. The Treasury

Department and the IRS also note that, in addition to the above-described fact pattern involving disregarded entities, § 1.701–2 and other federal income tax principles may apply to any transaction in which a corporation forms a partnership in an attempt to circumvent the proposed rules.

#### G. Qualified Subchapter S Subsidiaries

Section 1361(b)(3)(B) defines a QSub as any domestic corporation that is not an ineligible corporation (as defined in section 1361(b)(2)) if an S corporation owns 100 percent of the stock of such corporation and the S corporation elects to treat the corporation as a QSub. Under section 1361(b)(3)(A), unless otherwise provided by regulations, a QSub is not treated as a separate corporation, and therefore all of its assets, liabilities, and items of income, deduction, and credit are treated as assets, liabilities, and such items (as the case may be) of its parent S corporation.

Like a disregarded entity, a QSub may issue securities required to be registered under section 12(b) of the Exchange Act, or be required to file reports under section 15(d) of the Exchange Act. The Treasury Department and the IRS have concluded that, for purposes of section 162(m), an S corporation that is the owner of a QSub is treated as issuing any securities that are issued by its QSub. Accordingly, if a QSub is an issuer of securities that are 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, these proposed regulations treat the QSub's S corporation parent as a publicly held corporation for purposes of section 162(m). See Proposed § 1.162–33(c)(1)(iv).

#### III. Covered Employee

##### A. In General

Section 162(m)(3) defines the term “covered employee.” Before TCJA, section 162(m)(3) defined a covered employee as any employee of the taxpayer if (a) as of the close of the taxable year, such employee is the chief executive officer of the taxpayer or is an individual acting in such capacity, or (b) the total compensation of such employee for the taxable year is required to be reported to shareholders under the Exchange Act by reason of such employee being among the four highest compensated officers for the taxable year (other than the chief executive officer).

Section 13601(b) of TCJA amended the definition of covered employee in section 162(m)(3) to provide that a

covered employee means any employee of the taxpayer if (a) the employee is the principal executive officer (PEO) or principal financial officer (PFO) of the taxpayer at any time during the taxable year, or was an individual acting in such a capacity, (b) the total compensation of the employee for the taxable year is required to be reported to shareholders under the Exchange Act by reason of such employee being among the three highest compensated officers for the taxable year (other than the PEO and PFO), or (c) the individual was a covered employee of the taxpayer (or any predecessor) for any preceding taxable year beginning after December 31, 2016. Section 13601(c) of TCJA also added flush language to provide that a covered employee includes any employee whose total compensation for the taxable year places the individual among the three highest compensated officers for the taxable year (other than any individual who is the PEO or PFO of the taxpayer at any time during the taxable year, or was an individual acting in such a capacity) even if the compensation of the officer is not required to be reported to shareholders under the Exchange Act.

The SEC executive compensation disclosure rules generally require disclosure of compensation of the three most highly compensated executive officers if they were employed at the end of the taxable year and up to two executive officers whose compensation would have been disclosed but for the fact that they were not employed at the end of the taxable year. See Item 402 of Regulation S-K, 17 CFR 229.402(a)(3). After TCJA amended the definition of covered employee, stakeholders submitted comments indicating that they would benefit from initial guidance on whether amended section 162(m)(3)(B) and the flush language to section 162(m)(3) require an employee to be employed at the end of the taxable year to qualify as a covered employee. Notice 2018-68 provided that a covered employee for any taxable year means any employee who is among the three highest compensated executive officers for the taxable year, regardless of whether the executive officer is serving at the end of the publicly held corporation's taxable year, and regardless of whether the executive officer's compensation is subject to disclosure for the last completed fiscal year under the applicable SEC rules. To reach this conclusion, consistent with Notice 2018-68, the proposed regulations rely on the flush language to section 162(m)(3), the legislative

history,<sup>6</sup> and the SEC executive compensation disclosure rules that do not necessarily require an executive officer to be employed at the end of the fiscal year for his or her compensation to be disclosed for the year. Based on these considerations, the proposed regulations adopt the position set forth in Notice 2018-68.<sup>7</sup>

#### B. Taxable Years Not Ending on Same Date as Fiscal Years

The SEC executive compensation disclosure rules are based on a corporation's fiscal year. Usually, a corporation's fiscal and taxable years end on the same date; however, this is not always the case (for example, due to a short taxable year as a result of a corporate transaction that does not result in a short fiscal year). In these cases, the publicly held corporation will have three most highly compensated executive officers under section 162(m)(3)(B) for the short taxable year (instead of the fiscal year). In Notice 2018-68, the Treasury Department and IRS requested comments on the application of the SEC executive compensation disclosure rules to determine the three most highly compensated executive officers for a taxable year that does not end on the same date as the fiscal year for purposes of section 162(m)(3)(B). The notice provided that until additional guidance is issued, taxpayers should base their determination of the three most highly compensated executive officers for purposes of section 162(m)(3)(B) upon a reasonable good faith interpretation of the statute.

A commenter suggested that the determination of the three highest compensated executive officers should be based on the total amount of otherwise deductible remuneration. The proposed regulations do not adopt this approach. In defining covered employee, section 162(m)(3)(B) provides that the three most highly compensated executive officers are officers whose compensation is required to be (or would be required to be) reported to shareholders under the Exchange Act. Therefore, under the statutory text, the determination of the three most highly compensated executive officers is made pursuant to the rules under the Exchange Act. Accordingly, the proposed regulations provide that the amount of compensation used to identify the three most highly compensated executive officers is

determined pursuant to the executive compensation disclosure rules under the Exchange Act using the taxable year as the fiscal year for purposes of making the determination. Thus, for example, if a publicly held corporation uses a calendar year fiscal year for SEC reporting purposes, but has a taxable year beginning July 1, 2019, and ending June 30, 2020, then the three most highly compensated executive officers are determined for the taxable year ending June 30, 2020, by applying the executive compensation disclosure rules under the Exchange Act as if the fiscal year ran from July 1, 2019 to June 30, 2020. The same rule applies to short taxable years. Assume in the previous example that, due to a corporate transaction, the corporation's taxable year ran from July 1, 2019, to March 31, 2020. In that situation, the three most highly compensated executive officers would be determined for the taxable year ending March 31, 2020 by applying the disclosure rules as if the fiscal year began July 1, 2019, and ended March 31, 2020. For a discussion of the proposed special applicability dates related to the determination of the three most highly compensated executive officers for a corporation whose fiscal year and taxable year do not end on the same date, see section VIII.B of this preamble.

#### C. Covered Employees Limited to Executive Officers

The SEC executive compensation disclosure rules require disclosure of compensation for certain executive officers. The term executive officer is defined in 17 CFR 240.3b-7 as follows:

The term executive officer, when used with reference to a registrant, means its president, any vice president of the registrant in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions for the registrant. Executive officers of subsidiaries may be deemed executive officers of the registrant if they perform such policy making functions for the registrant.

Under the amended definition of covered employee, a PEO and PFO are covered employees by virtue of having those positions or acting in those capacities. The three highest compensated officers (other than the PEO or PFO) are covered employees by reason of their compensation. With respect to the three highest compensated officers for a taxable year, a commenter asked whether only an executive officer (as defined in 17 CFR 240.3b-7) may qualify as a covered employee. Because the SEC executive compensation disclosure rules that

<sup>6</sup> See House Conf. Rpt. 115-466, 489 (2017).

<sup>7</sup> Furthermore, in explaining the amended definition of covered employee, the Blue Book concurred with the guidance provided in Notice 2018-68. Blue Book at page 260.

require disclosure of the three highest compensated executive officers apply only to executive officers, only an executive officer may qualify as a covered employee under section 162(m)(3)(B).

A publicly held corporation may own an interest in a partnership as discussed in section IV.B. of this preamble. Consistent with the definition of the term executive officer in 17 CFR 240.3b-7, an officer of a partnership is deemed to be an executive officer of a publicly held corporation that owns an interest in such partnership if the officer performs a policy making function for the publicly held corporation. As a deemed executive officer of the publicly held corporation, the officer of the partnership may be a covered employee under section 162(m)(3)(B) if the officer is one of the three highest compensated executive officers of the publicly held corporation.

#### D. Covered Employees After Separation From Service

Consistent with section 162(m)(3)(C), as amended by TCJA, Notice 2018-68 provides that a covered employee identified for taxable years beginning after December 31, 2016, will continue to be a covered employee for all subsequent taxable years. Accordingly, if an individual is a covered employee for a taxable year, the individual remains a covered employee for all subsequent taxable years, even after the individual has separated from service. For example, if a publicly held corporation makes nonqualified deferred compensation (NQDC) payments to a former PEO after separation from service, then the deduction for the payments generally would be subject to section 162(m). Notice 2018-68 based this conclusion on the statutory text in section 162(m)(3)(C) and the legislative history, which provides that

if an individual is a covered employee with respect to a corporation for a taxable year beginning after December 31, 2016, the individual remains a covered employee for all future years. Thus, an individual remains a covered employee with respect to compensation otherwise deductible for subsequent years, including for years during which the individual is no longer employed by the corporation and years after the individual has died.

(House Conf. Rpt. 115-466, 489 (2017)). The Blue Book reiterated the legislative history in explaining the amended definition of covered employee.<sup>8</sup>

<sup>8</sup> The Blue Book states that, “[i]n addition, if an individual is a covered employee with respect to a corporation for a taxable year beginning after December 31, 2016, the individual remains a

covered employee for all future years. Thus, an individual remains a covered employee with respect to compensation otherwise deductible for subsequent years, including for years during which the individual is no longer employed by the corporation and years after the individual has died.” Blue Book at page 260.

One commenter suggested that a covered employee ceases to be a covered employee for taxable years following the taxable year in which the individual separates from service because the statutory text uses the term “employee” instead of “individual” in defining covered employee. In other words, the commenter asserted that the term “employee” in the statute should be interpreted as referring to a “current employee” instead of a “current or former employee.” The commenter suggested that because this is the plain reading of the statute, the legislative history should be ignored. The proposed regulations do not adopt this suggestion. The statute gives no indication that the term “employee” is limited to a current employee, and a reference in the Code to an “employee” has frequently been interpreted in regulations as a reference to a current or a former employee.<sup>9</sup> Given the ambiguity in the meaning of “employee” and the legislative intent in this context to include a former employee, as evidenced by the legislative history and the Blue Book explanation of the term covered employee, the proposed regulations define employee to include a former employee.

#### E. Predecessor Corporation

Section 162(m)(3)(C) provides that the term “covered employee” means any employee who was a covered employee of the taxpayer for any preceding taxable year beginning after December 31, 2016. The term “covered employee” also means any employee who was a covered employee of any predecessor of the taxpayer for any preceding taxable year beginning after December 31, 2016. For clarity, these proposed regulations use the term “predecessor of a publicly held corporation” instead of “predecessor.” An individual who is a covered employee for one taxable year (including a taxable year of a predecessor of a publicly held corporation) remains a covered employee for subsequent taxable years.

In certain circumstances, the term “predecessor of a publicly held corporation” includes the publicly held corporation itself if it was a publicly held corporation for a prior taxable year. Specifically, the proposed regulations

covered employee for all future years. Thus, an individual remains a covered employee with respect to compensation otherwise deductible for subsequent years, including for years during which the individual is no longer employed by the corporation and years after the individual has died.” Blue Book at page 260.

<sup>9</sup> For example, under § 1.105-11(c)(3)(iii), the nondiscrimination rules of section 105(h)(3) apply to former employees even though the Code uses only the term “employees.”

provide that a predecessor of a publicly held corporation includes a publicly held corporation that, after becoming privately held, again becomes a publicly held corporation for a taxable year ending before the 36-month anniversary of the due date for the corporation’s U.S. Federal income tax return (excluding any extensions) for the last taxable year for which the corporation was previously publicly held. For a discussion of the proposed special applicability date related to the definition of predecessor of a publicly held corporation as applied to a privately held corporation that was previously a publicly held corporation and again becomes a publicly held corporation, see section VIII.B of this preamble.

The proposed regulations also provide that the term “predecessor of a publicly held corporation” includes a publicly held corporation that is acquired (target corporation), or the assets of which are acquired, by another publicly held corporation (acquiror corporation) in certain transactions. Accordingly, the covered employees of the target corporation in those transactions are also covered employees of the acquiror corporation.

The proposed regulations define the term “predecessor of a publicly held corporation” by reference to the type of corporate acquisition in which a publicly held corporation is acquired. The proposed regulations describe corporate acquisitions in four categories: (1) Corporate reorganizations, (2) corporate divisions, (3) stock acquisitions, and (4) asset acquisitions. Certain transactions may fall within more than one category, but this redundancy is intended to provide certainty as to the application of these rules if a taxpayer is unsure which category covers the acquisition in question.

With respect to corporate reorganizations, the proposed regulations provide that a predecessor of a publicly held corporation includes a publicly held corporation that is acquired or that is the transferor corporation in a corporate reorganization described in section 368(a)(1). For example, if a publicly held target corporation merges into a publicly held acquiror corporation, then any covered employee of the target corporation would become a covered employee of the acquiror corporation.

With respect to corporate divisions, the proposed regulations provide that a predecessor of a publicly held corporation includes a publicly held distributing corporation that distributes or exchanges the stock of one or more

controlled corporations in a transaction described in section 355(a)(1) (a 355(a)(1) transaction) if the controlled corporation is a publicly held corporation. This rule applies to the distributing corporation only with respect to covered employees of the distributing corporation who are hired by the controlled corporation (or by a corporation affiliated with the controlled corporation that received stock of the controlled corporation as a shareholder of the distributing corporation in the 355(a)(1) transaction) within the period beginning 12 months before and ending 12 months after the distribution. For example, if a publicly held distributing corporation exchanges with its shareholders the stock of a controlled corporation for stock of the distributing corporation in a 355(a)(1) transaction, and the controlled corporation is a publicly held corporation after the exchange, then any covered employee of the distributing corporation would become a covered employee of the controlled corporation if hired by the controlled corporation within the period beginning 12 months before and ending 12 months after the exchange. Furthermore, a covered employee of the distributing corporation who becomes a covered employee of the controlled corporation will remain a covered employee of the distributing corporation for all subsequent taxable years because, as discussed in section III.D of this preamble, if an individual is a covered employee for a taxable year, the individual remains a covered employee for all subsequent taxable years.

With respect to stock acquisitions, a predecessor of a publicly held corporation includes a publicly held corporation that becomes a member of an affiliated group (as defined in proposed § 1.162–33(c)(1)(ii)). For example, if an affiliated group that is considered a publicly held corporation pursuant to proposed § 1.162–33(c)(1)(ii) in the proposed regulations acquires a publicly held target corporation that becomes a member of the affiliated group, then the target corporation would be considered a predecessor of the affiliated group. Therefore, any covered employee of the target corporation would become a covered employee of the affiliated group.

With respect to asset acquisitions, if an acquiror corporation or one or more members of an affiliated group (acquiror group) 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 acquiror corporation or group. For example, if an acquiror corporation acquires 80% or more of the operating assets of a publicly held target corporation, then any covered employees of the target corporation that become employees of the acquiror corporation would become covered employees of the acquiror corporation. For acquisitions of assets that occur over time, the proposed regulations provide that generally only acquisitions that occur within a 12-month period are taken into account to determine whether at least 80% of the target corporation's operating assets were acquired.

Similarly, this asset acquisition rule provides that the target is a predecessor of a publicly held corporation only with respect to a covered employee of the target corporation who is hired by the acquiror (or a corporation affiliated with the acquiror) within the period beginning 12 months before and ending 12 months after the date on which all events necessary for the acquisition have occurred.

These proposed regulations provide that the rules for determining predecessors are applied cumulatively, with the result that a predecessor of a corporation includes each predecessor of the corporation and the predecessor or predecessors of any prior predecessor or predecessors.

Also, in a similar manner to the rule for a publicly held corporation that becomes privately held, and subsequently becomes publicly held, these proposed regulations provide that a target corporation may be a predecessor corporation in certain circumstances. For example, the proposed regulations provide that if a target corporation was a publicly held corporation, subsequently becomes privately held, is then acquired by an acquiror that is not a publicly held corporation, and the acquiror becomes a publicly held corporation for a taxable year ending before the 36-month anniversary of the due date for the target corporation's U.S. Federal income tax return (excluding any extensions) for the last taxable year for which the target corporation was publicly held, then the target corporation is a predecessor of the publicly held corporation. The proposed regulations also provide a similar rule for asset acquisitions.

These proposed regulations further clarify that, in the case of an election to treat as an asset purchase either the sale, exchange, or distribution of stock pursuant to regulations under section 336(e) or the purchase of stock pursuant to regulations under section 338, the corporation is treated as the same corporation before and after the

transaction for which the election is made. Similar exceptions are made to the general treatment of an election under section 336(e) and section 338 that would treat the post-election corporation as a new corporation for purposes of other rules regarding various compensation tax provisions (see § 1.338–1(b)(2)(i)). These exceptions align with the other predecessor rules in these proposed regulations by treating a substantial continuation of the earlier business in the post-election corporation as continuing the pre-election corporation, so that the covered employees continue to be covered employees.

#### F. Disregarded Entities

Under section 162(m)(3), only employees of the taxpayer may be covered employees. When a corporation owns an entity that is disregarded as an entity separate from its owner under § 301.7701–2(c)(2)(i), the corporation that is a publicly held corporation (and not its wholly-owned entity) is the taxpayer for purposes of section 162(m)(3). In that case, the covered employees of the publicly held corporation are identified pursuant to the rules discussed in sections III.A through III.E of this preamble. Accordingly, a PEO, PFO, or executive officer of a disregarded entity wholly-owned by a corporation is generally not treated as a PEO, PFO, or executive officer of the corporate owner (the publicly held corporation). However, consistent with the definition of the term executive officer in 17 CFR 240.3b–7 that treats executive officers of subsidiaries as executive officers of the registrant if the executive officers perform policy making functions for the registrant, an executive officer of a disregarded entity is treated as an executive officer of its corporate owner for the taxable year if the executive officer performs policy making functions for the corporate owner during the taxable year. These proposed regulations include examples illustrating how to determine whether employees of a disregarded entity are treated as covered employees of its publicly held corporate owner for purposes of section 162(m).

The Treasury Department and the IRS are aware that, in an attempt to circumvent the proposed rules treating a corporation that wholly-owns a disregarded entity that issues certain securities as a publicly held corporation for purposes of section 162(m), a corporation could form a partnership with a minority partner and the partnership could then employ an individual who otherwise would have

been a covered employee of the corporation. In these circumstances, § 1.701–2 and other federal income tax principles may apply to a transaction in which a corporation forms a partnership in an attempt to circumvent the proposed rules.

#### G. Qualified Subchapter S Subsidiaries

Like the case when a corporation owns a disregarded entity, when an S corporation that is a publicly held corporation owns a QSub, the S corporation, and not its QSub, is the taxpayer for purposes of section 162(m)(3). Therefore, pursuant to the rules discussed in sections III.A through III.E of this preamble, a PEO, PFO, or executive officer of such QSub generally is not treated as a PEO, PFO, or executive officer of the S corporation owner (that is, the publicly held corporation). Under these proposed regulations, an executive officer of a QSub is treated as an executive officer of its S corporation owner for the taxable year if the executive officer performs policy making functions for the S corporation owner during the taxable year. See Proposed § 1.162–33(c)(2)(iv). This treatment is consistent with the definition of the term executive officer in 17 CFR 240.3b-7, which treats executive officers of subsidiaries as executive officers of the registrant if the executive officers perform policy making functions for the registrant.

#### IV. Applicable Employee Remuneration

##### A. In General

Section 162(m)(4) defines the term “applicable employee remuneration” with respect to any covered employee for any taxable year as the aggregate amount allowable as a deduction for such taxable year (determined without regard to section 162(m)) for remuneration for services performed by such employee (whether or not during the taxable year). Before TCJA, applicable employee remuneration did not include remuneration payable on a commission basis (as defined in section 162(m)(4)(B)) or performance-based compensation (as defined in section 162(m)(4)(C)). Section 13601(a) of TCJA amended the definition of applicable employee remuneration to eliminate these exclusions, while section 13601(d) of TCJA added a special rule for remuneration paid to beneficiaries. This special rule, set forth in section 162(m)(4)(F), provides that remuneration shall not fail to be applicable employee remuneration merely because it is includible in the income of, or paid to, a person other

than the covered employee, including after the death of the covered employee.

For simplicity, when incorporating the amendments TCJA made to the definition of applicable employee remuneration, these proposed regulations use the term “compensation” instead of “applicable employee remuneration.” Consistent with the amendments made by TCJA, these proposed regulations provide that compensation means the aggregate amount allowable as a deduction under chapter 1 of the Code for the taxable year (determined without regard to section 162(m)) for remuneration for services performed by a covered employee, whether or not the services were performed during the taxable year. The proposed regulations also clarify 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.

##### B. Compensation Paid by a Partnership to a Covered Employee

These proposed regulations address the issue of compensation paid by a partnership (as defined for Federal tax purposes) to a covered employee of a publicly held corporation; this issue has been subject to a no-rule position for private letter rulings since 2010. Between 2006 and 2008, the IRS issued four private letter rulings addressing specific situations in which a publicly held corporation was a partner in a partnership. As part of the analysis, the private letter rulings stated that if a publicly held corporation is a partner in a partnership, then section 162(m) does not apply to the corporation’s distributive share of the partnership’s deduction for compensation paid by the partnership for services performed for it by a covered employee of the corporation. Therefore, the private letter rulings ruled on the facts presented that section 162(m) did not limit the otherwise deductible compensation expense of the publicly held corporation for compensation the partnership paid the covered employee. Upon further consideration, and recognizing the potential for abuse, the IRS stopped issuing private letter rulings involving section 162(m) and partnerships.<sup>10</sup>

<sup>10</sup> Initially, the IRS announced the no-rule position in 2010 in section 5.06 of Revenue Procedure 2010–3, 2010–1 I.R.B. 110, which provided that “[w]hether the deduction limit under § 162(m) applies to compensation attributable to services performed for a related partnership” was an area under study in which rulings or determination letters will not be issued until the IRS resolves the issue through publication of a revenue ruling, revenue procedure, regulations, or otherwise. Most recently, section 4.01(13) of

Stakeholders have asked the Treasury Department and the IRS to address this issue in these proposed regulations.

In relevant part, section 162(m)(1) provides that “[i]n the case of any publicly held corporation, no deduction shall be allowed under this chapter for applicable employee remuneration with respect to any covered employee.” This language does not limit the application of section 162(m) to deductions for compensation paid by the publicly held corporation; it also covers the deduction for compensation paid to the corporation’s covered employees by another party to the extent the corporation is allocated a share of the otherwise deductible item. For instance, if a publicly held corporate partner is allocated a distributive share of the partnership’s deduction for compensation paid by the partnership, the allocated distributive share of the deduction is subject to section 162(m) even though the corporation did not directly pay the compensation to the covered employee. Thus, the publicly held corporation must take into account its distributive share of the partnership’s deduction for compensation expense paid to the publicly held corporation’s covered employee and aggregate that distributive share and the corporation’s otherwise allowable deduction for compensation paid directly to that employee in determining the amount allowable to the corporation as a deduction for compensation under section 162(m). See § 1.702–1(a)(8)(ii) and (iii).

The Treasury Department and the IRS are aware that this issue has not been addressed in generally applicable guidance and understand taxpayers may have taken positions contrary to those set forth in these proposed regulations. Accordingly, the proposed regulations provide transition relief for current compensation arrangements, but also prohibit the formation or expansion of these types of structures for the purpose of avoiding the application of section 162(m) prior to the issuance of final regulations. Specifically, in order to ensure that compensation agreements are not formed or otherwise structured to circumvent this rule after publication of these proposed regulations and prior to the publication of the final regulations, the proposed regulations propose that the rule with respect to compensation paid by a partnership will apply to any deduction for compensation that is otherwise

Revenue Procedure 2019–3, 2019–01 I.R.B. 130, provides that this issue is an area in which rulings or determination letters will not ordinarily be issued.



allowable for a taxable year ending on or after December 20, 2019 but will not apply to compensation paid pursuant to a written binding contract in effect on December 20, 2019 that is not materially modified after that date. The Treasury Department and the IRS request comments on whether similar rules should apply to trusts.

#### C. Compensation for Services in a Capacity Other Than an Executive Officer

A commenter suggested that, if a covered employee separates from service as an executive officer and subsequently performs services as a director of the publicly held corporation, then the compensation paid to the individual as a director should not be considered applicable employee remuneration for purposes of section 162(m)(4). These proposed regulations do not adopt this suggestion.

Since the enactment of section 162(m) in 1993, director fees were considered applicable employee remuneration for purposes of section 162(m)(4). In describing compensation for which the deduction is limited by section 162(m), the legislative history to the enactment of section 162(m) states:

Unless specifically excluded, the deduction limitation applies to all remuneration for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash. If an individual is a covered employee for a taxable year, the deduction limitation applies to all compensation not explicitly excluded from the deduction limitation, regardless of whether the compensation is for services as a covered employee and regardless of when the compensation was earned.

House Conf. Rpt. 103–213, 585 (1993). Thus, in enacting section 162(m), Congress did not exclude compensation for services not performed as a covered employee from the deduction limitation. As stated in the preamble to the 1993 proposed regulations, “[t]he deduction limit of section 162(m) applies to any compensation that could otherwise be deducted in a taxable year, except for enumerated types of payments set forth in section 162(m)(4)” (58 FR 66310, 66310). Compensation earned by a covered employee through a non-employee position, such as director fees, was never one of the “enumerated types of payments set forth in section 162(m)(4)” and so this compensation does not fall within the exception and has always been considered applicable employee remuneration for which the deduction is limited by section

162(m).<sup>11</sup> The amendments to section 162(m)(4) made by TCJA did not change this aspect of the definition of applicable employee remuneration; accordingly, the proposed regulations do not adopt the commenter’s suggestion.

Pursuant to the amended definition of covered employee in section 162(m)(3)(C), a covered employee includes any individual who was a covered employee of the publicly held corporation (or any predecessor) for any taxable year beginning after December 31, 2016. Therefore, a covered employee remains a covered employee after separation from service. If, after separation from service as an employee, a covered employee returns to provide services to the publicly held corporation in any capacity, including as a common law employee, a director, or an independent contractor, then any deduction for compensation paid to the covered employee is subject to section 162(m).

#### V. Privately Held Corporations That Become Publicly Held

Section 162(m) applies to the deduction for compensation paid to a covered employee that is otherwise deductible for a taxable year of a publicly held corporation. These proposed regulations provide that, in the case of a corporation that is a privately held corporation that becomes a publicly held corporation, section 162(m) applies to the deduction for any compensation that is otherwise deductible for the taxable year ending on or after the date that the corporation becomes a publicly held corporation. Furthermore, the proposed regulations provide that a corporation is considered to become publicly held on the date that its registration statement becomes effective either under the Securities Act or the Exchange Act.

Commenters suggested that these proposed regulations retain the transition relief provided in the final regulations for privately held corporations that become publicly held. Commenters reasoned that corporations that become publicly held corporations need time to adjust compensation arrangements to take into account

<sup>11</sup> Furthermore, as explained in section II.E of this preamble, the final regulations provide that all compensation paid to a covered employee by more than one member of an affiliated group is aggregated for purposes of prorating the amount disallowed as a deduction by section 162(m). For purposes of aggregating the total compensation paid by the affiliated group, the final regulations do not exclude compensation paid for services performed by a covered employee in a capacity other than an employee (for example, as an independent contractor).

section 162(m). The proposed regulations do not adopt this suggestion.

As background, in enacting section 162(m) in 1993, Congress excepted performance-based compensation from the definition of applicable employee remuneration and, thus, the section 162(m) deduction limitation. Before TCJA, section 162(m)(4)(C) defined performance-based compensation as “any remuneration payable solely on account of the attainment of one or more performance goals, but only if—

(i) the performance goals are determined by a compensation committee of the board of directors of the taxpayer which is comprised solely of 2 or more outside directors,

(ii) the material terms under which the remuneration is to be paid, including the performance goals, are disclosed to shareholders and approved by a majority of the vote in a separate shareholder vote before the payment of such compensation, and

(iii) before any payment of such remuneration, the compensation committee referred to in clause (i) certifies that the performance goals and any other material terms were in fact satisfied.

These requirements are also set forth in §§ 1.162–27(e)(2) through (e)(5). In enacting section 162(m), Congress recognized that privately held corporations may have difficulty adopting compensation arrangements that satisfy the requirements for performance-based compensation. Specifically, Congress was concerned about the shareholder approval requirement. Congress also recognized that, when a corporation becomes a publicly held corporation in connection with an initial public offering (IPO), prospective shareholders who read the corporation’s prospectus are aware of the compensation arrangements adopted prior to the IPO. Accordingly, Congress thought that shareholders who read the prospectus and purchase the corporation’s shares are, in effect, approving the corporation’s compensation arrangements. The 1993 legislative history provides as follows:

[I]n the case of a privately held company that becomes publicly held, the prospectus is subject to the rules similar to those applicable to publicly held companies. Thus, if there has been disclosure that would satisfy the rules described above, persons who buy stock in the publicly held company will be aware of existing compensation arrangements. No further shareholder approval is required of compensation arrangements existing prior to the time the company became public unless there is a material modification of such arrangements.

House Conf. Rpt. 103–213, 588 (1993). Based on the legislative history, the final regulations provided transition relief for corporations that become publicly held. Section 1.162–27(f)(1) provides that in the case of a corporation that was not a publicly held corporation and then becomes a publicly held corporation, section 162(m) “does not apply to any remuneration paid pursuant to a compensation plan or agreement that existed during the period in which the corporation was not publicly held.” If a corporation becomes publicly held in connection with an IPO, then the relief provided in § 1.162–27(f)(1) applies only to the extent that the prospectus accompanying the IPO disclosed information concerning the existing compensation plans or agreements and satisfied all applicable securities laws.

Section 13601(a) of TCJA amended the definition of applicable employee remuneration in section 162(m)(4) to eliminate the exception for performance-based compensation, which among other things, made shareholder approval of compensation arrangements irrelevant with respect to entitlement to the deduction. Accordingly, these proposed regulations do not retain the transition relief provided in the final regulations.

For a discussion of rules applicable to privately held corporations that previously were publicly held corporations, see section III.E. of this preamble.

## VI. Grandfather Rules

### A. In General

Section 13601(e) of TCJA generally provides that TCJA amendments to section 162(m) apply to taxable years beginning after December 31, 2017. However, it further provides that those amendments do not apply to remuneration that is provided pursuant to a written binding contract that was in effect on November 2, 2017, and that was not modified in any material respect on or after such date.

As discussed in Notice 2018–68, the text of section 13601(e) of the TJCA is almost identical to the text of pre-TCJA section 162(m)(4)(D), which provided a grandfather rule in connection with the enactment of section 162(m) in 1993. Under that grandfather rule, section 162(m) did not apply to remuneration payable under a written binding contract that was in effect on February 17, 1993, and that was not modified thereafter in any material respect before such remuneration was paid. Section 1.162–27(h) provides guidance on the definitions of written binding contract

and material modification for purposes of applying the original grandfather rule, and Notice 2018–68 adopted those definitions for purposes of the grandfather rule in connection with section 13601(e) of TCJA. The proposed regulations likewise adopt those definitions. Notice 2018–68 also provided examples illustrating the use of these definitions, and many of those examples are incorporated in these proposed regulations. However, to increase clarity, the proposed regulations replace some examples from Notice 2018–68 with other examples. This replacement with new examples does not reflect a substantive change from the definitions of written binding contract and material modification provided in Notice 2018–68.

Notice 2018–68 clarified that remuneration is payable under a written binding contract that was in effect on November 2, 2017, only to the extent that the corporation is obligated under applicable law (for example, state contract law) to pay the remuneration under the contract if the employee performs services or satisfies the applicable vesting conditions. Accordingly, the TJCA amendments to section 162(m) apply to any amount of remuneration that exceeds the amount of remuneration that applicable law obligates the corporation to pay under a written binding contract that was in effect on November 2, 2017, if the employee performs services or satisfies the applicable vesting conditions.

As an alternative to the grandfather rules in Notice 2018–68, some commenters suggested that these proposed regulations adopt a safe harbor regarding the determination of whether a contract qualifies as a written binding contract so that compensation paid pursuant to the contract would be grandfathered. Under the suggested safe harbor, any arrangement in effect on or before November 2, 2017, would be treated as a written binding contract if an amount related to the compensation payable under the contract was accrued (or could have been accrued) as a cost under Generally Accepted Accounting Principles (GAAP), regardless of whether the corporation is obligated to pay the remuneration under applicable law.

Although the Treasury Department and the IRS understand that the application of the written binding contract standard may be burdensome in certain cases and welcome the potential for simplification, the suggested safe harbor raises several issues. First, as expressed in the comment, the accrual of a cost is often based on predictions of whether the

amount will be paid, which may not necessarily reflect whether the amount must be paid in all cases. This raises issues of whether costs identified correlate with the statutory standard of being paid under a legally binding contract if, in fact, the employer was not necessarily bound to pay the amounts of compensation but rather was likely to pay them. Second, the suggested safe harbor is an accounting standard based on financial statements audited by accountants. This raises issues of tax administration, including the potential for the IRS to audit for section 162(m) purposes a corporation’s “audited” financial statements, and challenges IRS examiners would have in applying GAAP principles. For these reasons, the proposed regulations do not adopt this suggested safe harbor. However, the Treasury Department and the IRS welcome further comments on whether the suggested safe harbor standard would be administrable, including how it would be implemented with respect to differing positions on corporate tax returns (such as use of the standard in Notice 2018–68 and these proposed regulations) that have already been filed.

### B. Compensation Subject to Discretion

Under the definition of written binding contract in Notice 2018–68 and these proposed regulations, applicable law (such as state contract law) determines the amount of compensation that a corporation is obligated to pay pursuant to a written binding contract in effect on November 2, 2017. Some commenters suggested that negative discretion be completely disregarded in determining the amount of compensation that a corporation is obligated to pay pursuant to a written binding contract. The proposed regulations do not adopt this approach, because it is contrary to the statutory text and the legislative history. See House Conf. Rpt. 115–466, 490 (2017). The Treasury Department and the IRS are aware, however, that compensation arrangements may purport to provide the corporation with a wider scope of negative discretion than applicable law permits the corporation to exercise. In that case, the negative discretion is taken into account only to the extent the corporation may exercise the negative discretion under applicable law.

One commenter asked whether an amount of compensation is grandfathered if it is paid pursuant to a written binding contract under which the corporation is obligated to recover an amount of compensation from the employee if a vesting condition is later determined not to have been satisfied.

For example, a vesting condition may be based on the achievement of results reported in the financial statements. In this example, if a corporation pays a bonus based on the financial statements but the financial statements are subsequently restated and demonstrate that the vesting condition was not, in fact, satisfied, then the corporation is required to recover a portion of the bonus from the employee. If, under applicable law, the employee retains the remaining portion of the bonus then, pursuant to the grandfather rules in Notice 2018–68 and these proposed regulations, that remaining portion of the bonus is grandfathered compensation that is not subject to TCJA amendments. Similarly, if the corporation has discretion to recover compensation (in whole or in part), only the amount of compensation that the corporation is obligated to pay under applicable law that is not subject to potential recovery is grandfathered. The proposed regulations include examples illustrating these principles.

Applicable law may provide a corporation with contingent discretion to recover compensation. This issue was not addressed in Notice 2018–68. Under these proposed regulations, a corporation is not treated as currently having discretion merely because it will have discretion to recover an amount if a condition occurs subsequent to the vesting and payment of the compensation and the occurrence of the condition is objectively outside of the corporation's control. For example, pursuant to a written binding contract in effect on November 2, 2017, a corporation may be obligated under applicable law to pay \$500,000 of compensation if the employee satisfies a vesting condition, but the corporation may be permitted to recover \$300,000 from the employee if the employee is convicted of a felony within three calendar years from the date of payment. If the employee is not convicted of a felony within three calendar years from the date of payment, then the \$500,000 is grandfathered. If, however, the employee is convicted of a felony within three years after the payment of the \$500,000, then the corporation has discretion whether to recover the \$300,000 from the employee. Accordingly, if the employee is convicted of a felony within three calendar years after the payment, \$300,000 of the \$500,000 is not grandfathered. This is true regardless of whether the corporation exercises its discretion to recover the \$300,000. Because the corporation may not

recover \$200,000 of the \$500,000 payment in any event, the \$200,000 remains grandfathered regardless of whether the employee is convicted of a felony.

#### C. Account and Nonaccount Balance Plans

Notice 2018–68 includes examples illustrating the application of the grandfather rule to account balance plans, and those examples are incorporated into these proposed regulations. Commenters requested guidance on the application of the grandfather rule to nonaccount balance plans, and some of these commenters suggested that benefits accruing under a nonaccount balance plan after November 2, 2017, should be automatically grandfathered. The proposed regulations do not adopt this approach. Consistent with the text of section 13601(e) of TCJA providing the grandfather rule, the amount of compensation that is grandfathered under a nonaccount balance plan is the amount that the corporation is obligated to pay under applicable law on November 2, 2017. The proposed regulations include examples illustrating these rules.

Commenters also requested guidance on determining the amount of compensation that a corporation is obligated to pay under applicable law with respect to linked plan arrangements. In these arrangements, the amount payable to an employee under a NQDC plan is linked to a qualified employer plan. For example, a typical arrangement may provide that the amount of NQDC to be paid to an employee is the account balance (or an accumulated benefit) in a NQDC plan reduced by the account balance in a section 401(k) plan. These proposed regulations include an example involving this type of arrangement.

#### D. Earnings on Grandfathered Amounts in Account and Nonaccount Balance Plans

Notice 2018–68 includes an example illustrating the circumstances in which earnings credited to account balance plans after November 2, 2017, are grandfathered, as well as an example illustrating that those earnings are not grandfathered when the corporation retains the right under applicable law to amend the plan at any time either to stop or to reduce future credits (including earnings) to the account balance. Commenters suggested that earnings credited after November 2, 2017, on grandfathered amounts in nonaccount balance plans should also be grandfathered. The proposed

regulations do not adopt the commenters' suggestion. Instead, consistent with TCJA and the guidance in Notice 2018–68, the proposed regulations provide that earnings credited after November 2, 2017, on grandfathered amounts are grandfathered only if the corporation is obligated to pay the earnings under applicable law pursuant to a written binding contract in effect on November 2, 2017.

Stakeholders asked how § 1.409A–3(j)(4)(ix)(C)(3) affects the determination of whether earnings credited on a grandfathered amount after November 2, 2017, are grandfathered if the corporation retains the right under applicable law to terminate the plan at any time in compliance with section 409A. Section 1.409A–3(j)(4)(ix)(C)(3) provides that, if a service recipient terminates a NQDC plan, then the time and form of payments may be accelerated, but payment may not be made within 12 months of the date of termination of the plan. The definition of written binding contract in Notice 2018–68 and these proposed regulations provides that earnings credited after November 2, 2017, on grandfathered amounts are grandfathered only if the corporation is obligated to pay the earnings under applicable law pursuant to a written binding contract in effect on November 2, 2017. Accordingly, if, under applicable law, the corporation is obligated to continue to credit earnings for amounts under the NQDC plan during the 12 months after terminating the plan, then the earnings would be grandfathered.<sup>12</sup> In that case, the grandfathered amount would be the amount that the corporation is obligated to pay under applicable law as of November 2, 2017, plus the 12 months of earnings that the corporation is obligated to credit under applicable law. However, any additional amounts that become payable under the plan after November 2, 2017, and earnings on those amounts would not be grandfathered.

Applicable law and the terms of the plan determine the amount of earnings that the corporation is obligated to credit for amounts under the plan during the 12 months after plan

<sup>12</sup> Section 1.409A–3(j)(4)(ix)(C) provides that if a service recipient terminates a NQDC plan (as defined in § 1.409A–1(c)) for one participant, then it must terminate the NQDC plan for all participants. Given this requirement, a corporation might refrain from terminating a NQDC plan and continue to credit earnings on a grandfathered amount after November 2, 2017. If a corporation is permitted under applicable law to terminate the NQDC plan, then only the amount it would be obligated to pay under applicable law if it did terminate the NQDC plan is grandfathered.

termination. Thus, for example, with respect to a nonaccount balance plan, under applicable law, the amount of earnings that the corporation is obligated to credit might be limited to the difference between the present value of the benefit under the plan as of November 2, 2017, and any increase in present value due solely to passage of time (12 months). Furthermore, with respect to a nonaccount balance plan that provides for a formula amount (for example, the amount payable under the plan is based on the participant's final salary and years of service), the amount of earnings that the corporation is obligated to credit under applicable law might be limited to a reasonable rate of interest to reflect the time value of money during the passage of time (12 months) applied to the benefit under the plan as of November 2, 2017 (and not reflecting any additional salary increase or years of service accumulated after November 2, 2017).

#### E. Severance Agreements

Commenters asked about the application of the grandfather rule in Notice 2018–68 to compensation payable pursuant to a severance agreement that is a written binding contract and is in effect on November 2, 2017. Severance payable under such a contract is grandfathered only if the amount of severance is based on compensation elements the employer is obligated to pay under the contract. For example, if the amount of severance is based on final base salary, the severance is grandfathered only if the corporation is obligated to pay both the base salary and the severance under applicable law pursuant to a written binding contract in effect on November 2, 2017. For this purpose, a corporation may be obligated to pay severance under a written binding contract as of November 2, 2017, even if the employee remains employed as of November 2, 2017, but only with respect to the amount the corporation would have been required to pay if the employee had been terminated as of November 2, 2017.

Commenters also asked whether all or a portion of severance is grandfathered if a portion of the amount is based on a variable component, such as a discretionary or performance bonus. The examples in these proposed regulations illustrate that each component of the severance formula is analyzed separately to determine the amount of severance that is grandfathered. For example, the amount of severance may be equal to two times the sum of: (1) Final base salary and (2) any bonus paid within 12 months prior to separation from service. In this

example, the amount of severance is based on two components, base salary and bonus. Therefore, the entire amount of severance (based on both components) is grandfathered only if, under applicable law, the corporation is obligated to pay both portions, the base salary and the bonus pursuant to a written binding contract in effect on November 2, 2017.

#### F. Material Modification

##### 1. In General

These proposed regulations adopt the definition of material modification in Notice 2018–68. Under that definition, a material modification occurs when the contract is amended to increase the amount of compensation payable to the employee. Furthermore, if a written binding contract is materially modified, it is treated as a new contract entered into as of the date of the material modification. Accordingly, amounts received by an employee under the contract before a material modification are not affected, but amounts received subsequent to the material modification are treated as paid pursuant to a new contract, rather than as paid pursuant to a written binding contract in effect on November 2, 2017. The adoption of a supplemental contract or agreement that provides for increased compensation, or the payment of additional compensation, is a material modification of a written binding contract if the facts and circumstances demonstrate that the additional compensation is paid on the basis of substantially the same elements or conditions as the compensation that is otherwise paid pursuant to the written binding contract in effect on November 2, 2017. However, a material modification of a written binding contract does not include a supplemental payment that is equal to or less than a reasonable cost-of-living increase over the payment made in the preceding year under that written binding contract. In that case, only the deduction for the reasonable cost-of-living increase is subject to section 162(m) as amended by TCJA. In addition, the failure, in whole or in part, to exercise negative discretion under a contract does not result in the material modification of that contract. Finally, if amounts are paid to an employee from more than one written binding contract (or if a single written document consists of several written binding contracts), then a material modification of one written binding contract does not automatically result in a material modification of the other contracts unless the material modification affects

the amounts payable under those contracts.

##### 2. Earnings on Grandfathered Amounts That are Subsequently Deferred

Notice 2018–68 provides rules for determining whether a material modification occurs if a written binding contract in effect on November 2, 2017, is subsequently modified to defer the payment of compensation. Under those rules, which are adopted in these proposed regulations, if the contract is modified to defer the payment of compensation, any compensation paid or to be paid that is in excess of the amount that was originally payable to the employee under the contract will not be treated as resulting in a material modification if the additional amount is based on either a reasonable rate of interest or a predetermined actual investment (whether or not assets associated with the amount originally owed are actually invested therein) such that the amount payable by the employer at the later date will be based on the actual rate of return on the predetermined actual investment (including any decrease, as well as any increase, in the value of the investment). The proposed regulations provide that a predetermined actual investment means a predetermined actual investment as defined in § 31.3121(v)(2)–1(d)(2)(i)(B), and also include examples illustrating these rules relating to the treatment of earnings.

However, even though the payment of earnings will not result in the contract being materially modified, this generally does not mean that the earnings are treated as grandfathered. For situations in which an employee defers an amount of grandfathered compensation after November 2, 2017, the earnings on the deferred amount are not grandfathered if, as of November 2, 2017, the corporation was not obligated under the terms of the contract to provide the deferral election and to pay the earnings on the deferred amount under applicable law. Pursuant to the definition of written binding contract in Notice 2018–68 and these proposed regulations, these earnings are not grandfathered because, as of November 2, 2017, the corporation was not obligated to pay them under applicable law.

##### 3. Material Modification Prior to Payment of a Grandfathered Amount

Commenters asked whether a grandfathered amount of compensation is no longer considered grandfathered if the underlying compensation arrangement is materially modified after November 2, 2017, but before the

payment of the grandfathered amount. Pursuant to the definition of material modification in Notice 2018–68 and these proposed regulations, if the contract is materially modified after November 2, 2017, but before the payment of a grandfathered amount of compensation, then the compensation is treated as paid pursuant to the new contract and is no longer grandfathered. For example, if, under applicable law, a corporation is obligated to pay \$100,000 on December 31, 2020, under a written binding contract in effect on November 2, 2017, then the \$100,000 is grandfathered. If, on January 1, 2019, the contract is materially modified, then the \$100,000 is treated as paid pursuant to a new contract and is not grandfathered.

#### 4. Acceleration of Payment or Vesting

Under the definition of material modification in Notice 2018–68 and these proposed regulations, a modification of a written binding contract that accelerates the payment of compensation is a material modification unless the amount of compensation paid is discounted to reasonably reflect the time value of money. For example, if a corporation is obligated under applicable law to pay compensation on December 31, 2020, pursuant to a written binding contract in effect on November 2, 2017, then the compensation is grandfathered. If the corporation pays the entire amount of compensation on December 31, 2019 without a discount to reasonably reflect the time value of money, then the entire amount of compensation is treated as paid pursuant to a new contract and is no longer grandfathered. Furthermore, any subsequent payment made pursuant to the contract is not grandfathered because the contract itself was materially modified when the prior payment was accelerated without a discount to reasonably reflect the time value of money.

Commenters asked whether accelerating the payment of compensation attributable to equity-based compensation is considered a material modification when the payment is subject to a substantial risk of forfeiture. For example, an option may be subject to a substantial risk of forfeiture if, on the date of grant, the terms of the option provide that an employee may exercise the option only after performing services for three years after the date of grant. In this example, if the terms of the option are subsequently modified to require performance of services for only two years, then the modification results in the lapse of a substantial risk of

forfeiture. One might consider this a material modification because the employee may exercise the option and receive compensation attributable to the exercise earlier than provided in the terms of the option on the date of grant. However, commenters suggested that accelerating vesting of equity-based compensation should not be a material modification because the acceleration does not provide for an increase in the amount of compensation received. The commenters reasoned that the acceleration of vesting of an equity award for which the amount of compensation is always variable is unlike the acceleration of the payment of a fixed cash award in which the acceleration may always be considered an increase in compensation due to the time value of money. To support their recommendation, commenters pointed out that, with respect to incentive stock options, section 424(h)(3)(C) and § 1.424–1(e)(4)(ii) provide that acceleration of vesting of an incentive stock option is not a modification.

These proposed regulations adopt the commenters' suggestion. Specifically, these proposed regulations provide that for compensation received pursuant to the substantial vesting of restricted property, or the exercise of a stock option or stock appreciation right that do not provide for a deferral of compensation (as defined in § 1.409A–1(b)(5)(i) and (ii)), a modification of a written binding contract in effect on November 2, 2017, that results in a lapse of the substantial risk of forfeiture (as defined in § 1.83–3(c)) is not considered a material modification. Likewise, with respect to other compensation arrangements, if an amount of compensation payable under a written binding contract in effect on November 2, 2017, is subject to a substantial risk of forfeiture (as defined in § 1.409A–1(d)), then a modification of the contract that results in a lapse of the substantial risk of forfeiture is not considered a material modification. Thus, for all forms of compensation, a modification to a written binding contract that accelerates vesting will not be considered a material modification.

The Treasury Department and the IRS considered alternatives to the commenters' suggestion. For example, the Treasury Department and the IRS considered an approach based on the rules under section 280G. Under those rules, an acceleration of vesting can give rise to an excess parachute payment under section 280G even if the timing of the payment is not accelerated. See § 1.280G–1, Q&A–24. In other words, the rules under section 280G are based on the principle that there is

independent value attributable to the acceleration of vesting, even if the timing of the payment is unchanged. Given the limited scope of the section 162(m) grandfathering rule and its diminishing applicability over time, the Treasury Department and the IRS have determined that it is not necessary to apply that principle in this context.

#### G. Ordering Rule for Payments Consisting of Grandfathered and Non-Grandfathered Amounts

Some NQDC arrangements provide for a series of payments instead of a lump sum. For a NQDC arrangement that is a written binding contract entered into prior to November 2, 2017, only a portion of the amounts payable under the arrangement might be grandfathered depending on the terms of the arrangement and applicable law. To identify the grandfathered amount when payment under the arrangement is made in a series of payments, the proposed regulations provide that the grandfathered amount is allocated to the first otherwise deductible payment paid under the arrangement. If the grandfathered amount exceeds the payment, then the excess is allocated to the next otherwise deductible payment paid under the arrangement. This process is repeated until the entire grandfathered amount has been paid. For example, assume that a NQDC arrangement provides for an annual payment of \$100,000 for three years, and only \$120,000 is grandfathered. Pursuant to the proposed regulations, the entire \$100,000 paid in the first year is grandfathered. In the second year, only \$20,000 of the \$100,000 payment is grandfathered; the remaining \$80,000 paid in the second year is not grandfathered. In the third year, none of the \$100,000 payment is grandfathered.

#### VII. Coordination With Section 409A

Section 409A addresses NQDC arrangements and sets forth certain requirements that must be met to avoid current income inclusion and certain additional income tax. NQDC arrangements must designate a time and form of payment, among other requirements, to comply with section 409A. Pursuant to § 1.409A–2(b)(7)(i), a payment may be delayed past the designated payment date to the extent that the service recipient reasonably anticipates that, if the payment were made as scheduled, the service recipient's deduction with respect to such payment would not be permitted due to the application of section

162(m).<sup>13</sup> Generally, a payment delayed in accordance with § 1.409A-2(b)(7)(i) must be paid no later than the service provider's first taxable year in which the deduction of such payment will not be barred by the application of section 162(m).

If any scheduled payment to a service provider in a service recipient's taxable year is delayed in accordance with § 1.409A-2(b)(7)(i), then the delay in payment is treated as a subsequent deferral election unless all scheduled payments to that service provider that could be delayed in accordance with § 1.409A-2(b)(7)(i) are also delayed.<sup>14</sup> A subsequent deferral election will violate section 409A if the election fails to satisfy the requirements of section 409A(a)(4)(C).<sup>15</sup> A similar rule under § 1.409A-1(b)(4)(ii) permits delayed payments of compensation that otherwise qualifies as a short-term deferral under § 1.409A-1(b)(4)(i) (commonly referred to as the short-term deferral exception).

Before TCJA, an individual who was a covered employee for one taxable year would not necessarily remain a covered employee for subsequent taxable years, and would not be a covered employee after separation from service. Accordingly, parties to NQDC arrangements anticipated that in these cases, pursuant to §§ 1.409A-1(b)(4)(ii) and 1.409A-2(b)(7)(i), the corporation would be able to make the payment when the individual separated from service (if not earlier), when the individual would no longer be a covered employee and the deduction for the payment would no longer be restricted due to the application of section 162(m). Because TCJA amendments to the definition of covered employee fundamentally alter the premise of

§§ 1.409A-1(b)(4)(ii) and 1.409A-2(b)(7)(i), commenters asked whether a service recipient may delay the scheduled payment of grandfathered amounts in accordance with §§ 1.409A-1(b)(4)(ii) and 1.409A-2(b)(7)(i), without delaying the payment of non-grandfathered amounts, in circumstances in which the service recipient has discretion to delay the payment. Commenters stated that the service provider may not want the non-grandfathered payments delayed and that the corporation would be willing to pay those payments under the original schedule since a delay in many cases would not result in the corporation being able to deduct the payment.

The Treasury Department and the IRS have concluded that the rules should be modified to accommodate this change. Consequently, in circumstances in which the service recipient has discretion to delay the payment, a service recipient may delay the scheduled payment of grandfathered amounts in accordance with §§ 1.409A-1(b)(4)(ii) and 1.409A-2(b)(7)(i), without delaying the payment of non-grandfathered amounts, and the delay of the grandfathered amounts will not be treated as a subsequent deferral election. As discussed in section VI of this preamble, the amendments made to section 162(m) by TCJA do not apply to grandfathered amounts. Therefore, the deduction for amounts grandfathered under the amended section 162(m) is not subject to section 162(m) when paid to a former covered employee who separated from service. Thus, the payment of these grandfathered amounts may be delayed consistent with §§ 1.409A-1(b)(4)(ii) and 1.409A-2(b)(7)(i). The Treasury Department and the IRS intend to incorporate these modifications into the regulations under section 409A, and taxpayers may rely on the guidance in this paragraph of the preamble for any taxable year beginning after December 31, 2017, until the issuance of proposed regulations under section 409A incorporating these modifications and permitting taxpayers to rely on such proposed regulations under section 409A.

Even though §§ 1.409A-1(b)(4)(ii) and 1.409A-2(b)(7)(i) provide that the service recipient has discretion to delay a payment, and that the discretion is not required to be set forth in the written plan, the Treasury Department and the IRS understand that compensation arrangements in effect on November 2, 2017, may explicitly require the service recipient to delay a payment if the service recipient reasonably believes the deduction with respect to the payment will not be permitted under section

162(m). Commenters pointed out that with respect to a service provider who is a covered employee, non-grandfathered amounts may require the passage of a significant period of time before a payment of the entire amount would be deductible, and may possibly never become deductible if the service provider dies and the payment (or remaining amount due) is payable at death. Commenters requested that relief be provided so that compensation arrangements may be amended to no longer require the service recipient to delay a payment that the service recipient reasonably believes will not be deductible under section 162(m) without resulting in a failure to meet the requirements of section 409A. The Treasury Department and the IRS have determined that this type of relief is appropriate given the impact of TCJA amendments on application of the rules in §§ 1.409A-1(b)(4)(ii) and 1.409A-2(b)(7)(i). Accordingly, if a NQDC arrangement is amended to remove the provision requiring the corporation to delay a payment if the corporation reasonably anticipates at the time of the scheduled payment that the deduction would not be permitted under section 162(m), then the amendment will not result in an impermissible acceleration of payment under § 1.409A-3(j), and will not be considered a material modification for purposes of the grandfather rule under the amended section 162(m). The plan amendment must be made no later than December 31, 2020. If, pursuant to the amended plan, the corporation would have been required to make a payment (or payments) prior to December 31, 2020, then the payment (or payments) must be made no later than December 31, 2020. The Treasury Department and the IRS intend to incorporate these modifications into the regulations under section 409A, and taxpayers may rely on the guidance in this paragraph of the preamble for any taxable year beginning after December 31, 2017, until the issuance of proposed regulations under section 409A incorporating these modifications and permitting taxpayers to rely on such proposed regulations under section 409A.

Amounts payable under NQDC arrangements may consist of both grandfathered amounts and non-grandfathered amounts. With respect to these arrangements, employers may apply the guidance provided in the previous two paragraphs of this preamble. Accordingly, the plan may be amended to remove the provision requiring the corporation to delay the payment of non-grandfathered amounts

<sup>13</sup> In general, if a payment is delayed pursuant to § 1.409A-2(b)(7)(i), then the payment must be made either during the service provider's first taxable year in which the service recipient reasonably anticipates, or reasonably should anticipate, that the payment will not fail to be deductible because of section 162(m), if the payment is made during such year or, if later, during the period beginning on the day the service provider separates from service and ending on the later of the last day of the taxable year of the service recipient in which the separation from service occurs or the 15th day of the third month following the separation from service.

<sup>14</sup> See § 1.409A-2(b)(7) for additional requirements for the service recipient to delay a payment so that the delay is not treated as a subsequent deferral election, such as treating all payments to similarly situated service providers on a reasonably consistent basis.

<sup>15</sup> Pursuant to section 409A(a)(4)(C), a subsequent deferral election (i) must be made at least 12 months before the prior scheduled payment date, (ii) cannot be effective for at least 12 months after the date of the subsequent election, and (iii) must delay the payment at least 5 years from the original scheduled payment date.

if it is anticipated that the corporation's deduction with respect to the payments will not be permitted under section 162(m); notwithstanding such an amendment, the corporation may continue to delay payment of the grandfathered amounts in accordance with §§ 1.409A-1(b)(4)(ii) and 1.409A-2(b)(7)(i).

## VIII. Proposed Applicability Dates

### A. General Applicability Date

Generally, these regulations are proposed to apply to compensation that is otherwise deductible for taxable years beginning on or after [DATE OF PUBLICATION OF THE FINAL RULE IN THE FEDERAL REGISTER].

Taxpayers may choose to rely on these proposed regulations until the applicability date of the final regulations, provided that taxpayers apply these proposed regulations consistently and in their entirety. Because these proposed regulations do not broaden the definition of "covered employee" as provided in Notice 2018-68 and do not restrict the application of the definition of "written binding contract" as provided in Notice 2018-68, except as provided by the special applicability dates described in section VIII.B of this preamble, taxpayers may no longer rely on Notice 2018-68 for taxable years ending on or after December 20, 2019, but instead may rely on these proposed regulations for those taxable years.

### B. Special Applicability Dates

These regulations are proposed to include special applicability dates covering certain aspects of the following provisions of the proposed regulations:

1. Definition of covered employee.
2. Definition of predecessor of a publicly held corporation.
3. Definition of compensation.
4. Application of section 162(m) to a deduction for compensation otherwise deductible for a taxable year ending on or after a privately held corporation becomes a publicly held corporation.
5. Definitions of written binding contract and material modification.

First, the definition of covered employee is proposed to apply to taxable years ending on or after September 10, 2018, the publication date of Notice 2018-68, which provided guidance on the definition of covered employee. Notice 2018-68 also provided that the Treasury Department and the IRS anticipate that the guidance in the notice will be incorporated in future regulations that, with respect to the issues addressed in the notice, will apply to any taxable year ending on or

after September 10, 2018. Because these proposed regulations adopt the definition of covered employee in Notice 2018-68, the guidance on the definition of covered employee in these proposed regulations is proposed to apply to taxable years ending on or after September 10, 2018. The Treasury Department and the IRS recognize, however, that the rules related to a corporation whose fiscal year and taxable year do not end on the same date were not discussed in Notice 2018-68. Accordingly, the proposed regulations provide that, for a corporation whose fiscal and taxable years 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 taxable years beginning on or after December 20, 2019.

Second, the provisions defining a predecessor corporation of a publicly held corporation are proposed to apply to corporate transactions for which all events necessary for the transaction occur on or after [DATE OF PUBLICATION OF THE FINAL RULE IN THE FEDERAL REGISTER]. With respect to the rules that apply to corporations that change from publicly held to privately held status or vice-versa, the definition of the term predecessor corporation of a publicly held corporation applies to a privately held corporation that again becomes a publicly held corporation on or after [DATE OF PUBLICATION OF THE FINAL RULE IN THE FEDERAL REGISTER]. Accordingly, depending on the timing of any earlier transition from a publicly held corporation to a privately held corporation, the publicly held corporation that existed before the issuance of final regulations may be treated as a predecessor of a privately held corporation that becomes a publicly held corporation after the date of issuance of final regulations. Until the applicability date of the final regulations, taxpayers may rely on the definition of predecessor of a publicly held corporation in these proposed regulations or a reasonable good faith interpretation of the term "predecessor." The Treasury Department and the IRS have determined, however, that excluding the following target corporations from the definition of the term "predecessor" in the following situations is not a reasonable good faith interpretation of the statute: (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, and at least 80% of the total value, of the stock of which is acquired by a publicly held acquiring corporation (including an affiliated group). No inference is intended regarding whether the treatment of a target corporation as other than a "predecessor" in any other situation is a reasonable good faith interpretation of the statute.

Third, as discussed in section IV.C. of this preamble, the rule that the definition of compensation in proposed § 1.162-33(c)(3) includes an amount equal to the publicly held corporation's distributive share of a partnership's deduction for compensation expense attributable to the compensation paid by the partnership is proposed to apply to any deduction for compensation that is otherwise allowable for a taxable year ending on or after December 20, 2019. The Treasury Department and the IRS are aware that arrangements currently exist that reflect an understanding that the allocated deduction would not be limited by section 162(m). Accordingly, this aspect of the definition of compensation would not apply to compensation paid pursuant to a written binding contract in effect on December 20, 2019 that is not materially modified after that date.

Fourth, the guidance on the applicability of section 162(m)(1) to the deduction for any compensation otherwise deductible for a taxable year ending on or after the date when a corporation becomes a publicly held corporation is proposed to apply to corporations that become publicly held after December 20, 2019. A corporation that was not a publicly held corporation and then becomes a publicly held corporation on or before December 20, 2019 may rely on the transition relief as provided in § 1.162-27(f)(1) until the earliest of the events provided in § 1.162-27(f)(2).

Fifth, the definitions of written binding contract and material modification are proposed to apply to taxable years ending on or after September 10, 2018, the publication date of Notice 2018-68, which provided guidance defining these terms. Notice 2018-68 also provided that the Treasury Department and IRS anticipated that the guidance in the notice would be incorporated in future regulations that, with respect to the issues addressed in the notice, would apply to any taxable year ending on or after September 10, 2018. Because these proposed regulations adopt the definitions of the terms "written binding contract" and "material modification" that were

included in Notice 2018–68, the guidance on these definitions in these proposed regulations is proposed to apply to taxable years ending on or after September 10, 2018.

### Special Analyses

This regulation is not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Department of the Treasury and the Office of Management and Budget regarding review of tax regulations. Pursuant to the Regulatory Flexibility Act (RFA) (5 U.S.C. chapter 6), it is hereby certified that these proposed regulations would not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that section 162(m)(1) applies only to publicly held corporations (for example, corporations that list securities on a national securities exchange and are rarely small entities) and only impacts those publicly held corporations that compensate certain executive officers in excess of \$1 million in a taxable year. Notwithstanding this certification that the proposed regulations would not have a significant economic impact on a substantial number of small entities, the Treasury Department and the IRS invite comments on the impacts these proposed regulations may have on small entities. Pursuant to section 7805(f) of the Code, this proposed rule has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small entities.

### Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the **ADDRESSES** heading. Treasury and the IRS request comments on all aspects of the proposed rules. All comments will be available at [www.regulations.gov](http://www.regulations.gov) or upon request.

A public hearing has been scheduled for March 9, 2020, beginning at 10 a.m. in the Auditorium of the Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For more information about having your name placed on the building access list

to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit an outline of the topics to be discussed and the time to be devoted to each topic by February 18, 2020. Submit a signed paper or electronic copy of the outline as prescribed in this preamble under the **ADDRESSES** heading. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

### Drafting Information

The principal author of these regulations is Ilya Enkishev, Office of Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes). However, other personnel from the Treasury Department and the IRS participated in the development of these regulations.

### List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

### Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

#### PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 continues to read in part as follows:

**Authority:** 26 U.S.C. 7805 \* \* \*

■ **Par. 2.** Section 1.162–27 is amended by revising paragraphs (a) and (j)(1) to read as follows:

**§ 1.162–27 Certain employee remuneration in excess of \$1,000,000 not deductible for taxable years beginning on or after January 1, 1994, and for taxable years beginning prior to January 1, 2018**

(a) *Scope.* This section provides rules for the application of the \$1 million deduction limitation under section 162(m)(1) for taxable years beginning on or after January 1, 1994, and beginning prior to January 1, 2018, and, as provided in paragraph (j) of this section, for taxable years beginning after December 31, 2017. For rules concerning the applicability of section 162(m)(1) to taxable years beginning after December 31, 2017, see § 1.162–33. Paragraph (b) of this section provides the general rule limiting deductions under section 162(m)(1). Paragraph (c)

of this section provides definitions of generally applicable terms. Paragraph (d) of this section provides an exception from the deduction limitation for compensation payable on a commission basis. Paragraph (e) of this section provides an exception for qualified performance-based compensation. Paragraphs (f) and (g) of this section provide special rules for corporations that become publicly held corporations and payments that are subject to section 280G, respectively. Paragraph (h) of this section provides transition rules, including the rules for contracts that are grandfathered and not subject to section 162(m)(1). Paragraph (j) of this section contains the effective date provisions, which also specify when these rules apply to the deduction for compensation otherwise deductible in a taxable year beginning after December 31, 2017. For rules concerning the deductibility of compensation for services that are not covered by section 162(m)(1) and this section, see section 162(a)(1) and § 1.162–7. This section is not determinative as to whether compensation meets the requirements of section 162(a)(1). For rules concerning the deduction limitation under section 162(m)(6) applicable to certain health insurance providers, see § 1.162–31.

\* \* \* \* \*

(j) *Effective date—(1) In general.*

Section 162(m) and this section apply to the deduction for compensation that is otherwise deductible by the corporation in taxable years beginning on or after January 1, 1994, and beginning prior to January 1, 2018. Section 162(m) and this section also apply to compensation that is a grandfathered amount (as defined in § 1.162–33(g)) at the time it is paid to the covered employee. For examples of the application of the rules of this section to grandfathered amounts paid during taxable years beginning after December 31, 2017, see § 1.162–33(g).

\* \* \* \* \*

■ **Par. 3.** Section 1.162–33 is added to read as follows:

**§ 1.162–33 Certain employee remuneration in excess of \$1,000,000 not deductible for taxable years beginning after December 31, 2017**

(a) *Scope.* This section provides rules for the application of the \$1 million deduction limitation under section 162(m)(1) for taxable years beginning after December 31, 2017. For rules concerning the applicability of section 162(m)(1) to taxable years beginning on or after January 1, 1994, and prior to January 1, 2018, see § 1.162–27. Paragraph (b) of this section provides the general rule limiting deductions under section 162(m)(1). Paragraph (c)



of this section provides definitions of generally applicable terms. Paragraph (d) of this section provides rules for determining when a corporation becomes a publicly held corporation. Paragraph (e) of this section provides rules for payments that are subject to section 280G. Paragraph (f) of this section provides a special rule for coordination with section 4985. Paragraph (g) of this section provides transition rules, including the rules for contracts that are grandfathered. Paragraph (h) of this section sets forth the effective date provisions. For rules concerning the deductibility of compensation for services that are not covered by section 162(m)(1) and this section, see section 162(a)(1) and § 1.162-7. This section is not determinative as to whether compensation meets the requirements of section 162(a)(1). For rules concerning the deduction limitation under section 162(m)(6) applicable to certain health insurance providers, see § 1.162-31.

(b) *Limitation on deduction.* Section 162(m)(1) precludes a deduction under chapter 1 of the Internal Revenue Code by any publicly held corporation for compensation paid to any covered employee to the extent that the compensation for the taxable year exceeds \$1,000,000.

(c) *Definitions—(1) Publicly held corporation—(i) General rule.* A publicly held corporation means any corporation that issues securities required to be registered under section 12 of the Exchange Act or that is required to file reports under section 15(d) of the Exchange Act. In addition, a publicly held corporation means any S corporation (as defined in section 1361(a)(1)) that issues securities that are required to be registered under section 12(b) of the Exchange Act, or that is required to file reports under section 15(d) of the Exchange Act. For purposes of this section, whether a corporation is publicly held is determined based solely on whether, as of the last day of its taxable year, the securities issued by the corporation are required to be registered under section 12 of the Exchange Act or the corporation is required to file reports under section 15(d) of the Exchange Act. Whether registration under the Exchange Act is required by rules other than those of the Exchange Act is irrelevant to this determination. A publicly traded partnership that is treated as a corporation under section 7704 (or otherwise) is a publicly held corporation if, as of the last day of its taxable year, its securities are required to be registered under section 12 of the Exchange Act or it is required to file

reports under section 15(d) of the Exchange Act.

(ii) *Affiliated groups—(A) In general.* A publicly held corporation includes an affiliated group of corporations, as defined in section 1504 (determined without regard to section 1504(b)) that includes one or more publicly held corporations (as defined in paragraph (c)(1)(i) of this section). In the case of an affiliated group that includes two or more publicly held corporations as defined in paragraph (c)(1)(i) of this section, each member of the affiliated group that is a publicly held corporation as defined in paragraph (c)(1)(i) of this section is separately subject to this section, and the affiliated group as a whole is subject to this section. Thus, for example, assume that a publicly held corporation (as defined in paragraph (c)(1)(i) of this section) is a wholly-owned subsidiary of another publicly held corporation (as defined in paragraph (c)(1)(i) of this section), which is a wholly-owned subsidiary of a privately held corporation. In this case, the two subsidiaries are separately subject to this section, and all three corporations are members of an affiliated group that is subject to this section. Furthermore, each subsidiary has its own set of covered employees as defined in paragraphs (c)(2)(i) through (iv) of this section (although it is possible that the same individual may be a covered employee of both subsidiaries).

(B) *Proration of amount disallowed as a deduction.* If, in a taxable year, a covered employee (as defined in paragraphs (c)(2)(i) through (iv) of this section) of one member of an affiliated group is paid compensation by more than one member of the affiliated group, compensation paid by each member of the affiliated group is aggregated with compensation paid to the covered employee by all other members of the affiliated group (excluding compensation paid by any other publicly held corporation in the affiliated group, as defined in paragraph (c)(1)(i) of this section, of which the individual is also a covered employee as defined in paragraphs (c)(2)(i) through (iv) of this section). In the event that, in a taxable year, a covered employee (as defined in paragraphs (c)(2)(i) through (iv) of this section) is paid compensation by more than one publicly held corporation in an affiliated group and is also a covered employee of more than one publicly held payor corporation (as defined in paragraph (c)(1)(i) of this section) in the affiliated group, the amount disallowed as a deduction is determined separately with respect to each publicly held

corporation of which the individual is a covered employee. Any amount disallowed as a deduction by this section must be prorated among the payor corporations (excluding any other publicly held payor corporation of which the individual is also a covered employee) in proportion to the amount of compensation paid to the covered employee (as defined in paragraphs (c)(2)(i) through (iv) of this section) by each such corporation in the taxable year. This process is repeated for each publicly held payor corporation of which the individual is a covered employee.

(iii) *Disregarded entities.* For purposes of paragraph (c)(1) of this section, a publicly held corporation includes a corporation that owns an entity that is disregarded as an entity separate from its owner within the meaning of § 301.7701-2(c)(2)(i) of this chapter if the disregarded entity 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.

(iv) *Qualified subchapter S subsidiaries.* For purposes of paragraph (c)(1) of this section, a publicly held corporation includes an S corporation that owns a qualified subchapter S subsidiary as defined in section 1361(b)(3)(B) (QSub) if the QSub 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.

(v) *Examples.* The following examples illustrate the provisions of this paragraph (c)(1). For each example, assume that no corporation is a predecessor of a publicly held corporation within the meaning of this paragraph (c)(2)(ii). Furthermore, for each example, unless provided otherwise, a reference to a publicly held corporation means a publicly held corporation as defined in paragraph (c)(1)(i) of this section. Additionally, for each example, assume that the corporation is a calendar year taxpayer and has a fiscal year ending December 31 for reporting purposes under the Exchange Act. These examples are not intended to provide guidance on the legal requirements of the Securities Act and Exchange Act and the rules thereunder (17 CFR part 240).

(A) *Example 1 (Corporation required to file reports under section 15(d) of the Exchange Act)—(1) Facts.* Corporation Z plans to issue debt securities in a public offering registered under the Securities Act. Corporation Z is not required to file reports under section 15(d) of the Exchange Act with respect to any other class of securities and does not have another class of securities required to be registered

under section 12 of the Exchange Act. On April 1, 2021, the Securities Act registration statement for Corporation Z's debt securities is declared effective by the SEC. As a result, Corporation Z is required to file reports under section 15(d) of the Exchange Act. Accordingly, as of December 31, 2021, the last day of its taxable year, Corporation Z is required to file reports under section 15(d) of the Exchange Act.

(2) *Conclusion.* Corporation Z is a publicly held corporation for its 2021 taxable year because it is required to file reports under section 15(d) of the Exchange Act as of the last day of its taxable year.

(B) *Example 2 (Corporation not required to file reports under section 15(d) of the Exchange Act)*—(1) *Facts.* The facts are the same as in paragraph (c)(1)(v)(A) of this section (*Example 1*), except that, on January 1, 2022, pursuant to section 15(d) of the Exchange Act, Corporation Z's obligation to file reports under section 15(d) is automatically suspended for the fiscal year ending December 31, 2022, because Corporation Z meets the statutory requirements for an automatic suspension to file reports under section 15(d). Accordingly, as of December 31, 2022, Corporation Z is not required to file reports under section 15(d) of the Exchange Act.

(2) *Conclusion.* Corporation Z is not a publicly held corporation for its 2022 taxable year because it is not required to file reports under section 15(d) of the Exchange Act as of the last day of its taxable year.

(C) *Example 3 (Corporation not required to file reports under section 15(d) of the Exchange Act)*—(1) *Facts.* The facts are the same as in paragraph (c)(1)(v)(B) of this section (*Example 2*), except that, on January 1, 2022, pursuant to section 15(d) of the Exchange Act, Corporation Z's obligation to file reports under section 15(d) is not automatically suspended for the fiscal year ending December 31, 2022 because Corporation Z does not meet the statutory requirements for automatic suspension. Instead, on May 2, 2022, Corporation Z is eligible to suspend its section 15(d) reporting obligation under Rule 12h-3 of the Exchange Act (17 CFR 240.12h-3) and files Form 15, Certification and Notice of Termination of Registration under Section 12(g) of the Securities Exchange Act of 1934 or Suspension of Duty to File Reports under Sections 13 and 15(d) of the Securities Exchange Act of 1934 (or its successor), to suspend its section 15(d) reporting obligation for its fiscal year ending December 31, 2022. Accordingly, as of December 31, 2022, Corporation Z is not required to file reports under section 15(d) of the Exchange Act.

(2) *Conclusion.* Corporation Z is not a publicly held corporation for its 2022 taxable year because it is not required to file reports under section 15(d) of the Exchange Act as of the last day of its taxable year.

(D) *Example 4 (Corporation required to file reports under section 15(d) of the Exchange Act)*—(1) *Facts.* The facts are the same as in paragraph (c)(1)(v)(C) of this section (*Example 3*), except that, Corporation Z does not utilize Rule 12h-3 under the Exchange Act (17 CFR 240.12h-3) to file a Form 15, Certification and Notice of Termination of

Registration under Section 12(g) of the Securities Exchange Act of 1934 or Suspension of Duty to File Reports under Sections 13 and 15(d) of the Securities Exchange Act of 1934 (or its successor), to suspend its section 15(d) reporting obligation during its fiscal year ending December 31, 2022. Accordingly, Corporation Z's reporting obligation under section 15(d) of the Exchange Act is not suspended for its fiscal year ending December 31, 2022.

(2) *Conclusion.* Corporation Z is a publicly held corporation for its 2022 taxable year because it is required to file reports under section 15(d) of the Exchange Act as of the last day of its taxable year.

(E) *Example 5 (Corporation required to file reports under section 15(d) of the Exchange Act)*—(1) *Facts.* Corporation Y is a wholly-owned subsidiary of Corporation X, which is required to file reports under the Exchange Act. Corporation Y issued a class of debt securities in a public offering registered under the Securities Act, and therefore is required to file reports under Exchange Act Section 15(d), including for its fiscal year ending December 31, 2020. Corporation Y has no other class of securities registered under the Exchange Act. In its Form 10-K, Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 (or its successor), for the 2020 fiscal year, Corporation Y may omit Item 11 Executive Compensation (required by Part III of Form 10-K), which requires disclosure of compensation of certain executive officers because it is wholly-owned by Corporation X and the other conditions of General Instruction I to Form 10-K are satisfied.

(2) *Conclusion.* Corporation Y is a publicly held corporation for its 2020 taxable year because it is required to file reports under section 15(d) of the Exchange Act as of the last day of its taxable year.

(F) *Example 6 (Corporation not required to file reports under section 15(d) of the Exchange Act and not required to register securities under section 12 of the Exchange Act)*—(1) *Facts.* Corporation A has a class of securities registered under section 12(g) of the Exchange Act. For its 2020 taxable year, Corporation A is a publicly held corporation. On September 30, 2021, Corporation A is eligible to terminate the registration of its securities under section 12(g) of the Exchange Act pursuant to Rule 12g-4(a)(2) of the Exchange Act (17 CFR 240.12g-4(a)(2)), but does not terminate the registration of its securities prior to December 31, 2021. Because Corporation A did not issue securities in a public offering registered under the Securities Act, Corporation A is not required to file reports under section 15(d) of the Exchange Act.

(2) *Conclusion.* Corporation A is not a publicly held corporation for its 2021 taxable year because, as of the last day of its taxable year, the securities issued by Corporation A are not required to be registered under section 12 of the Exchange Act and Corporation A is not required to file reports under section 15(d) of the Exchange Act.

(G) *Example 7 (Corporation required to file reports under section 15(d) of the Exchange Act)*—(1) *Facts.* The facts are the same as in paragraph (c)(1)(v)(F) of this section

(*Example 6*), except that Corporation A previously issued a class of securities in a public offering registered under the Securities Act. Furthermore, on October 1, 2021, Corporation A terminates the registration of its securities under section 12(g) of the Exchange Act. Because Corporation A issued a class of securities in a public offering registered under the Securities Act and is not eligible to suspend its reporting obligation under section 15(d) of the Exchange Act, as of December 31, 2021, Corporation A is required to file reports under section 15(d) of the Exchange Act.

(2) *Conclusion.* Corporation A is a publicly held corporation for its 2021 taxable year because it is required to file reports under section 15(d) of the Exchange Act as of the last day of its taxable year.

(H) *Example 8 (Corporation not required to file reports under section 15(d) of the Exchange Act and not required to register securities under section 12 of the Exchange Act)*—(1) *Facts.* On November 1, 2021, Corporation B is an issuer with only one class of equity securities. On November 5, 2021, Corporation B files a registration statement for its equity securities under section 12(g) of the Exchange Act. Corporation B's filing of its registration statement is voluntary because the Exchange Act does not require Corporation B to register its class of securities under section 12(g) of the Exchange Act based on the number and composition of its record holders. On December 1, 2021, the Exchange Act registration statement for Corporation B's securities is declared effective by the SEC. As of December 31, 2021, the last day of its taxable year, Corporation B continues to have its class of equity securities registered voluntarily under section 12 of the Exchange Act. Furthermore, Corporation B is not required to file reports under section 15(d) of the Exchange Act because it did not register any class of securities in a public offering under the Securities Act.

(2) *Conclusion.* Corporation B is not a publicly held corporation for its 2021 taxable year because, as of the last day of that taxable year, the securities issued by Corporation B are not required to be registered under section 12 of the Exchange Act and Corporation B is not required to file reports under section 15(d) of the Exchange Act.

(I) *Example 9 (Corporation not required to file reports under section 15(d) of the Exchange Act and not required to register securities under section 12 of the Exchange Act)*—(1) *Facts.* The facts are the same as in paragraph (c)(1)(v)(H) of this section (*Example 8*), except that, on December 31, 2022, because of a change in circumstances, under the Exchange Act, Corporation B must register its class of equity securities under section 12(g) of the Exchange Act within 120 days of December 31, 2022. On February 1, 2023, the Exchange Act registration statement for Corporation B's securities is declared effective by the SEC.

(2) *Conclusion.* Corporation B is not a publicly held corporation for its 2022 taxable year because, as of the last day of that taxable year, Corporation B is not required to file reports under section 15(d) of the Exchange Act, and the class of equity securities issued

by Corporation B is not yet required to be registered under section 12 of the Exchange Act. Corporation B has 120 days following December 31, 2022, to file a registration statement to register its class of equity securities under section 12(g) of the Exchange Act.

(J) *Example 10 (Securities of foreign private issuer in the form of ADRs traded in the over-the-counter market)*—(1) *Facts.* For its fiscal and taxable years ending December 31, 2021, Corporation W is a foreign private issuer. Because Corporation W has not registered an offer or sale of securities under the Securities Act, it is not required to file reports under section 15(d) of the Exchange Act. Corporation W qualifies for an exemption from registration of its securities under section 12(g) of the Exchange Act pursuant to Rule 12g3–2(b) under the Exchange Act (17 CFR 240.12g3–2(b)). Corporation W wishes to have its securities traded in the U.S. in the over-the-counter market in the form of ADRs. Because Corporation W qualifies for an exemption pursuant to Rule 12g3–2(b) under the Exchange Act (17 CFR 240.12g3–2(b)), Corporation W is not required to register its securities underlying the ADRs under section 12 of the Exchange Act. However, the depositary bank is required to register the ADRs under the Securities Act. Even though the depositary bank is required to register the ADRs under the Securities Act, such registration of the ADRs does not create a requirement for either the depositary bank or Corporation W to file reports under section 15(d) of the Exchange Act. On February 3, 2021, the Securities Act registration statement for the ADRs is declared effective by the SEC. On February 4, 2021, Corporation W's ADRs begin trading in the over-the-counter market. On December 31, 2021, the securities of Corporation W are not required to be registered under Section 12 of the Exchange Act because Corporation W qualifies for an exemption pursuant to Rule 240.12g3–2(b) of the Exchange Act. Furthermore, on December 31, 2021, Corporation W is not required to file reports under section 15(d) of the Exchange Act.

(2) *Conclusion.* Corporation W is not a publicly held corporation for its 2021 taxable year because, as of the last day of that taxable year, the securities underlying the ADRs are not required to be registered under section 12 of the Exchange Act and Corporation W is not required to file reports under section 15(d) of the Exchange Act. The conclusion would be the same if Corporation W had its securities traded in the over-the-counter market other than in the form of ADRs.

(K) *Example 11 (Securities of foreign private issuer in the form of ADRs quoted on Over the Counter Bulletin Board)*—(1) *Facts.* The facts are the same as in paragraph (c)(1)(v)(J) of this section (*Example 10*), except that Corporation W has its securities quoted on the Over the Counter Bulletin Board (OTCBB) in the form of ADRs. Because Corporation W qualifies for an exemption pursuant to Rule 12g3–2(b) of the Exchange Act (17 CFR 240.12g3–2(b)), Corporation W is not required to register its securities underlying the ADRs under section 12 of the Exchange Act. However, the depositary bank is required to register the ADRs under the

Securities Act. Section 6530(b)(1) of the OTCBB Rules requires that a foreign equity security may be quoted on the OTCBB only if the security is registered with the SEC pursuant to section 12 of the Exchange Act and the issuer of the security is current in its reporting obligations. To comply with section 6530(b)(1) of the OTCBB Rules, on February 5, 2021, Corporation W files a registration statement for its class of securities underlying the ADRs under section 12(g) of the Exchange Act. On February 26, 2021, the Exchange Act registration statement for Corporation W's securities is declared effective by the SEC. As of December 31, 2021, Corporation W is subject to the reporting obligations under the section 12 of the Exchange Act as a result of section 12 registration.

(2) *Conclusion.* Corporation W is not a publicly held corporation for its 2021 taxable year because, as of the last day of that taxable year, its ADRs and the securities underlying the ADRs are not required by the Exchange Act to be registered under section 12, and Corporation W is not required to file reports under section 15(d) of the Exchange Act. The conclusion would be the same if Corporation W had its securities traded on the OTCBB other than in the form of ADRs.

(L) *Example 12 (Securities of foreign private issuer in the form of ADRs listed on a national securities exchange without a capital raising transaction)*—(1) *Facts.* For its fiscal and taxable years ending December 31, 2021, Corporation V is a foreign private issuer. Corporation V wishes to list its securities on the New York Stock Exchange (NYSE) in the form of ADRs without a capital raising transaction. Under the Exchange Act, Corporation V is required to register its securities underlying the ADRs under section 12(b) of the Exchange Act. Because the ADRs and the deposited securities are separate securities, the depositary bank is required to register the ADRs under the Securities Act. On February 2, 2021, Corporation V's registration statement under section 12(b) of the Exchange Act in connection with the underlying securities, and the depositary bank's registration statement under the Securities Act in connection with the ADRs, are declared effective by the SEC. On March 1, 2021, Corporation V's securities begin trading on the NYSE in the form of ADRs. As of December 31, 2021, Corporation V is not required to file reports under section 15(d) of the Exchange Act; however, the securities underlying the ADRs are required to be registered under section 12(b) of the Exchange Act.

(2) *Conclusion.* Corporation V is a publicly held corporation for its 2021 taxable year because, as of the last day of that taxable year, the securities underlying the ADRs are required to be registered under section 12 of the Exchange Act. The conclusion would be the same if Corporation V had its securities listed on the NYSE other than in the form of ADRs.

(M) *Example 13 (Securities of foreign private issuer in the form of ADRs listed on a national securities exchange with a capital raising transaction)*—(1) *Facts.* The facts are the same as in paragraph (c)(1)(v)(L) of this section (*Example 12*), except that

Corporation V wishes to raise capital and have its securities listed on the NYSE in the form of ADRs. Corporation V is required to register the offer of securities underlying the ADRs under the Securities Act and to register the class of those securities under section 12(b) of the Exchange Act. The depositary bank is required to register the ADRs under the Securities Act. On February 2, 2021, Corporation V's registration statements under the Securities Act and section 12(b) of the Exchange Act, and the registration statement for the ADRs under the Securities Act, are declared effective by the SEC. As of December 31, 2021, Corporation V is not required to file reports under section 15(d) of the Exchange Act; however, the securities underlying the ADRs are required to be registered under section 12(b) of the Exchange Act.

(2) *Conclusion.* Corporation V is a publicly held corporation for its 2021 taxable year because, as of the last day of that taxable year, its securities underlying the ADRs are required to be registered under section 12 of the Exchange Act. The conclusion would be the same if Corporation V had its securities listed on the NYSE other than in the form of ADRs.

(N) *Example 14 (Foreign private issuer incorporates subsidiary in the United States to issue debt securities and subsequently issues a guarantee)*—(1) *Facts.* Corporation T is a corporation incorporated in Country S (which is not the United States). For its fiscal and taxable years ending December 31, 2021, Corporation T is a foreign private issuer. Corporation T wishes to access the U.S. capital markets. Corporation T incorporates Corporation U in the United States to issue debt securities. On January 15, 2021, the SEC declares Corporation U's Securities Act registration statement effective. Corporation U is a wholly-owned subsidiary of Corporation T. To enhance the credit of Corporation U and the marketability of Corporation U's debt securities, Corporation T issues a guarantee of Corporation U's securities and, as required, registers the guarantee under the Securities Act on the registration statement that the SEC declares effective on January 15, 2021. On December 31, 2021, Corporations T and U are required to file reports under section 15(d) of the Exchange Act.

(2) *Conclusion.* Corporations T and U are publicly held corporations for their 2021 taxable years because they are required to file reports under section 15(d) of the Exchange Act as of the last day of their taxable years.

(O) *Example 15 (Affiliated group composed of two corporations, one of which is a publicly held corporation)*—(1) *Facts.* Employee D, a covered employee of Corporation N, performs services and receives compensation from Corporations N and O, members of an affiliated group of corporations. Corporation N, the parent corporation, is a publicly held corporation. Corporation O is a direct subsidiary of Corporation N and is a privately held corporation. The total compensation paid to Employee D from all affiliated group members is \$3,000,000 for the taxable year, of which Corporation N pays \$2,100,000 and Corporation O pays \$900,000.

(2) *Conclusion.* Because the compensation paid by all affiliated group members is aggregated for purposes of section 162(m)(1), \$2,000,000 of the aggregate compensation paid is nondeductible. Corporations N and O each are treated as paying a ratable portion of the nondeductible compensation. Thus, two thirds of each corporation's payment will be nondeductible. Corporation N has a nondeductible compensation expense of \$1,400,000 ( $\$2,100,000 \times \$2,000,000 / \$3,000,000$ ). Corporation O has a nondeductible compensation expense of \$600,000 ( $\$900,000 \times \$2,000,000 / \$3,000,000$ ).

(P) *Example 16 (Affiliated group composed of two corporations, one of which is a publicly held corporation)—(1) Facts.* The facts are the same as in paragraph (c)(1)(v)(O) of this section (*Example 15*), except that, Corporation O is a publicly held corporation and Corporation N is a privately held corporation, and Employee D is a covered employee of Corporation O (instead of Corporation N).

(2) *Conclusion.* The result is the same as in paragraph (c)(1)(v)(T) of this section (*Example 15*). Even though Corporation O is a subsidiary that is a publicly held corporation, it is still a member of the affiliated group comprised of Corporations N and O. Accordingly, \$2,000,000 of the aggregate compensation paid is nondeductible. Thus, Corporations N and O each are treated as paying a ratable portion of the nondeductible compensation.

(Q) *Example 17 (Affiliated group composed of two publicly held corporations)—(1) Facts.* The facts are the same as in paragraph (c)(1)(v)(O) of this section (*Example 15*), except that Corporation O is also a publicly held corporation. As in paragraph (c)(1)(v)(O) of this section (*Example 15*), Employee D is not a covered employee of Corporation O.

(2) *Conclusion.* The result is the same as in paragraph (c)(1)(v)(O) of this section (*Example 15*). Even though Corporation O is a subsidiary that is a publicly held corporation, it is still a member of the affiliated group comprised of Corporations N and O. Corporations N and O are payor corporations that are members of an affiliated group for purposes of proration the amount disallowed as a deduction. Accordingly, \$2,000,000 of the aggregate compensation paid is nondeductible. Thus, Corporations N and O each are treated as paying a ratable portion of the nondeductible compensation.

(R) *Example 18 (Affiliated group composed of two publicly held corporations)—(1) Facts.* The facts are the same as in paragraph (c)(1)(v)(Q) of this section (*Example 17*), except that Employee D is also a covered employee of Corporation O.

(2) *Conclusion.* Even though Corporations N and O are each publicly held corporations and separately subject to this section, they are still members of the affiliated group comprised of Corporations N and O. Because Employee D is a covered employee of both Corporations N and O, which are each a separate publicly held corporation, the determination of the amount disallowed as a deduction is made separately for each publicly held corporation. Accordingly, Corporation N has a nondeductible

compensation expense of \$1,100,000 (the excess of \$2,100,000 over \$1,000,000), and Corporation O has no nondeductible compensation expense because the amount it paid to Employee D was below \$1,000,000.

(S) *Example 19 (Affiliated group composed of three corporations, one of which is a publicly held corporation)—(1) Facts.* Employee C, a covered employee of Corporation P, performs services for, and receives compensation from, Corporations P, Q, and R, members of an affiliated group of corporations. Corporation P, the parent corporation, is a publicly held corporation. Corporation Q is a direct subsidiary of Corporation P, and Corporation R is a direct subsidiary of Corporation Q. Corporations Q and R are both privately held corporations. The total compensation paid to Employee C from all affiliated group members is \$3,000,000 for the taxable year, of which Corporation P pays \$1,500,000, Corporation Q pays \$900,000, and Corporation R pays \$600,000.

(2) *Conclusion.* Because the compensation paid by all affiliated group members is aggregated for purposes of section 162(m)(1), \$2,000,000 of the aggregate compensation paid is nondeductible. Corporations P, Q, and R are each treated as paying a ratable portion of the nondeductible compensation. Thus, two thirds of each corporation's payment will be nondeductible. Corporation P has a nondeductible compensation expense of \$1,000,000 ( $\$1,500,000 \times \$2,000,000 / \$3,000,000$ ). Corporation Q has a nondeductible compensation expense of \$600,000 ( $\$900,000 \times \$2,000,000 / \$3,000,000$ ). Corporation R has a nondeductible compensation expense of \$400,000 ( $\$600,000 \times \$2,000,000 / \$3,000,000$ ).

(T) *Example 20 (Affiliated group composed of three corporations, one of which is a publicly held corporation)—(1) Facts.* The facts are the same as in paragraph (c)(1)(v)(S) of this section (*Example 19*), except that Corporation Q is a publicly held corporation and Corporation P is a privately held corporation, and Employee C is a covered employee of Corporation Q (instead of Corporation P).

(2) *Conclusion.* The result is the same as in paragraph (c)(1)(v)(S) of this section (*Example 19*). Even though Corporation Q is a subsidiary that is a publicly held corporation, it is still a member of the affiliated group comprised of Corporations P, Q, and R. Accordingly, \$2,000,000 of the aggregate compensation paid is nondeductible. Thus, Corporations P, Q, and R are each treated as paying a ratable portion of the nondeductible compensation.

(U) *Example 21 (Affiliated group composed of three corporations, two of which are publicly held corporations)—(1) Facts.* The facts are the same as in paragraph (c)(1)(v)(T) of this section (*Example 20*), except that Corporation R is also a publicly held corporation. As in paragraph (c)(1)(v)(T) of this section (*Example 20*), Corporation Q is a publicly held corporation, Corporation P is a privately held corporation, and Employee C is a covered employee of Corporation Q but not a covered employee of Corporation R.

(2) *Conclusion.* The result is the same as in paragraph (c)(1)(v)(T) of this section

(*Example 20*). Even though Corporation R is a subsidiary that is a publicly held corporation, it is still a member of the affiliated group comprised of Corporations P, Q, and R. Accordingly, \$2,000,000 of the aggregate compensation paid is nondeductible. Thus, Corporations P, Q, and R are each treated as paying a ratable portion of the nondeductible compensation.

(V) *Example 22 (Affiliated group composed of three publicly held corporations)—(1) Facts.* The facts are the same as in paragraph (c)(1)(v)(S) of this section (*Example 19*), except that, Corporations Q and R are also publicly held corporations, and Employee C is a covered employee of both Corporations P and Q, but is not a covered employee of Corporation R.

(2) *Conclusion.* Even though Corporations Q and R are subsidiaries that are publicly held corporations and separately subject to this section, they are still members of the affiliated group comprised of Corporations P, Q, and R. Because Employee C is a covered employee of both Corporations P and Q, the determination of the amount disallowed as a deduction is prorated among Corporation P and R, and separately prorated among Corporations Q and R. With respect to Corporations P and R, \$1,100,000 of the aggregate compensation is nondeductible (the difference between the total compensation of \$2,100,000 paid by Corporations P and R and the \$1,000,000 deduction limitation). Corporations P and R are each treated as paying a ratable portion of the nondeductible compensation. Accordingly, Corporation P has a nondeductible compensation expense of \$785,714 ( $\$1,500,000 \times \$1,100,000 / \$2,100,000$ ), and Corporation R has a nondeductible compensation expense of \$314,285 ( $\$600,000 \times \$1,100,000 / \$2,100,000$ ). With respect to Corporations Q and R, \$500,000 of the aggregate compensation is nondeductible (the difference between the total compensation of \$1,500,000 paid by Corporations Q and R and the \$1,000,000 deduction limitation). Accordingly, Corporation Q has a nondeductible compensation expense of \$300,000 ( $\$900,000 \times \$500,000 / \$1,500,000$ ), and Corporation R has a nondeductible compensation expense of \$200,000 ( $\$600,000 \times \$500,000 / \$1,500,000$ ). The total amount of nondeductible compensation expense with respect to Corporation R is \$514,285.

(W) *Example 23 (Affiliated group composed of three publicly held corporations)—(1) Facts.* The facts are the same as in paragraph (c)(1)(v)(V) of this section (*Example 22*), except that Employee C does not perform any services for Corporation R and does not receive any compensation from Corporation R.

(2) *Conclusion.* Even though Corporations Q and R are subsidiaries that are publicly held corporations and separately subject to this section, they are still members of the affiliated group comprised of Corporations P, Q, and R. Because Employee C performs services only for Corporations P and Q and because Employee C is a covered employee of both Corporations P and Q, which are each a separate publicly held corporation, the determination of the amount disallowed as a deduction is made separately for each

publicly held corporation. Accordingly, Corporation P has a nondeductible compensation expense of \$500,000 (the excess of \$1,500,000 over \$1,000,000), and Corporation Q has no nondeductible compensation expense because the amount it paid to Employee C was below \$1,000,000.

(X) *Example 24 (Affiliated group composed of three corporations, one of which is a publicly held corporation)*—(1) *Facts.* The facts are the same as in paragraph (c)(1)(v)(S) of this section (*Example 19*), except that Corporation R is a direct subsidiary of Corporation P instead of being a direct subsidiary of Corporation Q.

(2) *Conclusion.* The result is the same as in paragraph (c)(1)(v)(S) of this section (*Example 19*). Corporations P, Q, and R are members of an affiliated group. Accordingly, \$2,000,000 of the aggregate compensation paid is nondeductible. Thus, Corporations P, Q, and R are each treated as paying a ratable portion of the nondeductible compensation.

(Y) *Example 25 (Affiliated group composed of three publicly held corporations)*—(1) *Facts.* The facts are the same as in paragraph (c)(1)(v)(X) of this section (*Example 24*), except that Corporations Q and R are also publicly held corporations, and Employee C is a covered employee of both Corporations P and Q.

(2) *Conclusion.* The result is the same as in paragraph (c)(1)(v)(V) of this section (*Example 22*). Even though Corporations Q and R are subsidiaries that are publicly held corporations and separately subject to this section, they are still members of the affiliated group comprised of Corporations P, Q, and R. Because Employee C is a covered employee of both Corporations P and Q, the determination of the amount disallowed as a deduction is prorated among Corporation P and R, and separately among Corporations Q and R.

(Z) *Example 26 (Disregarded entity)*—(1) *Facts.* Corporation G is a privately held corporation for its 2020 taxable year. Entity H, a limited liability company, is wholly-owned by Corporation G and is disregarded as an entity separate from its owner under § 301.7701-2(c)(2)(i). As of December 31, 2020, Entity H is required to file reports under section 15(d) of the Exchange Act.

(2) *Conclusion.* Because Entity H is required to file reports under section 15(d) of the Exchange Act and is disregarded as an entity separate from its owner Corporation G, Corporation G is a publicly held corporation under paragraph (c)(1)(iii) of this section for its 2020 taxable year.

(2) *Covered employee*—(i) *General rule.* Except as provided in paragraph (c)(2)(v) of this section, with respect to a publicly held corporation as defined in paragraph (c)(1) of this section (without regard to paragraph (c)(1)(ii) of this section), for the publicly held corporation's taxable year, a covered employee means any of the following—

(A) The principal executive officer (PEO) or principal financial officer (PFO) of the publicly held corporation serving at any time during the taxable year, including individuals acting in either such capacity.

(B) The three highest compensated executive officers of the publicly held corporation for the taxable year (other than the principal executive officer or principal financial officer, or an individual acting in such capacity), regardless of whether the executive officer is serving at the end of the publicly held corporation's taxable year, and regardless of whether the executive officer's compensation is subject to disclosure for the last completed fiscal year under the executive compensation disclosure rules under the Exchange Act. The amount of compensation used to identify the three most highly compensated executive officers for the taxable year is determined pursuant to the executive compensation disclosure rules under the Exchange Act (using the taxable year as the fiscal year for purposes of making the determination), regardless of whether the corporation's fiscal year and taxable year end on the same date.

(C) Any individual who was a covered employee of the publicly held corporation (or any predecessor of a publicly held corporation, as defined in paragraph (c)(2)(ii) of this section) for any preceding taxable year beginning after December 31, 2016. For taxable years beginning prior to January 1, 2018, covered employees are identified in accordance with the rules in § 1.162-27(c)(2).

(ii) *Predecessor of a publicly held corporation*—(A) *Publicly held corporations that become privately held.* For purposes of this paragraph (c)(2)(ii), a predecessor of a publicly held corporation includes a publicly held corporation that, after becoming a privately held corporation, again becomes a publicly held corporation for a taxable year ending before the 36-month anniversary of the due date for the corporation's U.S. Federal income tax return (disregarding any extensions) for the last taxable year for which the corporation was previously publicly held.

(B) *Corporate reorganizations.* A predecessor of a publicly held corporation includes a publicly held corporation the stock or assets of which are acquired in a corporate reorganization (as defined in section 368(a)(1)).

(C) *Corporate divisions.* A predecessor of a publicly held corporation includes a publicly held corporation that is a distributing corporation (within the meaning of section 355(a)(1)(A)) that distributes the stock of a controlled corporation (within the meaning of section 355(a)(1)(A)) to its shareholders in a distribution or exchange qualifying under section 355(a)(1) (corporate

division). The rule of this paragraph (c)(2)(ii)(C) applies only with respect to covered employees of the distributing corporation who commence the performance of services for the controlled corporation (or for a corporation affiliated with the controlled corporation that receives stock of the controlled corporation in the corporate division) within the period beginning 12 months before and ending 12 months after the distribution.

(D) *Affiliated groups.* A predecessor of a publicly held corporation includes a publicly held corporation that becomes a member of an affiliated group (as defined in paragraph (c)(1)(ii) of this section).

(E) *Asset acquisitions.* If a publicly held corporation, including one or more members of an affiliated group as defined in paragraph (c)(1)(ii) of this section (acquiror), acquires at least 80% of the operating assets (determined by fair market value on the date of acquisition) of another publicly held corporation (target), then the target is a predecessor of the acquiror. For an acquisition of assets that occurs over time, only assets acquired within a 12-month period are taken into account to determine whether at least 80% of the target's operating assets were acquired. However, this 12-month period is extended to include any continuous period that ends on, or begins on, any day during which the acquiror has an arrangement to purchase, directly or indirectly, assets of the target. Additions to the assets of target by a shareholder made as part of a plan or arrangement to avoid the application of this subsection to acquiror's purchase of target's assets are disregarded in applying this paragraph. This paragraph (c)(2)(ii)(E) applies only with respect to covered employees of the target who commence the performance of services for the acquiror (or a corporation affiliated with the acquiror) within the period beginning 12 months before and ending 12 months after the date of the transaction as defined in paragraph (c)(2)(ii)(I) of this section (incorporating any extensions to the 12-month period made pursuant to this paragraph).

(F) *Predecessor of a predecessor.* For purposes of this paragraph (c)(2)(ii), a reference to a predecessor of a corporation includes each predecessor of the corporation and the predecessor or predecessors of any prior predecessor or predecessors.

(G) *Corporations that are not publicly held at the time of the transaction and sequential transactions*—(1) *Predecessor corporation is not publicly held at the time of the transaction.* If a corporation that was previously publicly held (the

first corporation) would be a predecessor to another corporation (the second corporation) under the rules of this paragraph (c)(2)(ii) but for the fact that it is not a publicly held corporation at the time of the relevant transaction (or transactions), the first corporation is a predecessor of a publicly held corporation if the second corporation is a publicly held corporation at the time of the relevant transaction (or transactions) and the relevant transaction (or transactions) take place during a taxable year ending before the 36-month anniversary of the due date for the first corporation's U.S. Federal income tax return (excluding any extensions) for the last taxable year for which the first corporation was previously publicly held.

(2) *Second corporation is not publicly held at the time of the transaction.* If a corporation that is publicly held (the first corporation) at the time of the relevant transaction (or transactions) would be a predecessor to another corporation (the second corporation) under the rules of this paragraph (c)(2)(ii) but for the fact that the second corporation is not a publicly held corporation at the time of the relevant transaction (or transactions), the first corporation is a predecessor of a publicly held corporation if the second corporation becomes a publicly held corporation for a taxable year ending before the 36-month anniversary of the due date for the first corporation's U.S. Federal income tax return (excluding any extensions) for the first corporation's last taxable year in which the transaction is taken into account.

(3) *Neither corporation is publicly held at the time of the transaction.* If a corporation that was previously publicly held (the first corporation) would be a predecessor to another corporation (the second corporation) under the rules of this paragraph (c)(2)(ii) but for the fact that neither it nor the second corporation is a publicly held corporation at the time of the relevant transaction (or transactions), the first corporation is a predecessor of a publicly held corporation if the second corporation becomes a publicly held corporation for a taxable year ending before the 36-month anniversary of the due date for the first corporation's U.S. Federal income tax return (excluding any extensions) for the last taxable year for which the first corporation was previously publicly held.

(4) *Sequential transactions.* If a corporation that was previously publicly held (the first corporation) would be a predecessor to another corporation (the second corporation)

under the rules of this paragraph (c)(2)(ii) but for the fact that the first corporation is (or its assets are) transferred to one or more intervening corporations prior to being transferred to the second corporation, and if each intervening corporation would be a predecessor of a publicly held corporation with respect to the second corporation if the intervening corporation or corporations were publicly held corporations, then paragraphs (c)(2)(ii)(G)(1) through (3) of this section also apply without regard to the intervening corporations.

(H) *Elections under sections 336(e) and 338.* For purposes of this paragraph (c)(2), when a corporation makes an election to treat as an asset purchase either the sale, exchange, or distribution of stock pursuant to regulations under section 336(e) or the purchase of stock pursuant to regulations under section 338, the corporation that issued the stock is treated as the same corporation both before and after such transaction.

(I) *Date of transaction.* For purposes of this paragraph (c)(2)(ii), the date that a transaction is treated as having occurred is the date on which all events necessary for the transaction to be described in the relevant provision have occurred.

(J) *Publicly traded partnership.* For purposes of applying this paragraph (c)(2)(ii), a publicly traded partnership is a predecessor of a publicly held corporation if under the same facts and circumstances a corporation substituted for the publicly traded partnership would be a predecessor of the publicly held corporation, and at the time of the transaction the publicly traded partnership is treated as a publicly held corporation as defined in paragraph (c)(1)(i) of this section. In making this determination, the rules in paragraphs (c)(2)(ii)(A) through (I) of this section apply to publicly traded partnerships by analogy.

(iii) *Disregarded entities.* If a publicly held corporation under paragraph (c)(1) of this section owns an entity that is disregarded as an entity separate from its owner under § 301.7701-2(c)(2)(i) of this chapter, then the covered employees of the publicly held corporation are determined pursuant to paragraphs (c)(2)(i) and (ii) of this section. The executive officers of the entity that is disregarded as an entity separate from its corporate owner under § 301.7701-2(c)(2)(i) of this chapter are neither covered employees of the entity nor of the publicly held corporation unless they meet the definition of covered employee in paragraphs (c)(2)(i) and (ii) of this section with respect to the publicly held corporation, in which

case they are covered employees for its taxable year.

(iv) *Qualified subchapter S subsidiaries.* If a publicly held corporation under paragraph (c)(1) of this section owns an entity that is a QSub under section 1361(b)(3)(B), then the covered employees of the publicly held corporation are determined pursuant to paragraphs (c)(2)(i) and (ii) of this section. The executive officers of the QSub are neither covered employees of the QSub nor of the publicly held corporation unless they meet the definition of covered employee in paragraphs (c)(2)(i) and (ii) of this section with respect to the publicly held corporation, in which case they are covered employees for its taxable year.

(v) *Covered employee of an affiliated group.* A person who is identified as a covered employee in paragraphs (c)(2)(i) through (iv) of this section for a publicly held corporation's taxable year is also a covered employee for the taxable year of a publicly held corporation as defined in paragraph (c)(1)(ii) of this section.

(vi) *Examples.* The following examples illustrate the provisions of this paragraph (c)(2). For each example, assume that the corporation has a taxable year that is a calendar year and has a fiscal year ending December 31 for reporting purposes under the Exchange Act. Additionally, for each example, unless explicitly provided, assume that none of the employees were covered employees for any taxable year preceding the first taxable year set forth in that example (since being a covered employee for a preceding taxable year would provide a separate and independent basis for classifying that employee as a covered employee for a subsequent taxable year).

(A) *Example 1 (Covered employees of members of an affiliated group)—(1) Facts.* Corporations A, B, and C are direct wholly-owned subsidiaries of Corporation D. Corporation D is a publicly held corporation as defined in paragraph (c)(1)(i) of this section because its class of securities is required to be registered under section 12 of the Exchange Act as of December 31, 2020. Corporation A is a publicly held corporation as defined in paragraph (c)(1)(i) of this section because it is required to file reports under section 15(d) of the Exchange Act as of December 31, 2020. Corporations B and C are not publicly held corporations for their 2020 taxable years. Employee E served as the PEO of Corporation D from January 1, 2020, to March 31, 2020. Employee F served as the PEO of Corporation D from April 1, 2020, to December 31, 2020. Employee G served as the PEO of Corporation A for its entire 2020 taxable year. Employee H served as the PEO of Corporation B for its entire 2020 taxable year. Employee I served as the PEO of Corporation C for its entire 2020 taxable year. From April 1, 2020, through September 30,

2020, Employee E served as an advisor (not as a PEO) to Employee I and received compensation from Corporation C for these services. In 2020, all four corporations paid compensation to their respective PEOs.

(2) *Conclusion (Employees F and E)*. Because both Employees E and F served as the PEO during Corporation D's 2020 taxable year, both Employees E and F are covered employees for Corporation D's 2020 and subsequent taxable years. Corporations D and C are members of an affiliated group as defined in paragraph (c)(1)(ii) of this section. Because Employee E received compensation from Corporations D and C, the compensation paid by both corporations is aggregated. Any amount disallowed as a deduction by this section is prorated between Corporations D and C in proportion to the amount of compensation paid to Employee E by each corporation in 2020.

(3) *Conclusion (Employee G)*. Because Employee G served as a PEO of Corporation A, a publicly held corporation, Employee G is a covered employee of Corporation A for its 2020 and subsequent taxable years.

(4) *Conclusion (Employee H)*. Even though Employee H served as the PEO of Corporation B, Employee H is not a covered employee of Corporation B for its 2020 taxable year, because Corporation B is considered a publicly held corporation solely by reason of being a member of an affiliated group as defined in paragraph (c)(1)(ii) of this section.

(5) *Conclusion (Employee I)*. Even though Employee I served as the PEO of Corporation C, Employee I is not a covered employee of Corporation C for its 2020 taxable year, because Corporation C is considered a publicly held corporation solely by reason of being a member of an affiliated group as defined in paragraph (c)(1)(ii) of this section. The aggregation of the compensation paid to Employee E by Corporations D and C (for purposes of determining the amount of deduction disallowed by this section) is immaterial to determining whether Employee I is a covered employee of Corporation C.

(B) *Example 2 (Covered employees of a publicly held corporation)*—(1) *Facts*. Corporation J is a publicly held corporation. Corporation J is not a smaller reporting company or emerging growth company for purposes of reporting under the Exchange Act. For 2020, Employee K served as the sole PEO of Corporation J and Employees L and M both served as the PFO of Corporation J at different times during the year. Employees N, O, and P were, respectively, the first, second, and third highest compensated executive officers of Corporation J for 2020 other than the PEO and PFO, and all three retired before the end of 2020. Employees Q, R, and S were, respectively, Corporation J's fourth, fifth, and sixth highest compensated executive officers other than the PEO and PFO for 2020, and all three were serving at the end of 2020. On March 1, 2021, Corporation J filed its Form 10-K, Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 with the SEC. With respect to Item 11, Executive Compensation (as required by Part III of Form 10-K, or its successor), Corporation J disclosed the compensation of Employee K

for serving as the PEO, Employees L and M for serving as the PFO, and Employees Q, R, and S pursuant to Item 402 of Regulation S-K, 17 CFR 229.402(a)(3)(iii). Corporation J also disclosed the compensation of Employees N and O pursuant to Item 402 of Regulation S-K, 17 CFR 229.402(a)(3)(iv).

(2) *Conclusion (PEO)*. Because Employee K served as the PEO during 2020, Employee K is a covered employee for Corporation J's 2020 taxable year.

(3) *Conclusion (PFO)*. Because Employees L and M served as the PFO during 2020, Employees L and M are covered employees for Corporation J's 2020 taxable year.

(4) *Conclusion (Three Highest Compensated Executive Officers)*. Even though the executive compensation disclosure rules under the Exchange Act require Corporation J to disclose the compensation of Employees N, O, Q, R, and S for 2020, Corporation J's three highest compensated executive officers who are covered employees for its 2020 taxable year are Employees N, O, and P, because these are the three highest compensated executive officers other than the PEO and PFO for 2020.

(C) *Example 3 (Covered employees of a smaller reporting company)*—(1) *Facts*. The facts are the same as in paragraph (c)(2)(vi)(B) of this section (*Example 2*), except that Corporation J is a smaller reporting company or emerging growth company for purposes of reporting under the Exchange Act. Accordingly, with respect to Item 11, Executive Compensation (as required by Part III of Form 10-K, or its successor), Corporation J disclosed the compensation of Employee K for serving as the PEO, Employees Q and R pursuant to Item 402(m) of Regulation S-K, 17 CFR 229.402(m)(2)(ii), and Employees N and O pursuant to Item 402(m) of Regulation S-K, 17 CFR 229.402(m)(2)(iii).

(2) *Conclusion*. The result is the same as in paragraph (c)(2)(vi)(L) of this section (*Example 2*). For purposes of identifying a corporation's covered employees, it is not relevant whether the reporting obligation under the Exchange Act for smaller reporting companies and emerging growth companies apply to the corporation, nor is it relevant whether the specific executive officers' compensation must be disclosed pursuant to the disclosure rules under the Exchange Act applicable to the corporation.

(D) *Example 4 (Covered employees of a publicly held corporation that is not required to file a Form 10-K)*—(1) *Facts*. The facts are the same as in paragraph (c)(2)(vi)(B) of this section (*Example 2*), except that on February 4, 2021, Corporation J files Form 15, Certification and Notice of Termination of Registration under Section 12(g) of the Securities Exchange Act of 1934 or Suspension of Duty to File Reports under Sections 13 and 15(d) of the Securities Exchange Act of 1934 (or its successor), to terminate the registration of its securities. Corporation J's duty to file reports under Section 13(a) of the Exchange Act is suspended upon the filing of the Form 15 and, as a result, Corporation J is not required to file a Form 10-K and disclose the compensation of its executive officers for 2020.

(2) *Conclusion*. The result is the same as in paragraph (c)(2)(vi)(B) of this section (*Example 2*). Covered employees include executive officers of a publicly held corporation even if the corporation is not required to disclose the compensation of its executive officers under the Exchange Act. Therefore, Employees K, L, M, N, O, and P are covered employees for 2020. The conclusion would be different if Corporation J filed Form 15, Certification and Notice of Termination of Registration under Section 12(g) of the Securities Exchange Act of 1934 or Suspension of Duty to File Reports under Sections 13 and 15(d) of the Securities Exchange Act of 1934 (or its successor), to terminate the registration of its securities prior to December 31, 2020. In that case, Corporation J would not be a publicly held corporation for its 2020 taxable year, and, therefore, Employees K, L, M, N, O, and P would not be covered employees for Corporation J's 2020 taxable year.

(E) *Example 5 (Covered employees of two publicly held corporations after a corporate transaction)*—(1) *Facts*. Corporation T is a domestic publicly held corporation for its 2019 taxable year. Corporation U is a domestic privately held corporation for its 2019 and 2020 taxable years. On July 31, 2020, Corporation U acquires for cash 80% of the only class of outstanding stock of Corporation T. The group (comprised of Corporations U and T) elects to file a consolidated Federal income tax return. As a result of this election, Corporation T has a short taxable year ending on July 31, 2020. Corporation T does not change its fiscal year for reporting purposes under the Exchange Act to correspond to the short taxable year. Corporation T remains a domestic publicly held corporation for its short taxable year ending on July 31, 2020, and its subsequent taxable year ending on December 31, 2020, for which it files a consolidated Federal income tax return with Corporation U. For Corporation T's taxable year ending July 31, 2020, Employee V serves as the only PEO, and Employee W serves as the only PFO. Employees X, Y, and Z are the three most highly compensated executive officers of Corporation T for the taxable year ending July 31, 2020, other than the PEO and PFO. As a result of the acquisition, effective July 31, 2020, Employee V ceases to serve as the PEO of Corporation T. Instead, Employee AA begins serving as the PEO of Corporation T on August 1, 2020. Employee V continues to provide services for Corporation T and never serves as PEO again (or as an individual acting in such capacity). For Corporation T's taxable year ending December 31, 2020, Employee AA serves as the only PEO, and Employee W serves as the only PFO. Employees X, Y, and Z continue to serve as executive officers of Corporation T during the taxable year ending December 31, 2020. Employees BB, CC, and DD are the three most highly compensated executive officers of Corporation T, other than the PEO and PFO, for the taxable year ending December 31, 2020.

(2) *Conclusion (Employee V)*. Because Employee V served as the PEO during Corporation T's short taxable year ending July 31, 2020, Employee V is a covered

employee for Corporation T's short taxable year ending July 31, 2020. Furthermore, Employee V is a covered employee for Corporation T's short taxable year ending July 31, 2020, even though Employee V's compensation is required to be disclosed pursuant to the executive compensation disclosure rules under the Exchange Act only for the fiscal year ending December 31, 2020. Because Employee V was a covered employee for Corporation T's short taxable year ending July 31, 2020, Employee V is also a covered employee for Corporation T's short taxable year ending December 31, 2020.

(3) *Conclusion (Employee W)*. Because Employee W served as the PFO during Corporation T's short taxable years ending July 31, 2020, and December 31, 2020, Employee W is a covered employee for both taxable years. Furthermore, Employee W is a covered employee for Corporation T's short taxable year ending July 31, 2020, even though Employee W's compensation is required to be disclosed pursuant to the executive compensation disclosure rules under the Exchange Act only for the fiscal year ending December 31, 2020. Employee W would be a covered employee for Corporation T's short taxable year ending December 31, 2020, even if Employee W did not serve as the PFO during this taxable year because Employee W was a covered employee for Corporation T's short taxable year ending July 31, 2020.

(4) *Conclusion (Employee AA)*. Because Employee AA served as the PEO during Corporation T's short taxable year ending December 31, 2020, Employee AA is a covered employee for this taxable year.

(5) *Conclusion (Employees X, Y, and Z)*. Employees X, Y, and Z are covered employees for Corporation T's short taxable years ending July 31, 2020, and December 31, 2020. Employees X, Y, and Z are covered employees for Corporation T's short taxable year ending July 31, 2020, because these employees are the three highest compensated executive officers for this taxable year. Employees X, Y, and Z are covered employees for Corporation T's short taxable year ending December 31, 2020, because they were covered employees for Corporation T's short taxable year ending July 31, 2020. Accordingly, Employees X, Y, and Z would be covered employees for Corporation T's short taxable years ending July 31, 2020, and December 31, 2020, even if their compensation would not be required to be disclosed pursuant to the executive compensation disclosure rules under the Exchange Act.

(6) *Conclusion (Employees BB, CC, and DD)*. Employees BB, CC, and DD are covered employees for Corporation T's short taxable year ending December 31, 2020 because these employees are the three highest compensated executive officers for this taxable year.

(F) *Example 6 (Predecessor of a publicly held corporation)*—(1) *Facts*. Corporation EE is a publicly held corporation for its 2021 taxable year. Corporation EE is a privately held corporation for its 2022 and 2023 taxable years. For its 2024 taxable year, Corporation EE is a publicly held corporation.

(2) *Conclusion*. Corporation EE is a predecessor of a publicly held corporation

within the meaning of paragraph (c)(2)(ii)(A) of this section because it became a publicly held corporation for a taxable year ending prior to April 15, 2025. Therefore, for Corporation EE's 2024 taxable year, the covered employees of Corporation EE include the covered employees of Corporation EE for its 2021 taxable year and any additional covered employees determined pursuant to paragraph (c)(2) of this section.

(G) *Example 7 (Predecessor of a publicly held corporation)*—(1) *Facts*. The facts are the same as in paragraph (c)(2)(vi)(F) of this section (*Example 6*), except that Corporation EE remains a privately held corporation until it becomes a publicly held corporation for its 2027 taxable year.

(2) *Conclusion*. Corporation EE is not a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii)(A) of this section because it became a publicly held corporation for a taxable year ending after April 15, 2025. Therefore, any covered employee of Corporation EE for its 2021 taxable year is not a covered employee of Corporation EE for its 2027 taxable year due to that individual's status as a covered employee of Corporation EE for a preceding taxable year beginning after December 31, 2016 (but may be a covered employee due to status during the 2027 taxable year).

(H) *Example 8 (Predecessor of a publicly held corporation that is party to a merger)*—(1) *Facts*. On June 30, 2021, Corporation FF (a publicly held corporation) merged into Corporation GG (a publicly held corporation) in a transaction that qualifies as a reorganization under section 368(a)(1)(A), with Corporation GG as the surviving corporation. As a result of the merger, Corporation FF has a short taxable year ending June 30, 2021. Corporation FF is a publicly held corporation for this short taxable year. Corporation GG does not have a short taxable year and is a publicly held corporation for its 2021 taxable year.

(2) *Conclusion*. Corporation FF is a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii)(B) of this section. Therefore, any covered employee of Corporation FF for its short taxable year ending June 30, 2021, is a covered employee of Corporation GG for its 2021 taxable year. Accordingly, for Corporation GG's 2021 and subsequent taxable years, the covered employees of Corporation GG include the covered employees of Corporation FF (for a preceding taxable year beginning after December 31, 2016) and any additional covered employees determined pursuant to paragraph (c)(2) of this section.

(I) *Example 9 (Predecessor of a publicly held corporation that is party to a merger)*—(1) *Facts*. The facts are the same as in paragraph (c)(2)(vi)(H) of this section (*Example 8*), except that, after the merger, Corporation GG is a privately held corporation for its 2021 taxable year.

(2) *Conclusion*. Because Corporation GG is a privately held corporation for its 2021 taxable year, it is not subject to section 162(m)(1) for this taxable year.

(J) *Example 10 (Predecessor of a publicly held corporation that is party to a merger)*—(1) *Facts*. The facts are the same as in

paragraph (c)(2)(vi)(I) of this section (*Example 9*), except Corporation GG becomes a publicly held corporation on June 30, 2023, and is a publicly held corporation for its 2023 taxable year.

(2) *Conclusion*. Because Corporation GG became a publicly held corporation for a taxable year ending prior to April 15, 2025, Corporation FF is a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii)(G) of this section. Therefore, any covered employee of Corporation FF for its short taxable year ending June 30, 2021, is a covered employee of Corporation GG for its 2023 and subsequent taxable years. Accordingly, for Corporation GG's 2023 and subsequent taxable years, the covered employees of Corporation GG include the covered employees of Corporation FF (for a preceding taxable year beginning after December 31, 2016) and any additional covered employees determined pursuant to paragraph (c)(2) of this section.

(K) *Example 11 (Predecessor of a publicly held corporation that is party to a merger)*—(1) *Facts*. The facts are the same as in paragraph (c)(2)(vi)(J) of this section (*Example 10*), except that Corporation FF is a privately held corporation for its taxable year ending June 30, 2021, but was a publicly held corporation for its 2020 taxable year.

(2) *Conclusion*. Even though Corporation FF was a privately held corporation when it merged with Corporation GG on June 30, 2021, Corporation FF may still be a considered a predecessor corporation if Corporation GG becomes a publicly held corporation within a taxable year ending prior to April 15, 2024. Because Corporation GG became a publicly held corporation for a taxable year ending December 31, 2023, Corporation FF is a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii)(G) of this section. Therefore, any covered employee of Corporation FF for its 2020 taxable year is a covered employee of Corporation GG for its 2024 and subsequent taxable years. Accordingly, for Corporation GG's 2023 and subsequent taxable years, the covered employees of Corporation GG include the covered employees of Corporation FF (for a preceding taxable year beginning after December 31, 2016) and any additional covered employees determined pursuant to paragraph (c)(2) of this section.

(L) *Example 12 (Predecessor of a publicly held corporation that is party to a merger and subsequently becomes member of an affiliated group)*—(1) *Facts*. The facts are the same as in paragraph (c)(2)(vi)(I) of this section (*Example 9*). Additionally, on June 30, 2022, Corporation GG becomes a member of an affiliated group (as defined in paragraph (c)(1)(ii) of this section) that files a consolidated Federal income tax return. Corporation II is the parent corporation of the group and is a publicly held corporation. Employee HH was a covered employee of Corporation FF for its taxable year ending June 30, 2021. On July 1, 2022, Employee HH becomes an employee of Corporation II.

(2) *Conclusion*. By becoming a member of an affiliated group (as defined in paragraph (c)(1)(ii) of this section) on June 30, 2022,



Corporation GG became a publicly held corporation for a taxable year ending prior to April 15, 2025. Therefore, Corporation FF is a predecessor of a publicly held corporation (Corporation GG) within the meaning of paragraph (c)(2)(ii)(G) of this section. Furthermore, Corporation FF is a predecessor of a publicly held corporation (Corporation II) within the meaning of paragraph (c)(2)(ii)(G) of this section. Accordingly, for Corporation II's 2022 and subsequent taxable years, Employee HH is a covered employee of Corporation II because Employee HH was a covered employee of Corporation FF for its taxable year ending June 30, 2021.

(M) *Example 13 Predecessor of a publicly held corporation that is party to a merger and subsequently becomes member of an affiliated group*—(1) *Facts.* The facts are the same as in paragraph (c)(2)(vi)(L) of this section (*Example 12*), except that, Corporation FF was a privately held corporation for its taxable year ending June 30, 2021, and Employee HH was a covered employee of Corporation FF for its taxable year ending December 31, 2020.

(2) *Conclusion.* Even though Corporation FF was a privately held corporation when it merged with Corporation GG on June 30, 2021, Corporation FF may still be a considered a predecessor corporation if Corporation GG becomes a publicly held corporation for a taxable year ending prior to April 15, 2024. Because Corporation GG became a publicly held corporation for its 2022 taxable year by becoming a member of an affiliated group (as defined in paragraph (c)(1)(ii) of this section), Corporation FF is a predecessor of a publicly held corporation (Corporation GG) within the meaning of paragraph (c)(2)(ii)(G) of this section. Furthermore, Corporation FF is a predecessor of a publicly held corporation (Corporation II) within the meaning of paragraph (c)(2)(ii)(G) of this section. Therefore, any covered employee of Corporation FF for its 2020 taxable year is a covered employee of Corporation II for its 2022 and subsequent taxable years. Accordingly, for Corporation II's 2022 taxable year, Employee HH is a covered employee of Corporation II because Employee HH was a covered employee of Corporation FF for its 2020 taxable year.

(N) *Example 14 (Predecessor of a publicly held corporation that is a party to a merger)*—(1) *Facts.* Corporation JJ is a publicly held corporation for its 2019 taxable year. Corporation JJ is incorporated in State KK. On June 1, 2019, Corporation JJ formed a wholly-owned subsidiary, Corporation LL. Corporation LL is a publicly held corporation incorporated in State MM. On June 30, 2021, Corporation JJ merged into Corporation LL under State MM law in a transaction that qualifies as a reorganization under section 368(a)(1)(A), with Corporation LL as the surviving corporation. As a result of the merger, Corporation JJ has a short taxable year ending June 30, 2021. Corporation JJ is a publicly held corporation for this short taxable year.

(2) *Conclusion.* Corporation JJ is a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii)(B) of this section. Therefore, any covered employee of Corporation JJ for its short

taxable year ending June 30, 2021, is a covered employee of Corporation LL for its taxable years ending after June 30, 2021. Accordingly, for taxable years ending after June 30, 2021, the covered employees of Corporation LL include the covered employees of Corporation JJ (for a preceding taxable year beginning after December 31, 2016) and any additional covered employees determined pursuant to paragraph (c)(2) of this section.

(O) *Example 15 (Predecessor of a publicly held corporation becomes member of an affiliated group)*—(1) *Facts.* Corporations NN and OO are publicly held corporations for their 2021 and 2022 taxable years. On June 30, 2021, Corporation OO acquires for cash 100% of the only class of outstanding stock of Corporation NN. The group (comprised of Corporations NN and OO) elects to file a consolidated income tax return. As a result of this election, Corporation NN has a short taxable year ending on June 30, 2021. Corporation NN is a publicly held corporation for its taxable year ending June 30, 2021, and a privately held corporation for subsequent taxable years. On June 30, 2022, Corporation OO completely liquidates Corporation NN.

(2) *Conclusion.* After Corporation OO acquired Corporation NN, Corporations NN and OO comprised an affiliated group as defined in paragraph (c)(1)(ii) of this section. Thus, Corporation NN is a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii)(D) of this section. Therefore, any covered employee of Corporation NN for its short taxable year ending June 30, 2021, is a covered employee of Corporation OO for its taxable years ending after June 30, 2021. Accordingly, for taxable years ending after June 30, 2021, the covered employees of Corporation OO include the covered employees of Corporation NN (for a preceding taxable year beginning after December 31, 2016) and any additional covered employees determined pursuant to paragraph (c)(2) of this section.

(P) *Example 16 (Predecessor of a publicly held corporation becomes member of an affiliated group)*—(1) *Facts.* The facts are the same as in paragraph (c)(2)(vi)(O) of this section (*Example 15*), except that Corporation OO is a privately held corporation on June 30, 2021, and for its 2021 and 2022 taxable years.

(2) *Conclusion.* Because Corporation OO is a privately held corporation for its 2021 and 2022 taxable years, it is not subject to section 162(m)(1) for these taxable years.

(Q) *Example 17 (Predecessor of a publicly held corporation becomes member of an affiliated group)*—(1) *Facts.* The facts are the same as in paragraph (c)(2)(vi)(P) of this section (*Example 16*), except that on October 1, 2022, Corporation OO's Securities Act registration statement in connection with its initial public offering is declared effective by the SEC, and Corporation OO is a publicly held corporation for its 2022 taxable year.

(2) *Conclusion (Taxable Year Ending December 31, 2021).* Because Corporation OO is a privately held corporation for its 2021 taxable year, it is not subject to section 162(m)(1) for this taxable year.

(3) *Conclusion (Taxable Year Ending December 31, 2022).* For the 2022 taxable

year, Corporations NN and OO comprised an affiliated group as defined in paragraph (c)(1)(ii) of this section. Corporation NN is a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii)(D) and (F) of this section because Corporation OO became a publicly held corporation for a taxable year ending prior to April 15, 2025. Therefore, any covered employee of Corporation NN for its short taxable year ending June 30, 2021, is a covered employee of Corporation OO for its 2022 and subsequent taxable years. Accordingly, for Corporation OO's 2022 and subsequent taxable years, the covered employees of Corporation OO include the covered employees of Corporation NN (for a preceding taxable year beginning after December 31, 2016) and any additional covered employees determined pursuant to paragraph (c)(2) of this section.

(R) *Example 18 (Predecessor of a publicly held corporation and asset acquisition)*—(1) *Facts.* Corporations PP and QQ are publicly held corporations for their 2020 and 2021 taxable years. On June 30, 2021, Corporation PP acquires for cash 80% of the operating assets (determined by fair market value) of Corporation QQ. Employees RR, SS, TT, and UU were covered employees for Corporation QQ's taxable year ending December 31, 2020. On April 1, 2020, Employee RR becomes an employee of Corporation PP. On June 30, 2021, Employee SS becomes an employee of Corporation PP. On October 1, 2021, Employee TT becomes an employee of Corporation PP. On August 1, 2022, Employee UU becomes an employee of Corporation PP.

(2) *Conclusion.* Because Corporation PP acquired 80% of Corporation QQ's operating assets (determined by fair market value), Corporation QQ is a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii)(E) of this section. Therefore, any covered employee of Corporation QQ for its 2020 taxable year (who commenced services for Corporation PP within the 12 months before or the 12 months after the acquisition) is a covered employee of Corporation PP for its 2021 and subsequent taxable years. Accordingly, for Corporation PP's 2021 and subsequent taxable years, the covered employees of Corporation PP include Employees RR, SS, and TT, and any additional covered employees determined pursuant to paragraph (c)(2) of this section. Because Employee UU became an employee of Corporation PP after June 30, 2022, Employee UU is not a covered employee of Corporation PP for its 2022 taxable year, but may be a covered employee of Corporation PP by application of paragraph (c)(2) of this section to Employee UU's employment at Corporation PP.

(S) *Example 19 (Predecessor of a publicly held corporation and asset acquisition)*—(1) *Facts.* The facts are the same as in paragraph (c)(2)(vi)(R) of this section (*Example 18*), except that Corporation PP is a privately held corporation on June 30, 2021 and for its 2021 taxable year.

(2) *Conclusion.* Because Corporation PP is a privately held corporation for its 2021 taxable year, it is not subject to section 162(m)(1) for this taxable year.

(T) *Example 20 (Predecessor of a publicly held corporation and asset acquisition)—(1) Facts.* The facts are the same as in paragraph (c)(2)(vi)(S) of this section (*Example 19*), except that, on October 1, 2022, Corporation PP's Securities Act registration statement in connection with its initial public offering is declared effective by the SEC, and Corporation PP is a publicly held corporation for 2022 taxable year.

(2) *Conclusion (2021 taxable year).* Because Corporation PP is a privately held corporation for its 2021 taxable year, it is not subject to section 162(m)(1) for this taxable year.

(3) *Conclusion (2022 taxable year).* Corporation QQ is a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii)(G) of this section because Corporation PP became a publicly held corporation for a taxable year ending prior to April 15, 2025. Therefore, any covered employee of Corporation QQ for its 2020 taxable year is a covered employee of Corporation PP for its 2022 and subsequent taxable years. Accordingly, for Corporation PP's 2022 and subsequent taxable years, the covered employees of Corporation PP include the covered employees of Corporation QQ and any additional covered employees determined pursuant to paragraph (c)(2) of this section.

(U) *Example 21 (Predecessor of a publicly held corporation and asset acquisition)—(1) Facts.* Corporations VV, WW, and XX are publicly held corporations for their 2020 and 2021 taxable years. Corporations VV and WW are members of an affiliated group. Corporation WW is a direct subsidiary of Corporation VV. On June 30, 2021, Corporation VV acquires for cash 40% of the operating assets (determined by fair market value) of Corporation XX. On January 31, 2022, Corporation WW acquires an additional 40% of the operating assets (determined by fair market value) of Corporation XX. Employees YY, ZZ, and AAA are covered employees for Corporation XX's 2020 taxable year. Employees BBB and CCC are covered employees for Corporation XX's 2021 taxable year. On January 15, 2021, Employee AAA becomes an employee of Corporation WW. On July 1, 2021, Employee YY becomes an employee of Corporation WW. On February 1, 2022, Employees ZZ and BBB become employees of Corporation WW. On June 30, 2023, Employee CCC becomes an employee of Corporation WW.

(2) *Conclusion.* Because an affiliated group, comprised of Corporations VV and WW, acquired 80% of Corporation XX's operating assets (determined by fair market value), Corporation XX is a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii)(E) of this section. Therefore, any covered employee of Corporation XX for its 2020 and 2021 taxable years (who commenced services for Corporation WW within the period beginning 12 months before and ending 12 months after the acquisition), is a covered employee of Corporation WW for its 2021, 2022 and subsequent taxable years. Accordingly, for Corporation WW's 2021 and subsequent taxable years, the covered employees of Corporation WW include Employees AAA

and YY, and any additional covered employees determined pursuant to paragraph (c)(2) of this section. For Corporation WW's 2022 and subsequent taxable years, the covered employees of Corporation WW include Employees AAA, YY, ZZ and BBB, and any additional covered employees determined pursuant to paragraph (c)(2) of this section. Because Employee CCC became an employee of Corporation WW after January 31, 2023, Employee CCC is not a covered employee of Corporation WW for its 2023 taxable year, but may be a covered employee of Corporation WW by application of this paragraph (c)(2) to Employee CCC's employment at Corporation WW.

(V) *Example 22 (Predecessor of a publicly held corporation and asset acquisition)—(1) Facts.* The facts are the same as in paragraph (c)(2)(vi)(U) of this section (*Example 21*), except that Corporations VV and WW are not publicly held corporations on June 30, 2021, and for their 2021 taxable years.

(2) *Conclusion.* Because Corporations VV and WW are not publicly held corporations for their 2021 taxable years, they are not subject to section 162(m)(1) for this taxable year.

(W) *Example 23 (Predecessor of a publicly held corporation and asset acquisition)—(1) Facts.* The facts are the same as in paragraph (c)(2)(vi)(V) of this section (*Example 22*), except that, on October 1, 2022, Corporation VV's Securities Act registration statement in connection with its initial public offering is declared effective by the SEC, and Corporation VV is a publicly held corporation for its 2022 taxable year.

(2) *Conclusion (2021 taxable year).* Because Corporations VV and WW are not publicly held corporations for their 2021 taxable years, they are not subject to section 162(m)(1) for this taxable year.

(3) *Conclusion (2022 taxable year).* Corporation XX is a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii)(G) of this section because the affiliated group, comprised of Corporations VV and WW, became a publicly held corporation for a taxable year ending prior to April 15, 2024. Therefore, any covered employee of Corporation XX for its 2020 taxable year is a covered employee of Corporation WW for its 2022 taxable year. Accordingly, for Corporation WW's 2022 and subsequent taxable years, the covered employees of Corporation WW include the covered employees of Corporation XX (for a preceding taxable year beginning after December 31, 2016) and any additional covered employees determined pursuant to this paragraph (c)(2).

(X) *Example 24 (Predecessor of a publicly held corporation and a division)—(1) Facts.* Corporation DDD is a publicly held corporation for its 2021 and 2022 taxable years. On March 2, 2021, Corporation DDD forms a wholly-owned subsidiary, Corporation EEE, and transfers assets to it. On April 1, 2022, Corporation DDD distributes all shares of Corporation EEE to its shareholders in a transaction described in section 355(a)(1). On April 1, 2022, Corporation EEE's Securities Act registration statement in connection with its initial public offering is declared effective by the

SEC. Corporation EEE is a publicly held corporation for its 2022 taxable year. Employee FFF serves as the PFO of Corporation DDD from January 1, 2022, to March 31, 2022. On April 2, 2022, Employee FFF joins Corporation EEE to serve as an advisor (as a common law employee) to the PFO of Corporation EEE. After March 31, 2022, Employee FFF ceases to provide services for Corporation EEE.

(2) *Conclusion.* Because the distribution of the stock of Corporation EEE is a transaction described under section 355(a)(1), Corporation DDD is a predecessor of Corporation EEE within the meaning of paragraph (c)(2)(ii)(C) of this section. Accordingly, Corporation DDD is a predecessor of Corporation EEE within the meaning of paragraph (c)(2)(ii)(A) of this section even if Corporation EEE was a privately held corporation prior to its 2022 taxable year. Because Employee FFF was a covered employee of Corporation DDD for its 2022 taxable year, Employee FFF is a covered employee of Corporation EEE for its 2022 taxable year. The result is the same whether Employee FFF performs services for Corporation EEE as a common law employee or an independent contractor.

(Y) *Example 25 (Predecessor of a publicly held corporation and a division)—(1) Facts.* The facts are the same as in paragraph (c)(2)(vi)(X) of this section (*Example 24*), except that, Corporation DDD exchanges 100% of the shares of Corporation EEE with Corporation GGG in a transaction described in section 355(a)(1) and Corporation EEE does not register any class of securities with the SEC. Furthermore, Employee FFF performs services for Corporation GGG instead of for Corporation EEE. Corporation GGG is a privately held corporation for its 2022 taxable year. On October 1, 2023, Corporation GGG's Securities Act registration statement in connection with its initial public offering is declared effective by the SEC. Corporation GGG is a publicly held corporation for its 2023 taxable year. On January 1, 2028, Employee FFF begins serving as a director of Corporation DDD. Corporation DDD is a publicly held corporation for its 2028 taxable year.

(2) *Conclusion (2022 taxable year).* Because Corporation GGG is a privately held corporation for its 2022 taxable year, section 162(m)(1) does not limit the deduction for compensation deductible for this taxable year.

(3) *Conclusion (2023 taxable year).* Because the exchange of the stock of Corporation EEE is a transaction described under section 355(a)(1), because Corporations EEE and GGG are an affiliated group, and because Corporation GGG became a publicly held corporation for a taxable year ending prior to April 15, 2025, Corporation DDD is a predecessor of Corporation GGG within the meaning of paragraphs (c)(2)(ii)(D) and (G) of this section. Employee FFF was a covered employee of Corporation DDD for its 2022 taxable year, and began performing services for Corporation GGG following April 1, 2021, and before April 1, 2023. Therefore, Employee FFF is a covered employee of Corporation GGG for its 2023 taxable year.

(4) *Conclusion (2028 taxable year).* Because Employee FFF served as the PFO of

Corporation DDD from January 1, 2022, to March 31, 2022, Employee FFF was a covered employee of Corporation DDD for its 2022 taxable year. Because an individual who is a covered employee for a taxable year remains a covered employee for all subsequent taxable years (even after the individual has separated from service), Employee FFF is a covered employee of Corporation DDD for its 2028 taxable year.

(Z) *Example 26 (Predecessor of a publicly held corporation and a division)—(1) Facts.* The facts are the same as in paragraph (c)(2)(vi)(Y) of this section (*Example 25*), except that, Employee FFF begins performing services for Corporation GGG on June 30, 2023, instead of on April 2, 2022, and never performs services for Corporation DDD after June 30, 2023. Furthermore, on June 30, 2023, Employee HHH, a covered employee of Corporation EEE for all of its taxable years, begins performing services for Corporation GGG as an independent contractor advising its PEO but not serving as a PEO.

(2) *Conclusion (2023 taxable year).* Because the exchange of the stock of Corporation EEE is a transaction described under section 355(a)(1) and because Corporation GGG became a publicly held corporation for a taxable year ending before April 15, 2025, Corporation DDD is a predecessor of Corporation GGG within the meaning of paragraphs (c)(2)(ii)(D) and (G) of this section. Even though Employee FFF was a covered employee of Corporation DDD for its 2022 taxable year, because Employee FFF began performing services for Corporation GGG after April 1, 2023, Employee FFF is not a covered employee of Corporation GGG for its 2023 taxable year. However, if Employee FFF is a PEO, PFO, or one of the three highest compensated executives (other than the PEO or PFO) of Corporation GGG for its 2023 or subsequent taxable years, then Employee FFF is a covered employee of Corporation GGG for such taxable year (and subsequent taxable years). Because Employee HHH was a covered employee of Corporation EEE for its 2022 taxable year, Employee is a covered employee of Corporation GGG for its 2023 taxable year.

(AA) *Example 27 (Predecessor of a publicly held corporation and election under section 338(h)(10))—(1) Facts.* Corporation III is the common parent of a group of corporations filing consolidated returns that includes Corporation JJJ as a member. Corporation III wholly-owns Corporation JJJ, a publicly held corporation within the meaning of paragraph (c)(1)(i) of this section. On June 30, 2021, Corporation LLL purchases Corporation JJJ from Corporation III. Corporation III and Corporation LLL make a timely election under section 338(h)(10) with respect to the purchase of Corporation JJJ stock. For its taxable year after the purchase ending December 31, 2021, Corporation JJJ continues to be a publicly held corporation within the meaning of paragraph (c)(1)(i) of this section.

(2) *Conclusion.* As provided in paragraph (c)(2)(ii)(H), Corporation JJJ is treated as the same corporation for purposes of purposes of paragraph (c)(2). Accordingly, any covered employee of Corporation JJJ for its short taxable year ending June 30, 2021, is a covered employee of Corporation JJJ for its

short taxable year ending on December 31, 2021, and subsequent taxable years.

(BB) *Example 28 (Disregarded entity)—(1) Facts.* Corporation MMM is a privately held corporation for its 2020 taxable year. Entity NNN is a wholly-owned limited liability company and is disregarded as an entity separate from its owner, Corporation MMM, under § 301.7701-2(c)(2)(i) of this chapter. As of December 31, 2020, Entity NNN is required to file reports under section 15(d) of the Exchange Act. For the 2020 taxable year, Employee OOO is the PEO and Employee PPP is the PFO of Corporation MMM. Employees QQQ, RRR, and SSS are the three most highly compensated executive officers of Corporation MMM (other than Employees OOO and PPP). Employee TTT is the PFO of Entity NNN and does not perform any policy making functions for Corporation MMM. Entity NNN has no other executive officers.

(2) *Conclusion.* Because Entity NNN is disregarded as an entity separate from its owner, Corporation MMM, and is required to file reports under section 15(d) of the Exchange Act, Corporation MMM is a publicly held corporation under paragraph (c)(1)(iii) of this section for its 2020 taxable year. Even though Employee TTT is a PFO of Entity NNN, Employee TTT is not considered a PFO of Corporation MMM under paragraph (c)(2)(iii) of this section. As PEO and PFO, Employees OOO and PPP are covered employees of Corporation MMM under paragraph (c)(2)(i) of this section. Additionally, as the three most highly compensated executive officers of Corporation MMM (other than Employees OOO and PPP), Employees QQQ, RRR, and SSS are also covered employees of Corporation MMM under paragraph (c)(2)(i) of this section for Corporation MMM's 2020 taxable year because their compensation would be disclosed if Corporation MMM were subject to the SEC executive compensation disclosure rules. The conclusion would be the same if Entity NNN was not required to file reports under section 15(d) of the Exchange Act and Corporation MMM was a publicly held corporation pursuant to paragraph (c)(1)(i) instead of paragraph (c)(1)(iii) of this section.

(CC) *Example 29 (Disregarded entity)—(1) Facts.* The facts are the same as in paragraph (c)(2)(vi)(BB) of this section (*Example 28*), except that Employee TTT performs a policy making function for Corporation MMM. If Corporation MMM were subject to the SEC executive compensation disclosure rules, then Employee TTT would be treated as an executive officer of Corporation MMM pursuant to 17 CFR 240.3b-7 for purposes of determining the three highest compensated executive officers for Corporation MMM's 2020 taxable year. Employees QQQ, RRR and SSS are the three most highly compensated executive officers of Corporation MMM (other than Employees OOO and PPP). Employee TTT is compensated more than Employee QQQ, but less than Employees RRR and SSS.

(2) *Conclusion.* Because Entity NNN is disregarded as an entity separate from its owner, Corporation MMM, and is required to file reports under section 15(d) of the Exchange Act, Corporation MMM is a

publicly held corporation under paragraph (c)(1)(iii) of this section for its 2020 taxable year. As PEO and PFO, Employees OOO and PPP are covered employees of Corporation MMM under paragraph (c)(2)(i) of this section. Employee TTT is one of the three highest compensated executive officers for Corporation MMM's taxable year. Because Employees TTT, RRR, and SSS are the three most highly compensated executive officers of Corporation MMM (other than Employees OOO and PPP), they are covered employees of Corporation MMM under paragraph (c)(2)(i) of this section for Corporation MMM's 2020 taxable year because their compensation would be disclosed if Corporation MMM were subject to the SEC executive compensation disclosure rules. The conclusion would be the same if Entity NNN was not required to file reports under section 15(d) of the Exchange Act and Corporation MMM was a publicly held corporation pursuant to paragraph (c)(1)(i) instead of paragraph (c)(1)(iii) of this section.

(DD) *Example 30 (Individual as covered employee of a publicly held corporation that includes the affiliated group)—(1) Facts.* Corporations UUU and VVV are publicly held corporations for their 2020, 2021, and 2022 taxable years. Corporation VVV is a direct subsidiary of Corporation UUU. Employee WWW is an employee, but not a covered employee, of Corporation UUU for its 2020, 2021, and 2022 taxable years. From April 1, 2020, to September 30, 2020, Employee WWW performs services for Corporation VVV. Employee WWW does not perform any services for Corporation VVV for its 2021 and 2022 taxable years. Employee WWW is a covered employee of Corporation VVV for its 2020, 2021, and 2022 taxable years. For the 2020 taxable year, Employee WWW receives compensation for services provided to Corporations UUU and VVV only from Corporation UUU in the amount of \$1,500,000. Employee WWW receives \$2,000,000 from Corporation UUU for performing services for Corporation UUU during each of its 2021 and 2022 taxable years. On June 30, 2022, Corporation VVV pays \$500,000 to Employee WWW from a nonqualified deferred compensation plan that complies with section 409A.

(2) *Conclusion (2020 taxable year).* Because Employee WWW is a covered employee of Corporation VVV and because the affiliated group of corporations (composed of Corporations UUU and VVV) is a publicly held corporation, Employee WWW is a covered employee of the publicly held corporation that is the affiliated group pursuant to paragraph (c)(2)(v) of this section. Accordingly, compensation paid by Corporations UUU and VVV is aggregated for purposes of section 162(m)(1) and, as a result, \$500,000 of the aggregate compensation paid is nondeductible. The conclusion would be the same if Corporation UUU was a privately held corporation for its 2020 taxable year.

(3) *Conclusion (2021 taxable year).* Because Employee WWW is a covered employee of Corporation VVV pursuant to paragraph (c)(2)(i)(C) of this section and because the affiliated group of corporations (composed of Corporations UUU and VVV) is a publicly

held corporation, Employee WWW is a covered employee of the publicly held corporation that is the affiliated group pursuant to paragraph (c)(2)(v) of this section. Accordingly, compensation paid by Corporations UUU and VVV is aggregated for purposes of section 162(m)(1) and, as a result, \$1,000,000 of the aggregate compensation paid is nondeductible. The conclusion would be the same if Corporation UUU was a privately held corporation for its 2021 taxable year.

(4) *Conclusion (2022 taxable year)*. Because Employee WWW is a covered employee of Corporation VVV pursuant to paragraph (c)(2)(i)(C) of this section and because the affiliated group of corporations (composed of Corporations UUU and VVV) is a publicly held corporation, Employee WWW is a covered employee of the publicly held corporation that is the affiliated group pursuant to paragraph (c)(2)(v) of this section. Accordingly, compensation paid by Corporations UUU and VVV is aggregated for purposes of section 162(m)(1) and, as a result, \$1,500,000 of the aggregate compensation paid is nondeductible. The conclusion would be the same if Corporation UUU was a privately held corporation for its 2022 taxable year.

(EE) *Example 31 (Individual as covered employee of a publicly held corporation that includes the affiliated group)—(1) Facts*. Corporation BBBB is a publicly held corporation for its 2020 through 2022 taxable years. Corporations YYY and ZZZ are direct subsidiaries of Corporation BBBB and are privately held corporations for their 2020 through 2022 taxable years. Employee AAAA serves as the PFO of Corporation BBBB from January 1, 2020 to December 31, 2020, when Employee AAAA separates from service. On January 1, 2021, Employee AAAA commences employment with Corporation YYY. In 2021, Employee AAAA receives compensation from Corporation YYY in excess of \$1,000,000. On April 1, 2022, Employee AAAA commences employment with Corporation ZZZ. On September 30, 2022, Employee AAAA separates from service from Corporations YYY and ZZZ. In 2022, Employee AAAA receives compensation from Corporations YYY and ZZZ in excess of \$1,000,000. For the 2021 and 2022 taxable years, Employee AAAA does not serve as either the PEO or PFO of Corporations YYY and ZZZ, and is not one of the three highest compensated executive officers (other than the PEO or PFO) of Corporations YYY and ZZZ.

(2) *Conclusion (2021 taxable year)*. Employee AAAA is a covered employee of Corporation BBBB for the 2020 taxable year and subsequent taxable years. Because Employee AAAA is a covered employee of Corporation BBBB and because the affiliated group of corporations (composed of Corporations BBBB, YYY, and ZZZ) is a publicly held corporation, Employee AAAA is a covered employee of the publicly held corporation that is the affiliated group pursuant to paragraph (c)(2)(v) of this section for the 2020 taxable year and subsequent taxable years. Therefore, Corporation YYY's deduction for compensation paid to Employee AAAA for the 2021 taxable year is

subject to limitation under section 162(m)(1). The result would be the same if Corporation YYY was a publicly held corporation as defined in paragraph (c)(1)(i) of this section.

(3) *Conclusion (2022 taxable year)*. Because Employee AAAA is a covered employee of Corporation BBBB and because the affiliated group of corporations (composed of Corporations BBBB, YYY, and ZZZ) is a publicly held corporation, Employee AAAA is a covered employee of the publicly held corporation that is the affiliated group pursuant to paragraph (c)(2)(v) of this section. Therefore, Corporation YYY's and ZZZ's deduction for compensation paid to Employee AAAA for the 2022 taxable year is subject to limitation under section 162(m)(1). Because the compensation paid by all affiliated group members is aggregated for purposes of section 162(m)(1), \$1,000,000 of the aggregate compensation paid is nondeductible. Corporations YYY and ZZZ each are treated as paying a ratable portion of the nondeductible compensation. The result would be the same if either Corporation YYY or ZZZ (or both) was a publicly held corporation as defined in paragraph (c)(1)(i).

(3) *Compensation—(i) In general*. For purposes of the deduction limitation described in paragraph (b) of this section, compensation means the aggregate amount allowable as a deduction under chapter 1 of the Internal Revenue Code for the taxable year (determined without regard to section 162(m)(1)) for remuneration for services performed by a covered employee in any capacity, whether or not the services were performed during the taxable year. Compensation includes an amount that is includible in the income of, or paid to, a person other than the covered employee (including a beneficiary after the death of the covered employee) for services performed by the covered employee.

(ii) *Compensation paid by a partnership*. For purposes of paragraph (c)(3)(i) of this section, compensation includes an amount equal to a publicly held corporation's distributive share of a partnership's deduction for compensation expense attributable to the remuneration paid by the partnership for services performed by a covered employee of the publicly held corporation.

(iii) *Exceptions*. Compensation does not include—

(A) Remuneration covered in section 3121(a)(5)(A) through (D) (concerning remuneration that is not treated as wages for purposes of the Federal Insurance Contributions Act);

(B) Remuneration consisting of any benefit provided to or on behalf of an employee if, at the time the benefit is provided, it is reasonable to believe that the employee will be able to exclude it from gross income; or

(C) Salary reduction contributions described in section 3121(v)(1).

(iv) *Examples*. The following examples illustrate the provisions of this paragraph (c)(3). For each example, assume that the corporation is a calendar year taxpayer.

(A) *Example 1—(1) Facts*. Corporation Z is a publicly held corporation for its 2020 taxable year, during which Employee A serves as the PEO of Corporation Z and also serves on the board of directors of Corporation Z. In 2020, Corporation Z paid \$1,200,000 to Employee A plus an additional \$50,000 fee for serving as chair of the board of directors of Corporation Z. These amounts are otherwise deductible for Corporation Z's 2020 taxable year.

(2) *Conclusion*. The \$1,200,000 paid to Employee A in 2020 plus the additional \$50,000 director's fee paid to Employee A in 2020 are compensation within the meaning of paragraph (c)(3) of this section. Therefore, Corporation Z's \$1,250,000 deduction for the 2020 taxable year is subject to limitation under section 162(m)(1).

(B) *Example 2—(1) Facts*. Corporation X is a publicly held corporation for its 2020 through 2024 taxable years. Employee B serves as the PEO of Corporation X for its 2020 taxable year. In 2020, Corporation X established a new nonqualified retirement plan for its executive officers. The retirement plan provides for the distribution of benefits over a three-year period beginning after a participant separates from service. Employee B separates from service in 2021 and becomes a member of the board of directors of Corporation X in 2022. In 2022, Employee B receives a \$75,000 fee for services as a director and \$1,500,000 as the first payment under the retirement plan. Employee B continues to serve on the board of directors until 2023 when Employee B dies before receiving the retirement benefit for 2023 and before becoming entitled to any director's fees for 2023. In 2023 and 2024, Corporation X pays the \$1,500,000 annual retirement benefits to Person C, a beneficiary of Employee B.

(2) *Conclusion (2022 Taxable Year)*. In 2022, Corporation X paid Employee B \$1,575,000, including \$1,500,000 under the retirement plan and \$75,000 in director's fees. The retirement benefit and the director's fees are compensation within the meaning of this paragraph (c)(3). Therefore, Corporation X's \$1,575,000 deduction for the 2022 taxable year is subject to limitation under section 162(m)(1).

(3) *Conclusion (2023 and 2024 Taxable Years)*. In 2023 and 2024, Corporation X made payments to Person C of \$1,500,000 under the retirement plan. The retirement benefits are compensation within the meaning of this paragraph (c)(3). Therefore, Corporation X's deduction for each annual payment of \$1,500,000 for the 2023 and 2024 taxable years is subject to limitation under section 162(m)(1).

(D) *Example 3—(1) Facts*. Corporation T is a publicly held corporation for its 2021 taxable year. Corporation S is a privately held corporation for its 2021 taxable year. On January 2, 2021, Corporations S and T form

a general partnership. Under the partnership agreement, Corporations S and T each have a 50% share of the partnership's income, loss, and deductions. For the taxable year ending December 31, 2021, Employee D, a covered employee of Corporation T, performs services for the partnership, and the partnership pays \$800,000 to Employee D for these services, \$400,000 of which is allocated to Corporation T.

(2) *Conclusion.* Because Corporation T's distributive share of the partnership's \$400,000 deduction is attributable to the compensation paid by the partnership for services performed by Employee D, a covered employee of Corporation T, the \$400,000 is compensation within the meaning of this paragraph (c)(3) and section 162(m)(1) limits Corporation T's deduction for this expense for the 2021 taxable year. Corporation T's \$400,000 share of the partnership's deduction is aggregated with Corporation T's deduction for compensation paid to Employee D, if any, in determining the amount allowable as a deduction to Corporation T for remuneration paid to Employee D for Corporation T's 2021 taxable year. See § 1.702-1(a)(8)(iii). The result is the same whether the covered employee performs services for the partnership as a common law employee, an independent contractor, or a partner, and whether the payment for services is a payment under section 707(a) or a guaranteed payment under section 707(c).

(4) *Securities Act.* The Securities Act means the Securities Act of 1933.

(5) *Exchange Act.* The Exchange Act means the Securities Exchange Act of 1934.

(6) *SEC.* The SEC means the United States Securities and Exchange Commission.

(7) *Foreign Private Issuer.* A foreign private issuer means an issuer as defined in 17 CFR 240.3b-4(c).

(8) *American Depositary Receipt (ADR).* An American Depositary Receipt means a negotiable certificate that evidences ownership of a specified number (or fraction) of a foreign private issuer's securities held by a depository (typically, a U.S. bank).

(9) *Privately held corporation.* A privately held corporation is a corporation that is not a publicly held corporation as defined in paragraph (c)(1) of this section (without regard to paragraph (c)(1)(ii) of this section).

(d) *Corporations that become publicly held—(1) In general.* In the case of a corporation that was a privately held corporation and then becomes a publicly held corporation, the deduction limitation of paragraph (b) of this section applies to any compensation that is otherwise deductible for the taxable year ending on or after the date that the corporation becomes a publicly held corporation. A corporation is considered to become publicly held on the date that its

registration statement becomes effective either under the Securities Act or the Exchange Act. The rules in this section apply to a partnership that becomes a publicly traded partnership that is a publicly held corporation within the meaning of paragraph (c)(1)(i) of this section.

(2) *Example.* The following example illustrates the provision of this paragraph (d).

(i) *Facts.* In 2021, Corporation E plans to issue debt securities in a public offering registered under the Securities Act. Corporation E is not required to file reports under section 15(d) of the Exchange Act with respect to any other class of securities and does not have another class of securities required to be registered under section 12 of the Exchange Act. On December 18, 2021, the Securities Act registration statement for Corporation Z's debt securities is declared effective by the SEC.

(ii) *Conclusion.* Corporation E is considered to become a publicly held corporation on December 18, 2021 because it is now required to file reports under section 15(d) of the Exchange Act. The deduction limitation of paragraph (b) of this section applies to any remuneration that is otherwise deductible for Corporation E's taxable year ending on or after December 18, 2021.

(e) *Coordination with disallowed excess parachute payments under section 280G.* The \$1,000,000 limitation in paragraph (b) of this section is reduced (but not below zero) by the amount (if any) that would have been included in the compensation of the covered employee for the taxable year but for being disallowed by reason of section 280G. For example, assume that during a taxable year a corporation pays \$1,500,000 to a covered employee. Of the \$1,500,000, \$600,000 is an excess parachute payment, as defined in section 280G(b)(1), and a deduction for that excess parachute payment is disallowed by reason of section 280G(a). Because the \$1,000,000 limitation in paragraph (b) of this section is reduced by the amount of the excess parachute payment, the corporation may deduct \$400,000 (\$1,000,000 – \$600,000), and \$500,000 of the otherwise deductible amount is nondeductible by reason of section 162(m)(1). Thus \$1,100,000 (of the total \$1,500,000 payment) is nondeductible, reflecting the disallowance related to the excess parachute payment under section 280G and the application of section 162(m)(1).

(f) *Coordination with excise tax on specified stock compensation.* The \$1,000,000 limitation in paragraph (b) of this section is reduced (but not below zero) by the amount (if any) of any payment (with respect to such employee) of the tax imposed by section 4985 directly or indirectly by the

expatriated corporation (as defined in section 4985(e)(2)) or by any member of the expanded affiliated group (as defined in section 4985(e)(4)) that includes such corporation.

(g) *Transition rules—(1) Amount of compensation payable under a written binding contract which was in effect on November 2, 2017—(i) General rule.* This section does not apply to the deduction for remuneration payable under a written binding contract that was in effect on November 2, 2017, and that is not modified in any material respect on or after such date (a grandfathered amount). Instead, section 162(m), as in effect prior to its amendment by Public Law 115-97, applies to limit the deduction for such remuneration. Accordingly, because § 1.162-27 implemented section 162(m), as in effect prior to its amendment by Public Law 115-97, the rules of § 1.162-27 determine the applicability of the deduction limitation under section 162(m) with respect to the payment of a grandfathered amount. Remuneration is a grandfathered amount only to the extent that as of November 2, 2017, the corporation was and remains obligated under applicable law (for example, state contract law) to pay the remuneration under the contract if the employee performs services or satisfies the applicable vesting conditions. Accordingly, this section applies to the deduction for any amount of remuneration that exceeds the grandfathered amount if the employee performs services or satisfies the applicable vesting conditions. If a grandfathered amount and non-grandfathered amount are otherwise deductible for the same taxable year and, under the rules of § 1.162-27, the deduction of some or all of the grandfathered amount may be limited (for example, the grandfathered amount does not satisfy the requirements of § 1.162-27(e)(2) through (5) as qualified performance-based compensation), then the grandfathered amount is aggregated with the non-grandfathered amount to determine the deduction disallowance for the taxable year under section 162(m)(1) (so that the deduction limit applies to the excess of the aggregated amount over \$1 million). If a portion of the remuneration payable under a contract is a grandfathered amount and a portion is subject to this section and payment under the contract is made in a series of payments, the grandfathered amount is allocated to the first payment of an amount under the contract that is otherwise deductible. If the grandfathered amount exceeds the initial payment, the excess is allocated

to the next payment of an amount under the contract that is otherwise deductible, and this process is repeated until the entire grandfathered amount has been paid.

(ii) *Contracts that are terminable or cancelable.* If a written binding contract is renewed after November 2, 2017, this section (and not § 1.162-27) applies to any payments made after the renewal. A written binding contract that is terminable or cancelable by the corporation without the employee's consent after November 2, 2017, is treated as renewed as of the earliest date that any such termination or cancellation, if made, would be effective. Thus, for example, if the terms of a contract provide that it will be automatically renewed or extended as of a certain date unless either the corporation or the employee provides notice of termination of the contract at least 30 days before that date, the contract is treated as renewed as of the date that termination would be effective if that notice were given. Similarly, for example, if the terms of a contract provide that the contract will be terminated or canceled as of a certain date unless either the corporation or the employee elects to renew within 30 days of that date, the contract is treated as renewed by the corporation as of that date (unless the contract is renewed before that date, in which case, it is treated as renewed on that earlier date). Alternatively, if the corporation will remain legally obligated by the terms of a contract beyond a certain date at the sole discretion of the employee, the contract will not be treated as renewed as of that date if the employee exercises the discretion to keep the corporation bound to the contract. A contract is not treated as terminable or cancelable if it can be terminated or canceled only by terminating the employment relationship of the employee. A contract is not treated as renewed if upon termination or cancellation of the contract the employment relationship continues but would no longer be covered by the contract. However, if the employment continues after such termination or cancellation, payments with respect to such post-termination or post-cancellation employment are not made pursuant to the contract (and, therefore, are not grandfathered amounts).

(iii) *Compensation payable under a plan or arrangement.* If a compensation plan or arrangement is binding, the deduction for the amount that the corporation is obligated to pay pursuant to written binding contract in effect on November 2, 2017, to an employee pursuant to the plan or arrangement is

not subject to this section even if the employee was not eligible to participate in the plan or arrangement as of November 2, 2017, if the employee was employed on November 2, 2017, by the corporation that maintained the plan or arrangement, or the employee had the right to participate in the plan or arrangement under a written binding contract as of that date.

(iv) *Compensation subject to recovery by corporation.* If the corporation is obligated or has discretion to recover compensation paid in a taxable year only upon the future occurrence of a condition that is objectively outside of the corporation's control, then the corporation's right to recovery is disregarded for purposes of determining the grandfathered amount for the taxable year. If the condition occurs, only the amount the corporation is obligated to pay under applicable law remains grandfathered taking into account the occurrence of the condition. Whether or not the corporation exercises its discretion to recover any compensation does not affect the amount of compensation that the corporation remains obligated to pay under applicable law.

(2) *Material modifications*—(i) If a written binding contract is modified after November 2, 2017, this section (and not § 1.162-27) applies to any payments made after the modification. A material modification occurs when the contract is amended to increase the amount of compensation payable to the employee. If a written binding contract is materially modified, it is treated as a new contract entered into as of the date of the material modification. Thus, amounts received by an employee under the contract before a material modification are not affected, but amounts received subsequent to the material modification are treated as paid pursuant to a new contract, rather than as paid pursuant to a written binding contract in effect on November 2, 2017.

(ii) A modification of the contract that accelerates the payment of compensation is a material modification unless the amount of compensation paid is discounted to reasonably reflect the time value of money. If the contract is modified to defer the payment of compensation, any compensation paid or to be paid that is in excess of the amount that was originally payable to the employee under the contract will not be treated as resulting in a material modification if the additional amount is based on applying to the amount originally payable either a reasonable rate of interest or the rate of return on a predetermined actual investment as defined in § 31.3121(v)(2)-1(d)(2)(i)(B)

of this chapter, (whether or not assets associated with the amount originally owed are actually invested therein) such that the amount payable by the employer at the later date will be based on the reasonable rate of interest or the actual rate of return on the predetermined actual investment (including any decrease, as well as any increase, in the value of the investment).

(iii) The adoption of a supplemental contract or agreement that provides for increased compensation, or the payment of additional compensation, is a material modification of a written binding contract if the facts and circumstances demonstrate that the additional compensation to be paid is based on substantially the same elements or conditions as the compensation that is otherwise paid pursuant to the written binding contract. However, a material modification of a written binding contract does not include a supplemental payment that is equal to or less than a reasonable cost-of-living increase over the payment made in the preceding year under that written binding contract. In addition, the failure, in whole or in part, to exercise negative discretion under a contract does not result in the material modification of that contract.

(iv) If a grandfathered amount is subject to a substantial risk of forfeiture (as defined in § 1.409A-1(d)), then a modification of the contract that results in a lapse of the substantial risk of forfeiture is not considered a material modification. For compensation received pursuant to the substantial vesting of restricted property, or the exercise of a stock option or stock appreciation right that do not provide for a deferral of compensation (as defined in § 1.409A-1(b)(5)(i) and (ii)), a modification of a written binding contract in effect on November 2, 2017, that results in a lapse of the substantial risk of forfeiture (as defined in § 1.83-3(c)) is not considered a material modification.

(3) *Examples.* The following examples illustrate the provisions of this paragraph (g). For each example, assume for all relevant years that the corporation is a publicly held corporation within the meaning of paragraph (c)(1) of this section and is a calendar year taxpayer. Furthermore, assume that, for each example, if any arrangement is subject to section 409A, then the arrangement complies with section 409A, and that no arrangement is subject to section 457A.

(i) *Example 1 (Multi-year agreement for annual salary)*—(A) *Facts.* On October 2,

2017, Corporation X executed a 3-year employment agreement with Employee A for an annual salary of \$2,000,000 beginning on January 1, 2018. Employee A serves as the PFO of Corporation X for the 2017 through 2020 taxable years. The agreement provides for automatic extensions after the 3-year term for additional 1-year periods, unless the corporation exercises its option to terminate the agreement within 30 days before the end of the 3-year term or, thereafter, within 30 days before each anniversary date.

Termination of the employment agreement does not require the termination of Employee A's employment with Corporation X. Under applicable law, the agreement for annual salary constitutes a written binding contract in effect on November 2, 2017, to pay \$2,000,000 of annual salary to Employee A for three years through December 31, 2020.

(B) *Conclusion*. If this § 1.162–33 applies, Employee A is a covered employee for Corporation X's 2018 through 2020 taxable years. Because the October 2, 2017, employment agreement is a written binding contract to pay Employee A an annual salary of \$2,000,000, this section does not apply (and § 1.162–27 does apply) to the deduction for Employee A's annual salary. Pursuant to § 1.162–27(c)(2), Employee A is not a covered employee for Corporation X's 2018 through 2020 taxable years. Accordingly, the deduction for Employee A's annual salary for the 2018 through 2020 taxable years is not subject to section 162(m)(1). However, the employment agreement is treated as renewed on January 1, 2021, unless it is previously terminated, and the deduction limit of this section (and not § 1.162–27) will apply to the deduction for any payments made under the employment agreement on or after that date.

(ii) *Example 2 (Agreement for severance based on annual salary and discretionary bonus)*—(A) *Facts*. The facts are the same as in paragraph (g)(3)(i) of this section (*Example 1*), except that the employment agreement also requires Corporation X to pay Employee A severance if Corporation X terminates the employment relationship without cause within the term of the agreement. The amount of severance is equal to the sum of two times Employee A's annual salary plus two times Employee A's discretionary bonus (if any) paid within 12 months preceding termination. Under applicable law, the agreement for severance constitutes a written binding contract in effect on November 2, 2017, to pay \$4,000,000 (two times Employee A's \$2,000,000 annual salary) if Corporation X terminates Employee A's employment without cause within the term of the agreement.

(B) *Conclusion*. If this § 1.162–33 applies, Employee A is a covered employee for Corporation X's 2018 through 2020 taxable years. Because the October 2, 2017, employment agreement is a written binding contract to pay Employee A \$4,000,000 if Employee A is terminated without cause prior to December 31, 2020, this section does not apply (and § 1.162–27 does apply) to the deduction for \$4,000,000 of Employee A's severance. Pursuant to § 1.162–27(c)(2), Employee A is not a covered employee for Corporation X's 2018 through 2020 taxable years. Accordingly, the deduction for

\$4,000,000 of Employee A's severance is not subject to section 162(m)(1). However, the employment agreement is treated as renewed on January 1, 2021, unless it is previously terminated, and this section (and not § 1.162–27) will apply to the deduction for any payments made under the employment agreement, including for severance, on or after that date.

(iii) *Example 3 (Agreement for severance based on annual salary and discretionary bonus)*—(A) *Facts*. The facts are the same as in paragraph (g)(3)(ii) of this section (*Example 2*), except that, on October 31, 2017, Corporation X paid Employee A a discretionary bonus of \$10,000. Under applicable law, the agreement for severance constitutes a written binding contract in effect on November 2, 2017, to pay \$4,000,000 (two times Employee A's \$2,000,000 annual salary) if Corporation X terminates Employee A's employment without cause prior to December 31, 2020, and \$20,000 if Corporation X terminates Employee A's employment without cause prior to October 31, 2018. On June 30, 2018, Corporation X terminates Employee A without cause and makes a \$4,020,000 severance payment to Employee A.

(B) *Conclusion*. If this § 1.162–33 applies, Employee A is a covered employee for Corporation X's 2018 taxable year. Because the October 2, 2017, agreement is a written binding contract to pay Employee A \$4,000,000 if Employee A is terminated without cause prior to December 31, 2020, and \$20,000 if Corporation X terminates Employee A's employment without cause prior to October 31, 2018, this section does not apply (and § 1.162–27 does apply) to the deduction for Employee A's severance payment of \$4,020,000. Pursuant to § 1.162–27(c)(2), Employee A is not a covered employee for Corporation X's 2018 taxable year. Accordingly, the deduction for the entire \$4,020,000 of Employee A's severance payment is not subject to section 162(m)(1).

(iv) *Example 4 (Effect of discretionary bonus payment on agreement for severance based on annual salary and discretionary bonus)*—(A) *Facts*. The facts are the same as in paragraph (g)(3)(ii) of this section (*Example 2*), except that, on May 14, 2018, Corporation X paid a \$600,000 discretionary bonus to Employee A and, on April 30, 2019, terminated Employee A's employment without cause. Pursuant to the terms of the employment agreement for severance, on May 1, 2019, Corporation X made a \$5,200,000 severance payment (the sum of two times the \$2,000,000 annual salary and two times the \$600,000 discretionary bonus) to Employee A.

(B) *Conclusion*. If this § 1.162–33 applies, Employee A is a covered employee for Corporation X's 2019 taxable year. Because the October 2, 2017, agreement is a written binding contract to pay Employee A \$4,000,000 if Employee A is terminated without cause prior to December 31, 2020, this section does not apply (and § 1.162–27 does apply) to the deduction for \$4,000,000 of Employee A's severance payment. Accordingly, the deduction for \$4,000,000 of Employee A's severance payment is not subject to section 162(m)(1). Because the

October 2, 2017, agreement is not a written binding contract to pay Employee A a discretionary bonus, the deduction for \$1,200,000 (based on the discretionary bonus) of the \$5,200,000 payment is subject to this section (and not § 1.162–27).

(v) *Example 5 (Effect of adjustment to annual salary on severance)*—(A) *Facts*. The facts are the same as in paragraph (g)(3)(ii) of this section (*Example 2*), except that the employment agreement provides for discretionary increases in salary and, on January 1, 2019, Corporation X increased Employee A's annual salary from \$2,000,000 to \$2,050,000, an increase that was less than a reasonable, cost-of-living adjustment.

(B) *Conclusion (Annual salary)*: If this § 1.162–33 applies, Employee A is a covered employee for Corporation X's 2018 through 2020 taxable years. Because the October 2, 2017, agreement is a written binding contract to pay Employee A an annual salary of \$2,000,000, this section does not apply (and § 1.162–27 does apply) to the deduction for Employee A's annual salary unless the change in the salary is a material modification. Even though the \$50,000 increase is paid on the basis of substantially the same elements or conditions as the salary that is otherwise paid under the contract, the \$50,000 increase does not constitute a material modification because it is less than or equal to a reasonable cost-of-living increase to the \$2,000,000 annual salary Corporation X is required to pay under applicable law as of November 2, 2017. However, the deduction for the \$50,000 increase is subject to this section (and not § 1.162–27).

(C) *Conclusion (Severance payment)*: Because the October 2, 2017, agreement is a written binding contract to pay Employee A severance of \$4,000,000, this section would not apply (and § 1.162–27 would apply) to the deduction for this amount of severance unless the change in the employment agreement is a material modification. Even though the \$100,000 increase in severance (two times the \$50,000 increase in salary) would be paid on the basis of substantially the same elements or conditions as the severance that would otherwise be paid pursuant to the written binding contract, the \$50,000 increase in salary on which it is based does not constitute a material modification of the written binding contract since it is less than or equal to a reasonable cost-of-living increase. However, the deduction for the \$100,000 increase in severance is subject to this section (and not § 1.162–27).

(vi) *Example 6 (Effect of adjustment to annual salary on severance)*—(A) *Facts*. The facts are the same as in paragraph (g)(3)(v) of this section (*Example 5*), except that, on January 1, 2019, Corporation X increased Employee A's annual salary from \$2,000,000 to \$3,000,000, an increase that exceeds a reasonable, cost-of-living adjustment.

(B) *Conclusion (Annual salary)*: If this § 1.162–33 applies, Employee A is a covered employee for Corporation X's 2018 through 2020 taxable years. Because the October 2, 2017, agreement is a written binding contract to pay Employee A an annual salary of \$2,000,000, this section does not apply (and

§ 1.162–27 does apply) to the deduction for Employee A's annual salary unless the change in the employment agreement is a material modification. The \$1,000,000 increase is a material modification of the written binding contract because the additional compensation is paid on the basis of substantially the same elements or conditions as the compensation that is otherwise paid pursuant to the written binding contract, and it exceeds a reasonable, annual cost-of-living increase from the \$2,000,000 annual salary for 2018 that Corporation X is required to pay under applicable law as of November 2, 2017. Because the written binding contract is materially modified as of January 1, 2019, the deduction for all annual salary paid to Employee A in 2019 and thereafter is subject to this section (and not § 1.162–27).

(C) *Conclusion (Severance payment)*: Because the October 2, 2017, agreement is a written binding contract to pay Employee A severance of \$4,000,000, this section would not apply (and § 1.162–27 would apply) to the deduction for this amount of severance unless the change in the employment agreement is a material modification. The additional \$2,000,000 (two times the \$1,000,000 increase in annual salary) constitutes a material modification of the written binding contract because the \$1,000,000 increase in salary on which it is based constitutes a material modification of the written binding contract since it exceeds a reasonable cost-of-living increase from the \$2,000,000 annual salary for 2018 that Corporation X is required to pay under applicable law as of November 2, 2017. Because the agreement is materially modified as of January 1, 2019, the deduction for any amount of severance payable to Employee A under the severance agreement is subject to this section (and not § 1.162–27).

(vii) *Example 7 (Elective deferral of an amount that corporation was obligated to pay under applicable law)*—(A) *Facts*. The facts are the same as in paragraph (g)(3)(i) of this section (*Example 1*), except that, on December 15, 2018, Employee A makes a deferral election under a NQDC plan to defer \$200,000 of annual salary earned and payable in 2019. Pursuant to the deferred compensation agreement, the \$200,000, including earnings, is to be paid in a lump sum at Employee A's separation from service. The earnings are based on the Standard & Poor's 500 Index. Under applicable law, pursuant to the written binding contract in effect on November 2, 2017, (and absent the deferral agreement) Corporation X would have been obligated to pay \$200,000 to Employee A in 2019, but is not obligated to pay any earnings on the \$200,000 deferred pursuant to the deferral election Employee A makes on December 15, 2018. Employee A separates from service on December 15, 2020. On December 15, 2020, Corporation X pays \$250,000 (the deferred \$200,000 of salary plus \$50,000 in earnings).

(B) *Conclusion*. If this § 1.162–33 applies, Employee A is a covered employee for Corporation X's 2020 taxable year. Employee A's deferred compensation agreement is not a material modification of the written binding contract in effect on November 2,

2017, because the earnings to be paid under the deferred compensation agreement are based on a predetermined actual investment (as defined in § 31.3121(v)(2)–1(d)(2)(i)(B)). The deduction for the \$50,000 of earnings to be paid that exceed the amount originally payable to Employee A under the written binding contract (\$200,000 of salary) are subject to this section (and not § 1.162–27). This section does not apply (and § 1.162–27 does apply) to the deduction for the \$200,000 portion of the \$250,000 payment because Corporation X was obligated under applicable law to pay as of November 2, 2017. Pursuant to § 1.162–27(c)(2), Employee A is not a covered employee for Corporation X's 2020 taxable year; thus, the deduction for the \$200,000 payment is not subject to section 162(m)(1).

(viii) *Example 8 (Compensation subject to mandatory recovery by corporation)*—(A) *Facts*. Employee B serves as the PFO of Corporation Z for its 2017 through 2019 taxable years. On October 2, 2017, Corporation Z executed a bonus agreement with Employee B that provides for a performance bonus of \$3,000,000 to be paid on May 1, 2019, if Corporation Z's net earnings increase by at least 10% for its 2018 taxable year based on the financial statements filed with the SEC. The agreement prohibits Corporation Z from reducing the amount of the bonus for any reason but provides that, if the bonus is paid and subsequently the financial statements are restated to show that the net earnings did not increase by at least 10%, then Corporation Z shall recover the \$3,000,000 from Employee B within six months of the restatement. Under applicable law, the agreement for the performance bonus constitutes a written binding contract in effect on November 2, 2017, to pay \$3,000,000 to Employee B if Corporation Z's net earnings increase by at least 10% for its 2018 taxable year based on the financial statements filed with the SEC. On May 1, 2019, Corporation Z pays \$3,000,000 to Employee B because its net earnings increased by at least 10% of its 2018 taxable year.

(B) *Conclusion*. If this § 1.162–33 applies, Employee B is a covered employee for Corporation Z's 2019 taxable year. The terms of the contract providing for recovery of the \$3,000,000 do not preclude Corporation Z from being contractually obligated under applicable law to pay \$3,000,000 to Employee B if the net earnings increase by at least 10% for its 2018 taxable year. Because the October 2, 2017, agreement is a written binding contract to pay Employee B \$3,000,000 if Corporation Z's net earnings increase by at least 10% for its 2018 taxable year based on the financial statements filed with the SEC, this section does not apply (and § 1.162–27 does apply) to the deduction for the \$3,000,000 payment. Pursuant to § 1.162–27(c)(2), Employee B is not a covered employee for Corporation Z's 2019 taxable year, so the deduction for the \$3,000,000 payment is not subject to section 162(m)(1).

(ix) *Example 9 (Compensation subject to discretionary recovery by corporation)*—(A) *Facts*. The facts are the same as in paragraph (g)(3)(viii) of this section (*Example 8*), except that the agreement provides that, if the

financial statements are restated to show that the net earnings did not increase by at least 10%, then Corporation Z may, in its discretion, recover all or a portion of the \$3,000,000 bonus from Employee B within six months of the restatement. Under applicable law, the agreement constitutes a written binding contract in effect on November 2, 2017, to pay \$3,000,000 to Employee B if the conditions are met. However, under applicable law, taking into account the employer's ability to exercise discretion and the employer's past exercise of such discretion with respect to a recovery in the event of an earnings restatement, on November 2, 2017, the bonus plan is a written binding contract only with respect to \$500,000 if Corporation Z's financial statements are restated to show that the net earnings did not increase by at least 10%. On May 1, 2019, Corporation Z pays \$3,000,000 to Employee B. On July 1, 2019, Corporation Z's financial statements are restated to show that its net earnings did not increase by at least 10% for its 2018 taxable year. On July 30, 2019, Corporation Z recovers \$1,000,000 from Employee B.

(B) *Conclusion*. If this § 1.162–33 applies, Employee B is a covered employee for Corporation Z's 2019 taxable year. Because the October 2, 2017, agreement is a written binding contract to pay Employee B \$3,000,000 if the applicable conditions are met, this section does not apply (and § 1.162–27 does apply) to the deduction for the \$3,000,000 provided Corporation Z's financial statements are not restated to show that its net earnings did not increase by at least 10%. However, because Corporation Z's financial statements were so restated, then, on November 2, 2017, under applicable law, taking into account the employer's ability to exercise discretion and the employer's past exercise of such discretion, the bonus plan constitutes a written binding contract to pay only \$500,000. Because Corporation Z recovered \$1,000,000 of the \$3,000,000 payment, this section does not apply (and § 1.162–27 does apply) to the deduction for \$500,000 of the \$2,000,000 that Corporation Z did not recover. Pursuant to § 1.162–27(c)(2), Employee B is not a covered employee for Corporation Z's 2019 taxable year, so the deduction for the \$500,000 is not subject to section 162(m)(1). The deduction for the remaining \$1,500,000 is subject to this section (and not § 1.162–27).

(x) *Example 10 (Compensation subject to discretionary recovery by corporation based on a condition)*—(A) *Facts*. The facts are the same as in paragraph (g)(3)(viii) of this section (*Example 8*), except that the agreement does not include a provision regarding an earnings restatement. Instead, the agreement provides that Corporation Z may, in its discretion, require Employee B to repay the \$3,000,000 bonus if, within three years from the date of payment, Employee B engages in willful or reckless behavior that has a material adverse impact on Corporation Z, or is convicted of, or pleads *nolo contendere* or guilty to a felony. Under applicable law, the agreement constitutes a written binding contract in effect on November 2, 2017, to pay \$3,000,000 to Employee B if the conditions are met.



However, under applicable law, taking into account the employer's ability to exercise discretion and the employer's past exercise of such discretion, if conditions arise to permit Corporation Z to recover the \$3,000,000 bonus from Employee B, then the bonus plan established on October 2, 2017, constitutes a written binding contract to pay only \$2,000,000 to Employee B if Corporation Z's net earnings increase by at least 10% for its 2018 taxable year based on the financial statements filed with the SEC. On May 1, 2019, Corporation Z pays \$3,000,000 to Employee B. Prior to May 1, 2022, Employee B does not engage in willful or reckless behavior that has a material adverse impact on Corporation Z, and is not convicted of, or plead *nolo contendere* or guilty to a felony.

(B) *Conclusion.* If this § 1.162–33 applies, Employee B is a covered employee for Corporation Z's 2019 taxable year. Because the October 2, 2017, agreement is a written binding contract under applicable law to pay Employee B \$3,000,000 if the applicable conditions are met, this section does not apply (and § 1.162–27 does apply) to the deduction for the \$3,000,000. Pursuant to § 1.162–27(c)(2), Employee B is not a covered employee for Corporation Z's 2019 taxable year, so the deduction for the \$3,000,000 is not subject to section 162(m)(1).

(xi) *Example 11 (Compensation subject to discretionary recovery by corporation based on a condition)*—(A) *Facts.* The facts are the same as in paragraph (g)(3)(x) of this section (*Example 10*), except that, on April 1, 2021, Employee B pleads guilty to a felony. Because Employee B pled guilty to a felony prior to May 1, 2022, Corporation Z has discretion to recover the \$3,000,000 bonus from Employee B. Corporation Z chooses not to recover any amount of the \$3,000,000 from Employee B.

(B) *Conclusion.* If this § 1.162–33 applies, Employee B is a covered employee for Corporation Z's 2019 taxable year. Because Employee B pled guilty to a felony prior to May 1, 2022, the bonus plan constitutes a written binding contract in effect on November 2, 2017, to pay only \$2,000,000 to Employee B if the applicable conditions were met. Accordingly, this section does not apply (and § 1.162–27 does apply) to the deduction for the \$2,000,000 portion of the \$3,000,000. Pursuant to § 1.162–27(c)(2), Employee B is not a covered employee for Corporation Z's 2019 taxable year; thus, the deduction for the \$2,000,000 portion of the \$3,000,000 is not subject to section 162(m)(1). The deduction for the remaining \$1,000,000 of the \$3,000,000 is subject to this section (and not § 1.162–27).

(xii) *Example 12 (Election to defer bonus)*—(A) *Facts.* On December 31, 2015, Employee C, an employee of Corporation Y, makes an election under a NQDC plan to defer the entire amount that would otherwise be paid to Employee C on December 31, 2016, under Corporation Y's 2016 annual bonus plan. Pursuant to the NQDC plan, the earnings on the deferred amount may be based on either of the following two investment choices (but not the greater of the two): Annual total shareholder return for Corporation Y or Moody's Average Corporate Bond Yield. On a prospective basis,

Employee C may change the investment measure. The deferred amount and the earnings thereon are to be paid in a lump sum at Employee C's separation from service. Employee C initially elects to have earnings based on annual total shareholder return for Corporation Y. On December 31, 2018, Employee C elects to have earnings based on Moody's Average Corporate Bond Yield. The bonus plan provides that Corporation Y may not reduce the bonus or any applicable earnings. Employee C earns a \$200,000 bonus for the 2016 taxable year. Under applicable law, the deferred compensation agreement constitutes a written binding contract in effect on November 2, 2017, to pay the \$200,000 bonus plus earnings. Specifically, Corporation Y is obligated to pay earnings on the \$200,000 deferred pursuant to the deferral election Employee C makes on December 31, 2015. On January 1, 2018, Employee C is promoted to serve as PEO of Corporation Y and becomes a covered employee for the first time. On December 15, 2020, Employee C separates from service and Corporation Y pays \$225,000 (the deferred \$200,000 bonus plus \$25,000 in earnings) to Employee C.

(B) *Conclusion.* If this § 1.162–33 applies, Employee C is a covered employee for Corporation Y's 2020 taxable year because Employee C served as the PEO of Corporation Y during the taxable year. The December 31, 2015, agreement is a written binding contract to pay the \$200,000 bonus plus earnings. Furthermore, Employee C's December 31, 2018, election to change the earnings measure does not constitute a material modification. Accordingly, this section does not apply (and § 1.162–27 does apply) to the deduction for the \$225,000 payment from Corporation Y to Employee C. Pursuant to § 1.162–27(c)(2), Employee C is not a covered employee because Employee C did not serve as the PEO at the close of the Corporation Y's taxable year, so the deduction for the \$225,000 payment is not subject to section 162(m)(1).

(xiii) *Example 13 (Nonaccount balance plan)*—(A) *Facts.* On November 2, 2012, Employee D commences employment with Corporation W as its PFO. Employee D separates from service as PFO on January 7, 2020. For each taxable year, Employee D receives a base salary of \$2,000,000. On January 1, 2016, Corporation W and Employee D enter into a NQDC arrangement that is a nonaccount balance plan (as defined in § 1.409A–1(c)(2)(i)(C)). Under the terms of the plan, Corporation W will pay Employee D a lump sum payment equal to 25% of Employee D's base salary in the year of separation from service multiplied by 1/12 for each month of service. The plan provides that this payment will be made six months after separation from service and that Corporation W may, at any time, amend the plan to reduce the amount of future benefits; however, Corporation W may not reduce the benefit accrued prior to the date of the amendment. Furthermore, under the terms of the plan and in accordance with § 1.409A–3(j)(4)(ix)(C)(3), if Corporation W terminates the plan, the payments due under the plan may be accelerated to any date no earlier than 12 months after the date of termination

and no later than 24 months after the date of termination. Under applicable law, if an employer terminates a NQDC plan and does not make a payment until 12 months after the date of termination, then, to reflect the time value of money, the employer is obligated to pay a reasonable rate of interest (compounded annually) on any benefit accrued under the plan at the date of termination until the date of payment. Assume for this purpose that for all applicable periods 3% is a reasonable rate of interest. As of November 2, 2017, Employee D has 60 months of service for Corporation W as calculated under the NQDC plan terms. Under applicable law, the plan constitutes a written binding contract in effect on November 2, 2017, to pay \$2,575,000. The \$2,575,000 is equal to the amount Corporation W is obligated to pay if it terminated the plan on November 2, 2017 ( $25\% \times \$2,000,000 \times 1/12 \times 60$  months of service (\$2,500,000), plus a 3% reasonable rate of interest that the \$2,500,000 earns after plan termination (\$75,000)). On January 7, 2020, when Employee D separates from service, Corporation D pays \$3,583,333.33 ( $25\% \times \$2,000,000 \times 1/12 \times 86$  months of service).

(B) *Conclusion.* If this § 1.162–33 applies, Employee D is a covered employee for Corporation W's 2020 taxable year. Because, as of November 2, 2017, the plan is a written binding contract with respect to \$2,575,000, this section does not apply (and § 1.162–27 does apply) to the deduction for the \$2,575,000 portion of the \$3,583,333.33 payment. Pursuant to § 1.162–27(c)(2), Employee D is not a covered employee, so the deduction for the \$2,575,000 portion of the \$3,583,333.33 payment is not subject to section 162(m)(1). The deduction for the remaining \$1,008,333.33 portion of the \$3,583,333.33 payment is subject to this section (and not § 1.162–27).

(xiv) *Example 14 (Nonaccount balance plan with offset)*—(A) *Facts.* The facts are the same as in paragraph (g)(3)(xiii) of this section (*Example 13*), except that the plan provides that the amount to be paid to an employee is decreased by the employee's account balance in Corporation W's 401(k) plan on the date of separation from service. The terms of the offset comply with section 409A. On November 2, 2017, and July 7, 2020, Employee D's account balance in the 401(k) plan is \$500,000 and \$600,000, respectively. Under applicable law, the NQDC plan constitutes a written binding contract in effect on November 2, 2017, to pay \$2,075,000, which is equal to the amount of remuneration Corporation W is obligated to pay if it terminated the NQDC plan on November 2, 2017. The \$2,075,000 is the difference between the \$500,000 401(k) plan account balance on November 2, 2017, and the \$2,500,000 accumulated benefit ( $25\% \times \$2,000,000 \times 1/12 \times 60$  months of service), plus the 3% interest that the \$2,500,000 earns after plan termination (\$75,000). On July 7, 2020, under the terms of the NQDC plan, Corporation D pays \$2,983,333.33 (the difference between the \$600,000 401(k) account balance on July 7, 2020, and \$3,583,333.33 ( $25\% \times \$2,000,000 \times 1/12 \times 86$  months of service)).

(B) *Conclusion.* If this § 1.162–33 applies, Employee D is a covered employee for Corporation W's 2020 taxable year. Because, as of November 2, 2017, the plan is a written binding contract with respect to \$2,075,000, this section does not apply (and § 1.162–27 does apply) to the deduction for \$2,075,000 of the \$2,983,333.33 payment. Pursuant to § 1.162–27(c)(2), Employee D is not a covered employee, so the deduction for the \$2,075,000 portion of the \$2,983,333.33 payment is not subject to section 162(m)(1). The deduction for the remaining \$908,333.33 portion of the \$2,983,333.33 payment is subject to this section (and not § 1.162–27).

(xv) *Example 15 (Nonaccount balance plan)*—(A) *Facts.* The facts are the same as in paragraph (g)(3)(xiii) of this section (*Example 13*), except that the nonaccount balance plan provides that Corporation W will pay Employee D a lump sum payment of \$5,000,000 on November 7, 2020, if Employee D provides services from January 1, 2016, through June 30, 2017. Under applicable law, the plan constitutes a written binding contract in effect on November 2, 2017, to pay \$4,712,979.55, which is the sum of \$4,575,708.30 (the amount of remuneration Corporation W is obligated to pay if it reduced the amount of future benefits to \$0 on November 2, 2017) and the increase in present value of \$137,271.55 (the difference between \$4,575,708.30 and \$4,712,979.55 (the present value of \$5,000,000 on November 2, 2018)). On November 7, 2020, Corporation W makes a lump sum payment of \$5,000,000 to Employee D.

(B) *Conclusion.* If this § 1.162–33 applies, Employee D is a covered employee for Corporation W's 2020 taxable year. Because, as of November 2, 2017, the plan is a written binding contract with respect to \$4,712,979.55, this section does not apply (and § 1.162–27 does apply) to the deduction for the \$4,712,979.55 portion of the \$5,000,000 payment. Pursuant to § 1.162–27(c)(2), Employee D is not a covered employee, so the deduction for the \$4,712,979.55 portion of the \$5,000,000 payment is not subject to section 162(m)(1). The deduction for the remaining \$287,020.45 portion of the \$5,000,000 payment is subject to this section (and not § 1.162–27).

(xvi) *Example 16 (Performance bonus plan with negative discretion)*—(A) *Facts.* Employee E serves as the PEO of Corporation V for the 2017 and 2018 taxable years. On February 1, 2017, Corporation V establishes a bonus plan, under which Employee E will receive a cash bonus of \$1,500,000 if a specified performance goal is satisfied. The compensation committee retains the right, if the performance goal is met, to reduce the bonus payment to no less than \$400,000 if, in its judgment, other subjective factors warrant a reduction. On November 2, 2017, under applicable law which takes into account the employer's ability to exercise negative discretion, the bonus plan established on February 1, 2017, constitutes a written binding contract to pay \$400,000. On March 1, 2018, the compensation committee certifies that the performance goal was satisfied, but exercises its discretion to reduce the award to \$500,000. On April 1,

2018, Corporation V pays \$500,000 to Employee E. The payment satisfies the requirements of § 1.162–27(e)(2) through (5) as qualified performance-based compensation.

(B) *Conclusion.* If this § 1.162–33 applies, Employee E is a covered employee for Corporation V's 2018 taxable year. Because the February 1, 2017, plan is a written binding contract to pay Employee E \$400,000 if the performance goal is satisfied, this section does not apply (and § 1.162–27 does apply) to the deduction for the \$400,000 portion of the \$500,000 payment. Furthermore, the failure of the compensation committee to exercise its discretion to reduce the award further to \$400,000, instead of \$500,000, does not result in a material modification of the contract. Pursuant to § 1.162–27(e)(1), the deduction for the \$400,000 payment is not subject to section 162(m)(1) because the payment satisfies the requirements of § 1.162–27(e)(2) through (5) as qualified performance-based compensation. The deduction for the remaining \$100,000 of the \$500,000 payment is subject to this section (and not § 1.162–27) and therefore the status as qualified performance-based compensation is irrelevant to the application of section 162(m)(1) to this remaining portion.

(xvii) *Example 17 (Account balance plan)*—(A) *Facts.* Employee F serves as the PFO of Corporation U for the 2016 through 2018 taxable years. On January 4, 2016, Corporation U and Employee F enter into a NQDC arrangement that is an account balance plan. Under the terms of the plan, Corporation A will pay Employee X's account balance on June 30, 2019, but only if Employee F continues to serve as the PFO through December 31, 2018. Pursuant to the terms of the plan, Corporation U credits \$100,000 to Employee F's account annually on December 31 of each year for three years beginning on December 31, 2016, and credits earnings and losses on the account balance daily. The plan also provides that Corporation U may, in its discretion and at any time, amend the plan either to stop or to reduce the amount of future credits; however, Corporation U may not reduce Employee F's account balance credited before the date of any such amendment. Under the terms of the plan and in accordance with § 1.409A–3(j)(4)(ix)(C)(3), if Corporation U terminates the plan, the payment under the plan may be accelerated, but may not be made within 12 months of the date of termination. Under the plan terms and applicable law, if Corporation U terminates the plan, then it is obligated to pay any earnings that accumulated through the date of payment. Under applicable law, the plan constitutes a written binding contract in effect on November 2, 2017, to pay \$100,000 of remuneration that Corporation U credited to the account balance on December 31, 2016, plus any earnings credited on that amount through November 2, 2018, which is equal to the amount Corporation U is obligated to pay if it terminates the plan on November 2, 2017 (i.e., after that date, Corporation U is obligated to credit earnings but not any further contributions). On November 2, 2017, Employee E's account balance under the plan

is \$110,000. On November 2, 2018, Employee E's account balance under the plan would be \$115,000 (the \$110,000 account balance on November 2, 2017, plus \$5,000 earnings on that amount). On June 30, 2019, Corporation U pays Employee F \$350,000, the account balance on June 30, 2019.

(B) *Conclusion.* If this § 1.162–33 applies, Employee F is a covered employee for Corporation U's 2019 taxable year because Employee F served as the PFO of Corporation U during the taxable year. Because the January 4, 2016, agreement constitutes a written binding contract to pay \$115,000, this section does not apply (and § 1.162–27 does apply) to the deduction for the \$115,000 portion of the \$350,000. Pursuant to § 1.162–27(c)(2), Employee F is not a covered employee of Corporation U for the 2019 taxable year, so the deduction for the \$115,000 portion of the \$350,000 is not subject to section 162(m)(1). The deduction for the remaining \$235,000 portion of the payment is subject to this section (and not § 1.162–27).

(xviii) *Example 18 (Effect of increasing credits to an account balance plan)*—(A) *Facts.* The facts are the same as in paragraph (g)(3)(xvii) of this section (*Example 17*), except that on January 1, 2018, Corporation U increased the amount it would credit to Employee F's account on December 31, 2018 to \$200,000. The amount of the increase exceeds a reasonable, annual cost-of-living increase. On June 30, 2019, Corporation U pays Employee F the account balance of \$455,000 (including earnings).

(B) *Conclusion.* If this § 1.162–33 applies, Employee F is a covered employee for Corporation U's 2019 taxable year. The January 1, 2018 increase in the amount credited to the account balance plan is a material modification of the plan because the additional compensation (the excess of \$200,000 over \$100,000) credited under the plan is credited on the basis of substantially the same elements or conditions as the compensation that would otherwise be credited pursuant to the plan (\$100,000), and it exceeds a reasonable, annual cost-of-living increase. Because the plan is materially modified as of January 1, 2018, and all payments under the plan are made on or after January 1, 2018, the deduction for all payments under the plan is subject to this section (and not § 1.162–27).

(xix) *Example 19 (Equity-based compensation with underlying grants made prior to November 2, 2017)*—(A) *Facts.* On January 2, 2017, Corporation T executed a 4-year employment agreement with Employee G to serve as its PEO, and Employee G serves as the PEO for the four-year term. Pursuant to the employment agreement, on January 2, 2017, Corporation T executed a grant agreement and granted to Employee G nonqualified stock options to purchase 1,000 shares of Corporation T stock, stock appreciation rights (SARs) on 1,000 shares, and 1,000 shares of Corporation T restricted stock. On the date of grant, the stock options had no readily ascertainable fair market value as defined in § 1.83–7(b), and neither the stock options nor the SARs provided for a deferral of compensation under §§ 1.409A–1(b)(5)(i)(A) and (B). The stock options,

SARs, and shares of restricted stock are subject to a substantial risk of forfeiture and all substantially vest on January 2, 2020. Employee G may exercise the stock options and the SARs at any time from January 2, 2020, through January 2, 2027. On January 2, 2020, Employee G exercises the stock options and the SARs, and the 1,000 shares of restricted stock become substantially vested (as defined in § 1.83-3(b)). The grant agreement pursuant to which grants of the stock options, SARs, and shares of restricted stock are made constitutes a written binding contract under applicable law. The compensation attributable to the stock options and the SARs satisfy the requirements of § 1.162-27(e)(2) through (5) as qualified performance-based compensation.

(B) *Conclusion.* If this § 1.162-33 applies, Employee G is a covered employee for Corporation T's 2020 taxable year. Because the January 2, 2017, grant agreement constitutes a written binding contract, this section does not apply (and § 1.162-27 does apply) to the deduction for compensation received pursuant to the exercise of the stock options and the SARs, or the restricted stock becoming substantially vested (as defined in § 1.83-3(b)). Pursuant to § 1.162-27(e)(1), the deduction attributable to the stock options and the SARs is not subject to section 162(m)(1) because the compensation satisfies the requirements of § 1.162-27(e)(2) through (5) as qualified performance-based compensation. However, the deduction attributable to the restricted stock is subject to section 162(m)(1) because the compensation does not satisfy the requirements of § 1.162-27(e)(2) through (5) as qualified performance-based compensation.

(xx) *Example 20 (Equity-based compensation with underlying grants made prior to November 2, 2017 for which vesting is accelerated)*—(A) *Facts.* The facts are the same as in paragraph (g)(3)(xix) of this section (*Example 19*), except that, on December 31, 2018, Corporation T modifies the grant agreement pursuant to which grants are made to provide that the stock options, SARs, and shares of Corporation T restricted stock are vested as of January 2, 2019. On January 3, 2019, Employee G exercises the stock options and the SARs.

(B) *Conclusion.* If this § 1.162-33 applies, Employee G is a covered employee for Corporation T's 2019 taxable year. The modification of the January 2, 2017, grant agreement is not a material modification. Because the January 2, 2017, agreement under which grants were made constitutes a written binding contract, this section does not apply (and § 1.162-27 does apply) to the deduction for compensation received pursuant to the exercise of the stock options and the SARs, or the restricted stock becoming vested. Pursuant to § 1.162-27(e)(2)(iii)(B), the acceleration of substantial vesting of the stock options and SARs is not an impermissible increase in compensation to disqualify the compensation attributable to the stock options and SARs from satisfying the requirements of § 1.162-27(e)(2) through (5) as qualified performance-based compensation, so the deduction attributable

to the stock options and the SARs is not subject to section 162(m)(1). However, the deduction attributable to the restricted stock is subject to section 162(m)(1) because the compensation does not satisfy the requirements of § 1.162-27(e)(2) through (5) as qualified performance-based compensation.

(xxi) *Example 21 (Plan in which an employee is not a participant on November 2, 2017)*—(A) *Facts.* On October 2, 2017, Employee H executes an employment agreement with Corporation Y to serve as its PFO, and commences employment with Corporation Y. The employment agreement, which is a written binding contract under applicable law, provides that if Employee H continues in his position through April 1, 2018, Employee H will become eligible to participate in the NQDC plan of Corporation Y and that Employee H's benefit accumulated on that date will be \$3,000,000. On April 1, 2021, Employee H receives a payment of \$4,500,000 (the increase from \$3,000,000 to \$4,500,000 is not a result of a material modification as defined in paragraph (g)(2) of this section), which is the entire benefit accumulated under the plan through the date of payment.

(B) *Conclusion.* If this § 1.162-33 applies, Employee H is a covered employee for Corporation Y's 2021 taxable year. Even though Employee H was not eligible to participate in the NQDC plan on November 2, 2017, Employee H had the right to participate in the plan under a written binding contract as of that date. Because the amount required to be paid pursuant to the written binding contract is \$3,000,000, this section does not apply (and § 1.162-27 does apply) to the deduction for the \$3,000,000 portion of the \$4,500,000. Pursuant to § 1.162-27(c)(2), Employee H is not a covered employee of Corporation Y for the 2021 taxable year. Accordingly, the deduction for the \$3,000,000 portion of the \$4,500,000 is not subject to section 162(m)(1). The deduction for the remaining \$1,500,000 portion of the payment is subject to this section (and not § 1.162-27).

(xxii) *Example 22 (Material modification of annual salary)*—(A) *Facts.* On January 2, 2017, Corporation R executed a 5-year employment agreement with Employee I to serve as Corporation R's PFO, providing for an annual salary of \$1,800,000. The agreement constitutes a written binding contract under applicable law. In 2017 and 2018, Employee I receives the salary of \$1,800,000 per year. In 2019, Corporation R increases Employee I's salary by \$40,000, which is less than a reasonable cost-of-living increase from \$1,800,000. On January 1, 2020, Corporation R increases Employee I's salary to \$2,400,000. The \$560,000 increase exceeds a reasonable, annual cost-of-living increase from \$1,840,000.

(B) *Conclusion (\$1,840,000 Payment in 2019).* If this § 1.162-33 applies, Employee I is a covered employee for Corporation R's 2018 through 2020 taxable years. Because the January 1, 2017, agreement is a written binding contract to pay Employee I an annual salary of \$1,800,000, this section does not apply (and § 1.162-27 does apply) to the deduction for Employee I's annual salary

unless the change in the employment agreement is a material modification. Pursuant to § 1.162-27(c)(2), Employee I is not a covered employee of Corporation R for the 2019 taxable year, so the deduction for the \$1,800,000 salary is not subject to section 162(m)(1). Even though the \$40,000 increase is made on the basis of substantially the same elements or conditions as the salary, the \$40,000 increase does not constitute a material modification of the written binding contract because the \$40,000 is less than or equal to a reasonable cost-of-living increase applied to the \$1,800,000 annual salary Corporation R owes under the agreement. However, the deduction for the \$40,000 increase is subject to this section (and not § 1.162-27).

(C) *Conclusion (Salary increase to \$2,400,000 in 2020).* The \$560,000 increase in salary in 2020 is a material modification of the written binding contract because the additional compensation is paid on the basis of substantially the same elements or conditions as the salary, and it exceeds a reasonable, annual cost-of-living increase from \$1,840,000. Because the written binding contract is materially modified as of January 1, 2020, the deduction for all salary paid to Employee I on and after January 1, 2020 is subject to this section (and not § 1.162-27).

(xxiii) *Example 23 (Additional payment not considered a material modification)*—(A) *Facts.* The facts are the same as in paragraph (g)(3)(xxii) of this section (*Example 22*), except that instead of an increase in salary, in 2020 Employee I receives a restricted stock grant subject to Employee I's continued employment for the balance of the contract.

(B) *Conclusion.* The restricted stock grant is not a material modification of the written binding contract because any additional compensation paid to Employee I under the grant is not paid on the basis of substantially the same elements and conditions as Employee I's salary. However, the deduction attributable to the restricted stock grant is subject to this section (and not § 1.162-27).

(xxiv) *Example 24 (Modification of written binding contract to provide for accelerated vesting)*—(A) *Facts.* Employee J serves as the PFO of Corporation Q for the 2017 through 2020 taxable years. On July 14, 2017, Corporation Q and Employee J enter into an agreement providing that Corporation Q will pay \$2,000,000 to Employee J if Employee J continues to serve as the PFO until the third anniversary of the agreement (July 14, 2020). The agreement provides that Corporation Q will make the payment on the date Employee J meets the service requirement. The right to the \$2,000,000 payment is subject to a substantial risk of forfeiture as defined in § 1.409A-1(d). Under applicable law, the plan constitutes a written binding contract in effect on November 2, 2017, to pay \$2,000,000 to Employee J if Employee J serves as the PFO through July 14, 2020. On November 29, 2019, Corporation Q modifies the written binding contract to provide for substantial vesting of the \$2,000,000 on that date and pays the \$2,000,000 to Employee J.

(B) *Conclusion.* If this § 1.162-33 applies, Employee J is a covered employee for Corporation Q's 2019 taxable year because

Employee J served as the PFO of Corporation Q during the taxable year. Because the July 14, 2017, agreement constitutes a written binding contract to pay \$2,000,000, this section does not apply (and § 1.162-27 does apply) to the deduction for the \$2,000,000 unless the contract is materially modified. Pursuant to § 1.162-27(c)(2), Employee J is not a covered employee of Corporation Q for the 2019 taxable year. The change in terms of the contract on November 29, 2019, to accelerate vesting but to otherwise pay the amounts under the original terms is not a material modification. Accordingly, the deduction for the \$2,000,000 is not subject to section 162(m)(1).

(h) *Effective/Applicability dates*—(1) *Effective date.* These regulations are effective on [DATE OF PUBLICATION OF THE FINAL RULE IN THE FEDERAL REGISTER].

(2) *Applicability dates*—(i) *General applicability date.* Except as otherwise provided in paragraph (h)(2)(ii) of this section, these regulations apply to taxable years beginning on or after [DATE OF PUBLICATION OF THE FINAL RULE IN THE FEDERAL REGISTER].

(ii) *Special applicability dates*—(A) *Definition of covered employee.* The definition of covered employee in paragraph (c)(2)(i) of this section applies to taxable years ending on or after September 10, 2018. However, for a corporation whose fiscal year and taxable year do not end on the same date, the rule in paragraph (c)(2)(i)(B) requiring the determination of the three most highly compensated executive officers to be made pursuant to the rules under the Exchange Act applies to taxable years ending on or after December 20, 2019.

(B) *Definition of predecessor of a publicly held corporation*—(1) *Publicly held corporations that become privately held.* The definition of predecessor of a publicly held corporation in paragraph (c)(2)(ii)(A) of this section applies to any publicly held corporation that becomes a privately held corporation for a taxable year beginning after December 31, 2017, and, subsequently, again becomes a publicly held corporation on or after [DATE OF PUBLICATION OF

THE FINAL RULE IN THE FEDERAL REGISTER]. Accordingly, the definition of predecessor of a publicly held corporation in paragraph (c)(2)(ii)(A) of this section does not apply to any publicly held corporation that became a privately held corporation for a taxable year beginning before January 1, 2018, with respect to the earlier period as a publicly held corporation; or a publicly held corporation that becomes a privately held corporation for a taxable year beginning after December 31, 2017, and, subsequently, again becomes a publicly held corporation before [DATE OF PUBLICATION OF THE FINAL RULE IN THE FEDERAL REGISTER].

(2) *Corporate transactions.* The definition of predecessor of a publicly held corporation in paragraphs (c)(2)(ii)(B) through (H) of this section applies to corporate transactions that occur (as provided in the transaction timing rule of paragraph (c)(2)(ii)(I) of this section) on or after [DATE OF PUBLICATION OF THE FINAL RULE IN THE FEDERAL REGISTER].

(C) *Definition of compensation.* The definition of compensation provided in paragraph (c)(3)(ii) of this section (relating to allocable shares of partnership deductions for compensation paid) applies to any deduction for compensation that is otherwise allowable for a taxable year ending on or after December 20, 2019. However, this definition of compensation does not apply to compensation paid pursuant to a written binding contract that is in effect on December 20, 2019 and that is not materially modified after that date. For purposes of this paragraph (h)(3), written binding contract and material modification have the same meanings as provided in paragraphs (g)(1) and (g)(2) of this section.

(D) *Corporations that become publicly held.* The rule in paragraph (d) of this section (providing that the deduction limitation of paragraph (b) of this section applies to a deduction for any compensation that is otherwise deductible for the taxable year ending on or after the date that a privately held

corporation becomes a publicly held corporation) applies to corporations that become publicly held on or after December 20, 2019. A privately held corporation that becomes a publicly held corporation before December 20, 2019 may rely on the transition rules provided in § 1.162-27(f)(1) until the earliest of the events provided in § 1.162-27(f)(2).

(E) *Transition rules.* The transition rules in paragraphs (g)(1) and (2) of this section (providing that this section does not apply to remuneration payable under a written binding contract which was in effect on November 2, 2017, and which is not modified in any material respect on or after such date) apply to taxable years ending on or after September 10, 2018.

■ **Par. 4.** Section 1.338-1 is amended by revising paragraph (b)(2)(i) to read as follows:

**§ 1.338-1 General principles, status of old target and new target.**

\* \* \* \* \*

(b) \* \* \*

(2) \* \* \*

(i) The rules applicable to employee benefit plans (including those plans described in sections 79, 104, 105, 106, 125, 127, 129, 132, 137, and 220), qualified pension, profit-sharing, stock bonus and annuity plans (sections 401(a) and 403(a)), simplified employee pensions (section 408(k)), tax qualified stock option plans (sections 422 and 423), welfare benefit funds (sections 419, 419A, 512(a)(3), and 4976), voluntary employee benefit associations (section 501(c)(9) and the regulations thereunder (26 CFR 1.501(c)(9)-1 through 1.501(c)(9)-8)) and certain excessive employee remuneration (section 162(m) and the regulations thereunder (26 CFR 1.162-27 and § 1.162-31));

\* \* \* \* \*

**Sunita Lough,**

*Deputy Commissioner for Services and Enforcement.*

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