

# INTERNAL REVENUE BULLETIN



## HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

## EMPLOYEE PLANS

### REV. RUL. 2020-2, page 298.

This revenue ruling provides tables of covered compensation under § 401(l)(5)(E) of the Internal Revenue Code and the Income Tax Regulations thereunder, effective January 1, 2020.

## EMPLOYMENT TAX

### NOTICE 2020-3, page 330.

The notice provides guidance for the 2020 calendar year regarding withholding from periodic payments for pensions, annuities, and certain other deferred income under section 3405(a), including the rules for withholding from periodic payments under section 3405(a) when no withholding certificate has been furnished.

## INCOME TAX

### NOTICE 2020-2, page 327.

This Notice announces that Treasury and the IRS intend to amend the section 871(m) regulations to delay the effective/applicability date of certain rules in those final regulations and extends the phase-in period provided in Notice 2018-72, 2018-40 I.R.B. 522, for certain provisions of the section 871(m) regulations.

### REG-107431-19, page 332.

REG-107431-19 provides proposed amendments to the regulations under sections 162, 164, and 170 of the Internal Revenue Code (Code). First, the proposed amendments update the regulations under section

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162 to reflect current law regarding the application of section 162 to a taxpayer that makes a payment or transfer to an entity described in section 170(c) for a business purpose. Second, the proposed amendments provide safe harbors under section 162 to provide certainty with respect to the treatment of payments made by business entities to an entity described in section 170(c). Third, the proposed amendments provide a safe harbor under section 164 for payments made to an entity described in section 170(c) by individuals who itemize deductions and receive or expect to receive a state or local tax credit in return. Fourth, the proposed amendments update the regulations under section 170 to reflect past guidance and case law regarding the application of the quid pro quo principle under section 170 to benefits received or expected to be received by a donor from a third party.

### REG-122180-18, page 342.

Section 162(m) generally limits the otherwise allowable deduction for compensation paid with respect to a covered employee of a publicly held corporation to no more than \$1,000,000 per year. The proposed regulations propose guidance on the application of §162(m), as amended by section 13601 of Tax Cuts and Jobs Act (the Act). The Act made significant amendments to §162(m), and provided a transition rule applicable to certain outstanding arrangements (commonly referred to as the grandfather rule). The proposed regulations propose guidance on the amendments made by the Act to the definitions of publicly held corporation, covered employee, and applicable employee remuneration. Additionally, the proposed regulations propose guidance on the operation of the grandfather rule.

**REV. RUL. 2020-1, page 296.**

Federal rates; adjusted federal rates; adjusted federal long-term rate, the long-term exempt rate, and the blended annual rate. For purposes of sections 382, 1274, 1288, 7872 and other sections of the Code, tables set forth the rates for January 2020.

**T.D. 9887, page 302.**

The regulations provide guidance to nonresident alien individuals and foreign corporations that hold certain financial products providing for payments that are contingent upon or determined by reference to U.S. source dividend payments. The regulations also provides guidance to withholding agents that are responsible for withholding U.S. tax with respect to a dividend equivalent, as well as certain other parties to section 871(m) transactions and their agents. Specifically, the

regulations provide guidance regarding (1) the definition of a broker for purposes of section 871(m), (2) how to calculate the delta of certain options listed on a foreign regulated exchange, and (3) who must determine whether a transaction is a section 871(m) transaction when multiple brokers or dealers are involved in the transaction.

**T.D. 9888, page 306.**

The final regulations provide guidance in determining whether a corporation is a predecessor or successor of a distributing or controlled corporation for purposes of the exception under section 355(e) to the nonrecognition treatment afforded qualifying distributions. The final regulations also provide certain limitations on the recognition of gain in certain cases involving a predecessor of a distributing corporation.

# The IRS Mission

Provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.

## Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned

against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

### **Part I.—1986 Code.**

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

### **Part II.—Treaties and Tax Legislation.**

This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

### **Part III.—Administrative, Procedural, and Miscellaneous.**

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

### **Part IV.—Items of General Interest.**

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

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# Part I

## Section 1274.— Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also Sections 42, 280G, 382, 467, 468, 482, 483, 642, 1288, 7520, 7872.)

### Rev. Rul. 2020-1

This revenue ruling provides various prescribed rates for federal income tax purposes for January 2020 (the current

month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(1) for buildings placed in service during the current month. Howev-

er, under section 42(b)(2), the applicable percentage for non-federally subsidized new buildings placed in service after July 30, 2008, shall not be less than 9%. Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520. Finally, Table 6 contains the deemed rate of return for transfers made during calendar year 2020 to pooled income funds described in section 642(c)(5) that have been in existence for less than 3 taxable years immediately preceding the taxable year in which the transfer was made.

**REV. RUL. 2020-1 TABLE 1**  
Applicable Federal Rates (AFR) for January 2020  
*Period for Compounding*

	<i>Annual</i>	<i>Semiannual</i>	<i>Quarterly</i>	<i>Monthly</i>
		<i>Short-term</i>		
AFR	1.60%	1.59%	1.59%	1.58%
110% AFR	1.76%	1.75%	1.75%	1.74%
120% AFR	1.92%	1.91%	1.91%	1.90%
130% AFR	2.08%	2.07%	2.06%	2.06%
		<i>Mid-term</i>		
AFR	1.69%	1.68%	1.68%	1.67%
110% AFR	1.86%	1.85%	1.85%	1.84%
120% AFR	2.03%	2.02%	2.01%	2.01%
130% AFR	2.19%	2.18%	2.17%	2.17%
150% AFR	2.54%	2.52%	2.51%	2.51%
175% AFR	2.96%	2.94%	2.93%	2.92%
		<i>Long-term</i>		
AFR	2.07%	2.06%	2.05%	2.05%
110% AFR	2.28%	2.27%	2.26%	2.26%
120% AFR	2.49%	2.47%	2.46%	2.46%
130% AFR	2.70%	2.68%	2.67%	2.67%

**REV. RUL. 2020-1 TABLE 2**  
Adjusted AFR for January 2020  
*Period for Compounding*

	<i>Annual</i>	<i>Semiannual</i>	<i>Quarterly</i>	<i>Monthly</i>
Short-term adjusted AFR	1.21%	1.21%	1.21%	1.21%
Mid-term adjusted AFR	1.28%	1.28%	1.28%	1.28%
Long-term adjusted AFR	1.57%	1.56%	1.56%	1.55%

**REV. RUL. 2020-1 TABLE 3**  
 Rates Under Section 382 for January 2020

Adjusted federal long-term rate for the current month	1.57%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	1.59%

**REV. RUL. 2020-1 TABLE 4**

Appropriate Percentages Under Section 42(b)(1) for January 2020

Note: Under section 42(b)(2), the applicable percentage for non-federally subsidized new buildings placed in service after July 30, 2008, shall not be less than 9%.

Appropriate percentage for the 70% present value low-income housing credit	7.43%
Appropriate percentage for the 30% present value low-income housing credit	3.18%

**REV. RUL. 2020-1 TABLE 5**

Rate Under Section 7520 for January 2020

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	2.0%
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**REV. RUL. 2020-1 TABLE 6**

Deemed Rate for Transfers to New Pooled Income Funds During 2020

Deemed rate of return for transfers during 2020 to pooled income funds that have been in existence for less than 3 taxable years	2.2%
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## **Section 42.—Low-Income Housing Credit**

The applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2020. See Rev. Rul. 2020-1, page 296.

## **Section 280G.—Golden Parachute Payments**

The applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2020. See Rev. Rul. 2020-1, page 296.

## **Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change**

The adjusted applicable federal long-term rate is set forth for the month of January 2020. See Rev. Rul. 2020-1, page 296.

## **Section 467.—Certain Payments for the Use of Property or Services**

The applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2020. See Rev. Rul. 2020-1, page 296.

## **Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs**

The applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2020. See Rev. Rul. 2020-1, page 296.

## **Section 482.—Allocation of Income and Deductions Among Taxpayers**

The applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2020. See Rev. Rul. 2020-1, page 296.

## **Section 483.—Interest on Certain Deferred Payments**

The applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2020. See Rev. Rul. 2020-1, page 296.

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## **Section 642.—Special Rules for Credits and Deductions**

Deemed rate for transfers to new pooled income funds during 2020 is set forth. See Rev. Rul. 2020-1, page 296.

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*26 CFR 1.401(l)-1: Permitted disparity in employer-provided contributions or benefits*

## **Rev. Rul. 2020-2**

This revenue ruling provides tables of covered compensation under § 401(l)(5)(E) of the Internal Revenue Code and the Income Tax Regulations thereunder, for the 2020 plan year.

Section 401(l)(5)(E)(i) defines covered compensation with respect to an employee as the average of the contribution and benefit bases in effect under section 230 of the Social Security Act (the “Act”) for each year in the 35-year period ending with the year in which the employee attains social security retirement age.

Section 401(l)(5)(E)(ii) states that the determination for any year preceding the year in which the employee attains social security retirement age shall be made by assuming that there is no increase in cov-

## **Section 1288.—Treatment of Original Issue Discount on Tax-Exempt Obligations**

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2020. See Rev. Rul. 2020-1, page 296.

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## **Section 7520.—Valuation Tables**

The applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2020. See Rev. Rul. 2020-1, page 296.

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ered compensation after the determination year and before the employee attains social security retirement age.

Section 1.401(l)-1(c)(34) of the Income Tax Regulations defines the taxable wage base as the contribution and benefit base under section 230 of the Act.

Section 1.401(l)-1(c)(7)(i) defines covered compensation for an employee as the average (without indexing) of the taxable wage bases in effect for each calendar year during the 35-year period ending with the last day of the calendar year in which the employee attains (or will attain) social security retirement age. A 35-year period is used for all individuals regardless of the year of birth of the individual. In determining an employee’s covered compensation for a plan year, the taxable wage base for all calendar years beginning after the first day of the plan year is assumed to be the same as the taxable wage base in effect as of the beginning of the plan year.

An employee’s covered compensation for

## **Section 7872.—Treatment of Loans With Below-Market Interest Rates**

The applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2020. See Rev. Rul. 2020-1, page 296.

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a plan year beginning after the 35-year period applicable under § 1.401(l)-1(c)(7)(i) is the employee’s covered compensation for a plan year during which the 35-year period ends. An employee’s covered compensation for a plan year beginning before the 35-year period applicable under § 1.401(l)-1(c)(7)(i) is the taxable wage base in effect as of the beginning of the plan year.

Section 1.401(l)-1(c)(7)(ii) provides that, for purposes of determining the amount of an employee’s covered compensation under § 1.401(l)-1(c)(7)(i), a plan may use tables, provided by the Commissioner, that are developed by rounding the actual amounts of covered compensation for different years of birth.

For purposes of determining covered compensation for the 2020 year, the taxable wage base is \$137,700.

The following tables provide covered compensation for 2020.

**ATTACHMENT I**  
**2020 COVERED COMPENSATION TABLE**

CALENDAR YEAR OF BIRTH	CALENDAR YEAR OF SOCIAL SECURITY RETIREMENT AGE	2020 COVERED COMPENSATION TABLE II
1907	1972	\$ 4,488
1908	1973	4,704
1909	1974	5,004
1910	1975	5,316
1911	1976	5,664
1912	1977	6,060
1913	1978	6,480
1914	1979	7,044
1915	1980	7,692
1916	1981	8,460
1917	1982	9,300
1918	1983	10,236
1919	1984	11,232
1920	1985	12,276
1921	1986	13,368
1922	1987	14,520
1923	1988	15,708
1924	1989	16,968
1925	1990	18,312
1926	1991	19,728
1927	1992	21,192
1928	1993	22,716
1929	1994	24,312
1930	1995	25,920
1931	1996	27,576
1932	1997	29,304
1933	1998	31,128
1934	1999	33,060
1935	2000	35,100
1936	2001	37,212
1937	2002	39,444
1938	2004	43,992
1939	2005	46,344
1940	2006	48,816
1941	2007	51,348
1942	2008	53,952
1943	2009	56,628
1944	2010	59,268
1945	2011	61,884
1946	2012	64,560

**ATTACHMENT I**  
**2020 COVERED COMPENSATION TABLE**

CALENDAR YEAR OF BIRTH	CALENDAR YEAR OF SOCIAL SECURITY RETIREMENT AGE	2020 COVERED COMPENSATION TABLE II
1947	2013	67,308
1948	2014	69,996
1949	2015	72,636
1950	2016	75,180
1951	2017	77,880
1952	2018	80,532
1953	2019	83,244
1954	2020	86,052
1955	2022	91,464
1956	2023	94,116
1957	2024	96,684
1958	2025	99,144
1959	2026	101,556
1960	2027	103,908
1961	2028	106,200
1962	2029	108,396
1963	2030	110,580
1964	2031	112,728
1965	2032	114,792
1966	2033	116,772
1967	2034	118,632
1968	2035	120,384
1969	2036	122,028
1970	2037	123,540
1971	2038	124,980
1972	2039	126,408
1973	2040	127,764
1974	2041	129,012
1975	2042	130,164
1976	2043	131,184
1977	2044	132,060
1978	2045	132,948
1979	2046	133,824
1980	2047	134,616
1981	2048	135,300
1982	2049	135,900
1983	2050	136,440
1984	2051	136,992
1985	2052	137,292
1986	2053	137,556
1987 and Later	2054 and Later	137,700

**ATTACHMENT II**  
**2020 ROUNDED COVERED COMPENSATION TABLE**

CALENDAR YEAR OF BIRTH	2020 COVERED COMPENSATION ROUNDED
1937	\$ 39,000
1938 – 1939	45,000
1940	48,000
1941	51,000
1942	54,000
1943	57,000
1944	60,000
1945	63,000
1946 – 1947	66,000
1948	69,000
1949	72,000
1950	75,000
1951	78,000
1952	81,000
1953	84,000
1954	87,000
1955	90,000
1956	93,000
1957	96,000
1958	99,000
1959	102,000
1960 – 1961	105,000
1962	108,000
1963	111,000
1964 – 1965	114,000
1966	117,000
1967 – 1968	120,000
1969 – 1970	123,000
1971 – 1972	126,000
1973 – 1975	129,000
1976 – 1978	132,000
1979 – 1982	135,000
1983 and Later	137,700

## DRAFTING INFORMATION

The principal author of this notice is Tom Morgan of the Office of the Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes). However, other personnel from the IRS participated in the development of this guidance. For further information regarding this notice, contact Mr. Morgan at 202-317-6700 or Gregory K. Davis at 443-853-5590 (not toll-free numbers).

*26 CFR 1.871-15: Treatment of dividend equivalents*

## T.D. 9887

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

#### Dividend Equivalents from Sources within the United States

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations relating to certain financial products providing for payments that are contingent upon or determined by reference to U.S. source dividend payments.

DATES: *Effective date:* These regulations are effective on December 17, 2019.

*Applicability dates:* For dates of applicability, see §1.871-15(r).

FOR FURTHER INFORMATION CONTACT: D. Peter Merkel or Karen Walny at (202) 317-6938 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

## Background

This document contains final regulations under §1.871-15 defining the term broker for purposes of section 871(m) of the Internal Revenue Code (the Code). In addition, the final regulations provide guidance relating to when the delta of an option that is listed on a foreign regulated exchange may be calculated based on the delta of that option at the close of business on the business day before the date of issuance. The final regulations also provide guidance identifying which party to a potential section 871(m) transaction is responsible for determining whether a transaction is a section 871(m) transaction when multiple brokers or dealers are involved in the transaction. Finally, this document withdraws temporary regulations under §1.871-15T regarding these matters.

### *I. Background on Section 871(m) Regulations*

On January 23, 2012, the **Federal Register** published temporary regulations (TD 9572) at 77 FR 3108 (2012 temporary regulations), and a notice of proposed rulemaking by cross-reference to the temporary regulations and notice of public hearing at 77 FR 3202 (2012 proposed regulations, and together with the 2012 temporary regulations, 2012 section 871(m) regulations) under section 871(m). The 2012 section 871(m) regulations related to dividend equivalents from sources within the United States paid to nonresident alien individuals and foreign corporations. Corrections to the 2012 temporary regulations were published on February 6, 2012, March 8, 2012, and August 31, 2012, in the **Federal Register** at 77 FR 5700, 77 FR 13968, and 77 FR 53141, respectively. The Department of the Treasury (Treasury Department) and the IRS received written comments on the 2012 proposed regulations, and a public hearing was held on April 27, 2012.

On December 5, 2013, the **Federal Register** published final regulations and removal of temporary regulations (TD 9648) at 78 FR 73079 (2013 final regulations), which finalized a portion of the 2012 section 871(m) regulations. On the same date, the **Federal Register** pub-

lished a withdrawal of notice of proposed rulemaking, a notice of proposed rulemaking, and a notice of public hearing at 78 FR 73128 (2013 proposed regulations). In light of comments on the 2012 proposed regulations, the 2013 proposed regulations described a new approach for determining whether a payment made pursuant to a notional principal contract (NPC) or an equity-linked instrument (ELI) is a dividend equivalent based on the delta of the contract. In response to written comments on the 2013 proposed regulations, the Treasury Department and the IRS released Notice 2014-14, 2014-13 IRB 881, on March 24, 2014 (see §601.601(d)(2)(ii)(b)), stating that the Treasury Department and the IRS anticipated limiting the application of the rules with respect to specified ELIs described in the 2013 proposed regulations to ELIs issued on or after 90 days after the date of publication of final regulations.

On September 18, 2015, the **Federal Register** published final regulations and temporary regulations (TD 9734), at 80 FR 56866, which finalized a portion of the 2013 proposed regulations and introduced new temporary regulations based on comments received with respect to the 2013 proposed regulations (2015 final regulations and 2015 temporary regulations, respectively, and together, the 2015 regulations). On the same date, the **Federal Register** published a notice of proposed rulemaking by cross-reference to temporary regulations and a notice of public hearing at 80 FR 56415 (2015 proposed regulations, and together with the 2015 final regulations, 2015 section 871(m) regulations). A correcting amendment to the 2015 final regulations and the 2015 proposed regulations was published on December 7, 2015, in the **Federal Register** at 80 FR 75946 and 80 FR 75956, respectively.

The Treasury Department and the IRS received written comments on the 2015 proposed regulations. The public hearing scheduled for January 15, 2016, was cancelled because no request to speak was received.

On July 1, 2016, the Treasury Department and the IRS released Notice 2016-42, 2016-29 IRB 67 (QI Notice), containing a proposed amended qualified intermediary agreement. The QI Notice included the

requirements and obligations applicable to a QI that acts as a qualified derivatives dealer (QDD). The Treasury Department and the IRS received written comments on Notice 2016-42, which included comments on certain aspects of section 871(m) and QDDs. On December 30, 2016, the Treasury Department and the IRS released Revenue Procedure 2017-15, 2017-3 IRB 437 (2017 QI Agreement), which contains the final QI withholding agreement and the requirements and obligations applicable to QDDs.

On December 2, 2016, the Treasury Department and the IRS released Notice 2016-76, 2016-51 IRB 834, providing guidance for complying with the final and temporary regulations under sections 871(m), 1441, 1461, and 1473 in 2017 and 2018 and explaining how the IRS intends to administer those regulations in 2017 and 2018.

On January 24, 2017, the **Federal Register** published final and temporary regulations (TD 9815) at 82 FR 8144 (2017 final regulations and 2017 temporary regulations, respectively, and together, the 2017 regulations), which generally adopted the 2015 proposed regulations with certain changes. The 2017 regulations also included several technical amendments to the 2015 final regulations in response to comments on those regulations. Finally, the 2017 temporary regulations were based on comments received with respect to the 2015 proposed regulations. A notice of proposed rulemaking cross-referencing the 2017 temporary regulations was published in the **Federal Register** on January 24, 2017 (82 FR 8172), with correcting amendments published in the **Federal Register** on October 26, 2017 (82 FR 49508) (together, the 2017 proposed regulations). No public hearing was requested or held. On August 21, 2017, the Treasury Department and the IRS published Notice 2017-42, 2017-34 IRB 212, which extended certain transition relief with respect to certain portions of the 2017 final regulations.

On February 5, 2018, the Treasury Department and the IRS published Notice 2018-5, 2018-6 IRB 341, which permits withholding agents to apply the transition rules for securities loans to which section 871(m) applies from Notice 2010-46, 2010-24 IRB 757, in 2018 and 2019.

On September 20, 2018, the Treasury Department and the IRS published Notice 2018-72, 2018-40 IRB 522, which further extended certain transition relief and permitted withholding agents to apply the transition rules from Notice 2010-46 in 2020.

All written comments received in response to the 2012 proposed regulations, 2013 proposed regulations, 2015 proposed regulations, and 2017 proposed regulations are available at [www.regulations.gov](http://www.regulations.gov) or upon request.

This Treasury decision finalizes the 2017 proposed regulations without any substantive change.

## II. Executive Order 13789

Executive Order 13789 (82 FR 19317), issued on April 21, 2017, instructs the Secretary of the Treasury (the Secretary) to review all significant tax regulations issued on or after January 1, 2016, and to take concrete action to alleviate the burdens of regulations that (i) impose an undue financial burden on U.S. taxpayers; (ii) add undue complexity to the Federal tax laws; or (iii) exceed the statutory authority of the IRS. Executive Order 13789 further instructs the Secretary to submit to the President within 60 days an interim report that identifies regulations that meet these criteria. Notice 2017-38, 2017-30 I.R.B. 147, which was published on July 24, 2017, did not include regulations under section 871(m) in a list of eight regulations identified by the Secretary in the interim report as meeting at least one of the first two criteria specified in E.O. 13789 (no regulations were identified as meeting the third criterion).

E.O. 13789 further instructs the Secretary to submit to the President by September 18, 2017, a final report that recommends specific actions to mitigate the burden imposed by regulations identified in the interim report. On October 16, 2017, the Secretary published in the **Federal Register** that final report (82 FR 48013), which indicated, among other things, that the Treasury Department continues to analyze all recently issued significant regulations and is considering possible reforms of several recent regulations not identified in the earlier report, including the regulations under section 871(m).

## Summary of Comments and Explanation of Provisions

The Treasury Department and the IRS received one comment regarding the 2017 proposed regulations. After consideration of the comment, the 2017 proposed regulations are adopted as final regulations without any substantive change. In addition, the regulations under §1.871-15T are withdrawn. Comments on the section 871(m) regulations that were not specific to §1.871-15T are beyond the scope of this rulemaking and are not addressed in this preamble.

The Treasury Department and the IRS are continuing to study and consider possible reforms to the other provisions of the section 871(m) regulations pursuant to E.O. 13789 that are not specifically addressed by this Treasury decision, including comments received that relate to those rules. The Treasury Department and the IRS will consider these comments in connection with any future guidance projects addressing the issues discussed in the comments.

### I. Delta Calculation for Listed Options

Generally, section 1.871-15(g)(2) provides the delta of a potential section 871(m) transaction is calculated on the earlier of when the contract is priced and when the contract is issued. See §1.871-15(a)(6) (providing that a contract is issued at the inception, original issuance, or issuance as a result of a deemed exchange pursuant to section 1001). With respect to options listed on a regulated exchange, §1.871-15(g)(4)(i) provided that the delta for those options is determined based on the delta of the option at the close of business on the business day before the date of issuance. Section 1.871-15(g)(4)(ii) (A) defines a regulated exchange as any exchange defined in §1.871-15(l)(3)(vii). The 2017 temporary regulations and the 2017 proposed regulations provide that the term regulated exchange also includes a foreign exchange that (A) is regulated by a government agency in the jurisdiction in which the market is located, (B) maintains certain requirements designed to protect investors and to prevent fraud and manipulation, (C) maintains rules to promote active trading of listed options, and (D) had

trades for which the average trading volume exceeded \$10 billion per day during the prior calendar year (the “\$10 billion threshold”). *See* §1.871-15T(g)(4)(ii)(B). When a foreign securities exchange has more than one tier or market level on which listed options may be separately listed, the 2017 temporary regulations and the 2017 proposed regulations treat each tier or market level of the exchange as a separate exchange. *See* §1.871-15T(g)(4)(ii)(B)(4).

A comment expressed concern that the \$10 billion threshold would exclude from the definition of a regulated exchange many European exchanges that are treated as regulated markets by the European Securities and Markets Authorities (“ESMA”) for purposes of the Markets in Financial Instruments Directive 2004/39/EC. The comment requested that the final regulations eliminate the \$10 billion threshold. Instead, the comment recommended that a foreign regulated exchange be defined to include an exchange treated as a regulated market by ESMA or a similar national authority and included in the respective ESMA register or similar national register (the “ESMA requirement”).

The \$10 billion threshold is intended to ensure that the exchange has a sufficient level of trading activity so that the pricing cannot be manipulated. The Treasury Department and the IRS have determined that the \$10 billion threshold continues to serve this purpose. In addition, the ESMA requirement requested by the comment appears duplicative of §1.871-15T(g)(4)(ii)(B)(I), which requires a foreign securities exchange to be regulated or supervised by a governmental authority of the country in which the market is located, because the ESMA register is compiled on the basis of notifications made to ESMA by the national competent authorities of member states. Further, a foreign exchange that does not qualify under §1.871-15T(g)(4)(ii)(B) can qualify under §1.871-15T(g)(4)(ii)(A) if the option exchange is a qualified board or exchange as determined by the Secretary pursuant to section 1256(g)(7)(C) or has a staff no action letter from the CFTC permitting direct access from the United States. Therefore, the Treasury Department and the IRS have determined that it is not appropriate to remove the requirement. However, consistent with

the preamble to the 2017 regulations, the Treasury Department and the IRS have clarified that the \$10 billion threshold is determined based on the notional amount of the options, which is the number of shares referenced by the option multiplied by the stock price of those shares at the time of the computation. *See* §1.871-15T(g)(4)(ii)(B)(I)(iv).

The Treasury Department and the IRS, however, will continue to study this comment regarding the \$10 billion threshold in connection with future guidance projects related to E.O. 13789. The Treasury Department and the IRS request comments regarding whether an alternative trading threshold for U.S. equity options would ensure that there is sufficient trading on the exchange to prevent price manipulation. For example, instead of establishing a threshold based on the average daily trading volume for an exchange as a whole, an alternative threshold may be based on only the average daily trading volume of equity options on the exchange or only the average daily trading volume of equity options for a specific stock or stock index on the exchange. Comments recommending an alternative threshold should include information supporting the suggestion, including information regarding the average daily trading volumes for the exchange with respect to equity options separated out by exchange (and stock or stock index, if applicable).

## Special Analyses

### I. Regulatory Planning and Review – Economic Analysis

Executive Orders 13563 and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits, including potential economic, environmental, public health and safety effects, distributive impacts, and equity. Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility.

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. Therefore, a regulatory impact assessment is not required.

## II. Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control numbers 1545-0096 and 1545-1597. The collection of information in these regulations is in §1.871-15(p). There is no change to the total annual burden in the current regulations under §§1.1441-1 through 1.1441-9 as a result of these final regulations. Without these final regulations, however, the total annual burden in the current regulations under §1.1441-1 through 1.1441-9 would increase because more than one taxpayer could be treated as a responsible party and be required to collect information regarding potential section 871(m) transactions.

The information is required to establish whether a payment is treated as a U.S. source dividend for purposes of section 871(m). This information will be used for audit and examination purposes. The IRS intends that these information collection requirements will be satisfied by persons complying with chapter 3 reporting requirements and the requirements of the applicable qualified intermediary (QI) revenue procedure, or alternative certification and documentation requirements set out in these regulations. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number.

The estimates for the number of impacted filers with respect to the collections of information described in this part II of the Special Analysis section are based on the distinct U.S. withholding agents who filed a form 1042-S reporting income code 34 (substitute payments—dividends) or income code 40 (Other dividend equivalents under IRS section 871(m) (formerly 871(l)) for calendar year 2017. The estimates for the number of impacted filers are also based on the number of U.S. withholding agents who filed a form 1042 and

checked the box in section 3, indicating that the withholding agent made payments

related to a potential section 871(m) transaction, for calendar year 2018. The IRS

estimates the number of affected filers to be the following:

Collection of information	Tax Forms Impacted		
	Number of respondents (estimated)	Number of filings (estimated)	Forms to which the information may be attached
§1.871-15(p)(ii) Transactions with multiple brokers	1500	51,000	Form 1042, Form 1042-S, and Form 1042-T
§1.871-15(p)(iii) Responsible party for transactions traded on an exchange and cleared by a clearing organization	1500	51,000	Form 1042, Form 1042-S, and Form 1042-T
§1.871-15(p)(iv) Responsible party for certain structured notes, warrants, and convertible instruments	1500	51,000	Form 1042, Form 1042-s, and Form 1042-T

The IRS does not have a reliable way of estimating the number of filings that will not need to be made as a result of these final regulations.

### III. Regulatory Flexibility Act

It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act (5 U.S.C. chapter 6). This certification is based on the fact that these regulations primarily will affect multinational financial institutions, which tend to be larger businesses, and foreign persons. Accordingly, a regulatory flexibility analysis under the Regulatory Flexibility Act is not required.

Pursuant to section 7805(f), the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses. No comments were received.

### IV. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private

sector, of \$100 million in 1995 dollars, updated annually for inflation. In 2019, that threshold is approximately \$154 million. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

### V. Executive Order 13132: Federalism

Executive Order 13132 (entitled “Federalism”) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This final rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

### Statement of Availability of IRS Documents

IRS Notices and other guidance cited in this preamble are published in the Internal Revenue Bulletin and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at <http://www.irs.gov>.

### Drafting Information

The principal authors of these final regulations are D. Peter Merkel and Karen Walny of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

### List of Subjects in 26 CFR Part 1

Income taxes, Reporting and record-keeping requirements.

### Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is 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 \* \* \*

§ 1.871-15T [Removed]

Par. 2. Section 1.871-15T is removed.

Par. 3. Section 1.871-15 is amended by:

1. Revising paragraphs (a)(1), (g)(4)(ii); (B), (p)(1)(ii) through (iv), and (p)(5);

2. Removing the language “(r)(2), (3), and (4)” from paragraph (r)(1) and adding “(r)(2) and (3)” in its place; and

3. Removing paragraph (r)(4).

The revisions read as follows:

§ 1.871-15 Treatment of dividend equivalents.

(a) \* \* \*

(1) *Broker.* A broker is a broker within the meaning provided in section 6045(c), except that the term does not include any corporation that is a broker solely because it regularly redeems its own shares.

\* \* \* \*

(g) \* \* \*

(4) \* \* \*

(ii) \* \* \*

(B) *Foreign securities exchange—(1)*  
*In general.* A foreign securities exchange that:

(i) Is regulated or supervised by a governmental authority of the country in which the market is located;

(ii) Has trading volume, listing, financial disclosure, surveillance, and other requirements designed to prevent fraudulent and manipulative acts and practices, to remove impediments to and perfect the mechanism of a free and open, fair and orderly market, and to protect investors, and the laws of the country in which the exchange is located and the rules of the exchange ensure that those requirements are actually enforced;

(iii) Has rules that effectively promote active trading of listed options on the exchange; and

(iv) Has an average daily trading volume on the exchange exceeding \$10 billion notional amount during the immediately preceding calendar year.

(2) *Application to an exchange with more than one tier or market.* If an exchange in a foreign country has more than one tier or market level on which listed options may be separately listed or traded, each tier or market level is treated as a separate exchange.

\* \* \* \*

(p) \* \* \*

(1) \* \* \*

(ii) *Transactions with multiple brokers.* For a potential section 871(m) transaction in which both the short party and an agent or intermediary acting on behalf of the short party are a broker or dealer, the short party must determine whether the potential section 871(m) transaction is a section 871(m) transaction. For a potential section 871(m) transaction in which the short party is not a broker or dealer and more than one agent or intermediary acting on behalf of the short party is a broker or dealer, the broker or dealer that is a party to the trans-

action and closest to the short party in the payment chain must determine whether the potential section 871(m) transaction is a section 871(m) transaction. For a potential section 871(m) transaction in which neither the short party nor any agent or intermediary acting on behalf of the short party is a broker or dealer, and the long party and an agent or intermediary acting on behalf of the long party are a broker or dealer, or more than one agent or intermediary acting on behalf of the long party is a broker or dealer, the broker or dealer that is a party to the transaction and closest to the long party in the payment chain must determine whether the potential section 871(m) transaction is a section 871(m) transaction.

(iii) *Responsible party for transactions traded on an exchange and cleared by a clearing organization.* Except as provided in paragraph (p)(1)(iv) of this section, for a potential section 871(m) transaction that is traded on an exchange and cleared by a clearing organization, and for which more than one broker-dealer acts as an agent or intermediary between the short party and a foreign payee, the broker or dealer that has an ongoing customer relationship with the foreign payee with respect to that transaction (generally the clearing firm) must determine whether the potential section 871(m) transaction is a section 871(m) transaction.

(iv) *Responsible party for certain structured notes, warrants, and convertible instruments.* When a potential section 871(m) transaction is a structured note, warrant, convertible stock, or convertible debt, the issuer is the party responsible for determining whether a potential section 871(m) transaction is a section 871(m) transaction.

\* \* \* \*

(5) *Example.* The following example illustrates the rules of paragraph (p) of this section.

(i) *Example 1: Responsible party for a transaction with multiple broker-dealers.* (A) *Facts.* CO is a domestic clearing organization and is not a broker as defined in paragraph (a)(1) of this section. CO serves as a central counterparty clearing and settlement service provider for derivatives exchanges in the United States. EB and CB are brokers organized in the United States and members of CO. FC, a foreign corporation, instructs EB to execute the purchase of a call option that is a specified ELI (as described in paragraph (e) of this section). EB effects the trade for FC on the exchange and then, as instructed by FC, transfers the

option to CB to be cleared with CO. The exchange matches FC's order with an order for a written call option with the same terms and then sends the matched trade to CO, which clears the trade. CB and the clearing member representing the person who sold the call option settle the trade with CO. Upon receiving the matched trade, the option contracts are novated and CO becomes the counterparty to CB and the counterparty to the clearing member representing the person who sold the call option.

(B) *Analysis.* Both EB and CB are broker-dealers acting on behalf of FC for a potential section 871(m) transaction. Under paragraph (p)(1)(iii) of this section, however, only CB is required to make the determinations described in paragraph (p) of this section because CB has the ongoing customer relationship with FC with respect to the call option.

(ii) [Reserved]

\* \* \* \*

Sunita Lough  
Deputy Commissioner for Services  
and Enforcement.

Approved: November 14, 2019

David J. Kautter  
Assistant Secretary of the Treasury  
(Tax Policy).

(Filed by the Office of the Federal Register on December 16, 2019, 8:45 a.m., and published in the issue of the Federal Register for December 17, 2019, 84 F.R. 68790)

26 CFR 1.355-8

## T.D. 9888

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

### Guidance Under Section 355(e) Regarding Predecessors, Successors, and Limitation on Gain Recognition; Guidance Under Section 355(f)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

**SUMMARY:** This document contains final regulations that provide guidance regarding the distribution by a distributing corporation of stock or securities of a controlled corporation without the recognition of income, gain, or loss. In particular, the final regulations provide guidance in determining whether a corporation is a predecessor or successor of a distributing or controlled corporation for purposes of the exception under section 355(e) of the Internal Revenue Code (Code) to the non-recognition treatment afforded qualifying distributions. In addition, the final regulations provide certain limitations on the recognition of gain in certain cases involving a predecessor of a distributing corporation. The final regulations also provide rules regarding the extent to which section 355(f) causes a distributing corporation (and in certain cases its shareholders) to recognize income or gain on the distribution of stock or securities of a controlled corporation. These regulations affect corporations that distribute the stock or securities of a controlled corporation and the shareholders or security holders of those distributing corporations.

**DATES:** *Effective date:* These final regulations are effective on December 16, 2019.

*Applicability dates:* For dates of applicability, see § 1.355-8(i).

**FOR FURTHER INFORMATION CONTACT:** W. Reid Thompson, (202) 317-5024, or Richard K. Passales, (202) 317-5024 (not toll-free numbers).

#### **SUPPLEMENTARY INFORMATION:**

##### **Background**

###### *I. Corporate Divisions Under Sections 355 and 368(a)(1)(D)*

Congress enacted section 355 “to permit the tax-free division of existing business arrangements among existing shareholders.” See S. Rep. No. 105-33, at 139 (1997) (Senate Report). Under section 355(a)(1), if certain requirements are met, a corporation (Distributing) may distribute stock, or stock and securities, of a controlled corporation (Controlled)

to Distributing’s shareholders, or to its shareholders and security holders, without recognition of gain or loss to, or inclusion of any amount in income of, the distributees upon receipt (Distribution). Section 355(c) generally provides that no gain or loss is recognized to Distributing upon a Distribution of qualified property which is not in pursuance of a plan of reorganization. Section 355(c)(2)(B) refers to Controlled stock and Controlled securities as “qualified property.” If Distributing distributes property other than qualified property in a Distribution and the fair market value of such property exceeds its adjusted basis, gain is recognized to Distributing as if the property were sold to the distributee at its fair market value. *See* section 355(c)(2)(A).

Taxpayers also may carry out a Distribution as part of a “divisive reorganization” under section 368(a)(1)(D). A divisive reorganization is a transfer by Distributing of part of its assets to Controlled if, immediately after the transfer, one or more of the shareholders of Distributing (including persons who were shareholders immediately before the transfer) have control, as defined in section 368(c), of Controlled, but only if, in pursuance of the plan, stock or securities of Controlled are distributed in a Distribution. Section 361(c) generally provides that no gain or loss is recognized to Distributing upon a Distribution of qualified property in pursuance of a plan of reorganization. Section 361(c)(2)(B) defines “qualified property” as (i) any stock, right to acquire stock, or obligation (including a security) of Distributing, or (ii) any stock, right to acquire stock, or obligation (including a security) of Controlled received by Distributing as part of the divisive reorganization. If Distributing distributes property other than qualified property in a Distribution as part of a divisive reorganization and the fair market value of such property exceeds its adjusted basis, gain is recognized to Distributing as if the property were sold to the distributee at its fair market value. *See* section 361(c)(2)(A).

###### *II. Section 355(e)*

Although a Distribution is generally tax-free under sections 355 and 361, Congress has determined that recognition

of corporate-level gain by Distributing is appropriate “[i]n cases in which it is intended that new shareholders will acquire ownership of a business in connection with a [Distribution],” because the overall transaction “more closely resembles a corporate level disposition of the portion of the business that is acquired.” Senate Report at 139-140. Accordingly, the enactment of the Taxpayer Relief Act of 1997, Public Law 105-34 (111 Stat. 788 (1997)), added section 355(e) to the Code. Under section 355(e), stock or securities of Controlled generally will not be treated as qualified property for purposes of section 355(c)(2) or section 361(c)(2) if the stock or securities are distributed as part of a plan or series of related transactions (Plan) pursuant to which one or more persons acquire directly or indirectly stock representing a “50-percent or greater interest” in the stock (Planned 50-percent Acquisition) of Distributing or Controlled. The term “50-percent or greater interest,” as defined in section 355(e)(4)(A) by reference to section 355(d)(4), means stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock. Section 1.355-7(b) provides detailed guidance regarding the meaning and determination of the existence of a Plan.

Section 355(e)(4)(D) provides that, for purposes of section 355(e), “any reference to [Controlled] or [Distributing] shall include a reference to any predecessor or successor of such corporation.” However, Section 355(e) does not define the terms “predecessor” and “successor.” To provide definitions for the terms “predecessor” and “successor” for purposes of section 355(e), as well as guidance regarding their application, the Department of the Treasury (Treasury Department) and the IRS issued proposed regulations in 2004 (2004 Proposed Regulations) and temporary and proposed regulations in 2016 (2016 Regulations).

###### *III. The 2004 Proposed Regulations and the 2016 Regulations*

The general theory underlying the 2004 Proposed Regulations and the 2016 Regulations was that section 355(e) should apply if a Distribution is used to

combine a tax-free division of the assets of a corporation other than Distributing or Controlled (Divided Corporation) with a Planned 50-percent Acquisition of the Divided Corporation. The Treasury Department and the IRS view this type of transaction as a “synthetic spin-off” of the assets that are transferred by the Divided Corporation to Distributing and then to Controlled. For example, a synthetic spin-off could be achieved through the following series of transactions occurring pursuant to a Plan (Base Case Example): (1) A corporation (P) merges into Distributing in a reorganization described in section 368(a)(1)(A), (2) Distributing contributes some (but not all) of P’s assets to Controlled in a reorganization described in section 368(a)(1)(D), and (3) Distributing distributes all of the stock of Controlled in a Distribution.

In the Base Case Example, the Divided Corporation (that is, P) could have separated its assets in its own Distribution. In that case, the Divided Corporation would have been a Distributing itself, and section 355(e) clearly would have applied to the Distribution if it were combined with a Planned 50-percent Acquisition of the Divided Corporation. However, the Treasury Department and the IRS observed that if a Distribution by a Distributing is used as the vehicle for a synthetic spin-off by the Divided Corporation, the synthetic spin-off would not be subject to section 355(e) unless the Divided Corporation is treated as a predecessor of Distributing under section 355(e)(4)(D) (Predecessor of Distributing, or POD). Accordingly, the Treasury Department and the IRS issued the 2004 Proposed Regulations and the 2016 Regulations to treat the Divided Corporation in the Base Case Example as a POD.

#### A. 2004 Proposed Regulations

On November 22, 2004, the Treasury Department and the IRS published in the **Federal Register** (69 FR 67873) the 2004 Proposed Regulations (REG-145535-02). In general, the 2004 Proposed Regulations would have defined a Predecessor of Distributing as any corporation the assets of which a Distributing has acquired in a transaction to which section 381(a) applies (Section 381 Transaction) and then divided tax-free through a Distribution.

The 2004 Proposed Regulations referred to the Section 381 Transaction and the contribution to Controlled of some (but not all) of the assets of the POD prior to the Distribution as a “combining transfer” and a “separating transfer,” respectively. The Treasury Department and the IRS drafted the 2004 proposal primarily to address combining and separating transfers carried out to effect transactions similar to the Base Case Example (in other words, synthetic spin-offs effectuated through Section 381 Transactions).

#### B. 2016 Regulations

After considering all comments received regarding the 2004 Proposed Regulations, on December 19, 2016, the Treasury Department and the IRS published temporary regulations (TD 9805) in the **Federal Register** (81 FR 91738) (2016 Temporary Regulations), which adopted the 2004 Proposed Regulations with significant modifications. On the same day, the Treasury Department and the IRS published in the **Federal Register** (81 FR 91888) a notice of proposed rulemaking (REG-140328-15) (2016 Proposed Regulations), which cross-referenced the 2016 Temporary Regulations. A correction to the 2016 Temporary Regulations was published in the **Federal Register** (82 FR 8811) on January 31, 2017. (References to § 1.355-8T in this preamble refer to the text of the 2016 Temporary Regulations as contained in 26 CFR part 1 revised as of April 1, 2019.)

Although the 2016 Regulations generally retained the synthetic spin-off theory underlying the 2004 Proposed Regulations, the Treasury Department and the IRS significantly broadened the scope of the POD definition (but also significantly narrowed its potential application, as described later in this part III.B). Commenters on the 2004 Proposed Regulations noted that a corporation could have been a POD only if the corporation transferred property to Distributing in a Section 381 Transaction (such as the merger in the Base Case Example) and questioned whether that approach was under-inclusive. In particular, one commenter explained that a taxpayer could structure a series of transactions to achieve many of the same tax and economic objectives as

the Base Case Example without using a Section 381 Transaction.

To illustrate that point, the commenter described the following series of transactions, all of which occur as part of the same Plan (2016 Preamble Example). First, Distributing (the common parent of a consolidated group) acquires all of the stock of P. P then contributes some (but not all) of its assets to a wholly owned subsidiary of Distributing (Internal Distributing) in a transaction to which section 351 applies. See § 1.1502-34. Thereafter, Internal Distributing (i) contributes one of the P assets to Controlled, and (ii) distributes all of the stock of Controlled to Distributing in a Distribution. Finally, Distributing distributes all of the stock of Controlled in a Distribution.

In response to these comments, the Treasury Department and the IRS broadened the POD definition in the 2016 Regulations by removing the requirement of a Section 381 Transaction from the definition. Under the 2016 Regulations, no particular transactional form was required; rather, the 2016 Regulations focused on the tax-free division of the POD’s property (however effected). The Treasury Department and the IRS revised the POD definition in this manner to ensure that section 355(e) would apply to the Base Case Example, the 2016 Preamble Example, and more generally to any synthetic spin-off that is combined with a Planned 50-percent Acquisition of the Divided Corporation. Importantly, however, the 2016 Regulations significantly limited POD treatment to transactions in which *all* of the steps involved in the tax-free division of property of the POD occur as part of a Plan. See section 355(e)(2)(A)(ii).

Because of these revisions to the 2004 Proposed Regulations, a variety of new transactional structures resulted in POD treatment under the 2016 Regulations. For instance, as illustrated in § 1.355-8T(h), *Example 5* (Example 5), a corporation was treated as a POD as a result of the following transactions, each of which occurs pursuant to the same Plan. First, P transfers some (but not all) of its assets to Distributing in exchange for 10 percent of the stock of Distributing in a transaction to which section 351 applies (leaving Distributing’s other shareholder, Y, with 90 percent of Distributing’s stock). Dis-

tributing then (i) contributes some (but not all) of the P assets to Controlled in a reorganization described in section 368(a)(1)(D), and (ii) distributes all of the stock of Controlled to P and Y pro rata. Finally, individual Z acquires 51 percent of the P stock. Because the assets of P were divided tax-free as part of a Plan, the 2016 Regulations treated P as a POD. As described in part II of the Summary of Comments and Explanation of Revisions, in response to comments, the Treasury Department and the IRS have further limited the scope of the POD definition in the final regulations to ensure that P will not be treated as a POD in Example 5.

In expanding the definition of a Predecessor of Distributing, the 2016 Regulations introduced the term “Potential Predecessor.” *See* § 1.355-8T(b)(2)(ii). Under the POD definition in the 2016 Regulations, only a Potential Predecessor could be a POD. *See* § 1.355-8T(b)(1)(i). Thus, if a corporation were not a Potential Predecessor, it could not have been a POD under the 2016 Regulations. The 2016 Regulations defined a Potential Predecessor as any corporation other than Distributing or Controlled. *See* § 1.355-8T(b)(2)(ii).

### **Summary of Comments and Explanation of Revisions**

Comments were received regarding the 2016 Regulations, but no public hearing was requested or held. After consideration of these comments, this Treasury decision adopts the 2016 Proposed Regulations with limited modifications, and it removes the 2016 Temporary Regulations. In general, the final regulations follow the approach of the 2016 Regulations while incorporating certain requested clarifications and minor revisions.

#### *I. Predecessor of Distributing Definition*

The Treasury Department and the IRS are promulgating the final regulations with the same goal as the 2004 Proposed Regulations and the 2016 Regulations: To ensure that section 355(e) applies properly to synthetic spin-offs of a Divided Corporation’s assets. As noted in part II of the Background, Congress has determined that corporate-level gain should be recognized by a Distributing “[i]n cases

in which it is intended that new shareholders will acquire ownership of a business in connection with a [Distribution],” because the overall transaction “more closely resembles a corporate level disposition of the portion of the business that is acquired.” Senate Report at 139-140. Consistent with this policy, the final regulations provide that a corporation cannot qualify as a POD unless the corporation’s assets are divided through a Distribution (that is, unless the corporation is a Divided Corporation).

The Treasury Department and the IRS have determined that, by limiting POD treatment to Divided Corporations, the final regulations will further the policy of section 355(e) while continuing to permit tax-free divisions of existing business arrangements among existing shareholders. *See* Senate Report at 139. In particular, the Treasury Department and the IRS have sought to avoid definitions that would cause section 355(e) to apply to transactions that do not resemble sales. For example, starting with the 2004 Proposed Regulations, the Treasury Department and the IRS have rejected a POD definition that would include any corporation that, without more, transfers assets to a Distributing in a Section 381 Transaction.

The following example illustrates how that rejected POD definition would have run contrary to the policies of section 355 and section 355(e). As part of a Plan, P merges tax-free into Distributing in a reorganization described in section 368(a)(1)(A), with the P shareholders receiving 40 percent of the stock of Distributing. Distributing then distributes all of the stock of Controlled (which holds none of the P assets) in a Distribution. If P were treated as a POD, the Distribution would result in gain recognition under section 355(e), because it occurred as part of the same Plan as an acquisition of a 50-percent or greater interest in P (that is, a Planned 50-percent Acquisition). *See* section 355(e)(3)(B). However, the Treasury Department and the IRS have determined that the policy of section 355(e) does not warrant the recognition of gain in this case, because the assets of P have not been divided and neither Distributing nor Controlled has undergone a Planned 50-percent Acquisition. Rather, the Distribution effected a division of existing business arrangements among exist-

ing shareholders, and Congress intended section 355 to afford tax-free treatment to such a transaction. *See* Senate Report at 139.

#### **II. Scope of the Potential Predecessor Definition**

Commenters criticized the breadth of the POD definition in the 2016 Regulations. Although commenters generally supported the treatment of P as a POD in the 2016 Preamble Example, commenters questioned the policy of treating P as a POD in Example 5. *See* part III.B of the Background section (describing the 2016 Preamble Example and Example 5). After considering all comments received on this issue, and as discussed further in the remainder of this part II, the Treasury Department and the IRS have determined that the series of transactions set forth in Example 5 should not be viewed as a synthetic spin-off, and that P therefore should not be treated as a POD in Example 5.

#### *A. Example 5 Reduces Neither the Total Value nor the Total Built-In Gain Inside P*

When a corporation distributes an appreciated asset with respect to its stock, the corporation disposes of the asset for no consideration, reducing both the total value and the total built-in gain inside the corporation. In this regard, the synthetic spin-off by P in the Base Case Example resembles an actual Distribution by P of stock of a controlled corporation holding the P assets actually held by Controlled. Both transactions reduce the total value and built-in gain of P (which, in the Base Case Example, becomes part of Distributing) by the value of, and built-in gain in, the P assets held by Controlled.

By contrast, Example 5 involves a section 351 exchange by P, which reduces neither the total value nor the total built-in gain inside P. In the section 351 exchange, P exchanges assets for Distributing stock of equal value. Under section 358, P’s basis in this Distributing stock is determined by reference to P’s basis in the assets exchanged therefor, and is then allocated between P’s Distributing stock and the Controlled stock P receives in the Distribution. Therefore, upon the conclusion of Example 5, P holds Distributing stock and

Controlled stock with an aggregate value and built-in gain equal to the aggregate value of, and built-in gain in, the assets P transferred to Distributing. Rather than disposing of an asset for no consideration (as is the case in an actual distribution of property with respect to a Distributing's stock), P merely has exchanged one asset for another in Example 5. As a result, the Treasury Department and the IRS have determined that the series of transactions set forth in Example 5 does not resemble an actual Distribution by P and should not be viewed as a synthetic spin-off.

#### *B. Ease of Elimination of Built-In Gain in the 2016 Preamble Example*

The key distinction between the 2016 Preamble Example and Example 5 is the relative ease with which a subsequent restructuring could be undertaken to eliminate P's substituted built-in gain in the 2016 Preamble Example. The 2016 Preamble Example, like Example 5, involves a section 351 exchange in which P exchanges assets for Internal Distributing stock with the same value and built-in gain. Unlike in Example 5, however, Distributing in the 2016 Preamble Example directly and indirectly owns 100 percent of the stock of both P and Internal Distributing. As a result, in the 2016 Preamble Example, Distributing could unilaterally eliminate the built-in gain preserved in P's Internal Distributing stock through an internal restructuring. The occurrence of such an internal restructuring would make the 2016 Preamble Example difficult to distinguish from the Base Case Example.

By contrast, upon the conclusion of Example 5, P owns only 10 percent of the stock of each of Distributing and Controlled, whereas corporation Y owns 90 percent. Although it may be theoretically possible for P to eliminate its built-in gain in this stock through certain transactions involving Distributing and Controlled, P lacks any meaningful control over either corporation. In addition, the Treasury Department and the IRS note that such built-in gain elimination transactions generally would carry significant non-tax consequences. Therefore, it would be unreasonable to assume that such transactions would occur and that P's built-in gain

in the Distributing and Controlled stock would be eliminated after the Distribution.

One commenter asserted that there is little opportunity for P to engage in a subsequent restructuring to eliminate its built-in gain in Distributing or Controlled stock in a case like Example 5 or the 2016 Preamble Example unless P is a member of Distributing's affiliated group (as defined in section 1504 without regard to section 1504(b)) (Expanded Affiliated Group). The Treasury Department and the IRS agree with this comment.

Based on the foregoing, the final regulations define the term Potential Predecessor as any corporation other than Distributing or Controlled, but only if either (i) as part of a Plan, the corporation transfers property to a Potential Predecessor, Distributing, or a member of the same Expanded Affiliated Group as Distributing in a Section 381 Transaction (as in the Base Case Example), or (ii) immediately after completion of the Plan, the corporation is a member of the same Expanded Affiliated Group as Distributing (as in the 2016 Preamble Example). Accordingly, under the final regulations, P in Example 5 is not a Potential Predecessor (and thus cannot be a POD).

### *III. Pre-Distribution and Post-Distribution Requirements*

#### *A. Overview*

Under the 2016 Regulations, a Potential Predecessor qualified as a POD only if two pre-Distribution requirements and one post-Distribution requirement were satisfied. The Treasury Department and the IRS intended that these requirements, taken together, (i) composed a technical description of a synthetic spin-off, and (ii) limited POD treatment to Potential Predecessors the assets of which are divided tax-free through a Distribution by Distributing. The following discussion summarizes these requirements.

#### *1. First Pre-Distribution Requirement: Relevant Property*

To satisfy the first pre-Distribution requirement, any Controlled stock distributed in the Distribution must have been (i) Relevant Property, the gain on which was

not recognized in full as part of a Plan, or (ii) acquired by Distributing for Relevant Property, the gain on which was not recognized in full as part of a Plan, and that was held by Controlled immediately before the Distribution (Relevant Property Requirement). The term "Relevant Property" generally referred to any property held by the Potential Predecessor at any point during the Plan Period (that is, the period that ends immediately after the Distribution and begins on the earliest date on which any part of the Plan is agreed to or understood, arranged, or substantially negotiated). See § 1.355-8T(b)(2)(iv).

#### *2. Second Pre-Distribution Requirement: Controlled Stock Reflects Basis of Separated Property*

To satisfy the second pre-Distribution requirement, any Controlled stock distributed in the Distribution must have reflected the basis of any Separated Property (Reflection of Basis Requirement). In general, the 2016 Regulations defined the term "Separated Property" as any Relevant Property relied on to satisfy the Relevant Property Requirement. See § 1.355-8T(b)(2)(vii). The 2016 Regulations did not define the phrase reflect the basis.

#### *3. Post-Distribution Requirement: Division of Relevant Property*

To satisfy the post-Distribution requirement, immediately following the Distribution, ownership of Relevant Property must have been divided between Controlled, on the one hand, and Distributing or the Potential Predecessor, on the other hand (Division of Relevant Property Requirement).

#### *B. Relevant Property Requirement: Fluctuations in Value*

One commenter requested clarification of the Relevant Property Requirement's application to a case in which (i) gain on Relevant Property is fully recognized at some point during the Plan Period, but (ii) the Relevant Property subsequently appreciates so that built-in gain exists at the time of the Distribution. The Treasury Department and the IRS did not intend for fluctuations in value to affect the de-

termination of POD status under the 2016 Regulations. Consequently, the final regulations replace the requirement that gain on Relevant Property not be recognized in full “as part of a Plan” with the requirement that gain (if any) on Relevant Property not be recognized in full “at any point during the Plan Period.”

#### C. Reflection of Basis Requirement

The Treasury Department and the IRS have received numerous comments requesting clarification of the Reflection of Basis Requirement’s scope and purpose. These comments arose from the failure of the 2016 Regulations to define the phrase reflect the basis.

To highlight the potential overbreadth of this undefined phrase, one commenter questioned whether P could qualify as a POD solely through a basis adjustment under § 1.1502-32. In the commenter’s example, P and unrelated Distributing (which is the common parent of a consolidated group) form corporation X in a section 351 exchange in which P contributes Asset 1 and Distributing contributes other assets in exchange for X stock, with Distributing receiving at least 80 percent of X’s stock by vote and value. Thereafter, Distributing contributes its X stock to Controlled in exchange for Controlled stock. Then, because of items relating to Asset 1, Distributing’s basis in its Controlled stock is adjusted under § 1.1502-32. Finally, Distributing distributes all of the stock of Controlled. Based on this illustrative example, the commenter expressed concern that the § 1.1502-32 basis adjustment could cause Distributing’s Controlled stock to reflect the basis of Asset 1, and the commenter asserted that treating P as a POD in this case would be inappropriate.

The Treasury Department and the IRS did not intend the Reflection of Basis Requirement in the 2016 Regulations to be satisfied solely by a basis adjustment under § 1.1502-32. The Reflection of Basis Requirement served two related purposes. First, the Treasury Department and the IRS intended the Reflection of Basis Requirement to ensure a connection between the gain in the POD’s property held by Controlled and the gain that Distributing must recognize under section

355(e). Second, the Treasury Department and the IRS intended this requirement to avoid improper duplication of gain if Controlled stock is distributed in multiple Distributions as part of the same Plan. See § 1.355-8T(h), *Example 7* (concluding with respect to consecutive Distributions that, although P is a POD with respect to the first Distribution, P is not a POD with respect to the second Distribution because the C stock distributed in the second Distribution did not reflect the basis of any Separated Property).

The Treasury Department and the IRS have addressed these concerns in the final regulations by clearly articulating the Reflection of Basis Requirement. The final regulations clarify that the Reflection of Basis Requirement is satisfied only if any Controlled stock that satisfies the Relevant Property Requirement had a basis prior to the Distribution that was determined, in whole or in part, by reference to the basis of Separated Property. The final regulations make the same clarification to the two other provisions that, under the 2016 Regulations, referred to a reflection of basis: § 1.355-8T(b)(2)(vi)(B)(2) (regarding the treatment of Controlled stock as a Substitute Asset); and § 1.355-8T(b)(2)(x) (providing a deemed exchange rule for purposes of the Relevant Property Requirement, the Reflection of Basis Requirement, and the Substitute Asset definition).

In addition, the final regulations clarify that the Reflection of Basis Requirement is satisfied only if, during the Plan Period prior to the Distribution, any Controlled stock that satisfies the Relevant Property Requirement (and the first prong of the Reflection of Basis Requirement) was neither distributed in a section 355(e) distribution nor transferred in a transaction in which the gain (if any) on that Controlled stock was recognized in full. This clarification ensures that the final regulations cannot be interpreted in a manner that would give rise to improper duplication of gain, a policy objective of the Treasury Department and the IRS in issuing the 2016 Regulations.

#### D. Treatment of Property Acquired Not Pursuant to a Plan

One commenter requested that the Treasury Department and the IRS clar-

ify that property acquired by a Potential Predecessor during the Plan Period would not be treated as Relevant Property if not acquired pursuant to a Plan. In particular, the commenter presented an example in which a Potential Predecessor becomes a member of Distributing’s consolidated group pursuant to a Plan. Prior to a Distribution, the Potential Predecessor acquires from other members of Distributing’s consolidated group property that had not been transferred directly or indirectly to Distributing pursuant to the Plan. The commenter requested clarification that this property is not Relevant Property.

The commenter’s specific concern was already addressed by an exception to the Relevant Property definition in the 2016 Regulations (see § 1.355-8T(b)(2)(iv)(B)), and the final regulations retain this exception. This exception provides that property held directly or indirectly by Distributing is Relevant Property of a Potential Predecessor only to the extent that the property (1) was transferred directly or indirectly to Distributing during the Plan Period, and (2) was Relevant Property of the Potential Predecessor before the direct or indirect transfers. This exception exempts the property in the commenter’s example from treatment as Relevant Property because the property was not transferred directly or indirectly to Distributing during the Plan Period.

In addition, the final regulations include a Plan limitation in the Division of Relevant Property Requirement. Thus, the Division of Relevant Property Requirement will be satisfied only if ownership of a Potential Predecessor’s Relevant Property has been divided as part of a Plan. Both the preamble to the 2016 Regulations and the text of § 1.355-8T(a)(3) (summarizing the POD definition) described the Division of Relevant Property Requirement in the 2016 Regulations as including a Plan limitation, and the Treasury Department and the IRS had intended for § 1.355-8T(b)(1)(iii) (the Division of Relevant Property Requirement) to include this limitation. The Treasury Department and the IRS intend that the Plan limitation in the Division of Relevant Property Requirement will ensure more generally that Relevant Property acquired by a Potential Predecessor during the Plan Period, but not pursuant to a Plan, will not result in an inappropriate application of section 355(e).

## E. Stock of Distributing as Relevant Property

One commenter questioned whether a reference in § 1.355-8T(b)(2)(v) (limiting the circumstances under which Distributing stock is treated as Relevant Property) to § 1.355-8T(b)(1)(ii) (the Relevant Property Requirement and the Reflection of Basis Requirement) was intended to refer instead to § 1.355-8T(b)(1)(iii) (the Division of Relevant Property Requirement). The Treasury Department and the IRS intended for § 1.355-8T(b)(2)(v) to reference the Division of Relevant Property Requirement and have incorporated this revision into the final regulations.

## IV. Implicit Permission

Although § 1.355-7 generally governs the determination of whether a Distribution and an acquisition of a 50-percent or greater interest in a POD have occurred as part of the same Plan, the 2016 Regulations contained special rules in this regard. *See* § 1.355-8T(a)(4)(ii). In general, references to Distributing in § 1.355-7 included references to a POD. However, any agreement, understanding, arrangement, or substantial negotiations regarding the acquisition of the stock of a POD were analyzed under § 1.355-7 with respect to the actions of officers or directors of Distributing or Controlled, controlling shareholders of Distributing or Controlled, or a person acting with permission of one of those persons. For that purpose, references in § 1.355-7 to Distributing did not include references to a POD. Therefore, the actions of officers, directors, or controlling shareholders of a POD, or of a person acting with the implicit or explicit permission of one of those persons, would not have been considered for this purpose unless those persons otherwise would have been treated as acting on behalf of Distributing or Controlled under § 1.355-7. The final regulations retain these rules.

One commenter expressed concern regarding the potential scope of the “implicit permission” concept in § 1.355-7 given that the 2016 Regulations contemplated that actions on behalf of a Potential Predecessor may be taken into account if such actions were carried out with the implicit permission of Distributing. The

Treasury Department and the IRS have not addressed this comment in the final regulations because the implicit permission concept is a component of § 1.355-7 and therefore is beyond the scope of this Treasury decision.

## V. Successors

Under section 355(e)(4)(D), any reference to Controlled or Distributing includes a reference to any successor of such corporation (Successor). Like the 2004 Proposed Regulations, the 2016 Regulations limited the definition of the term Successor to a corporation to which Distributing or Controlled (as the case may be) transfers property in a Section 381 Transaction after the Distribution. A partnership cannot receive assets in a Section 381 Transaction. Accordingly, a partnership could not have been a Successor under either the 2004 Proposed Regulations or the 2016 Regulations. As noted later in this part V, the final regulations retain this approach.

The 2004 Proposed Regulations and the 2016 Regulations also contained a deemed acquisition rule (*see* § 1.355-8T(d)(2)). Under this rule, after a Section 381 Transaction, an acquisition of stock of the acquiring corporation is treated also as an acquisition of the stock of the distributor or transferor corporation in the Section 381 Transaction. Thus, if the assets of Distributing or any POD are acquired by another corporation in a Section 381 Transaction, then any subsequent acquisition of the stock of the acquiring corporation is treated also as an acquisition of the stock of Distributing or the POD, as the case may be.

As a result of these rules, a corporation’s status as a Successor of Distributing or Controlled matters only insofar as an acquisition of its stock is treated as an acquisition of the stock of Distributing or Controlled, respectively, which could result in a Planned 50-percent Acquisition of Distributing or Controlled. Therefore, the only significance of a Planned 50-percent Acquisition of a Successor is its treatment as a deemed Planned 50-percent Acquisition of Distributing or Controlled (as the case may be). Accordingly, if any of the stock of Distributing or Controlled has been acquired in, or prior to, a Section 381 Transaction, the application of sec-

tion 355(e) will turn on whether a Planned 50-percent Acquisition of Distributing or Controlled has occurred, taking into account acquisitions of the stock of Distributing or Controlled in, and prior to, the Section 381 Transaction, as well as any acquisitions of the stock of the Successor following the Section 381 Transaction.

Commenters supported this approach, and the Treasury Department and the IRS have retained it in the final regulations. Thus, under the final regulations, a Successor of Distributing or of Controlled must be a corporation to which Distributing or Controlled, respectively, transfers property in a Section 381 Transaction after the Distribution. A partnership cannot be a Successor of Distributing or Controlled under the final regulations for purposes of section 355(e). Certain references in the 2016 Regulations to a Planned 50-percent Acquisition of a Successor have been refined to clarify the significance of Successor status.

## VI. Gain Limitation Rules

Taken together, sections 355(e), 355(c), and 361(c) generally require Distributing to recognize any gain in Controlled stock and securities distributed in a Distribution that is part of the same Plan as a Planned 50-percent Acquisition of a POD, Distributing, or Controlled (the amount of such gain, Statutory Recognition Amount). However, the 2016 Regulations contained special rules that limited the amount of gain that section 355(e) causes Distributing to recognize in certain cases involving a POD. In cases involving a Planned 50-percent Acquisition of a POD, § 1.355-8T(e)(2) (POD Gain Limitation Rule) generally limited the amount of gain Distributing was required to recognize to any built-in gain in the POD’s Separated Property (generally, POD assets held by Controlled). Similarly, in cases involving a Planned 50-percent Acquisition of Distributing as the result of a transfer by a POD to Distributing in a Section 381 Transaction, § 1.355-8T(e)(3) (Distributing Gain Limitation Rule) generally reduced the amount of gain Distributing was required to recognize by the built-in gain in the POD’s Separated Property. In addition, in cases involving multiple Planned 50-percent Acquisitions, § 1.355-8T(e)

(1) generally provided that the total gain limitation applicable under § 1.355-8T(e) is determined by adding the Statutory Recognition Amount (subject to the POD Gain Limitation Rule and the Distributing Gain Limitation Rule) with respect to each Planned 50-percent Acquisition. Finally, § 1.355-8T(e)(4) provided that the amount required to be recognized by Distributing under section 355(e) with regard to a single Distribution will not exceed the Statutory Recognition Amount.

Commenters questioned why the 2016 Regulations limited the Distributing Gain Limitation Rule to Section 381 Transactions, and recommended expanding the Distributing Gain Limitation Rule so that it applies to any Planned 50-Percent Acquisition of Distributing. In particular, one commenter asserted that the form of the transaction in which a Planned 50-percent Acquisition of Distributing occurs should not be relevant to the application of the gain limitation rules.

As discussed in the preamble to the 2016 Regulations, the Treasury Department and the IRS intended the Distributing Gain Limitation Rule to minimize the Federal income tax impact of directionality between economically equivalent Section 381 Transactions. In other words, the Distributing Gain Limitation Rule was intended to ensure that the amount of gain required to be recognized under section 355(e) would be the same regardless of whether the smaller or the larger corporation in a Section 381 Transaction acts as the acquiring corporation. The Distributing Gain Limitation Rule was limited to Section 381 Transactions in the 2016 Regulations because the direction of other types of transactions (such as section 351 exchanges) generally cannot be reversed without changing the substance of the transaction, and thus generally do not implicate the policy of directional neutrality. However, upon further study, the Treasury Department and the IRS have determined that the policy underlying the Distributing Gain Limitation Rule should not be limited to directional neutrality.

The POD definition is based on the theory that a Distribution that effects a tax-free division of the assets of a corporation other than Distributing (a POD) may be viewed as two separate Distributions: one by the POD (of a Controlled holding the

Separated Property) (POD Distribution), and one by Distributing (of a Controlled holding all of the property held by Controlled in the actual Distribution other than the Separated Property) (Non-POD Distribution). Section 355(e) requires gain recognition when new shareholders acquire ownership of a business in connection with a spin-off. Thus, when a Planned 50-percent Acquisition of a POD occurs in connection with a POD Distribution, the final regulations require gain recognition under section 355(e). However, unless there is also a Planned 50-percent Acquisition of Distributing, the Non-POD Distribution represents a division of existing business arrangements among existing shareholders, to which Congress intended to afford tax-free treatment. See Senate Report at 139-140. Accordingly, the POD Gain Limitation Rule limits the amount of gain required to be recognized to the built-in gain on the Separated Property.

The same policy goals justify the expansion of the Distributing Gain Limitation Rule so that it applies to any Planned 50-percent Acquisition of Distributing—however and by whomever effected. If a Distribution involves a POD and occurs in connection with a Planned 50-percent Acquisition of Distributing (but no Planned 50-percent Acquisition of the POD or Controlled), then the POD Distribution should not be subject to gain recognition because it represents a division of existing business arrangements among existing shareholders.

Accordingly, the Distributing Gain Limitation Rule in the final regulations applies if there is a Planned 50-percent Acquisition of Distributing. However, consistent with the policy underlying the Distributing Gain Limitation Rule, a Distribution will benefit from the Distributing Gain Limitation Rule only if a POD exists and does not also undergo a Planned 50-percent Acquisition. If no POD exists, then the limitation under the Distributing Gain Limitation Rule will equal the Statutory Recognition Amount, because there is no Separated Property. If a POD exists but also undergoes a Planned 50-percent Acquisition, then Distributing must recognize the Statutory Recognition Amount with respect to the Planned 50-percent Acquisition of the POD (subject to the POD Gain Limitation Rule) and the Planned

50-percent Acquisition of Distributing (subject to the Distributing Gain Limitation Rule). See § 1.355-8(e)(1)(ii) of the final regulations (Multiple Planned 50-percent Acquisitions). Similarly, if there are Planned 50-percent Acquisitions of both Distributing and Controlled, Distributing must recognize the Statutory Recognition Amount with respect to the Planned 50-percent Acquisition of Controlled (which is not eligible for limitation under any gain limitation rule) and the Planned 50-percent Acquisition of Distributing (subject to the Distributing Gain Limitation Rule). Although the multiple Planned 50-percent Acquisition rule just described may deny any benefit under the gain limitation rules, in no event will the final regulations require Distributing to recognize an amount that exceeds the Statutory Recognition Amount with regard to a single Distribution. See § 1.355-8(e)(4) of the final regulations (gain recognition limited to Statutory Recognition Amount).

The Treasury Department and the IRS have clarified the gain limitation rules in the final regulations to make them easier to understand and apply. The Treasury Department and the IRS also have refined the calculation of the gain limitation under the Distributing Gain Limitation Rule to account for the possibility of more than one POD with respect to a single Distribution. In addition, to clarify that both built-in gain and built-in loss assets are taken into account in computing any applicable gain limitation, the Treasury Department and the IRS have refined the description of gain in the Relevant Property Requirement by adding the parenthetical phrase “(if any),” and have added a similar clarification to the Separated Property definition.

## VII. Relevant Equity

The 2016 Temporary Regulations used the defined term “Relevant Stock” (stock that is Relevant Property) in connection with the defined terms “Separated Property” and “Underlying Property” (property directly or indirectly held by a corporation that is the issuer of Relevant Stock). See § 1.355-8T(b)(2)(iv), (vii), and (viii). These terms were used to ensure that gain would not be duplicated in determining the applicable gain limitation

amount (if any) if the Relevant Property held by Controlled included stock in a corporation. The potential for duplication existed because the gain limitation is calculated based on the built-in gain in Relevant Property held by Controlled, and the definition of “Relevant Property” included assets held directly or indirectly (and thus included both stock of a corporation and any assets held by the corporation).

The Treasury Department and the IRS have determined that a similar risk of duplicated gain exists when Relevant Property includes an interest in a partnership. Accordingly, the final regulations replace the term “Relevant Stock” with the term “Relevant Equity,” which means Relevant Property that is an equity interest in a corporation or a partnership. This clarification relates only to the determination of the limitation on gain under § 1.355-8(e) of the final regulations (if any).

### VIII. Section 336(e)

The 2016 Regulations prohibited a section 336(e) election if the amount of gain required to be recognized by Distributing with respect to the Distribution was less than the Statutory Recognition Amount due to the POD Gain Limitation Rule or the Distributing Gain Limitation Rule. This prohibition applied even if Distributing chose to recognize the Statutory Recognition Amount under § 1.355-8T(e)(4). One commenter criticized this prohibition as “inequitable as a policy matter and unnecessary as an administrative one.”

Although the final regulations retain this prohibition, the Treasury Department and the IRS continue to study and request comments on the following issues: (1) Whether permitting a section 336(e) election in this context would be consistent with the policy of section 336(e), (2) whether permitting a section 336(e) election in this context could give rise to inappropriate planning opportunities, (3) whether permitting a section 336(e) election in this context only if the Separated Property accounts for a certain minimum percentage of Controlled’s value or built-in gain would be appropriate, and (4) whether limiting the deemed asset disposition that results from a section 336(e) election in this context to a deemed disposition of the Separated Property would be appropriate.

### IX. Stock Deemed Acquired in a Section 381 Transaction

Section 355(e)(3)(B) provides a special rule for certain asset acquisitions. For purposes of section 355(e), if the assets of Distributing or Controlled are acquired by a successor corporation in a transaction described in section 368(a)(1)(A), (C), or (D), or in any other transaction specified in regulations, the shareholders (immediately before the acquisition) of the successor corporation are treated as acquiring stock in Distributing or Controlled, respectively, except as otherwise provided in regulations. Similarly, the 2016 Regulations provided that any Section 381 Transaction is treated as an acquisition of stock in the distributor or transferor corporation by shareholders of the acquiring corporation. A commenter pointed out a mathematical error in the textual example that followed this rule (in § 1.355-8T(d)(1)). The final regulations correct this error and make minor clarifications to improve the readability of the operative rule.

### X. No Step Transaction Implications From Examples

One commenter suggested that the Treasury Department and the IRS clarify that no inference should be drawn from the examples in § 1.355-8T(h) as to the intended application of the step transaction doctrine and other general Federal income tax principles. The Treasury Department and the IRS did not intend for any such inference to be drawn, and have added a specific disclaimer to this effect in the final regulations.

### XI. Transition Rule

The 2016 Regulations generally applied to Distributions occurring after January 18, 2017. However, under a transition rule, the 2016 Regulations generally did not apply to a Distribution that was (A) made pursuant to a binding agreement in effect on or before December 16, 2016 and at all times thereafter; (B) described in a ruling request submitted to the IRS on or before December 16, 2016; or (C) described on or before December 16, 2016 in a public announcement or in a filing with the Securities and Exchange Com-

mission. For the transition rule to apply, the agreement, ruling request, public announcement, or filing described in the preceding sentence had to describe all steps relevant to the determination of POD status. See § 1.355-8T(i)(2)(ii).

One commenter criticized the “all relevant steps” rule in § 1.355-8T(i)(2)(ii) as “extremely narrow” and inappropriate for immediately effective regulations. This commenter contended that it is “unlikely that all such transactions would be described . . . until very late in the long and expensive process of a corporate separation, if at all.”

The Treasury Department and the IRS note that the 2016 Regulations were not immediately applicable; they were published on December 19, 2016, but they generally applied only to Distributions that occurred after January 18, 2017. Moreover, the final regulations do not contain a transition rule, so the commenter’s concern is relevant only to transactions that were the subject of an agreement, ruling request, public announcement, or public filing that occurred in 2016 (or before). Finally, despite the commenter’s general concern, the Treasury Department and the IRS are unaware of any transactions that failed to qualify for the transition rule due to the “all relevant steps” rule in § 1.355-8T(i)(2)(ii). Accordingly, the Treasury Department and the IRS have determined that it is not necessary to reconsider the transition rule in the 2016 Regulations as part of this Treasury decision.

### XII. Additional Clarifications

Commenters noted generally that certain aspects of the 2016 Regulations were complicated and difficult to understand. The Treasury Department and the IRS have refined and clarified certain aspects of the 2016 Regulations in the final regulations to make the rules easier to follow and understand. For instance, certain paragraphs in the 2016 Regulations that were long and contained multiple distinct rules have been subdivided in the final regulations. In addition, defined terms have been added for certain rules (such as the Relevant Property Requirement, the Reflection of Basis Requirement, and the Division of Relevant Property Requirement). These defined terms are intended to allow the

reader to more intuitively grasp the meaning of the numerous provisions cross-reference in the final regulations.

Section 1.355-8T(c)(1) defined the term “Predecessor of Controlled” and provided certain rules relating to Predecessors of Controlled. One of these rules provided that, for purposes of § 1.355-8T(c)(1), a reference to Controlled included a reference to a Predecessor of Controlled. However, another provision in the 2016 Regulations (§ 1.355-8T(a)(4)(i)) provided more generally that, except as otherwise provided, any reference to Controlled included, as the context may have required, a reference to any Predecessor of Controlled. Accordingly, the rule in § 1.355-8T(c)(1) was unnecessary, and the Treasury Department and the IRS have omitted it in the final regulations.

### XIII. Examples

The Treasury Department and the IRS have modified three of the examples contained in the 2016 Regulations (*Examples 5, 7, and 8*), and omitted one example (*Example 6*), for the reasons described in this part XIII. All of the retained examples have been updated to reflect modifications in the final regulations. For instance, the POD analyses in *Examples 3 and 4* eliminate the statement that Controlled stock is Separated Property, because that fact is no longer relevant under the revised Reflection of Basis Requirement. In some of the examples, the analysis has been clarified to make it easier to follow and understand.

The facts of *Example 5* of the 2016 Regulations have been retained, but the consequences of the example have changed due to the modification the Treasury Department and the IRS have made to the Potential Predecessor definition. As a result of this modification, P in *Example 5* is no longer a Potential Predecessor (and thus is not a POD for that reason).

*Example 6* of the 2016 Regulations has been omitted. This example illustrated a variation on *Example 5* that used a forward triangular merger instead of a section 351 exchange. However, due to the modification to the Potential Predecessor definition, P in *Example 6* is no longer a Potential Predecessor (and thus is not a POD for that reason), which eliminates the utility of this example.

*Example 7* of the 2016 Regulations has been incorporated into new *Example 6* in the final regulations, which is based on the 2016 Preamble Example.

*Example 8* of the 2016 Regulations has been retained as *Example 7* in the final regulations, but has been modified so that P1 and P2 are Potential Predecessors under the final regulations. In particular, the section 351 exchange between P2 and D has been replaced by a Section 381 Transaction in which P2 merges into D.

### Applicability Date

Section 7805(b)(1)(A) and (B) of the Code generally provide that no temporary, proposed, or final regulation relating to the internal revenue laws may apply to any taxable period ending before the earliest of (A) the date on which such regulation is filed with the **Federal Register**, or (B) in the case of a final regulation, the date on which a proposed or temporary regulation to which the final regulation relates was filed with the **Federal Register**. In addition, section 7805(e) provides that any temporary regulation shall also be issued as a proposed regulation, and that such temporary regulation shall expire within 3 years after the date of issuance of the temporary regulation.

The final regulations, the substance of which is generally the same as that of the 2016 Regulations, apply to Distributions that occur after December 15, 2019, the day before the expiration date of the 2016 Temporary Regulations.

### 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 (5 U.S.C. chapter 6), it is hereby certified that these final regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations would primarily affect large corporations with a substantial number of shareholders, as well as corporations that

are members of large corporate groups. Additionally, the Treasury Department and the IRS have determined that no additional burden will be associated with these final regulations. Therefore, a regulatory flexibility analysis is not required.

Pursuant to section 7805(f) of the Internal Revenue Code, the 2016 Proposed Regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small businesses, and no comments were received.

### Drafting Information

The principal author of these regulations is W. Reid Thompson of the Office of Associate Chief Counsel (Corporate). However, other personnel from the Treasury Department and the IRS participated in their development.

### List of Subjects in 26 CFR Part 1

Income taxes, Reporting and record-keeping requirements.

### Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

#### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry for § 1.355-8T and adding an entry in numerical order for § 1.355-8 to read in part as follows:

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

Section 1.355-8 also issued under 26 U.S.C. 336(e), 355(e)(3)(B), 355(e)(5), and 355(f).

\* \* \* \* \*

Par. 2. Section 1.355-0 is amended by revising the introductory text, removing the entries for § 1.355-8T, and adding the entries for § 1.355-8 to read as follows:

#### § 1.355-0 Outline of sections.

In order to facilitate the use of §§ 1.355-1 through 1.355-8, this section lists the major paragraphs in those sections as follows:

\* \* \* \* \*

*§ 1.355-8 Definition of predecessor and successor and limitations on gain recognition under section 355(e) and section 355(f).*

- (a) In general.
- (1) Scope.
- (2) Overview.
  - (i) Purposes and conceptual overview.
  - (ii) References to and definitions of terms used in this section.
  - (iii) Special rules and examples.
- (3) Purposes of section; Predecessor of Distributing overview.
  - (i) Purposes.
  - (ii) Predecessor of Distributing overview.
    - (A) Relevant Property transferred to Controlled.
    - (B) Relevant Property includes Controlled Stock.
  - (4) References.
    - (i) References to Distributing or Controlled.
    - (ii) References to Plan or Distribution.
    - (iii) Plan Period.
    - (5) List of definitions.
    - (b) Predecessor of Distributing.
      - (1) Definition.
      - (i) In general.
      - (ii) Pre-Distribution requirements.
      - (A) Relevant Property requirement.
      - (B) Reflection of basis requirement.
      - (iii) Post-Distribution requirement.
    - (2) Additional definitions and rules related to paragraph (b)(1) of this section.
      - (i) References to Distributing and Controlled.
      - (ii) Potential Predecessor.
        - (A) Potential Predecessor definition.
        - (B) Expanded Affiliated Group definition.
      - (iii) Successors of Potential Predecessors.
      - (iv) Relevant Property; Relevant Equity.
        - (A) In general.
        - (B) Property held by Distributing.
        - (C) Reorganizations.
        - (v) Stock of Distributing as Relevant Property.
          - (A) In general.
          - (B) Certain reorganizations.
          - (vi) Substitute Asset.
          - (A) In general.
          - (B) Controlled stock received by Distributing.
          - (I) In general.

- (2) Exception.
- (C) Treatment as Relevant Property.
- (vii) Separated Property.
- (viii) Underlying Property.
- (ix) Multiple Predecessors of Distributing.
  - (x) Deemed exchanges.
  - (c) Additional definitions.
  - (1) Predecessor of Controlled.
  - (2) Successors.
    - (i) In general.
    - (ii) Determination of Successor status.
  - (3) Section 381 Transaction.
  - (d) Special acquisition rules.
    - (1) Deemed acquisitions of stock in Section 381 Transactions.
      - (i) Rule.
      - (ii) Example.
    - (2) Deemed acquisitions of stock after Section 381 Transactions.
    - (3) Separate counting for Distributing and each Predecessor of Distributing.
    - (e) Special rules for limiting gain recognition.
      - (1) Overview.
      - (i) Gain limitation.
      - (ii) Multiple Planned 50-percent Acquisitions.
        - (iii) Statutory Recognition Amount limit; Section 336(e).
      - (2) Planned 50-percent Acquisition of a Predecessor of Distributing.
        - (i) In general.
        - (ii) Operating rules.
          - (A) Separated Property other than Controlled stock.
          - (B) Controlled stock that is Separated Property.
        - (C) Anti-duplication rule.
        - (3) Planned 50-percent Acquisition of Distributing.
        - (4) Gain recognition limited to Statutory Recognition Amount.
        - (5) Section 336(e) election.
        - (f) Predecessor or Successor as a member of the affiliated group.
        - (g) Inapplicability of section 355(f) to certain intra-group Distributions.
          - (1) In general.
          - (2) Alternative application of section 355(f).
          - (h) Examples.
          - (i) Applicability date.

**§ 1.355-8T [Removed]**

Par. 3. Section 1.355-8T is removed.  
Par. 4. Section 1.355-8 is added to read as follows:

*§ 1.355-8 Definition of predecessor and successor and limitations on gain recognition under section 355(e) and section 355(f).*

(a) *In general*—(1) *Scope*. For purposes of section 355(e), this section provides rules under section 355(e)(4)(D) to determine whether a corporation is treated as a predecessor or successor of a distributing corporation (Distributing) or a controlled corporation (Controlled) with respect to a distribution by Distributing of stock (or stock and securities) of Controlled that qualifies under section 355(a) (or so much of section 356 as relates to section 355) (Distribution). This section also provides rules limiting the amount of Distributing's gain recognized under section 355(e) on a Distribution if section 355(e) applies to an acquisition by one or more persons, as part of a Plan, of stock that in the aggregate represents a 50-percent or greater interest (Planned 50-percent Acquisition) of a Predecessor of Distributing, or a Planned 50-percent Acquisition of Distributing. In addition, this section provides rules regarding the application of section 336(e) to a Distribution to which this section applies. This section also provides rules regarding the application of section 355(f) to a Distribution in certain cases.

(2) *Overview*—(i) *Purposes and conceptual overview*. Paragraph (a)(3) of this section summarizes the two principal purposes of this section and sets forth a brief conceptual overview of the scenarios in which a corporation may be a Predecessor of Distributing.

(ii) *References to and definitions of terms used in this section*. Paragraph (a)(4) of this section provides rules regarding references to the terms *Distributing*, *Controlled*, *Distribution*, *Plan*, and *Plan Period* for purposes of section 355(e), § 1.355-7, and this section. Paragraph (a)(5) of this section lists the terms used in this section and indicates where each term is defined. Paragraph (b) of this section defines the term *Predecessor of Distributing* and several related terms. Paragraph (c) of this section defines the terms *Predecessor of Controlled*, *Successor* (of Distributing or Controlled), and *Section 381 Transaction*.

(iii) *Special rules and examples*. Paragraph (d) of this section provides guidance with regard to acquisitions and deemed acquisitions of stock if there is a

Predecessor of Distributing or a Successor of either Distributing or Controlled. Paragraph (e) of this section provides two rules that may limit the amount of Distributing's gain on a Distribution if there is a Predecessor of Distributing, as well as an overall gain limitation. Paragraph (e) of this section also provides guidance with respect to the application of section 336(e). Regardless of whether there is a Predecessor of Distributing, Predecessor of Controlled, or Successor of either Distributing or Controlled, paragraph (f) of this section provides a special rule relating to section 355(e)(2)(C), which provides that section 355(e) does not apply to certain transactions within an Expanded Affiliated Group. Paragraph (g) of this section provides rules coordinating the application of section 355(f) with the rules of this section. Paragraph (h) of this section contains examples that illustrate the rules of this section.

(3) *Purposes of section; Predecessor of Distributing overview*—(i) *Purposes*. The rules in this section have two principal purposes. The first is to ensure that section 355(e) applies to a Distribution if, as part of a Plan, some of the assets of a Predecessor of Distributing are transferred directly or indirectly to Controlled without full recognition of gain, and the Distribution accomplishes a division of the assets of the Predecessor of Distributing. The second is to ensure that section 355(e) applies when there is a Planned 50-percent Acquisition of a Successor of Distributing or Successor of Controlled. The rules of this section must be interpreted and applied in a manner that is consistent with and reasonably carries out the purposes of this section.

(ii) *Predecessor of Distributing overview*. The term Predecessor of Distributing is defined in paragraph (b) of this section. Only a Potential Predecessor can be a Predecessor of Distributing. See paragraph (b)(1)(i) of this section. A Potential Predecessor can be a Predecessor of Distributing only if, as part of a Plan, the Distribution accomplishes a division of the assets of the Potential Predecessor. See paragraph (b)(1)(iii) of this section. Accordingly, in the absence of that Plan, a Predecessor of Distributing cannot exist for purposes of section 355(e). The detailed rules set forth in paragraph (b) of

this section provide that a Potential Predecessor the assets of which are divided as part of a Plan may be a Predecessor of Distributing in either of the following two scenarios:

(A) *Relevant Property transferred to Controlled*. As part of the Plan, one or more of the Potential Predecessor's assets were transferred to Controlled in one or more tax-deferred transactions prior to the Distribution.

(B) *Relevant Property includes Controlled Stock*. The Potential Predecessor's assets included Controlled stock that, as part of the Plan, was transferred to Distributing in one or more tax-deferred transactions prior to the Distribution.

(4) *References*—(i) *References to Distributing or Controlled*. For purposes of section 355(e), except as otherwise provided in this section, any reference to Distributing or Controlled includes, as the context may require, a reference to any Predecessor of Distributing or any Predecessor of Controlled, respectively, or any Successor of Distributing or Controlled, respectively. However, except as otherwise provided in this section, a reference to a Predecessor of Distributing or to a Successor of Distributing does not include a reference to Distributing, and a reference to a Predecessor of Controlled or to a Successor of Controlled does not include a reference to Controlled.

(ii) *References to Plan or Distribution*. Except as otherwise provided in this section, references to a *Plan* in this section are references to a plan within the meaning of § 1.355-7. References to a distribution in § 1.355-7 include a reference to a Distribution and other related pre-Distribution transactions that together effect a division of the assets of a Predecessor of Distributing. In determining whether a Distribution and a Planned 50-percent Acquisition of a Predecessor of Distributing, Distributing (including any Successor thereof), or Controlled (including any Successor thereof) are part of a Plan, the rules of § 1.355-7 apply. In applying those rules, references to Distributing or Controlled in § 1.355-7 generally include references to any Predecessor of Distributing and any Successor of Distributing, or any Successor of Controlled, as appropriate. However, with regard to any possible Planned 50-percent Acquisition of

a Predecessor of Distributing, any agreement, understanding, arrangement, or substantial negotiations with regard to the acquisition of the stock of the Predecessor of Distributing is analyzed under § 1.355-7 with regard to the actions of officers or directors of Distributing or Controlled, controlling shareholders (as defined in § 1.355-7(h)(3)) of Distributing or Controlled, or a person acting with permission of one of those parties. For purposes of the preceding sentence, references in § 1.355-7 to Distributing do not include references to a Predecessor of Distributing. Therefore, the actions of officers, directors, or controlling shareholders of a Predecessor of Distributing, or of a person acting with the implicit or explicit permission of one of those parties, are not considered unless those parties otherwise would be treated as acting on behalf of Distributing or Controlled under § 1.355-7 (for example, if a Predecessor of Distributing is a controlling shareholder of Distributing).

(iii) *Plan Period*. For purposes of this section, the term *Plan Period* means the period that ends immediately after the Distribution and begins on the earliest date on which any pre-Distribution step that is part of the Plan is agreed to or understood, arranged, or substantially negotiated by one or more officers or directors acting on behalf of Distributing or Controlled, by controlling shareholders of Distributing or Controlled, or by another person or persons with the implicit or explicit permission of one or more of such officers, directors, or controlling shareholders. For purposes of the preceding sentence, references to Distributing and Controlled do not include references to any Predecessor of Distributing, Predecessor of Controlled, or Successor of Distributing or Controlled.

(5) *List of definitions*. This section uses the following terms, which are defined where indicated—

(i) *Acquiring Owner*. Paragraph (d)(1) of this section.

(ii) *Controlled*. Paragraph (a)(1) of this section.

(iii) *Distributing*. Paragraph (a)(1) of this section.

(iv) *Distributing Gain Limitation Rule*. Paragraph (e)(1)(ii) of this section.

(v) *Distribution*. Paragraph (a)(1) of this section.

- (vi) *Division of Relevant Property Requirement.* Paragraph (b)(1)(iii) of this section.
- (vii) *Expanded Affiliated Group.* Paragraph (b)(2)(ii)(B) of this section.
- (viii) *Hypothetical Controlled.* Paragraph (e)(2)(i) of this section.
- (ix) *Hypothetical D/355(e) Reorganization.* Paragraph (e)(2)(i) of this section.
- (x) *Plan.* Paragraph (a)(4)(ii) of this section.
- (xi) *Plan Period.* Paragraph (a)(4)(iii) of this section.
- (xii) *Planned 50-percent Acquisition.* Paragraph (a)(1) of this section.
- (xiii) *POD Gain Limitation Rule.* Paragraph (e)(1)(ii) of this section.
- (xiv) *Potential Predecessor.* Paragraph (b)(2)(ii)(A) of this section.
- (xv) *Predecessor of Controlled.* Paragraph (c)(1) of this section.
- (xvi) *Predecessor of Distributing.* Paragraph (b)(1) of this section.
- (xvii) *Reflection of Basis Requirement.* Paragraph (b)(1)(ii)(B) of this section.
- (xviii) *Relevant Equity.* Paragraph (b)(2)(iv)(A) of this section.
- (xix) *Relevant Property.* Paragraph (b)(2)(iv)(A) of this section.
- (xx) *Relevant Property Requirement.* Paragraph (b)(1)(ii)(A) of this section.
- (xxi) *Section 381 Transaction.* Paragraph (c)(3) of this section.
- (xxii) *Separated Property.* Paragraph (b)(2)(vii) of this section.
- (xxiii) *Statutory Recognition Amount.* Paragraph (e)(1)(i) of this section.
- (xxiv) *Substitute Asset.* Paragraph (b)(2)(vi)(A) of this section.
- (xxv) *Successor.* Paragraph (c)(2)(i) of this section.
- (xxvi) *Successor Transaction.* Paragraph (c)(2)(i) of this section.
- (xxvii) *Underlying Property.* Paragraph (b)(2)(viii) of this section.
- (b) *Predecessor of Distributing*—(1) *Definition*—(i) *In general.* For purposes of section 355(e), a Potential Predecessor is a predecessor of Distributing (Predecessor of Distributing) if, taking into account the special rules of paragraph (b)(2) of this section—
 

(A) Both pre-Distribution requirements of paragraph (b)(1)(ii) of this section are satisfied; and

(B) The post-Distribution requirement of paragraph (b)(1)(iii) of this section is satisfied.

(ii) *Pre-Distribution requirements*—(A) *Relevant Property requirement.* The requirement set forth in this paragraph (b)(1)(ii)(A) (Relevant Property Requirement) is satisfied if, before the Distribution, and as part of a Plan, either—
 

(I) Any Controlled stock distributed in the Distribution was directly or indirectly acquired (or deemed acquired under the rules set forth in paragraph (b)(2)(x) of this section) by Distributing in exchange for any direct or indirect interest in Relevant Property—
 

(i) That is held directly or indirectly by Controlled immediately before the Distribution; and

(ii) The gain on which (if any) was not recognized in full at any point during the Plan Period; or

(2) Any Controlled stock that is distributed in the Distribution is Relevant Property of the Potential Predecessor.

(B) *Reflection of basis requirement.* The requirement set forth in this paragraph (b)(1)(ii)(B) (Reflection of Basis Requirement) is satisfied if any Controlled stock that satisfies the Relevant Property Requirement—
 

(I) Either—
 

(i) Had a basis prior to the Distribution that was determined in whole or in part by reference to the basis of any Separated Property; or

(ii) Is Relevant Property of the Potential Predecessor; and

(2) During the Plan Period prior to the Distribution, was neither distributed in a distribution to which section 355(e) applied nor transferred in a transaction in which the gain (if any) on that Controlled stock was recognized in full.

(iii) *Post-Distribution requirement.* The requirement set forth in this paragraph (b)(1)(iii) (Division of Relevant Property Requirement) is satisfied if, immediately after the Distribution, and as part of a Plan, direct or indirect ownership of the Potential Predecessor's Relevant Property has been divided between Controlled on the one hand, and Distributing or the Potential Predecessor (or a successor to the Potential Predecessor) on the other hand. For purposes of this paragraph (b)(1)(iii), if Controlled stock that is distributed in the Distribution is Relevant Property of a Potential Predecessor, then Controlled is deemed to have received Relevant Property of the Potential Predecessor.

(2) *Additional definitions and rules related to paragraph (b)(1) of this section*—(i) *References to Distributing and Controlled.* For purposes of the Relevant Property Requirement, the Reflection of Basis Requirement, and the Division of Relevant Property Requirement, references to Distributing and Controlled do not include references to any Predecessor of Distributing, Predecessor of Controlled, or Successor of Distributing or Controlled.

(ii) *Potential Predecessor*—(A) *Potential Predecessor definition.* The term *Potential Predecessor* means a corporation, other than Distributing or Controlled, if—
 

(1) As part of a Plan, the corporation transfers property to a Potential Predecessor, Distributing, or a member of the same Expanded Affiliated Group as Distributing in a Section 381 Transaction; or

(2) Immediately after completion of the Plan, the corporation is a member of the same Expanded Affiliated Group as Distributing.

(B) *Expanded Affiliated Group definition.* The term *Expanded Affiliated Group* means an affiliated group (as defined in section 1504 without regard to section 1504(b)).

(iii) *Successors of Potential Predecessors.* For purposes of the Division of Relevant Property Requirement, if a Potential Predecessor transfers property in a Section 381 Transaction to a corporation (other than Distributing or Controlled) during the Plan Period, the corporation is a successor to the Potential Predecessor.

(iv) *Relevant Property; Relevant Equity*—(A) *In general.* Except as otherwise provided in this paragraph (b)(2)(iv) or in paragraph (b)(2)(v) of this section, the term *Relevant Property* means any property that was held, directly or indirectly, by the Potential Predecessor during the Plan Period. The term *Relevant Equity* means Relevant Property that is an equity interest in a corporation or a partnership.

(B) *Property held by Distributing.* Except as provided in paragraph (b)(2)(iv) (C) of this section, property held directly or indirectly by Distributing (including Controlled stock) is Relevant Property of a Potential Predecessor only to the extent that the property was transferred directly or indirectly to Distributing during the

Plan Period, and it was Relevant Property of the Potential Predecessor before the direct or indirect transfer(s). For example, if during the Plan Period a subsidiary corporation of a Potential Predecessor merges into Controlled in a reorganization under section 368(a)(1)(A) and (2)(D), and, as a result, the Potential Predecessor directly or indirectly owns Distributing stock received in the merger, the subsidiary's assets held by Controlled are Relevant Property of that Potential Predecessor.

(C) *F reorganizations*. For purposes of paragraph (b)(2)(iv)(B) of this section, the transferor and transferee in any reorganization described in section 368(a)(1)(F) (F reorganization) are treated as a single corporation. Therefore, for example, Relevant Property acquired during the Plan Period by a corporation that is a transferor (as to a later F reorganization) is treated as having been acquired directly (and from the same source) by the transferee (as to the later F reorganization) during the Plan Period. In addition, any transfer (or deemed transfer) of assets to Distributing in an F reorganization will not cause the transferred assets to be treated as Relevant Property.

(v) *Stock of Distributing as Relevant Property*—(A) *In general*. For purposes of the Division of Relevant Property Requirement, except as provided in paragraph (b)(2)(v)(B) of this section, stock of Distributing is not Relevant Property (and thus is not Relevant Equity) to the extent that the Potential Predecessor becomes, as part of a Plan, the direct or indirect owner of that stock as the result of the transfer to Distributing of direct or indirect interests in the Potential Predecessor's Relevant Property. For example, stock of Distributing is not Relevant Property if it is acquired by a Potential Predecessor as part of a Plan in an exchange to which section 351(a) applies.

(B) *Certain reorganizations*. For purposes of the Division of Relevant Property Requirement, stock of Distributing is Relevant Property (and thus Relevant Equity) to the extent that the Potential Predecessor becomes, as part of the Plan, the direct or indirect owner of that stock as the result of a transaction described in section 368(a)(1)(E).

(vi) *Substitute Asset*—(A) *In general*. Subject to paragraph (b)(2)(vi)(B) of this

section, the term *Substitute Asset* means any property that is held directly or indirectly by Distributing during the Plan Period and was received, during the Plan Period, in exchange for Relevant Property that was acquired directly or indirectly by Distributing if all gain on the transferred Relevant Property is not recognized on the exchange. For example, property received by Controlled in exchange for Relevant Property in a transaction qualifying under section 1031 is a Substitute Asset. In addition, stock received by Distributing in a distribution qualifying under section 305(a) or section 355(a) on Relevant Equity is a Substitute Asset.

(B) *Controlled stock received by Distributing*—(1) *In general*. Except as provided in paragraph (b)(2)(vi)(B)(2) of this section, stock of Controlled received in exchange for a direct or indirect transfer of Relevant Property by Distributing is not a Substitute Asset.

(2) *Exception*. If the basis in Controlled stock received or deemed received in an exchange described in paragraph (b)(2)(vi)(B)(1) of this section is determined in whole or in part by reference to the basis of Relevant Equity the issuer of which ceases to exist for Federal income tax purposes under the Plan, that Controlled stock constitutes a Substitute Asset. See paragraph (b)(2)(x) of this section.

(C) *Treatment as Relevant Property*. For purposes of this section, a Substitute Asset is treated as Relevant Property with the same ownership and transfer history as the Relevant Property for which (or with respect to which) it was received.

(vii) *Separated Property*. The term *Separated Property* means each item of Relevant Property that is described in the Relevant Property Requirement (regardless of whether the fair market value of the Relevant Property exceeds its adjusted basis). However, if Relevant Equity is Separated Property, Underlying Property associated with that Relevant Equity is not treated as Separated Property. In addition, if Distributing directly or indirectly acquires Relevant Equity in a transaction in which gain is recognized in full, Underlying Property associated with that Relevant Equity is not treated as Separated Property.

(viii) *Underlying Property*. The term *Underlying Property* means property directly or indirectly held by a corporation

or partnership any equity interest in which is Relevant Equity.

(ix) *Multiple Predecessors of Distributing*. If there are multiple Potential Predecessors that satisfy the pre-Distribution requirements and post-Distribution requirement of paragraph (b)(1) of this section, each of those Potential Predecessors is a Predecessor of Distributing. For example, a Potential Predecessor that transfers property to a Predecessor of Distributing without full recognition of gain (and that otherwise meets the requirements of paragraph (b)(1) of this section) is also a Predecessor of Distributing if the applicable transfer occurred as part of a Plan that existed at the time of such transfer.

(x) *Deemed exchanges*. For purposes of paragraph (b)(1)(ii) of this section (regarding the Relevant Property Requirement and the Reflection of Basis Requirement) and paragraph (b)(2)(vi) of this section (regarding Substitute Assets), Distributing is treated as acquiring Controlled stock in exchange for a direct or indirect interest in Relevant Property if the basis of Distributing in that Controlled stock, immediately after a transfer of the Relevant Property, is determined in whole or in part by reference to the basis of that Relevant Property immediately before the transfer. For example, if a corporation transfers Relevant Property to Controlled in exchange for Distributing stock in a transaction that qualifies as a reorganization under section 368(a)(1)(C), then, for purposes of paragraphs (b)(1)(ii) and (b)(2)(vi) of this section, Distributing is treated as acquiring Controlled stock in exchange for a direct or indirect interest in Relevant Property. See § 1.358-6(c)(1).

(c) *Additional definitions*—(1) *Predecessor of Controlled*. Solely for purposes of applying paragraph (f) of this section, a corporation is a predecessor of Controlled (Predecessor of Controlled) if, before the Distribution, it transfers property to Controlled in a Section 381 Transaction as part of a Plan. Other than for the purpose described in the preceding sentence, no corporation can be a Predecessor of Controlled. If multiple corporations satisfy the requirements of this paragraph (c)(1), each of those corporations is a Predecessor of Controlled. For example, a corporation that transfers property to a Predecessor of Controlled in a Section 381 Transaction

is also a Predecessor of Controlled if the Section 381 Transaction occurred as part of a Plan that existed at the time of such transaction.

(2) *Successors*—(i) *In general*. For purposes of section 355(e), a successor (Successor) of Distributing or of Controlled is a corporation to which Distributing or Controlled, respectively, transfers property in a Section 381 Transaction after the Distribution (Successor Transaction).

(ii) *Determination of Successor status*. More than one corporation may be a Successor of Distributing or Controlled. For example, if Distributing transfers property to another corporation (X) in a Section 381 Transaction, and X transfers property to another corporation (Y) in a Section 381 Transaction, then each of X and Y is a Successor of Distributing. In this case, the determination of whether Y is a Successor of Distributing is made after the determination of whether X is a Successor of Distributing.

(3) *Section 381 Transaction*. The term *Section 381 Transaction* means a transaction to which section 381 applies.

(d) *Special acquisition rules*—(1) *Deemed acquisitions of stock in Section 381 Transactions*—(i) *Rule*. This paragraph (d)(1)(i) applies to each shareholder of the acquiring corporation immediately before a Section 381 Transaction (Acquiring Owner). Each Acquiring Owner is treated for purposes of this section as acquiring, in the Section 381 Transaction, stock representing an interest in the distributor or transferor corporation, to the extent that the Acquiring Owner's interest in the acquiring corporation immediately after the Section 381 Transaction exceeds the Acquiring Owner's direct or indirect interest in the distributor or transferor corporation immediately before the Section 381 Transaction.

(ii) *Example*. The example set forth in this paragraph (d)(1)(ii) illustrates the application of the deemed acquisition rule in paragraph (d)(1)(i) of this section. Assume that A held all of the stock of Distributing, Distributing held a 25-percent interest in a Predecessor of Distributing, and A held no direct interest, or other indirect interest, in the Predecessor of Distributing immediately before a Section 381 Transaction in which the Predecessor of Distributing transfers its assets to Distrib-

uting. In the Section 381 Transaction, the Predecessor of Distributing's shareholders (other than Distributing) collectively receive a 10-percent interest in Distributing (reducing A's interest in Distributing to 90 percent). Under paragraph (d)(1)(i) of this section, A is treated as acquiring in the Section 381 Transaction stock representing a 65-percent interest in the Predecessor of Distributing. This is because A's 90-percent interest in Distributing (the acquiring corporation in the Section 381 Transaction) immediately after the Section 381 Transaction exceeds A's 25-percent interest (held indirectly through Distributing) in the Predecessor of Distributing (the transferor corporation in the Section 381 Transaction) immediately before the Section 381 Transaction by 65 percent. Similarly, each Acquiring Owner of a Successor of Distributing is treated as acquiring, in the Successor Transaction, stock of Distributing, to the extent that the Acquiring Owner's interest in the Successor of Distributing immediately after the Successor Transaction exceeds the Acquiring Owner's direct or indirect interest in Distributing immediately before the Successor Transaction.

(2) *Deemed acquisitions of stock after Section 381 Transactions*. For purposes of this section, after a Section 381 Transaction (including a Successor Transaction), an acquisition of stock of an acquiring corporation (including a deemed stock acquisition under paragraph (d)(1)(i) of this section) is treated also as an acquisition of an interest in the stock of the distributor or transferor corporation. For example, an acquisition of the stock of Distributing that occurs after a Section 381 Transaction is treated not only as an acquisition of the stock of Distributing, but also as an acquisition of the stock of any Predecessor of Distributing whose assets were acquired by Distributing in the prior Section 381 Transaction. Similarly, an acquisition of the stock of a Successor of Distributing that occurs after the Successor Transaction is treated not only as an acquisition of the stock of the Successor of Distributing, but also as an acquisition of the stock of Distributing.

(3) *Separate counting for Distributing and each Predecessor of Distributing*. The measurement of whether one or more persons have acquired stock of

any specific corporation in a Planned 50-percent Acquisition is made separately from the measurement of any potential Planned 50-percent Acquisition of any other corporation. Therefore, there may be a Planned 50-percent Acquisition of a Predecessor of Distributing even if there is no Planned 50-percent Acquisition of Distributing. Similarly, there may be a Planned 50-percent Acquisition of Distributing even if there is no Planned 50-percent Acquisition of a Predecessor of Distributing.

(e) *Special rules for limiting gain recognition*—(1) *Overview*—(i) *Gain limitation*. This paragraph (e) provides rules that limit the amount of gain that must be recognized by Distributing by reason of section 355(e) to an amount that is less than the amount that Distributing otherwise would be required to recognize under section 355(c)(2) or section 361(c)(2) (Statutory Recognition Amount) in certain cases involving one or more Predecessors of Distributing.

(ii) *Multiple Planned 50-percent Acquisitions*. If there are Planned 50-percent Acquisitions of multiple corporations (for example, two Predecessors of Distributing), Distributing must recognize the Statutory Recognition Amount with respect to each such corporation, subject to the limitations in paragraph (e)(2) of this section relating to a Planned 50-percent Acquisition of a Predecessor of Distributing (POD Gain Limitation Rule) and paragraph (e)(3) of this section relating to a Planned 50-percent Acquisition of Distributing (Distributing Gain Limitation Rule), if applicable. The POD Gain Limitation Rule and the Distributing Gain Limitation Rule are applied separately to the Planned 50-percent Acquisition of each such corporation to determine the amount of gain required to be recognized.

(iii) *Statutory Recognition Amount limit; Section 336(e)*. Paragraph (e)(4) of this section sets forth an overall gain limitation based on the Statutory Recognition Amount. Paragraph (e)(5) of this section clarifies the availability of an election under section 336(e) with regard to certain Distributions.

(2) *Planned 50-percent Acquisition of a Predecessor of Distributing*—(i) *In general*. If there is a Planned 50-percent Acquisition of a Predecessor of Distribut-

uting, the amount of gain recognized by Distributing by reason of section 355(e) as a result of the Planned 50-percent Acquisition is limited to the amount of gain, if any, that Distributing would have recognized if, immediately before the Distribution, Distributing had engaged in the following transaction: Distributing transferred all Separated Property received from the Predecessor of Distributing to a newly formed corporation (Hypothetical Controlled) in exchange solely for stock of Hypothetical Controlled in a reorganization under section 368(a)(1)(D) and then distributed the stock of Hypothetical Controlled to the shareholders of Distributing in a transaction to which section 355(e) applied (Hypothetical D/355(e) Reorganization). The computation in this paragraph (e)(2)(i) is applied regardless of whether Distributing actually directly held the Separated Property.

(ii) *Operating rules.* For purposes of applying paragraph (e)(2)(i) of this section, the following rules apply:

(A) *Separated Property other than Controlled stock.* Each of the basis and the fair market value of Separated Property other than stock of Controlled treated as transferred by Distributing to a Hypothetical Controlled in a Hypothetical D/355(e) Reorganization equals the basis and the fair market value, respectively, of such property in the hands of Controlled immediately before the Distribution.

(B) *Controlled stock that is Separated Property.* Each of the basis and the fair market value of the stock of Controlled that is Separated Property treated as transferred by Distributing to a Hypothetical Controlled in a Hypothetical D/355(e) Reorganization equals the basis and the fair market value, respectively, of such stock in the hands of Distributing immediately before the Distribution.

(C) *Anti-duplication rule.* A Predecessor of Distributing's Separated Property is taken into account for purposes of applying this paragraph (e)(2) only to the extent such property was not taken into account by Distributing in a Hypothetical D/355(e) Reorganization with respect to another Predecessor of Distributing. Further, appropriate adjustments must be made to prevent other duplicative inclusions of section 355(e) gain under this paragraph (e) reflecting the same economic gain.

(3) *Planned 50-percent Acquisition of Distributing.* This paragraph (e)(3) applies if there is a Planned 50-percent Acquisition of Distributing. In that case, the amount of gain recognized by Distributing by reason of section 355(e) as a result of the Planned 50-percent Acquisition is limited to the excess, if any, of the Statutory Recognition Amount over the amount of gain, if any, that Distributing would have been required to recognize under paragraphs (e)(1)(ii) and (e)(2) of this section if there had been a Planned 50-percent Acquisition of every Predecessor of Distributing, but not of Distributing or Controlled. For purposes of this paragraph (e)(3), references to Distributing are not references to a Predecessor of Distributing.

(4) *Gain recognition limited to Statutory Recognition Amount.* The sum of the amounts required to be recognized by Distributing under section 355(e) (taking into account the POD Gain Limitation Rule and the Distributing Gain Limitation Rule) with regard to a single Distribution cannot exceed the Statutory Recognition Amount. In addition, Distributing may choose not to apply the POD Gain Limitation Rule or the Distributing Gain Limitation Rule to a Distribution, and instead may recognize the Statutory Recognition Amount. Distributing indicates its choice to apply the preceding sentence by reporting the Statutory Recognition Amount on its original or amended Federal income tax return for the year of the Distribution.

(5) *Section 336(e) election.* Distributing is not eligible to make a section 336(e) election (as defined in § 1.336-1(b)(11)) with respect to a Distribution to which this section applies unless Distributing would, absent the making of a section 336(e) election, recognize the Statutory Recognition Amount with respect to the Distribution (taking into account the POD Gain Limitation Rule and the Distributing Gain Limitation Rule) without regard to the final two sentences of paragraph (e)(4) of this section. See §§ 1.336-1 through 1.336-5 for additional requirements with regard to a section 336(e) election.

(f) *Predecessor or Successor as a member of the affiliated group.* For purposes of section 355(e)(2)(C), if a corporation transfers its assets to a member of the same Expanded Affiliated Group in a Section 381 Transaction, the transferor will be

treated as continuing in existence within the same Expanded Affiliated Group.

(g) *Inapplicability of section 355(f) to certain intra-group Distributions—(1) In general.* Section 355(f) does not apply to a Distribution if there is a Planned 50-percent Acquisition of a Predecessor of Distributing (but not of Distributing, Controlled, or their Successors), except as provided in paragraph (g)(2) of this section. Therefore, except as provided in paragraph (g)(2) of this section, section 355 (or so much of section 356 as relates to section 355) and the regulations under sections 355 and 356, including the POD Gain Limitation Rule, apply, without regard to section 355(f), to a Distribution within an affiliated group (as defined in section 1504(a)) if the Distribution and the Planned 50-percent Acquisition of the Predecessor of Distributing are part of a Plan. For purposes of this paragraph (g)(1), references to a Distribution (and Distributing and Controlled) include references to a distribution (and Distributing and Controlled) to which section 355 would apply but for the application of section 355(f).

(2) *Alternative application of section 355(f).* Distributing may choose not to apply paragraph (g)(1) of this section to each Distribution (that occurs under a Plan) to which section 355(f) would otherwise apply absent paragraph (g)(1) of this section. Instead, Distributing may apply section 355(f) to all such Distributions according to its terms, but only if all members of the same Expanded Affiliated Group report consistently the Federal income tax consequences of the Distributions that are part of the Plan (determined without regard to section 355(f)). In such a case, neither the POD Gain Limitation Rule nor the Distributing Gain Limitation Rule is available with regard to any applicable Distribution. Distributing indicates its choice to apply section 355(f) consistently to all applicable Distributions by reporting the Federal income tax consequences of each Distribution in accordance with section 355(f) on its Federal income tax return for the year of the Distribution.

(h) *Examples.* The following examples illustrate the principles of this section. Unless the facts indicate otherwise, assume throughout these examples that: Distributing (D) owns all the stock of

Controlled (C), and none of the shares of C held by D has a built-in loss; D distributes the stock of C in a Distribution to which section 355(d) does not apply; X, Y, and Z are individuals; each of D, D1, C, P, P1, P2, and R is a corporation having one class of stock outstanding, and none is a member of a consolidated group; and each transaction that is part of a Plan defined in this section is respected as a separate transaction under general Federal income tax principles. No inference should be drawn from any example concerning whether any requirements of section 355 are satisfied other than those of section 355(e) or whether any general Federal income tax principles (including the step transaction doctrine) are implicated by the example:

(1) *Example 1: Predecessor of D and Planned 50-Percent Acquisition of P*—(i) *Facts.* X owns 100% of the stock of P, which holds multiple assets. Y owns 100% of the stock of D. The following steps occur as part of a Plan: P merges into D in a reorganization under section 368(a)(1)(A). Immediately after the merger, X and Y own 10% and 90%, respectively, of the stock of D. D then contributes to C one of the assets (Asset 1) acquired from P in the merger. At the time of the contribution, Asset 1 has a basis of \$40x and a fair market value of \$110x. In exchange for Asset 1, D receives additional C stock and \$10x. D distributes the stock of C (but not the cash) to X and Y, pro rata. The contribution and Distribution constitute a reorganization under section 368(a)(1)(D), and D recognizes \$10x of gain under section 361(b) on the contribution. Immediately before the Distribution, taking into account the \$10x of gain recognized by D on the contribution, Asset 1 has an adjusted basis of \$50x under section 362(b) and a fair market value of \$110x, and the stock of C held by D has a basis of \$100x and a fair market value of \$200x.

(ii) *Analysis*—(A) *P is a Predecessor of D.* Under paragraph (b)(1) of this section, P is a Predecessor of D. First, P is a Potential Predecessor because, as part of a Plan, P transferred property to D in a Section 381 Transaction. See paragraph (b)(2)(ii)(A)(1) of this section. Second, both of the pre-Distribution requirements and the post-Distribution requirement are satisfied. The Relevant Property Requirement is satisfied because, immediately before the Distribution and as part of a Plan, C holds P Relevant Property (Asset 1) the gain on which was not recognized in full at any point during the Plan Period, and some of the C stock distributed in the Distribution was acquired by D in exchange for Asset 1. See paragraph (b)(1)(ii)(A)(1) of this section. The Reflection of Basis Requirement is satisfied because that C stock had a basis prior to the Distribution that was determined in whole or in part by reference to the basis of Separated Property (Asset 1), and was neither distributed in a distribution to which section 355(e) applied nor transferred in a transaction in which the gain on that C stock was recognized in full during the Plan Period prior to the Distribution. See paragraph (b)(1)(ii)(B) of this section. The Division of Relevant Prop-

erty Requirement is satisfied because immediately after the Distribution, D continues to hold Relevant Property of P, and therefore, as part of a Plan, P's Relevant Property has been divided between C and D. See paragraph (b)(1)(iii) of this section.

(B) *Planned 50-percent Acquisition of P.* Under paragraph (d)(1)(i) of this section, Y is treated as acquiring stock representing 90% of the voting power and value of P as a result of the merger of P into D. Accordingly, there has been a Planned 50-percent Acquisition of P.

(C) *Gain limited.* Without regard to the limitations in paragraph (e) of this section, D would be required to recognize \$100x of gain (\$200x of aggregate fair market value minus \$100x of aggregate basis of the C stock held by D), the Statutory Recognition Amount described in section 361(c)(2). However, under the POD Gain Limitation Rule, D's gain recognized by reason of the Planned 50-percent Acquisition of P will not exceed \$60x, an amount equal to the amount of gain D would have recognized had D transferred Asset 1 (Separated Property) to a newly formed corporation (C1) solely for C1 stock and distributed the C1 stock to D's shareholders in a Hypothetical D/355(e) Reorganization. See paragraph (e)(2)(i) of this section. For purposes of the computation in this paragraph (h)(1)(ii)(C), the basis and fair market value of Asset 1 equal the basis and fair market value of Asset 1 in the hands of C immediately before the Distribution. See paragraph (e)(2)(ii)(A) of this section. Under section 361(c)(2), D would recognize \$60x of gain, an amount equal to the gain in the hypothetical C1 stock (excess of the \$110x fair market value over the \$50x basis). Therefore, D recognizes \$60x of gain (in addition to the \$10x of gain recognized under section 361(b)).

(iii) *Plan not in existence at time of acquisition of Potential Predecessor's property.* The facts are the same as in paragraph (h)(1)(i) of this section (*Example 1*) except that the merger of P into D occurred before the existence of a Plan. Even though D transferred P property (Asset 1) to C, Asset 1 was not Relevant Property of P because P did not hold Asset 1 during the Plan Period. See paragraphs (b)(2)(iv) and (a)(4)(iii) of this section. Because Asset 1 is not Relevant Property, D did not receive C stock distributed in the Distribution in exchange for Relevant Property when it contributed Asset 1 to C, none of the distributed C stock had a basis prior to the Distribution that was determined in whole or in part by reference to the basis of Separated Property, and C did not hold Relevant Property immediately before the Distribution. Further, Relevant Property of P has not been divided. Therefore, P is not a Predecessor of D.

(2) *Example 2: Planned 50-percent Acquisition of D, but not Predecessor of D*—(i) *Facts.* X owns 100% of the stock of P, which holds multiple assets. Y owns 100% of the stock of D. The following steps occur as part of a Plan: P merges into D in a reorganization under section 368(a)(1)(A). Immediately after the merger, X and Y own 90% and 10%, respectively, of the stock of D. D then contributes to C one of the assets (Asset 1) acquired from P in the merger. In exchange for Asset 1, D receives additional C stock. D distributes the stock of C to X and Y, pro rata. The contribution and Distribution constitute a reorganization under section 368(a)(1)(D). Immediately before the Distribution, Asset 1 has a basis of \$50x and

a fair market value of \$110x, and the stock of C held by D has a basis of \$120x and a fair market value of \$200x.

(ii) *Analysis*—(A) *P is a Predecessor of D.* Under paragraph (b)(1) of this section, P is a Predecessor of D. First, P is a Potential Predecessor because, as part of a Plan, P transferred property to D in a Section 381 Transaction. See paragraph (b)(2)(ii)(A)(1) of this section. Second, both of the pre-Distribution requirements and the post-Distribution requirement are satisfied. The Relevant Property Requirement is satisfied because, immediately before the Distribution and as part of a Plan, C holds P Relevant Property (Asset 1) the gain on which was not recognized in full at any point during the Plan Period, and some of the C stock distributed in the Distribution was acquired by D in exchange for Asset 1. See paragraph (b)(1)(ii)(A)(1) of this section. The Reflection of Basis Requirement is satisfied because that C stock had a basis prior to the Distribution that was determined in whole or in part by reference to the basis of Separated Property (Asset 1), and was neither distributed in a distribution to which section 355(e) applied nor transferred in a transaction in which the gain on that C stock was recognized in full during the Plan Period prior to the Distribution. See paragraph (b)(1)(ii)(B) of this section. The Division of Relevant Property Requirement is satisfied because immediately before the Distribution, D continues to hold Relevant Property of P, and therefore, as part of a Plan, P's Relevant Property has been divided between C and D. See paragraph (b)(1)(iii) of this section.

(B) *Planned 50-percent Acquisition of D.* Under paragraph (d)(1)(i) of this section, Y is treated as acquiring stock representing 10% of the voting power and value of P as a result of the merger of P into D. The 10% acquisition of P stock does not cause section 355(e) gain recognition or cause application of the POD Gain Limitation Rule because there has not been a Planned 50-percent Acquisition of P. X acquires 90% of the voting power and value of D as a result of the merger of P into D. Accordingly, there has been a Planned 50-percent Acquisition of D. This Planned 50-percent Acquisition implicates section 355(e) and results in gain recognition, subject to the rules of paragraph (e) of this section.

(C) *Gain limited.* Without regard to the limitations in paragraph (e) of this section, D would be required to recognize \$80x of gain (\$200x of fair market value minus \$120x of basis of the C stock held by D), the Statutory Recognition Amount described in section 361(c)(2). However, under the Distributing Gain Limitation Rule, D's gain recognized by reason of the Planned 50-percent Acquisition of D will not exceed \$20x, the excess of the Statutory Recognition Amount (\$80x) over the amount of gain that D would have been required to recognize under the POD Gain Limitation Rule if there had been a Planned 50-percent Acquisition of P but not D or C (\$60x). See paragraph (e)(3) of this section. The hypothetical gain limitation under the POD Gain Limitation Rule equals the amount D would have recognized had it transferred Asset 1 (Separated Property) to a newly formed corporation (C1) solely for stock and distributed the C1 stock in a Hypothetical D/355(e) Reorganization. See paragraph (e)(2)(i) of this section. Under section 361(c)(2), D would

recognize \$60x of gain, an amount equal to the gain in the hypothetical C1 stock (excess of the \$110x fair market value over the \$50x basis). Therefore, D recognizes \$20x of gain (\$80x - \$60x).

(3) *Example 3: Predecessor of D owns C stock—(i) Facts.* X owns 100% of the stock of P, which holds multiple assets, including Asset 2. Y owns 100% of the stock of D. P owns 35% of the stock of C (Block 1), and D owns the remaining 65% of the C stock (Block 2). The following steps occur as part of a Plan: P merges into D in a reorganization under section 368(a)(1)(A), and D immediately thereafter distributes all of the C stock to X and Y pro rata. Immediately after the merger, X and Y own 10% and 90%, respectively, of the D stock, and, prior to the Distribution, D owns Block 1 with a basis of \$30x and a fair market value of \$35x, and Block 2 with a basis of \$10x and a fair market value of \$65x. D continues to hold Asset 2.

(ii) *Analysis—(A) P is a Predecessor of D.* Under paragraph (b)(1) of this section, P is a Predecessor of D. First, P is a Potential Predecessor because, as part of a Plan, P transferred property to D in a Section 381 Transaction. See paragraph (b)(2)(ii)(A)(I) of this section. Second, both of the pre-Distribution requirements and the post-Distribution requirement are satisfied. The Relevant Property Requirement is satisfied because some of the C stock distributed in the Distribution (Block 1) was Relevant Property of P. See paragraph (b)(1)(ii)(A)(2) of this section. The Reflection of Basis Requirement is satisfied because Block 1 of the C stock is Relevant Property of P, and was neither distributed in a distribution to which section 355(e) applied nor transferred in a transaction in which the gain on that C stock was recognized in full during the Plan Period prior to the Distribution. See paragraph (b)(1)(ii)(B) of this section. The Division of Relevant Property Requirement is satisfied because some of the C stock distributed in the Distribution was Relevant Property of P, and therefore C is deemed to have received Relevant Property of P, and D continues to hold Relevant Property of P immediately after the Distribution. See paragraph (b)(1)(iii) of this section. Therefore, as part of a Plan, P's Relevant Property has been divided between C and D.

(B) *Planned 50-percent Acquisition of P.* Under paragraph (d)(1)(i) of this section, Y is treated as acquiring stock representing 90% of the voting power and value of P as a result of the merger of P into D. Accordingly, there has been a Planned 50-percent Acquisition of P.

(C) *Gain limited.* Without regard to the limitations in paragraph (e) of this section, D would be required to recognize \$60x of gain (\$100x of fair market value minus \$40x of basis of the C stock held by D), the Statutory Recognition Amount under section 355(c)(2). However, under the POD Gain Limitation Rule, D's gain recognized by reason of the Planned 50-percent Acquisition of P will not exceed \$5x, an amount equal to the amount D would have recognized had it transferred Block 1 of the C stock (Separated Property) to a newly formed corporation (C1) solely for stock and distributed the C1 stock to D shareholders in a Hypothetical D/355(e) Reorganization. See paragraph (e)(2)(i) of this section. Because Relevant Equity (Block 1 of the C stock) is Separated Property, Underlying Property associated with that Relevant Equity is not treated as Separated

Property. See paragraph (b)(2)(vii) of this section. For purposes of the computation in this paragraph (h)(3)(ii)(C), the basis and fair market value of the Block 1 C stock equal its basis and fair market value in the hands of D immediately before the Distribution. See paragraph (e)(2)(ii)(A) of this section. Under section 361(c)(2), D would recognize \$5x of gain, an amount equal to the gain in the hypothetical C1 stock (\$35x fair market value - \$30x basis). Therefore, D recognizes \$5x of gain.

(4) *Example 4: C stock as Substitute Asset—(i) Facts.* X owns 100% of the stock of P, which owns multiple assets, including 100% of the stock of R and Asset 2. Y owns 100% of the stock of D. The following steps occur as part of a Plan: P merges into D in a reorganization under section 368(a)(1)(A) (P-D reorganization). Immediately after the merger, X and Y own 10% and 90%, respectively, of the stock of D. D then causes R to transfer all of its assets to C and liquidate in a reorganization under section 368(a)(1) (R-C reorganization). At the time of the P-D reorganization, the R stock has a basis of \$40x and a fair market value of \$110x. D distributes the stock of C to X and Y, pro rata. D continues to directly hold Asset 2. Immediately before the Distribution, the C stock held by D that was deemed received in the R-C reorganization (Block 1) has a basis of \$40x and a fair market value of \$110x, and all of the stock of C held by D has a basis of \$100x and a fair market value of \$200x.

(ii) *Analysis—(A) P is a Predecessor of D.* Under paragraph (b)(1) of this section, P is a Predecessor of D. First, P is a Potential Predecessor because, as part of a Plan, P transferred property to D in a Section 381 Transaction. See paragraph (b)(2)(ii)(A)(I) of this section. Second, both pre-Distribution requirements and the post-Distribution requirement are satisfied. The Relevant Property Requirement is satisfied because, for the following two reasons, some of the C stock distributed in the Distribution (Block 1) was Relevant Property of P. D is treated as acquiring Block 1 of the C stock in exchange for a direct or indirect interest in R stock (that is, Relevant Property) in the R-C reorganization because the basis of D in that C stock immediately after a transfer of the R stock (in the liquidation of R) is determined in whole or in part by reference to the basis of the R stock immediately before the transfer. See paragraph (b)(2)(x) of this section. Further, because the basis in Block 1 of the C stock is determined in whole or in part by reference to the basis of Relevant Equity (the R stock) the issuer of which ceases to exist for Federal income tax purposes under the Plan, Block 1 of the C stock is a Substitute Asset, and is therefore treated as Relevant Property with the same ownership and transfer history as the R stock. See paragraph (b)(2)(vi)(B)(2) of this section. The Reflection of Basis Requirement is satisfied because Block 1 of the C stock is Relevant Property of P, and was neither distributed in a distribution to which section 355(e) applied nor transferred in a transaction in which the gain on that C stock was recognized in full during the Plan Period prior to the Distribution. See paragraph (b)(1)(ii)(B) of this section. The Division of Relevant Property Requirement is satisfied because some of the C stock distributed in the Distribution was Relevant Property of P, and therefore C

is deemed to have received Relevant Property of P, and immediately after the Distribution, D continues to hold Asset 2, which is Relevant Property of P. See paragraph (b)(1)(iii) of this section. Therefore, as part of a Plan, P's Relevant Property has been divided between C and D.

(B) *Planned 50-percent Acquisition of P.* Under paragraph (d)(1)(i) of this section, Y is treated as acquiring stock representing 90% of the voting power and value of P as a result of the P-D reorganization. Accordingly, there has been a Planned 50-percent Acquisition of P.

(C) *Gain limited.* Without regard to the limitations in paragraph (e) of this section, D would be required to recognize \$100x of gain (\$200x of fair market value minus \$100x of basis of all C stock held by D), the Statutory Recognition Amount described in section 355(c)(2). However, under the POD Gain Limitation Rule, D's gain recognized by reason of the Planned 50-percent Acquisition of P will not exceed \$70x, an amount equal to the amount D would have recognized had it transferred Block 1 of the C stock (Separated Property) to a newly formed corporation (C1) solely for stock and distributed the C1 stock to D shareholders in a Hypothetical D/355(e) Reorganization. See paragraph (e)(2)(i) of this section. Because Relevant Equity (Block 1 of the C stock) is Separated Property, Underlying Property associated with that Relevant Equity is not treated as Separated Property. See paragraph (b)(2)(vii) of this section. Under section 361(c)(2), D would recognize \$70x of gain, an amount equal to the gain in the hypothetical C1 stock (excess of the \$110x fair market value over the \$40x basis). Therefore, D recognizes \$70x of gain.

(5) *Example 5: Section 351 transaction—(i) Facts.* X owns 100% of the stock of P, which holds multiple assets, including Asset 1, Asset 2, and Asset 3. Y owns 100% of the stock of D. The following steps occur as part of a Plan: P transfers Asset 1 and Asset 2 to D and Y transfers property to D in an exchange qualifying under section 351. Immediately after the exchange, P and Y own 10% and 90%, respectively, of the stock of D. D then contributes Asset 1 to C in exchange for additional C stock. D distributes all of the stock of C to P and Y, pro rata. D continues to directly hold Asset 2, and P continues to directly hold Asset 3. The contribution and Distribution constitute a reorganization under section 368(a)(1)(D). Immediately before the Distribution, Asset 1 has a basis of \$40x and a fair market value of \$110x, and the stock of C held by D has a basis of \$100x and a fair market value of \$200x. Following the Distribution, and as part of the same Plan, Z acquires 51% of the P stock.

(ii) *Analysis—P is not a Predecessor of D.* Under paragraph (b)(1) of this section, P is not a Predecessor of D. P is not a Potential Predecessor because P did not transfer property to a Potential Predecessor, D, or a member of the same Expanded Affiliated Group as D in a Section 381 Transaction and P is not a member of the same Expanded Affiliated Group as D immediately after completion of the Plan. See paragraph (b)(2)(ii) of this section. Thus, P cannot be a Predecessor of D. See paragraph (b)(1)(i) of this section.

(6) *Example 6: Section 351 transaction after an acquisition of P—(i) Facts.* X owns 100% of the

stock of P, which holds multiple assets, including Asset 1 and Asset 2. Y owns 100% of the stock of D, D owns 100% of the stock of D1, and D1 owns 100% of the stock of C. D files a consolidated return for the affiliated group of which it is the common parent. The following steps occur as part of a Plan: D acquires 100% of the stock of P from X. P transfers Asset 1 and Asset 2 to D1 for D1 stock in an exchange qualifying under section 351. See § 1.1502-34. D1 contributes Asset 1 to C in exchange for additional C stock. D1 distributes all of the stock of C to D in exchange for D1 stock (First Distribution). D then distributes all of the stock of C to Y (Second Distribution). D1 continues to directly hold Asset 2. Immediately before the First Distribution, Asset 1 has a basis of \$10x and a fair market value of \$60x, and the stock of C held by D1 has a basis of \$100x and a fair market value of \$200x.

(ii) *Analysis—(A) P is a Predecessor of D1.* Under paragraph (b)(1) of this section, P is a Predecessor of D1. First, P is a Potential Predecessor of D1 because P is a member of the same Expanded Affiliated Group as D1 immediately after completion of the Plan. See paragraph (b)(2)(ii)(A)(2) of this section. The Relevant Property Requirement is satisfied because, immediately before the First Distribution and as part of a Plan, C holds P Relevant Property (Asset 1) the gain on which was not recognized in full at any point during the Plan Period, and some of the C stock distributed in the First Distribution was acquired by D1 in exchange for Asset 1. See paragraph (b)(1)(ii)(A)(1) of this section. The Reflection of Basis Requirement is satisfied because that C stock had a basis prior to the First Distribution that was determined in whole or in part by reference to the basis of Separated Property (Asset 1), and was neither distributed in a distribution to which section 355(e) applied nor transferred in a transaction in which the gain on that C stock was recognized in full prior to the First Distribution. See paragraph (b)(1)(ii)(B) of this section. The Division of Relevant Property Requirement is satisfied because immediately after the First Distribution, each of C, on the one hand, and P or D1, on the other hand, continues to hold Relevant Property of P, and therefore, as part of a Plan, P's Relevant Property has been divided between C and D1. See paragraph (b)(1)(iii) of this section.

(B) *Planned 50-percent Acquisition of P.* D has acquired stock representing 100% of the voting power and value of P. Accordingly, there has been a Planned 50-percent Acquisition of P.

(C) *Gain on First Distribution.* Because there is a Planned 50-percent Acquisition of a Predecessor of Distributing (but not of Distributing, Controlled, or their Successors), section 355(f) will not apply to the First Distribution unless D and D1 choose to have section 355(f) apply. See paragraph (g) of this section. As a result, section 355, including the POD Gain Limitation Rule, will apply to the First Distribution. Under the POD Gain Limitation Rule, D1's gain recognized by reason of the Planned 50-percent Acquisition of P will not exceed \$50x, an amount equal to the amount D1 would have recognized had it transferred Asset 1 (Separated Property) to a newly formed corporation (C1) solely for stock and distributed the C1 stock to D1 shareholders in a Hypothetical D/355(e) Reorganization. See paragraph (e)(2)(i)

of this section. Under section 361(c)(2), D1 would recognize \$50x of gain, an amount equal to the gain in the hypothetical C1 stock (excess of the \$60x fair market value over the \$10x basis). Therefore, D1 recognizes \$50x of gain. Under paragraph (g)(2) of this section, however, D and D1 may choose to apply section 355(f) to the First Distribution as an exception to the general application of paragraph (g)(1) of this section. By application of section 355(f), section 355 (including the POD Gain Limitation Rule) would not apply to the First Distribution. Therefore, D1 would be required to recognize \$100x of gain (excess of the \$200x fair market value over the \$100x basis of C stock held by D1) under section 311(b), and D would be treated under section 302(d) as receiving a distribution of \$200x to which section 301 applies.

(D) *P is not a Predecessor of D.* Under paragraph (b)(1) of this section, P is not a Predecessor of D. First, P is a Potential Predecessor of D because P is a member of the same Expanded Affiliated Group as D immediately after completion of the Plan. See paragraph (b)(2)(ii)(A)(2) of this section. However, although the Relevant Property Requirement is satisfied, the Reflection of Basis Requirement is not satisfied. The Relevant Property Requirement is satisfied because, immediately before the Second Distribution and as part of a Plan, C holds P Relevant Property (Asset 1) the gain on which was not recognized in full at any point during the Plan Period, and some of the C stock distributed in the Second Distribution was indirectly acquired by D in exchange for Asset 1. See paragraph (b)(1)(ii)(A)(1) of this section. However, regardless of whether D and D1 choose under paragraph (g)(2) of this section to have section 355(f) apply to the First Distribution, the Reflection of Basis Requirement cannot be satisfied. If section 355(f) applies to the First Distribution, then all of the C stock will have been transferred in a transaction in which the gain on the C stock was recognized in full during the Plan Period prior to the Second Distribution. If section 355(f) does not apply to the First Distribution, then all of the C stock will have been transferred in a distribution to which section 355(e) applied during the Plan Period prior to the Second Distribution. Because not all of the pre-Distribution and post-Distribution requirements are satisfied, P cannot be a Predecessor of D.

(7) *Example 7: Sequential Predecessors—(i) Facts.* X owns 100% of P1, which holds multiple assets, including Asset 1 and Asset 2. Y owns 100% of P2, which holds Asset 3, and Z owns 100% of D. The following steps occur as part of a Plan: P1 merges into P2 in a reorganization under 368(a)(1)(A) (P1-P2 reorganization). Immediately after the merger, X and Y own 10% and 90%, respectively, of the stock of P2. P2 then merges into D in a reorganization under 368(a)(1)(A) (P2-D reorganization). Immediately after the merger, X, Y, and Z own 1%, 9%, and 90%, respectively, of the stock of D. D then contributes Asset 1 to C in exchange for additional C stock, and retains Asset 2 and Asset 3. D distributes all of the stock of C to X, Y, and Z, pro rata. Immediately before the Distribution, Asset 1 has a basis of \$40x and a fair market value of \$100x, and the stock of C held by D has a basis of \$100x and a fair market value of \$200x.

(ii) *Analysis—(A) P2 is a Predecessor of D.* Under paragraph (b)(1) of this section, P2 is a Predecessor of D. First, P2 is a Potential Predecessor because, as part of a Plan, P2 transferred property to D in a Section 381 Transaction. See paragraph (b)(2)(ii)(A)(1) of this section. Second, both pre-Distribution requirements and the post-Distribution requirement are satisfied. The Relevant Property Requirement is satisfied because, immediately before the Distribution and as part of a Plan, C holds P2 Relevant Property (Asset 1) the gain on which was not recognized in full at any point during the Plan Period, and some of the C stock distributed in the Distribution was acquired by D in exchange for Asset 1. See paragraph (b)(1)(ii)(A)(1) of this section. The Reflection of Basis Requirement is satisfied because that C stock had a basis prior to the Distribution that was determined in whole or in part by reference to the basis of Separated Property (Asset 1), and was neither distributed in a distribution to which section 355(e) applied nor transferred in a transaction in which the gain on that C stock was recognized in full during the Plan Period prior to the Distribution. See paragraph (b)(1)(ii)(B) of this section. The Division of Relevant Property Requirement is satisfied because immediately after the Distribution, D continues to hold P2 Relevant Property (Asset 2 and Asset 3), and therefore, as part of a Plan, P2's Relevant Property has been divided between C and D. See paragraph (b)(1)(iii) of this section.

(B) *P1 is a Predecessor of D.* Under paragraph (b)(1) of this section, P1 is a Predecessor of D. First, P1 is a Potential Predecessor because, as part of a Plan, P1 transferred property to a Potential Predecessor (P2) in a Section 381 Transaction. See paragraph (b)(2)(ii)(A)(1) of this section. Second, both pre-Distribution requirements and the post-Distribution requirement are satisfied. The Relevant Property Requirement is satisfied because, immediately before the Distribution and as part of a Plan, C holds P1 Relevant Property (Asset 1) the gain on which was not recognized in full at any point during the Plan Period, and some of the C stock distributed in the Distribution was acquired by D in exchange for Asset 1. See paragraph (b)(1)(ii)(A)(1) of this section. The Reflection of Basis Requirement is satisfied because that C stock had a basis prior to the Distribution that was determined in whole or in part by reference to the basis of Separated Property (Asset 1), and was neither distributed in a distribution to which section 355(e) applied nor transferred in a transaction in which the gain on that C stock was recognized in full during the Plan Period prior to the Distribution. See paragraph (b)(1)(ii)(B) of this section. The Division of Relevant Property Requirement is satisfied because immediately after the Distribution, D continues to hold Relevant Property of P1 (Asset 2), and therefore, as part of a Plan, P1's Relevant Property has been divided between C and D. See paragraph (b)(1)(iii) of this section.

(C) *Planned 50-percent Acquisitions of P1 and P2.* Under paragraph (d)(1)(i) of this section, Y is treated as acquiring stock representing 90% of the voting power and value of P1 as a result of the P1-P2 merger. In addition, under paragraph (d)(1)(i) of this section, Z is treated as acquiring stock representing 90% of the voting power and value of P2 in the

P2-D merger. Accordingly, there have been Planned 50-percent Acquisitions of P1 and P2.

(D) *Gain limited.* Without regard to the limitations in paragraph (e) of this section, D would be required to recognize \$100x of gain (\$200x of aggregate fair market value minus \$100x of aggregate basis of the C stock held by D), the Statutory Recognition Amount described in section 361(c)(2), because there have been Planned 50-percent Acquisitions of P1 and P2, both Predecessors of D. However, under paragraph (e) of this section, D's gain recognized by reason of the Planned 50-percent Acquisitions of P1 and P2 will not exceed \$60x, an amount equal to the amount D would have recognized had it transferred Asset 1 (Separated Property) to a newly formed corporation (C1) solely for stock and distributed the C1 stock to D shareholders in a Hypothetical D/355(e) Reorganization. Under section 361(c)(2), D would recognize \$60x, an amount equal to the gain in the hypothetical C1 stock (excess of the \$100x fair market value over the \$40x basis). Paragraph (e)(1)(ii) of this section provides that if there are Planned 50-percent Acquisitions of multiple corporations, Distributing must recognize the Statutory Recognition Amount with respect to each such corporation, subject to the POD Gain Limitation Rule and the Distributing Gain Limitation Rule, if applicable. In this case, the POD Gain Limitation Rule limits the amount of gain required to be recognized by D with respect to each of the Planned 50-percent Acquisitions of P1 and P2 to \$60x. See paragraph (e)(2)(i) of this section. Ordinarily, each \$60x limitation would be added together, and the total gain limitation provided by paragraph (e) of this section would be \$120x. However, the anti-duplication rule set forth in paragraph (e)(2)(ii)(C) of this section provides that, for purposes of applying the POD Gain Limitation Rule, a Predecessor of Distributing's Separated Property is taken into account only to the extent such property was not taken into account with respect to another Predecessor of Distributing. Thus, Asset 1 may not be taken into account more than once in determining the total gain limitation. Therefore, D recognizes \$60x of gain.

(8) *Example 8: Multiple Predecessors of D—(i) Facts.* X owns 100% of the stock of P1, which holds multiple assets, including Asset 1 and Asset 3. Y owns 100% of the stock of P2, which holds multiple assets, including Asset 2 and Asset 4. Z owns 100% of the stock of D. The following steps occur as part of a Plan: Each of P1 and P2 merges into D in a reorganization under section 368(a)(1)(A). Immediately after the mergers, each of X and Y owns 10%, and Z owns 80%, of the stock of D. D then contributes to C Asset 1 (acquired from P1), and Asset 2 (acquired from P2). In exchange for Asset 1 and Asset 2, D receives additional C stock. D distributes the stock of C to X, Y, and Z, pro rata. D's contribution of Asset 1 and Asset 2 and the Distribution constitute a reorganization under section 368(a)(1)(D). D continues to hold Asset 3 and Asset 4. Immediately before the Distribution, Asset 1 has a basis of \$50x and a fair market value of \$110x, Asset 2 has a basis of \$70x and a fair market value of \$90x, and the stock of C held by D has a basis of \$130x and a fair market value of \$220x.

(ii) *Analysis—(A) P1 and P2 are Predecessors of D.* Under paragraph (b)(1) of this section, each of P1 and P2 is a Predecessor of D. First, each of P1 and P2 is a Potential Predecessor because, as part of a Plan, each of P1 and P2 transferred property to D in a Section 381 Transaction. See paragraph (b)(2)(ii)(A)(I) of this section. Second, both pre-Distribution requirements and the post-Distribution requirement are satisfied. The Relevant Property Requirement is satisfied because, immediately before the Distribution and as part of a Plan, C holds P1 Relevant Property (Asset 1) and P2 Relevant Property (Asset 2), the gain on each of which was not recognized in full at any point during the Plan Period, and some of the C stock distributed in the Distribution was acquired by D in exchange for each of Asset 1 and Asset 2. See paragraph (b)(1)(ii)(A)(I) of this section. The Reflection of Basis Requirement is satisfied because that C stock had a basis prior to the distribution that was determined in whole or in part by reference to the basis of Separated Property (Asset 1 and Asset 2, respectively), and was neither distributed in a distribution to which section 355(e) applied nor transferred in a transaction in which the gain on that C stock was recognized in full during the Plan Period prior to the Distribution. See paragraph (b)(1)(ii)(B) of this section. The Division of Relevant Property Requirement is satisfied because immediately after the Distribution, D continues to hold Relevant Property of P1 and P2, and therefore, as part of a Plan, each of P1's and P2's Relevant Property has been divided between C and D. See paragraph (b)(1)(iii) of this section.

(B) *Planned 50-percent Acquisitions of P1 and P2.* Under paragraph (d)(1)(i) of this section, Z is treated as acquiring stock representing 80% of the voting power and value of each of P1 and P2 as a result of the mergers of P1 and P2 into D. Accordingly, there have been Planned 50-percent Acquisitions of P1 and P2.

(C) *Gain limited.* Without regard to the limitations in paragraph (e) of this section, D would be required to recognize \$90x of gain (\$220x of fair market value minus \$130x of basis of the C stock held by D), the Statutory Recognition Amount under section 361(c)(2). However, under the POD Gain Limitation Rule, D's gain recognized by reason of the Planned 50-percent Acquisition of P1 will not exceed \$60x (\$110x fair market value minus \$50x basis), an amount equal to the amount D would have recognized had it transferred Asset 1 (Separated Property) to a newly formed corporation (C1) solely for stock and distributed the C1 stock to D shareholders in a Hypothetical D/355(e) Reorganization. See paragraph (e)(2)(i) of this section. In addition, under the POD Gain Limitation Rule, D's gain recognized by reason of the deemed acquisition of P2 stock will not exceed \$20x (\$90x fair market value minus \$70x basis), an amount equal to the amount D would have recognized had it transferred Asset 2 (Separated Property) to a second newly formed corporation (C2) solely for stock and distributed the C2 stock to D shareholders in a Hypothetical D/355(e) Reorganization. See paragraph (e)(2)(i) of this section. Therefore, D recognizes \$80x of gain (\$60x + \$20x). See paragraph (e)(1)(ii) of this section.

(9) *Example 9: Successor of C—(i) Facts.* X owns 100% of the stock of each of D and R. The following steps occur as part of a Plan: D distributes all of its C stock to X. Immediately before the Distribution, D's C stock has a basis of \$10x and a fair market value of \$30x. C then merges into R in a reorganization under section 368(a)(1)(D). Immediately after the merger, X owns all of the R stock. As part of the same Plan, Z acquires 51% of the stock of R from X.

(ii) *Analysis—(A) R is a Successor of C.* Under paragraph (c)(2)(i) of this section, R is a Successor of C because, after the Distribution, C transfers property to R in a Section 381 Transaction.

(B) *Planned 50-percent Acquisition of C.* Under paragraph (d)(2) of this section, Z's acquisition of stock of R is treated as an acquisition of stock of C. Therefore, Z is treated as acquiring 51% of the stock of C. Accordingly, there has been a Planned 50-percent Acquisition of C.

(C) *Gain not limited.* Section 355(e) applies to the Distribution because there has been a Planned 50-percent Acquisition of C. Neither the POD Gain Limitation Rule nor the Distributing Gain Limitation Rule applies because there has been no Planned 50-percent Acquisition of a Predecessor of D, and no Planned 50-percent Acquisition of D. Therefore, D recognizes \$20x of gain (\$30x fair market value minus \$10x basis of the C stock held by D) under section 355(c)(2).

(10) *Example 10: Multiple Successors—(i) Facts.* X owns 100% of the stock of both D and R. Y owns 100% of the stock of S. The following steps occur as part of a Plan: D distributes all of the C stock to X. Immediately after the Distribution, D merges into R in a reorganization under section 368(a)(1)(A) (D-R merger). Following the D-R merger, R merges into S in a reorganization under section 368(a)(1)(A) (R-S merger). Immediately after the R-S merger, X and Y own 10% and 90%, respectively, of the S stock. Immediately before the Distribution, D's C stock has a basis of \$10x and a fair market value of \$30x.

(ii) *Analysis—(A) R and S are Successors of D.* Under paragraph (c)(2)(i) of this section, R is a Successor of D because, after the Distribution, D transfers property to R in a Section 381 Transaction. Under paragraph (c)(2)(ii) of this section, S is also a Successor of D because R (a Successor of D) transfers property to S in a Section 381 Transaction.

(B) *Planned 50-percent Acquisition of D.* Under paragraph (d)(1)(i) of this section, there is no deemed acquisition of D stock as a result of the D-R merger because X wholly owns the stock of D before the merger and wholly owns the stock of R after the merger. Under paragraph (d)(1)(i) of this section, Y is treated as acquiring stock representing 90% of the voting power and value of R (a Successor of D) as a result of the R-S merger. Under paragraph (d)(2) of this section, an acquisition of R stock is also treated as an acquisition of D stock. Accordingly, there has been a Planned 50-percent Acquisition of D.

(C) *Gain not limited.* Section 355(e) applies to the Distribution because there has been a Planned 50-percent Acquisition of D. The POD Gain Limitation Rule does not apply because there has been no Planned 50-percent Acquisition of a Predecessor of D. The Distributing Gain Limitation Rule applies

because there has been a Planned 50-percent Acquisition of D. However, the gain limitation under the Distributing Gain Limitation Rule equals the Statutory Recognition Amount, because there is no Predecessor of D (and thus no Separated Property). Therefore, D recognizes \$20x of gain (\$30x fair market value minus \$10x basis of the C stock held by D) under section 355(c)(2).

(i) *Applicability date.* This section applies to Distributions occurring after De-

cember 15, 2019. For Distributions occurring on or before December 15, 2019, see § 1.355-8T as contained in 26 CFR part 1 revised as of April 1, 2019.

Douglas W. O'Donnell  
*Acting Deputy Commissioner for Services and Enforcement.*

Approved: December 9, 2019.

David J. Kautter,  
*Assistant Secretary of the Treasury  
(Tax Policy).*

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## Part III

### Extension of the Phase-in Period for the Enforcement and Administration of Section 871(m)

#### Notice 2020-2

##### I. PURPOSE

This Notice provides taxpayers with additional guidance for complying with the final and temporary regulations under sections 871(m), 1441, 1461, and 1473 of the Internal Revenue Code (the Code) (collectively referred to as the section 871(m) regulations) in 2021,<sup>1</sup> 2022, and 2023. Specifically, this Notice extends the transition relief provided in Notice 2018-72, 2018-40 I.R.B. 522, for two years, as described in more detail below. The Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) intend to amend the section 871(m) regulations to delay the effective/applicability date of certain rules in those final regulations.

The anti-abuse rule provided in §1.871-15(o) will continue to apply during the phase-in years described in this Notice. As a result, a transaction that would not otherwise be treated as a section 871(m) transaction (including as a result of this Notice) may be a section 871(m) transaction under §1.871-15(o).<sup>2</sup>

##### II. BACKGROUND

On June 14, 2010, the Treasury Department and the IRS published Notice 2010-46, which addresses potential over-withholding in the context of securities lending and sale repurchase agreements. Notice 2010-46 provides a two-part solution to the problem of overwithholding on a chain of dividends and dividend equivalents. First, it provides an exception from withholding for payments to a qualified securities lender (QSL). Second, it provides a proposed framework to credit forward

prior withholding on a chain of substitute dividends paid pursuant to a chain of securities loans or stock repurchase agreements. The QSL regime requires a person that agrees to act as a QSL to comply with certain withholding and documentation requirements. The Treasury Department and the IRS permitted withholding agents to rely on transition rules described in Notice 2010-46, Part III, until guidance was developed that would include documentation and substantiation of withholding.

On September 18, 2015, the **Federal Register** published final regulations and temporary regulations (TD 9734, 80 FR 56866), which finalized a portion of a 2013 notice of proposed rulemaking (78 FR 73128), and introduced new temporary regulations based on comments received with respect to that notice of proposed rulemaking (80 FR 56415) (2015 final regulations and 2015 temporary regulations, respectively). The Treasury Department and the IRS stated in the preamble that the final qualified derivatives dealer (“QDD”) regulations would supplant the proposed regulatory framework described in Notice 2010-46. 80 FR at 56878.

On July 18, 2016, the Treasury Department and the IRS published Notice 2016-42, 2016-29 I.R.B. 67, which contained the proposed qualified intermediary agreement (QI Agreement) that included provisions relating to the QDD regime and reiterated the intent to replace the proposed regulatory framework described in Notice 2010-46 with the QDD regime.

On December 19, 2016, the Treasury Department and the IRS published Notice 2016-76, which provided for the phased-in application of certain provisions of the section 871(m) regulations to allow for the orderly implementation of those final regulations and announced that taxpayers may continue to rely on Notice 2010-46 until January 1, 2018.

On January 17, 2017, the Treasury Department and the IRS published Revenue Procedure 2017-15, 2017-3 I.R.B. 437, which sets forth the final QI Agreement (2017 QI Agreement), including the re-

quirements and obligations applicable to QDDs, and provided that taxpayers may continue to rely on Notice 2010-46 during 2017.

On January 24, 2017, the **Federal Register** published final regulations and temporary regulations (TD 9815, 82 FR 8144) (the 2017 regulations), which finalized the 2015 notice of proposed rulemaking (80 FR 56415) that was issued in conjunction with the 2015 temporary regulations. The effective/applicability dates in the 2017 regulations reflect the phased-in application described in Notice 2016-76. See Treas. Reg. §1.871-15(r)(3). Also, consistent with Notice 2016-76 and other announcements, the “Effect on Other Documents” section of the preamble to the 2017 regulations obsoleted Notice 2010-46 as of January 1, 2018. In response to a comment requesting that the QSL regime remain, the preamble to the 2017 regulations noted that “[w]hile the Treasury Department and the IRS understand that the QSL regime was administratively more convenient for taxpayers than the QI regime, it created administrability problems, particularly with respect to verification, for the IRS. That regime is being replaced by incorporating the QDD rules into the existing QI framework, including the specific rules for pooled reporting on Form 1042-S, and the QI requirements for compliance review and certification.” 82 FR at 8153.

On August 21, 2017, the Treasury Department and the IRS published Notice 2017-42, 2017-34 I.R.B. 212, which extended certain transition relief.

On February 5, 2018, the Treasury Department and the IRS published Notice 2018-5, 2018-6 I.R.B. 341, which permits withholding agents to apply the transition rules from Notice 2010-46 in 2018 and 2019.

On October 1, 2018, the Treasury Department and the IRS published Notice 2018-72, which further extended certain transition relief and permitted withholding agents to apply the transition rules from Notice 2010-46 in 2020.

<sup>1</sup> Unless otherwise provided, all references to years refer to calendar years.

<sup>2</sup> The terms used in this Notice have the meanings provided in the section 871(m) regulations.

Consistent with Executive Order 13777 (82 FR 12285), the Treasury Department and the IRS continue to evaluate the section 871(m) regulations and consider possible agency actions that may reduce unnecessary burdens imposed by the regulations. The Treasury Department and the IRS will take into account comments already received, and welcome any additional comments regarding the issues that new burden reduction guidance may address as well as the tax policy considerations, legal authority for, and the IRS administrative feasibility of any suggested approaches to be taken in the burden reduction guidance. Pending consideration of the section 871(m) regulations pursuant to Executive Order 13777, this Notice extends the phase-in period described in Notice 2018-72 through 2022. *See* sections III through VI of this Notice for more details. Treasury Department and the IRS intend to provide sufficient time for taxpayers and withholding agents to implement any changes to the section 871(m) regulations adopted in response to Executive Order 13777.

### III. EXTENSION OF THE PHASE-IN YEAR FOR DELTA-ONE AND NON-DELTA-ONE TRANSACTIONS

This section describes the extension to the phased-in application of the section 871(m) regulations to delta-one and non-delta-one transactions. This Notice does not apply to any transaction that is a section 871(m) transaction pursuant to §1.871-15(d)(1) (providing that before January 1, 2017, a notional principal contract (NPC) is a specified NPC if certain factors are present).

The Treasury Department and the IRS have determined that it is appropriate for taxpayers and withholding agents to delay certain provisions in the section 871(m) regulations for non-delta-one transactions, including transactions that are combined transactions under §1.871-15(n). Therefore, the Treasury Department and the IRS intend to revise the effective/applicability date for §1.871-15(d)(2) and (e) to provide that these rules will not apply to any payment made with respect to any non-delta-one transaction issued before January 1, 2023. As noted in Part I of this Notice, the anti-abuse rule continues to apply to the phased-in application of the section

871(m) regulations, including for the purpose of determining whether a transaction is a delta-one transaction.

Notice 2016-76 provides that the IRS will take into account the extent to which the taxpayer or withholding agent made a good faith effort to comply with the section 871(m) regulations with respect to delta-one transactions in 2017 and non-delta-one transactions in 2018 when it enforces the section 871(m) regulations. As a result of extensions in Notice 2017-42 and Notice 2018-72, the good faith effort standard applies to (1) any delta-one transaction in 2017 through 2020, and (2) any non-delta-one transaction that is a section 871(m) transaction pursuant to §1.871-15(d)(2) or (e) in 2021. This Notice further extends the periods during which the enforcement standards provided by Notice 2018-72 will apply. Consistent with this extension, the IRS will take into account the extent to which the taxpayer or withholding agent made a good faith effort to comply with the section 871(m) regulations in enforcing the section 871(m) regulations for (1) any delta-one transaction in 2017 through 2022, and (2) any non-delta-one transaction that is a section 871(m) transaction pursuant to §1.871-15(d)(2) or (e) in 2023.

Similarly, for purposes of the IRS's enforcement and administration of the QDD rules in the section 871(m) regulations and the relevant provisions of the 2017 QI Agreement, this Notice extends through 2022 the period during which the IRS will take into account the extent to which the QDD made a good faith effort to comply with the section 871(m) regulations and the relevant provisions of the 2017 QI Agreement. In addition, the IRS is considering revising the 2017 QI Agreement to provide that a QDD will be considered to satisfy the obligations that apply specifically to a QDD under that agreement for 2017 through 2022 provided that the QDD makes a good faith effort to comply with the relevant provisions of the 2017 QI Agreement.

### IV. EXTENSION OF THE SIMPLIFIED STANDARD FOR DETERMINING WHETHER TRANSACTIONS ARE COMBINED TRANSACTIONS

Notice 2016-76 provided a simplified standard for withholding agents to deter-

mine whether transactions entered into in 2017 are combined transactions. Specifically, a withholding agent is required to combine transactions entered into in 2017 for purposes of determining whether the transactions are section 871(m) transactions only when the transactions are over-the-counter transactions that are priced, marketed, or sold in connection with each other. Withholding agents are not required to combine any transactions that are listed securities entered into in 2017.

Notice 2017-42 and Notice 2018-72 extended the period during which this simplified standard for combined transactions applies to include 2018 through 2020. This Notice further extends the period during which this simplified standard for combined transactions applies to include 2021 and 2022. Transactions that are entered into in 2017 through 2022 that are combined under this simplified standard will continue to be treated as combined transactions for future years and will not cease to be combined transactions as a result of applying §1.871-15(n) or disposing of less than all of the potential section 871(m) transactions that are combined under this rule. Transactions that are entered into in 2017 through 2022 that are not combined under this simplified standard will not become combined transactions as a result of applying §1.871-15(n) to these transactions in future years, unless a reissuance or other event causes the transactions to be retested to determine whether they are section 871(m) transactions. *See* §1.871-15(g)(2) (providing that the delta of a potential section 871(m) transaction generally is determined on the earlier of when the transaction is (1) priced or (2) issued); *see also* §1.871-15(a)(6) (defining the term "issue" to include "an issuance as a result of a deemed exchange pursuant to section 1001"). This simplified standard applies only to withholding agents and does not apply to taxpayers that are long parties to potential section 871(m) transactions. As noted in Part I of this Notice, the anti-abuse rule continues to apply to the phased-in application of the section 871(m) regulations, including for the purpose of determining whether multiple transactions should be combined.

## V. EXTENSION OF PHASE-IN RELIEF FOR QUALIFIED DERIVATIVES DEALERS

Section 1.871-15T(q)(1) of the 2015 temporary regulations provided that when a QDD received a dividend or dividend equivalent payment and the QDD was contractually obligated to make an offsetting dividend equivalent payment on the same underlying security in an amount that was less than the dividend and dividend equivalent amount received, the QDD would be liable for tax under section 871(a) or section 881 for the difference. The 2015 final regulations provided that a withholding agent who made a payment of a dividend to a qualified intermediary acting as a QDD was not required to withhold on that payment if the withholding agent reliably associated the payment with a valid qualified intermediary withholding form containing a certification described in §1.1441-1(e)(3)(ii)(E). *See* §1.1441-1(b)(4)(xxii) of the 2015 final regulations.

Comments requested that the Treasury Department and the IRS adopt a different method of determining a QDD's tax liability. Those comments generally requested that this method be based on the QDD's net delta exposure for each underlying security. The Treasury Department and the IRS agreed that the net delta approach was an administrable and accurate method for a QDD to determine its residual exposure to underlying securities, and the 2017 final regulations adopted the net delta exposure method.

In adopting the net delta approach, the Treasury Department and the IRS were concerned that the exemption from withholding on dividends paid to a QDD, when combined with the net delta exposure method, could result in U.S. source dividends escaping U.S. tax completely in certain circumstances. Therefore, the 2017 final regulations revised §§1.871-15(q)(1) and 1.1441-1(b)(4)(xxii) to provide that a QDD remains liable for tax under section 881(a)(1) and subject to withholding under chapters 3 and 4 on dividends. However, to allow taxpayers time to implement the net delta approach, the 2017 QI Agreement and the 2017 final

regulations provided that dividends and dividend equivalents received by a QDD in its equity derivatives dealer capacity in 2017 will not be subject to tax under section 881(a)(1) or subject to withholding under chapters 3 and 4.

Notice 2017-42 and Notice 2018-72 announced that the Treasury Department and the IRS intend to amend §§1.871-15(q)(1) and (r)(3), and 1.1441-1(b)(4)(xxii)(C) to provide that a QDD will not be subject to tax on dividends and dividend equivalents received in 2017 through 2020 in its equity derivatives dealer capacity or withholding on those dividends (including deemed dividends). This Notice announces that the Treasury Department and the IRS intend to amend those provisions to provide that a QDD will not be subject to tax on dividends and dividend equivalents received in 2021 and 2022 in its equity derivatives dealer capacity or withholding on those dividends (including deemed dividends) as well.

Section 4.01(1) of Rev. Proc. 2017-15 provides that a QDD will be required to compute its section 871(m) amount using the net delta approach beginning in 2018. Notice 2017-42 and Notice 2018-72 provided that a QDD would be required to compute its section 871(m) amount using the net delta approach beginning in 2021. This Notice provides that a QDD will be required to compute its section 871(m) amount using the net delta approach beginning in 2023.

A QDD will remain liable for tax under section 881(a)(1) on dividends and dividend equivalents that it receives in any capacity other than as an equity derivatives dealer, and on any other U.S. source FDAP payments that it receives (whether or not in its equity derivatives dealer capacity). In addition, a QDD is responsible for withholding on dividend equivalents it pays to a foreign person on a section 871(m) transaction, whether acting in its capacity as an equity derivatives dealer or otherwise.

Finally, section 10.01(C) of the 2017 QI Agreement provides that: "For calendar year 2017, a QDD is not required to perform a periodic review with respect to its QDD activities (as otherwise required by section 10.04 of this Agreement) or

provide the factual information specified in Appendix I." Notice 2017-42 and Notice 2018-72 provided that a QDD is not required to perform a periodic review with respect to its QDD activities for 2017 through 2020. This Notice provides that a QDD is not required to perform a periodic review with respect to its QDD activities for 2021 or 2022. Note that a QDD must use the same year for the periodic review of its QI activities and its QDD activities. A QI that is a QDD must choose 2023 or a later year within its certification period in which to perform its periodic review unless its applicable certification period ends in 2022 or an earlier year.

## VI. EXTENSION OF TRANSITION RULES FROM NOTICE 2010-46

Notice 2018-5 and Notice 2018-72 provided that notwithstanding the preamble to the 2017 regulations, withholding agents may apply the transition rules described in Notice 2010-46, Part III, for payments made in 2018, 2019, and 2020. This Notice provides that withholding agents may also apply the transition rules described in Notice 2010-46, Part III, for payments made in 2021 and 2022.

## VII. TAXPAYER RELIANCE

Before the promulgation of the amendments to the section 871(m) regulations and the 2017 QI Agreement, taxpayers may rely on the provisions of this Notice regarding the proposed amendments described in sections III and V. Withholding agents may rely on the simplified standard for determining whether transactions are combined transactions as described in section IV and may apply the QSL transition rules described in section VI.

## VIII. DRAFTING INFORMATION

The principal authors of this Notice are Karen Walny and Peter Merkel of the Office of Associate Chief Counsel (International). For further information regarding this Notice, contact Karen Walny or Peter Merkel at (202) 317-6938 (not a toll-free number).

# Interim Guidance on Income Tax Withholding from Retirement and Annuity Distributions

## Notice 2020-3

### I. PURPOSE

This notice provides guidance for the 2020 calendar year regarding withholding from periodic payments for pensions, annuities, and certain other deferred income under § 3405(a) of the Internal Revenue Code (Code), including the rules for withholding from periodic payments under § 3405(a) when no withholding certificate has been furnished (default rate of withholding). This notice also informs taxpayers that the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) are considering whether the 2020 default rate of withholding under § 3405(a) will continue to be appropriate for calendar years after 2020 and request comments related to the potential adoption of a new default rate of withholding. The deadline for submission of comments is February 17, 2020.

### II. BACKGROUND

Section 3405 generally requires the payor of certain payments for pensions, annuities, and certain other deferred income to withhold amounts from the payments unless an individual has elected not to have withholding apply.<sup>1</sup> An individual's withholding election under § 3405 (or election not to have withholding apply, if available) generally is made using Form W-4P, Withholding Certificate for Pension or Annuity Payments.

Section 3405(a) generally requires the payor of periodic payments from pensions, annuities, or certain other deferred income to withhold from those payments as if the payments were wages paid by an employer to an employee, unless an individual has elected not to have withholding apply. Section 3402 requires an employer

to deduct and withhold income tax from employees' wages under methods and procedures prescribed by the Secretary. An employee who receives wages subject to withholding under § 3402 is required to furnish a withholding allowance certificate to his or her employer. *See* § 3402(f)(2), (5); Treas. Reg. § 31.3402(f)(5)-1.

Prior to the 2020 calendar year, information requested on Form W-4P regarding withholding from periodic payments generally paralleled the information requested on Form W-4 for withholding from wages.<sup>2</sup> The Form W-4 for the 2020 calendar year (which has been renamed the Form W-4, Employee's Withholding Certificate) has been redesigned to increase transparency and accuracy of the withholding system. Beginning in calendar year 2020, employers are required to use the redesigned form for all new employees and employees hired prior to 2020 who wish to adjust their withholding. As a result, information requested on the 2020 Form W-4 no longer parallels information requested on Form W-4P for withholding from periodic payments. Among other changes, the redesigned Form W-4 requests the employee's filing status, rather than marital status, and no longer requests the number of withholding allowances the employee is claiming. The 2020 Form W-4 also includes a new method by which an employee may request withholding using higher withholding rate tables. Importantly, the Treasury Department and the IRS have designed the withholding tables and computational procedures in the 2020 Publication 15-T, Federal Income Tax Withholding Methods, to work with both a 2019 or earlier Form W-4 and the redesigned 2020 Form W-4. Therefore, for purposes of withholding from periodic payments under § 3405(a), the IRS plans to provide in the 2020 Publication 15-A, Employer's Supplemental Tax Guide, that the 2020 Form W-4P will work with certain withholding tables and computational procedures in the 2020 Publication 15-T that are applicable to a 2019 or earlier Form W-4.

Section 3405(a)(4) was amended by section 11041(c)(2)(G) of the Tax Cuts

and Jobs Act, Pub. L. 115-97 (TCJA) to provide that the withholding rate for periodic payments when no withholding certificate has been furnished "shall be determined under rules prescribed by the Secretary." Under the law in effect before 2018, § 3405(a)(4) provided that, in the case of a payee entitled to periodic payments with respect to which a withholding certificate had not been furnished, the amount to be withheld from each such payment "shall be determined by treating the payee as a married individual claiming 3 withholding exemptions." Temporary Treasury Regulations issued under § 3405 (as in effect before 2018) continue to provide that, if no withholding certificate has been furnished with respect to periodic payments under § 3405(a), then the payor must base withholding on the rates for a married person claiming three withholding allowances. *See* Temp. Treas. Reg. § 35.3405-1T, Q&As A-10, B-3, B-4.

Following enactment of TCJA, the Treasury Department and the IRS issued guidance to address changes made by TCJA to withholding rules under §§ 3401, 3402, and 3405. *See* Notice 2018-14, 2018-7 I.R.B. 353, and Notice 2018-92, 2018-51 I.R.B. 1038. With respect to § 3405(a), section V of Notice 2018-14 provided that, for 2018, the default rate of withholding would parallel the rules for prior years and would be based on treating the payee as a married individual claiming three withholding allowances. Similarly, section 10 of Notice 2018-92 provided that, for 2019, the default rate of withholding under § 3405(a)(4) would parallel the rules for prior years, and would be based on treating the payee as a married individual claiming three withholding allowances.

### III. 2020 FORM W-4P AND RELATED TABLES AND COMPUTATIONAL PROCEDURES FOR WITHHOLDING UNDER SECTION 3405(a)

The information requested on the 2020 Form W-4P for periodic payments (other than the no-withholding election on Line

<sup>1</sup> The election not to have withholding apply generally is unavailable with respect to eligible rollover distributions under § 3405(c) and certain payments to be made outside of the United States or its possessions under § 3405(e)(13).

<sup>2</sup> The no-withholding election that is generally available for periodic payments under § 3405(a) is not available for wages; therefore, the no-withholding election on Line 1 of the 2019 Form W-4P does not parallel the conditions to claim exemption from wage withholding on the 2019 Form W-4.

1) generally will continue to parallel the information requested on Form W-4 prior to 2020. Payees of periodic payments may use either the worksheets to Form W-4P or the Tax Withholding Estimator ([www.irs.gov/W4App](http://www.irs.gov/W4App)) to assist in determining their entries on the 2020 Form W-4P. As explained in Section II of this notice, certain withholding tables and computational procedures in the 2020 Publication 15-T that are applicable to a 2019 or earlier Form W-4 will also work with the 2020 Form W-4P.

#### **IV. RULES FOR 2020 FOR WITHHOLDING FROM PERIODIC PAYMENTS UNDER SECTION 3405(a) WHEN NO WITHHOLDING CERTIFICATE HAS BEEN FURNISHED**

For the 2020 calendar year, the rules for withholding from periodic payments under § 3405(a) when no withholding certificate has been furnished will continue to parallel the rules for prior years. Therefore, for 2020, the default rate of withholding from periodic payments under § 3405(a) will be based on treating the payee as a married individual claiming three withholding allowances and applying that status to the applicable withholding tables and related computational procedures in the 2020 Publication 15-T. The IRS plans to provide in the 2020 Publication 15-A that this default rate of withholding will work with certain withholding tables and computational procedures in the 2020

Publication 15-T that are applicable to a 2019 or earlier Form W-4.

#### **V. WITHHOLDING UNDER SECTION 3405(a) FOR YEARS AFTER 2020**

The Treasury Department and the IRS will provide the rules and procedures that apply for calendar years after 2020 for withholding from periodic payments under § 3405(a) in applicable forms, instructions, publications, and other guidance. In addition, the Treasury Department and the IRS are considering whether the default rate of withholding from periodic payments under § 3405(a) described in section IV of this notice will continue to be appropriate for calendar years after 2020.

#### **VI. REQUEST FOR COMMENTS**

The Treasury Department and the IRS invite comments on whether the adoption of a new default rate of withholding from periodic payments under § 3405(a) that would apply prospectively (that is, would only apply to periodic payments that begin after the effective date of the new default withholding rate) would present any administrative challenges.

Comments should be submitted in writing on or before February 17, 2020. Comments should include a reference to Notice 2020-3. Comments may be submitted electronically via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (type IRS-2019-0051 in the search field on the

[regulations.gov](http://regulations.gov) homepage to find this notice and submit comments). Alternatively, comments may be mailed to: CC:PA:LPD:PR (Notice 2020-3), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. All comments will be available for public inspection and copying in their entirety.

#### **VII. PAPERWORK REDUCTION ACT**

Any collection of information associated with this notice has been submitted to the Office of Management and Budget for review under OMB control number 1545-0074 in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). In general, the collection of information is required under § 3405(a). An agency may not conduct or sponsor and a person is not required to respond to a collection of information unless it displays a valid OMB control number.

#### **VIII. DRAFTING INFORMATION**

The principal author of this notice is Kara M. Soderstrom of the Office of the 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 this guidance. For further information regarding this notice, contact Ms. Soderstrom at 202-317-6799 (not a toll-free number).

## Part IV

### Notice of Proposed Rulemaking and Notification of Public Hearing

#### Treatment of Payments to Charitable Entities in Return for Consideration

**REG-107431-19**

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notification of public hearing.

SUMMARY: This document provides proposed amendments to the regulations under sections 162, 164, and 170 of the Internal Revenue Code (Code). First, the proposed amendments update the regulations under section 162 to reflect current law regarding the application of section 162 to a taxpayer that makes a payment or transfer to an entity described in section 170(c) for a business purpose. Second, the proposed amendments provide safe harbors under section 162 to provide certainty with respect to the treatment of payments made by business entities to an entity described in section 170(c). Third, the proposed amendments provide a safe harbor under section 164 for payments made to an entity described in section 170(c) by individuals who itemize deductions and receive or expect to receive a state or local tax credit in return. Fourth, the proposed amendments update the regulations under section 170 to reflect past guidance and case law regarding the application of the *quid pro quo* principle under section 170 to benefits received or expected to be received by a donor from a third party.

DATES: Written or electronic comments must be received by January 31, 2020. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for February 20, 2020, must be received by January 31, 2020.

ADDRESSES: Submit electronic submissions via the Federal eRulemaking Portal at <http://www.regulations.gov> (indicate IRS and REG-107431-19) 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-107431-19), 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-107431-19), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Mon L. Lam and Merrill D. Feldstein at (202) 317-4059; concerning submission of comments and requests to speak at the public hearing, Regina Johnson at (202) 317-6901 (not toll-free numbers) or fdms.database@irs counsel.treas.gov.

#### SUPPLEMENTARY INFORMATION:

##### Background and Explanation of Provisions

###### I. Contributions in Exchange for State and Local Tax Credits

Section 170(a)(1) generally allows an itemized deduction for any “charitable contribution” paid within the taxable year. Section 170(c) defines “charitable contribution” as a “contribution or gift to or for the use of” an entity described in that section. Under section 170(c)(1), such entities include a State, a possession of the United States, or any political subdivision of the foregoing, or the District of Columbia. Section 170(c)(2) includes certain corporations, trusts, or community chests, funds, or foundations, organized

and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals. Section 1.170A-1(c)(5) of the Income Tax Regulations provides that transfers of property to an organization described in section 170(c) that bear a direct relationship to the taxpayer’s trade or business and that are made with a reasonable expectation of financial return commensurate with the amount of the transfer may constitute allowable deductions as trade or business expenses rather than as charitable contributions. Section 162(a) allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section 162(b) provides that no deduction shall be allowed under subsection (a) for any contribution or gift that would be allowable as a deduction under section 170 were it not for the percentage limitations, the dollar limitations, or the requirements as to the time of payment set forth in that section.

Section 1.162-15(a) applies to contributions to entities described in section 170(c). Section 1.162-15(a)(1) currently provides that no deduction is allowable under section 162(a) for a contribution or gift by an individual or a corporation if any part thereof is deductible under section 170. For example, if a taxpayer makes a contribution of \$5,000 and only \$4,000 of this amount is deductible under section 170(a) (whether because of the percentage limitation under either section 170(b)(1) or (2), the requirement as to time of payment, or both), no deduction is allowable under section 162(a) for the remaining \$1,000. However, §1.162-15(a)(2) clarifies that the limitations provided in section 162(b) and §1.162-15(a)(1) apply only to payments that are in fact contributions or gifts to organizations described in section 170. For example, payments by a transit company to a local hospital (which is a charitable organization within the meaning of section 170) in consideration of a binding obligation on the part of the hospital to provide hospital services and facilities for the company’s employees are not

contributions or gifts within the meaning of section 170 and may be deductible under section 162(a) if the requirements of section 162(a) are otherwise satisfied.

Section 164(a) allows a deduction for the payment of certain taxes, including: (1) state and local, and foreign, real property taxes; (2) state and local personal property taxes; and (3) state and local, and foreign, income, war profits, and excess profits taxes. In addition, section 164 allows a deduction for taxes not described in the preceding sentence that are paid or accrued within the taxable year in carrying on a trade or business or an activity described in section 212. Moreover, under section 164(b)(5), taxpayers may elect to deduct state and local general sales taxes in lieu of state and local income taxes.

Section 164(b)(6), as added by section 11042(a) of the Tax Cuts and Jobs Act Pub. L. 115-97, (the “TCJA”) provides that in the case of an individual, deductions for foreign real property taxes are not allowable under section 164(a)(1), and the deduction for the aggregate amount of the following state and local taxes paid during the calendar year is limited to \$10,000 (\$5,000 in the case of a married individual filing a separate return): (1) real property taxes; (2) personal property taxes; (3) income, war profits, and excess profits taxes; and (4) general sales taxes. This limitation applies to taxable years beginning after December 31, 2017, and before January 1, 2026, and does not apply to foreign taxes described in section 164(a)(3) or to any taxes described in section 164(a)(1) and (2) that are paid or accrued in carrying on a trade or business or an activity described in section 212.

In response to the limitation in section 164(b)(6), some taxpayers have considered tax planning strategies to avoid or mitigate its effects. Some of these strategies rely on state and local tax credit programs under which states provide tax credits in return for contributions by taxpayers to entities described in section 170(c), and some state and local governments have created new programs intended to facilitate use of these strategies.

On June 11, 2018, the Treasury Department and the IRS announced their intention to propose regulations addressing the proper application of sections 164 and 170 to taxpayers who make contributions

under state and local tax credit programs to entities described in section 170(c). See Notice 2018-54, 2018-24 I.R.B. 750. On August 27, 2018, proposed regulations (REG-112176-18) under sections 170 and 642(c) were published in the **Federal Register** (83 FR 43563) (“2018 proposed regulations”). The 2018 proposed regulations proposed amending §1.170A-1(h)(3) to provide, in general, that if a taxpayer makes a payment or transfers property to or for the use of an entity described in section 170(c), and the taxpayer receives or expects to receive a state or local tax credit in return for such payment or transfer, the tax credit constitutes a return benefit to the taxpayer and reduces the taxpayer’s charitable contribution deduction. The 2018 proposed regulations were premised, in part, on the *quid pro quo* principle articulated by the Supreme Court in *United States v. American Bar Endowment*, 477 U.S. 105, 116 (1986), and its progeny that “a payment of money generally cannot constitute a charitable deduction if the contributor expects a substantial benefit in return.” The 2018 proposed regulations also proposed amending regulations under section 642(c), to provide a similar rule for payments made by a trust or decedent’s estate.

The Treasury Department and the IRS received over 7,700 comments responding to the 2018 proposed regulations and 25 requests to speak at the public hearing, which was held on November 5, 2018. After taking into account the comments received and the concerns expressed at the public hearing, the Treasury Department and the IRS published final regulations in the **Federal Register** on June 13, 2019 (T.D. 9864, 84 FR 27513) (“the final regulations”). The final regulations retained the rules set out in the 2018 proposed regulations, with certain clarifying and technical changes. Most significantly, the final regulations retained the general rule that, if a taxpayer makes a payment or transfers property to or for the use of an entity described in section 170(c), and the taxpayer receives or expects to receive a state or local tax credit in return for such transfer, the tax credit constitutes a return benefit to the taxpayer, or *quid pro quo*, reducing the taxpayer’s charitable contribution deduction. See §1.170A-1(h)(3) of the final regulations.

In response to Notice 2018-54 and the 2018 proposed regulations, commenters raised several ancillary issues. These issues involved: (1) treatment of business entity payments to entities described in section 170(c); (2) treatment of payments by individuals with total state and local tax liabilities that were less than or equal to the section 164(b)(6) limitations; and (3) application of the *quid pro quo* principle under section 170 to benefits received or expected to be received by the donor from a party other than the donee.

Although the Treasury Department and the IRS have provided sub-regulatory safe harbors related to the first two issues (in Rev. Proc. 2019-12, 2019-04 I.R.B. 401, and Notice 2019-12, 2019-27 I.R.B. 57), the Treasury Department and the IRS believe that it is appropriate to include these safe harbors in proposed regulations and to request comments. Further, in the preamble to the final regulations, the Treasury Department and the IRS extensively addressed the third issue — whether a benefit received or expected to be received from a party other than the donee may constitute a *quid pro quo* that reduces the taxpayer’s charitable contribution deduction under section 170. The preamble to the final regulations stated that the Treasury Department and the IRS would propose additional regulations setting forth a general rule for benefits received or expected to be received from third parties. Accordingly, the proposed regulations, provided herein, would amend the regulations under sections 162, 164, and 170 to provide guidance on these three issues.

## **II. Payments by Business Entities in Exchange for State or Local Tax Credits**

After the issuance of Notice 2018-54, and continuing after the publication of the 2018 proposed regulations, the Treasury Department and the IRS received inquiries from taxpayers regarding the application of the proposed regulations to businesses that make payments to entities described in section 170(c) pursuant to state and local tax credit programs. The taxpayers sought guidance as to whether a business entity may deduct these payments under section 162 as ordinary and necessary business expenses incurred in carrying on a trade

or business. In response, on September 5, 2018, the IRS released a frequently asked question (“FAQ”) stating that a business taxpayer making a payment to an entity described in section 170(c) is generally permitted to deduct such payment as an ordinary and necessary business expense under section 162 if the payment is made with a business purpose. However, after the release of the FAQ, taxpayers continued to express concern about whether the business purpose requirement is met for contributions that result in a tax credit. Specifically, taxpayers asked whether payments by business entities in exchange for state and local tax credits would bear a direct relationship to the taxpayer’s trade or business such that these payments would qualify as ordinary and necessary business expenses of carrying on a trade or business under section 162(a).

On December 28, 2018, the IRS issued Rev. Proc. 2019-12, providing a safe harbor under section 162 for payments made by a business entity that is a C corporation or specified passthrough entity to or for the use of an organization described in section 170(c) if the C corporation or specified passthrough entity receives or expects to receive state or local tax credits in return. The revenue procedure states that, to the extent that a C corporation receives or expects to receive a state or local tax credit in return for a payment to an organization described in section 170(c), it is reasonable to conclude that there is a direct benefit and a reasonable expectation of commensurate financial return to the C corporation’s business in the form of a reduction in the state or local taxes the C corporation would otherwise be required to pay. Thus, the revenue procedure provides a safe harbor that allows a C corporation engaged in a trade or business to treat the portion of the payment that is equal to the amount of the credit received or expected to be received as meeting the requirements of an ordinary and necessary business expense under section 162.

The IRS determined that a similar analysis is appropriate in the case of a business entity other than a C corporation if (1) the business entity is regarded as separate from its owner for all Federal tax purposes under §301.7701-3 of the Procedure and Administration Regulations (“passthrough entity”); (2) the passthrough entity oper-

ates a trade or business within the meaning of section 162; (3) the passthrough entity is subject to a state or local tax incurred in carrying on its trade or business that is imposed directly on the entity; and (4) in return for a payment to an entity described in section 170(c), the passthrough entity receives or expects to receive a state or local tax credit that the entity applies or expects to apply to offset a state or local tax other than a state or local income tax. Thus, to the extent that a specified passthrough entity makes a payment to an entity described in section 170(c) and receives or expects to receive a state or local tax credit, Rev. Proc. 2019-12 permits the passthrough entity to treat the payment as meeting the requirements of an ordinary and necessary business expense under section 162. The safe harbors for C corporations and specified passthrough entities apply only to payments of cash and cash equivalents.

In the interest of providing certainty for taxpayers, the Treasury Department and the IRS believe that it is appropriate to propose regulations to incorporate the safe harbors set out in Rev. Proc. 2019-12 and to request comments on these safe harbors. Thus, these proposed regulations propose amending §1.162-15(a) to incorporate the Rev. Proc. 2019-12 safe harbors. These proposed regulations also propose amending §1.170A-1(c)(5) and (h)(3)(viii) to provide cross references to §1.162-15(a). The Treasury Department and the IRS specifically request comments on whether the safe harbors should be expanded to apply to an individual who is carrying on a trade or business or an activity described in section 212.

The proposed regulations propose additional revisions to §1.162-15(a) to more clearly reflect the current state of the law regarding a taxpayer’s payment or transfer to an entity described in section 170(c). If the taxpayer’s payment or transfer bears a direct relationship to its trade or business, and the payment is made with a reasonable expectation of commensurate financial return, the payment or transfer to the section 170(c) entity may constitute an allowable deduction as a trade or business expense under section 162, rather than a charitable contribution under section 170. See §1.170A-1(c)(5); *Marquis v. Commissioner*, 49 T.C. 695 (1968). A proposed

example illustrates that this rule applies regardless of whether the taxpayer expects to receive a state or local tax credit in return.

The proposed revisions are also consistent with the decision in *American Bar Endowment*, which states that a payment to an entity described in section 170(c) may have a dual character—part charitable contribution and part business expense. 477 U.S. at 117. Under *American Bar Endowment* and §1.170A-1(h), if a taxpayer makes a payment to an entity described under section 170(c) in an amount that exceeds the fair market value of the benefit that the taxpayer receives or expects to receive in return, and this excess amount is paid with charitable intent, the taxpayer is allowed a charitable contribution deduction under section 170 for this excess amount.

In addition, the proposed regulations propose to add a cross-reference to §1.170A-1(h) (payments to section 170(c) entities in exchange for consideration), which provides more detailed rules for determining whether a payment, or a portion of a payment, to an entity described in section 170(c) may be deducted under section 162(a) or section 170.

### III. Payments by Individuals in Exchange for State and Local Tax Credits

After publication of the 2018 proposed regulations, commenters expressed concerns that the proposed regulations would create unfair consequences for certain individuals who receive state or local tax credits in return for their payments. Specifically, commenters noted that individuals who itemize deductions for Federal income tax purposes and have total state and local tax liabilities for the taxable year of \$10,000 or less (\$5,000 or less in the case of a married individual filing a separate return) would be precluded from taking charitable contribution deductions to the extent that they receive state or local tax credits even though the individuals would have been able to deduct equivalent payments of state and local taxes. Thus, if these individuals chose to make a payment to a section 170(c) entity through a state or local tax credit program instead of paying tax to the state or local government, they

would lose the deduction to which they would otherwise have been entitled under section 164 even after the application of the section 164(b)(6) limitation.

These state and local tax credit programs effectively offer taxpayers a choice of paying taxes to the state or local government or making a payment to a section 170(c) entity and receiving a tax credit that offsets a tax liability the taxpayer would otherwise owe to the state or local government. This situation can be analogized to situations in which an individual entitled to receive a payment from a second party directs or permits the second party to satisfy its payment obligation by making a payment to a third party. In such situations, the payment may be treated, for Federal income tax purposes, as a payment by the payor to the individual entitled to receive payment. *Cf.* Rev. Rul. 86-14, 1986-1 C.B. 304, modifying Rev. Rul. 74-75, 1974-1 C.B. 19 (payment made by an employer to a third party to discharge an obligation of an employee treated for Federal income tax purposes as made by the employer to the employee).

For these reasons, on June 11, 2019, the IRS released Notice 2019-12, announcing that the Treasury Department and the IRS intend to publish proposed regulations with a safe harbor under section 164 for individuals who make payments to section 170(c) entities in return for state or local tax credits. Under this safe harbor, an individual who itemizes deductions and who makes a payment to an entity described in section 170(c) in exchange for a state or local tax credit may treat as a payment of state or local tax for purposes of section 164 the portion of such payment for which a charitable contribution deduction is or will be disallowed under §1.170A-1(h)(3). This treatment is allowed in the taxable year in which the payment is made, but only to the extent that the individual applies the resulting credit pursuant to applicable state or local law to offset the individual's state or local tax liability for such taxable year or the preceding taxable year. Notice 2019-12 requested comments for purposes of incorporating the safe harbor in proposed regulations.

The Treasury Department and the IRS received several comments in response to Notice 2019-12. Generally, commenters responded favorably to the safe harbor in

the notice, finding that its rationale was sound and that the rule would effectively eliminate concerns that the final regulations under §1.170A-1(h)(3) unfairly burden individuals who itemize deductions and have state and local tax liabilities that are less than the section 164(b)(6) limitation. One commenter noted that Executive Order 12866, which directs the agency issuing a regulation to identify the problem it intends to address and design the regulation in the most cost-effective manner to achieve that objective with the least amount of burden on society, further supports the safe harbor. See Executive Order 12866, section 1(b). This commenter also suggested that the IRS should track the effects of the safe harbor by requiring taxpayers to disclose state tax and local tax credits on their Form 1040, Schedule A. Alternatively, the commenter suggested that the IRS obtain this information directly from the states. Another commenter generally supported the safe harbor, but suggested that the Treasury Department and the IRS should avoid creating more safe harbor exceptions to §1.170A-1(h)(3) of the final regulations. This commenter also expressed concerns about the application of the safe harbor when the state and local tax limitation under section 164(b)(6) expires or is modified.

Other commenters were concerned that Notice 2019-12 did not fully address the tax consequences to taxpayers who received or expected to receive state or local tax credits. Specifically, these commenters asked that the Treasury Department and the IRS provide guidance to address the treatment of state or local tax credits for Federal income tax purposes upon their sale or expiration. As noted in the preamble to the final regulations, the Treasury Department and the IRS recognize the significance and complexity of these questions. The Treasury Department and the IRS continue to study these issues and invite additional comment to inform potential future guidance on these issues.

The Treasury Department and the IRS continue to believe that the notice provides a fair, reasonable, and legally sound basis for the safe harbor for individual taxpayers, and that the safe harbor should be added to the regulations under section 164. Accordingly, these proposed regulations propose adding §1.164-3(j)

to provide a safe harbor for individuals who make a payment to or for the use of an entity described in section 170(c) in return for a state or local tax credit. These proposed regulations also propose adding §1.170A-1(h)(3)(ix) to provide a cross reference to the safe harbor proposed under §1.164-3(j) and to request comments.

Under these proposed regulations, an individual who itemizes deductions and who makes a payment to a section 170(c) entity in exchange for a state or local tax credit may treat as a payment of state or local tax for purposes of section 164 the portion of such payment for which a charitable contribution deduction under section 170 is or will be disallowed under §1.170A-1(h)(3). This treatment is allowed in the taxable year in which the payment is made, but only to the extent that the resulting credit is applied pursuant to applicable state or local law to offset the individual's state or local tax liability for such taxable year or the preceding taxable year. Any unused credit permitted to be carried forward may be treated as a payment of state or local tax under section 164 in the taxable year or years for which the carryover credit is applied in accordance with state or local law. The safe harbor for individuals applies only to payments of cash and cash equivalents.

The proposed regulations are not intended to permit a taxpayer to avoid the limitations of section 164(b)(6). Therefore, the proposed regulations provide that any payment treated as a state or local tax under section 164, pursuant to the safe harbor provided in §1.164-3(j) of the proposed regulations, is subject to the limitations on deductions in section 164(b)(6). Furthermore, the proposed regulations are not intended to permit deductions of the same payments under more than one provision. Thus, the proposed regulations provide that an individual who relies on the safe harbor in §1.164-3(j) to deduct qualifying payments under section 164 may not also deduct the same payments under any other section of the Code.

#### **IV. Consideration Provided by Party Other Than the Donee**

Section 1.170A-1(h)(1) provides that no part of a payment that a taxpayer makes to or for the use of an organi-

zation described in section 170(c) that is in consideration for (as defined in §1.170A-13(f)(6)) goods or services (as defined in §1.170A-13(f)(5)) is a contribution or gift within the meaning of section 170(c) unless the taxpayer (i) intends to make a payment in an amount that exceeds the fair market value of the goods or services; and (ii) makes a payment in an amount that exceeds the fair market value of the goods or services.

Section 1.170A-1(h)(2) states that the charitable contribution deduction under section 170(a) may not exceed the amount of cash paid and the fair market value of property transferred to an organization described in section 170(c) over the fair market value of goods or services the organization provides in return. Section 1.170A-13(f)(5) defines goods or services as cash, property, services, benefits, and privileges. Section 1.170A-13(f)(6) provides that a donee provides goods or services in consideration for a taxpayer's payment if, at the time the taxpayer makes a payment to the donee, the taxpayer receives or expects to receive goods or services in exchange for that payment.

Section 1.170A-1(h)(3)(iii) defines "in consideration for" for purposes of determining whether a state or local tax credit should reduce a charitable contribution under section 170. This section provides that the term "in consideration for" shall have the meaning set forth in §1.170A-13(f)(6), except that the state or local tax credit need not be provided by the donee organization.

Some commenters on the 2018 proposed regulations interpreted the definition of "in consideration for" under §1.170A-13(f)(6) to suggest that consideration provided by a third party is disregarded in calculating the charitable contribution deduction, and that §1.170A-1(h)(3)(iii) of the proposed regulations provided an exception from this rule solely for state or local tax credits provided by third parties. Other commenters disagreed with this interpretation and suggested that the final regulations should set forth a general rule clarifying that consideration includes all benefits that a taxpayer receives or expects to receive, regardless of whether they are provided by the donee.

In the preamble to the final regulations, the Treasury Department and the IRS

acknowledged that the final regulations did not address all situations in which a taxpayer makes a payment or transfers property and receives or expects to receive benefits from a party that is not the donee. Accordingly, the preamble to the final regulations indicated that the Treasury Department and the IRS intended to propose amendments to the regulations under section 170 to make clear that the *quid pro quo* principle applies regardless of whether the party providing the *quid pro quo* is the donee.

As noted in the preamble to the final regulations, in *American Bar Endowment*, 477 U.S. at 116-17, and *Hernandez v. Commissioner*, 490 U.S. 680, 691-92 (1989), the Supreme Court made clear that a payment is not a charitable contribution if the donor expects to receive a substantial benefit in return. *American Bar Endowment* and *Hernandez* did not directly address the question of benefits provided by third parties; the return benefits at issue in those cases were provided by the donees. However, the Court derived the *quid pro quo* principle in those cases from a lower court decision and a revenue ruling that directly addressed the question. See *American Bar Endowment*, 477 U.S. at 117 (citing *Singer v. United States*, 449 F.2d 413 (Ct. Cl. 1971), and Rev. Rul. 67-246, 1967-2 C.B. 104); *Hernandez*, 490 U.S. at 691 (citing *Singer*). In *Singer*, the appellate division of the Court of Claims (the predecessor to the Court of Appeals for the Federal Circuit) held that a sewing machine company was not eligible for a charitable contribution deduction for selling sewing machines to schools at a discount because the company "expected a return in the nature of future increased sales" to students. *Singer*, 449 F.2d at 423-24. In so holding, the court expressly rejected the company's argument that this expected benefit should be ignored because it would come from the students rather than from the schools. *Id.* at 422-23. The court stated, "Obviously, we cannot agree with plaintiff's distinction." *Id.*

In Rev. Rul. 67-246, Example 11, a local store agreed to award a transistor radio, worth \$15, to each person who contributed \$50 or more to a specific charity. The ruling concluded that if a taxpayer received a \$15 radio as a result of a \$100 payment to the charity, only \$85 qualified

as a charitable contribution deduction. It did not matter that the donor received the \$15 radio from the store, a third party, rather than from the charity. This conclusion is reflected in the IRS's audit practices. See IRS Conservation Easement Audit Techniques Guide (Rev. Jan. 24, 2018, p. 16) (stating that a "quid pro quo contribution is a transfer of money or property . . . partly in exchange for goods or services in return from the charity or a third party," and "a quid pro quo may also be in the form of an indirect benefit from a third party").

Moreover, courts have ruled that a taxpayer's expectation of significant financial returns demonstrates a lack of charitable intent. For example, in *Ottawa Silica Co. v. United States*, 699 F.2d 1124 (Fed. Cir. 1983), the Federal Circuit denied a taxpayer's charitable contribution deduction for the value of land the taxpayer donated for construction of a school. The court's analysis focused on the taxpayer's expectation of benefits, and not on the source of such benefits. The court found that the taxpayer had reason to believe that construction of a school would result in the construction of new roads that would in turn increase the value of the taxpayer's retained land. The court recognized that although the taxpayer did not receive an agreement from any party that the roads would be built, the expectation of this benefit was a sufficient reason to deny the charitable contribution deduction. More recently, in *Wendell Falls Development, LLC v. Commissioner*, T.C. Memo. 2018-45, a taxpayer contributed a conservation easement that essentially restricted land for use as a park. The taxpayer expected this restriction to increase the value of the taxpayer's adjacent property. The Tax Court disallowed the taxpayer's claimed charitable contribution deduction for the easement, finding that the taxpayer contributed the easement with the expectation of receiving a substantial benefit (increased value of taxpayer's adjacent property) from the contribution, even though the expected benefit would not come from the donee. In accordance with these authorities, the source of the return benefit is immaterial in determining whether the donee at the time of the contribution expects to receive substantial benefits in return.

The *quid pro quo* principle is thus equally applicable regardless of whether the donor expects to receive the benefit from the donee or from a third party. In either case, the donor's payment is not a charitable contribution or gift to the extent that the donor expects a substantial benefit in return. Accordingly, the Treasury Department and the IRS propose amendments to §1.170A-1(h) that address a donor's payments in exchange for consideration in order for the regulation to reflect existing law. Specifically, these proposed amendments revise paragraph (h)(4) to provide definitions of "in consideration for" and "goods and services" for purposes of applying the rules in §1.170A-1(h). Under the proposed regulations, a taxpayer will be treated as receiving goods and services in consideration for a taxpayer's payment or transfer to an entity described in section 170(c) if, at the time the taxpayer makes the payment or transfer, the taxpayer receives or expects to receive goods or services in return.

The proposed regulations do not amend the language of §1.170A-13(f)(6) which discusses "in consideration for" for purposes of determining whether the taxpayer provides proper substantiation of its charitable contribution. Section 1.170A-13(f) details the requirements of a contemporaneous written acknowledgment, including a statement of whether the donee organization provides any goods or services in consideration for any cash or other property transferred to the donee organization and a description and a good faith estimate of the value of those goods or services. See §1.170A-13(f)(2)(ii) and (iii). These substantiation provisions refer only to written acknowledgments from donee organizations and do not address the application of *quid pro quo* principles to benefits received from parties other than donees. The Treasury Department and the IRS request comments on whether guidance concerning substantiation and reporting of *quid pro quo* benefits provided or expected to be provided by third parties, including state governments, would be beneficial to taxpayers in demonstrating that they have given more than they received or expected to receive and to the IRS in administering the proposed regulation. In addition, the Treasury Department and the IRS request comments regarding the manner by which

donors, donees, or third parties may report or provide substantiation for the value or type of consideration received or expected to be received from third parties.

For additional clarity, the proposed regulation amends the language in §1.170A-1(h)(2)(i)(B) to clarify that the fair market value of goods and services includes the value of goods and services provided by parties other than the donee. Also, the proposed regulation adds a definition of "goods and services" that is the same as the definition in §1.170A-13(f)(5). Finally, the proposed regulation revises the cross-references defining "in consideration for" and "goods and services" in paragraphs (h)(1) and (h)(3)(iii) to be consistent with the proposed definitions provided in paragraph (h)(4).

### Proposed Applicability Dates

The proposed amendments contained in §§1.162-15(a)(1) and (2) and 1.170A-1(c)(5), regarding the application of section 162 to taxpayers that make payments or transfers to entities described in section 170(c), are proposed to apply to payments or transfers on or after December 17, 2019. However, a taxpayer may rely on these proposed regulations for payments and transfers made on or after January 1, 2018 and before the date regulations finalizing these proposed regulations are published in the Federal Register.

The proposed amendment contained in §1.162-15(a)(3), regarding safe harbors for C corporations and specified passthrough entities making payments to or for the use of section 170(c) entities in exchange for state or local tax credits, is proposed to apply to payments on or after December 17, 2019. However, prior to this date, a taxpayer may continue to apply Rev. Proc. 2019-12, which applies to payments made on or after January 1, 2018.

The proposed amendments contained in §§1.164-3(j) and 1.170A-1(h)(3)(ix), regarding the safe harbor for payments by certain individuals to or for the use of section 170(c) entities, are proposed to apply to payments made on or after June 11, 2019, the date that the IRS issued Notice 2019-12, announcing it intended to publish proposed regulations with a safe harbor under section 164 for individuals

who make payments to section 170(c) entities in return for state or local tax credits. However, individuals may rely on these proposed regulations for payments made after August 27, 2018, the applicability date of the final regulations, and before the date regulations finalizing these proposed regulations are published in the Federal Register.

Finally, the proposed amendments contained in §§1.170A-1(h)(1), (h)(2)(i)(B), (h)(3)(iii), and (h)(4)(i), and 1.170A-13(f)(7) clarifying "in consideration for" for purposes of applying §1.170A-1(h) are proposed to apply to payments or transfers on or after December 17, 2019.

### Special Analyses

#### Regulatory Planning and Review – Economic Analysis

Executive Orders 13563 and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility. This proposed rule is expected to be an EO 13771 regulatory action. Details on the estimated costs of this proposed rule can be found in the rule's economic analysis.

These proposed regulations have been designated as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget (OMB) regarding review of tax regulations. The Office of Information and Regulatory Affairs has designated these regulations as significant under section 1(b) of the MOA. Accordingly, the OMB has reviewed these regulations.

#### A. Background

Section 164 of the Code allows a deduction for certain state and local taxes paid, including state or local income and property taxes. Section 164(b)(6), added by the

TCJA, generally limits an individual's deduction of these taxes to \$10,000 (\$5,000 in the case of a married individual filing a separate return). The limitation does not apply to foreign income taxes or to property taxes that are paid or incurred in carrying on a trade or business or an activity described in section 212. Section 162 allows a deduction for ordinary and necessary expenses paid or incurred in carrying on a trade or business. Section 170 allows a deduction for charitable contributions, specifically for payments or transfers to an entity described in section 170(c); however, the deduction must be reduced by any *quid pro quo* benefit that the taxpayer receives or expects to receive in return.

After the enactment of the TCJA, questions arose regarding the interaction of these deductions. To clarify the application of these provisions, the Treasury Department and the IRS issued guidance including: 1) Final regulations (T.D. 9864, 84 FR 27513) providing that a tax credit received or expected to be received in return for a payment or transfer to an entity described in section 170(c) (hereafter referred to as a charitable entity) is a return benefit to the taxpayer, resulting in the reduction of the charitable contribution deduction; 2) Notice 2019-12 announcing the intent to issue proposed regulations providing a safe harbor for individuals under which a charitable contribution that is disallowed because of a return benefit of a state or local tax credit may be treated as a payment of state or local tax; and 3) Rev. Proc. 2019-12 providing a safe harbor allowing as a deductible business expense certain payments by businesses to charitable organizations.

#### B. Need for the proposed regulations

The Treasury Department and the IRS believe that it is appropriate to propose as regulations and seek additional public comment on the safe harbors provided in Notice 2019-12 and Rev. Proc. 2019-12. In addition, comments received in response to Notice 2018-54 and the 2018 proposed regulations (guidance preceding the final regulations T.D. 9864) indicate that taxpayers will benefit from additional guidance regarding contributions to a charitable entity resulting in a return benefit from a third party.

#### C. Overview of the proposed regulations

First, these proposed regulations reflect the guidance in Notice 2019-12. Under the safe harbor an individual who itemizes deductions and who makes a payment to a charitable entity in exchange for a state or local tax credit may be able to claim a state and local tax deduction for the portion of the payment for which a charitable contribution deduction is or will be disallowed as a return benefit. The safe harbor for individuals applies only to payments of cash and cash equivalents. In addition, these payments are subject to the overall limitation on state and local deductions added by the TCJA. Further, any payment may be deducted under only one provision of the Code. Thus, an individual who has total state and local tax liability of \$10,000 or less, and who makes a payment to a charitable entity and receives a state tax credit in return resulting in the disallowance of a charitable contribution deduction, may claim an itemized deduction for the disallowed amount, subject to other requirements of the Code.

Second, the proposed regulations incorporate into the regulations under section 162 longstanding principles from case law and existing section 170 regulations regarding a taxpayer's payment or transfer to a charitable entity. Specifically, the proposed regulations confirm that, when a taxpayer's transfer or payment bears a direct relationship to its trade or business, and that transfer or payment is made with a reasonable expectation of commensurate financial return, the transfer or payment to the charitable entity may constitute an allowable deduction under section 162, rather than under section 170. In addition, the proposed regulations incorporate the safe harbors provided by Rev. Proc. 2019-12 for certain payments by C corporations and specified passthrough entities, for cases in which the financial return is a tax credit. Thus, under the proposed regulations, a C corporation may treat the portion of the payment to a charitable entity that is equal to the amount of tax credit received or expected to be received in return as a deductible business expense under section 162. Consistent with Rev. Proc. 2019-12, the proposed regulations also provide that a specified passthrough entity may treat a payment resulting in a tax credit as a busi-

ness expense if the business is regarded as separate from its owner for Federal tax purposes, if it operates a trade or business within the meaning of section 162, if it is subject to state or local tax incurred in carrying on its trade or business that is imposed directly on the passthrough entity, and if it receives or expects to receive a state or local tax credit in return for the payment.

Third, the proposed regulations clarify that a payment to a charitable entity that results in a return benefit is a *quid pro quo* for purposes of section 170, regardless of whether the donor expects to receive the benefit from the donee or from a third party. As a result, the contribution is reduced by the amount of the return benefit for purposes of determining the amount allowable as a charitable contribution deduction.

#### D. Economic Analysis

##### 1. Baseline

The Treasury Department and the IRS have assessed the benefits and costs of these proposed regulations compared to a no-action baseline that reflects anticipated Federal income tax-related behavior in the absence of these proposed regulations.

##### 2. Summary of Economic Effects

The proposed regulations reflect existing, published, Treasury Department and IRS policies. As a result, they provide some additional clarity to taxpayers by clearly articulating these existing policies as regulations. The Treasury Department does not expect any noticeable change in taxpayer behavior resulting from these regulations, but requests comments on their potential economic effects. The increased clarity, in particular the provision of safe harbors, is expected to reduce compliance burdens.

As described in the Special Analyses for the final regulations (T.D. 9864), allowing a payment that is disallowed as a charitable contribution deduction because of the receipt or expected receipt of a tax credit to be deducted as a payment of state or local tax means that payments by taxpayers with state and local tax liabilities of \$10,000 or less are subject to the same

tax treatment under these proposed regulations as under the TCJA (in absence of any guidance) and as under the law prior to the TCJA. (See Example 2, Table 1, T.D. 9864.) It also means that such taxpayers are not treated less favorably than taxpayers with state and local tax liabilities in excess of \$10,000 or taxpayers subject to the Alternative Minimum Tax. (See Examples 1 and 3 of Table 1, T.D. 9864.)

The Treasury Department and the IRS request comments on the economic effects of the proposed regulations.

#### *Regulatory Flexibility Act*

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that this proposed rule will not have a significant economic impact on a substantial number of small entities. Although data are not readily available for the IRS and the Treasury Department to assess the number of small entities that are likely to be directly affected by the regulations, the economic impact is unlikely to be significant.

As discussed elsewhere in this preamble, the proposed rule largely updates the regulations to reflect existing law and policy. The proposed amendments would update the section 162 and section 170 regulations to reflect current law. In addition, the proposed amendments add to the regulations safe harbors under section 162 and section 164, regarding deductions when payments are made to entities described in section 170(c) and the donor receives or expects to receive a state or local tax credit in return; these safe harbors were provided previously in Internal Revenue Bulletin guidance. These regulations are expected to provide some additional certainty to taxpayers but are not expected to result in any noticeable change in taxpayer behavior. The increased certainty, and in particular the provision of safe harbors, is expected to reduce compliance burdens. Accordingly, the Treasury Department and the IRS certify that the proposed rule will not have a significant economic impact on a substantial number of small entities.

Notwithstanding this certification, the Treasury Department and the IRS invite comments about the potential impact of this proposed rule on small entities.

Pursuant to section 7805(f), the proposed regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

#### **Comments and Requests and Public Hearing**

Before the regulations proposed herein are adopted as final regulations, consideration will be given to any electronic and written comments that are submitted timely to the IRS as prescribed in this preamble under the ADDRESSES heading. All comments submitted will be made available at <http://www.regulations.gov> or upon request. A public hearing has been scheduled for February, 20, 2020, beginning at 10 a.m. in the Auditorium of the Internal Revenue Building, 1111 Constitution Avenue, N.W., Washington, DC 20224. 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 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 January 31, 2020. Submit a signed paper or electronic copy of the outline as prescribed in this preamble under the "Addresses" heading. 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.

#### **Statement of Availability of IRS Documents**

IRS Revenue Procedures, Revenue Rulings, Notices, and other guidance cited in this document are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Su-

perintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at <http://www.irs.gov>.

#### **Drafting Information**

The principal author of these proposed regulations is the Office of the Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and the Treasury Department participated in their development.

#### **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and record-keeping 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 1.162-15 is amended by revising paragraph (a) to read as follows:

*§1.162-15 Contributions, dues, etc.*

(a) *Payments and transfers to entities described in section 170(c)—(1) In general.* A payment or transfer to or for the use of an entity described in section 170(c) that bears a direct relationship to the taxpayer's trade or business and that is made with a reasonable expectation of financial return commensurate with the amount of the payment or transfer may constitute an allowable deduction as a trade or business expense rather than a charitable contribution deduction under section 170. For payments or transfers in excess of the amount deductible under section 162(a), see §1.170A-1(h).

(2) *Examples.* The following examples illustrate the rules of paragraph (a)(1) of this section:

(i) *Example 1.* A, an individual, is a sole proprietor who manufactures musical instruments and sells them through a website. A makes a \$1,000 payment to a local church (which is a charitable organization described in section 170(c)) for a half-page advertisement in the church's program for a concert. In the program, the church thanks its concert sponsors, including A. A's advertisement includes the URL for the website through which A sells its instruments. A

reasonably expects that the advertisement will attract new customers to *A*'s website and will help *A* to sell more musical instruments. *A* may treat the \$1,000 payment as an expense of carrying on a trade or business under section 162.

(ii) *Example 2.* *P*, a partnership, operates a chain of supermarkets, some of which are located in State N. *P* operates a promotional program in which it sets aside the proceeds from one percent of its sales each year, which it pays to one or more charities described in section 170(c). The funds are earmarked for use in projects that improve conditions in State N. *P* makes the final determination on which charities receive payments. *P* advertises the program. *P* reasonably believes the program will generate a significant degree of name recognition and goodwill in the communities where it operates and thereby increase its revenue. As part of the program, *P* makes a \$1,000 payment to a charity described in section 170(c). *P* may treat the \$1,000 payment as an expense of carrying on a trade or business under section 162. This result is unchanged if, under State N's tax credit program, *P* expects to receive a \$1,000 income tax credit on account of *P*'s payment, and under State N law, the credit can be passed through to *P*'s partners.

(3) *Safe harbors for C corporations and specified passthrough entities making payments in exchange for state or local tax credits—(i) Safe harbor for C corporations.* If a C corporation makes a payment to or for the use of an entity described in section 170(c) and receives or expects to receive in return a state or local tax credit that reduces a state or local tax imposed on the C corporation, the C corporation may treat such payment as meeting the requirements of an ordinary and necessary business expense for purposes of section 162(a) to the extent of the amount of the credit received or expected to be received.

(ii) *Safe harbor for specified passthrough entities—(A) Definition of specified passthrough entity.* For purposes of this paragraph (a)(3)(ii), an entity is a specified passthrough entity if each of the following requirements is satisfied—

(1) The entity is a business entity other than a C corporation and is regarded for all Federal income tax purposes as separate from its owners under §301.7701-3 of this chapter;

(2) The entity operates a trade or business within the meaning of section 162;

(3) The entity is subject to a state or local tax incurred in carrying on its trade or business that is imposed directly on the entity; and

(4) In return for a payment to an entity described in section 170(c), the entity described in paragraph (a)(3)(ii)(A)(1) of this section receives or expects to receive

a state or local tax credit that this entity applies or expects to apply to offset a state or local tax described in paragraph (a)(3)(ii)(A)(3) of this section.

(B) *Safe harbor.* Except as provided in paragraph (a)(3)(ii)(C) of this section, if a specified passthrough entity makes a payment to or for the use of an entity described in section 170(c), and receives or expects to receive in return a state or local tax credit that reduces a state or local tax described in paragraph (a)(3)(ii)(A)(3) of this section, the specified passthrough entity may treat such payment as meeting the requirements of an ordinary and necessary business expense for purposes of section 162(a) to the extent of the amount of credit received or expected to be received.

(C) *Exception.* The safe harbor described in this paragraph (a)(3)(ii) does not apply if the credit received or expected to be received reduces a state or local income tax.

(iii) *Definition of payment.* For purposes of this paragraph (a)(3), payment is defined as a payment of cash or cash equivalent.

(iv) *Examples.* The following examples illustrate the rules of paragraph (a)(3) of this section.

(A) *Example 1: C corporation that receives or expects to receive dollar-for-dollar state or local tax credit.* *A*, a C corporation engaged in a trade or business, makes a payment of \$1,000 to an entity described in section 170(c). In return for the payment, *A* expects to receive a dollar-for-dollar state tax credit to be applied to *A*'s state corporate income tax liability. Under paragraph (a)(3)(i) of this section, *A* may treat the \$1,000 payment as an expense of carrying on a trade or business under section 162.

(B) *Example 2: C corporation that receives or expects to receive percentage-based state or local tax credit.* *B*, a C corporation engaged in a trade or business, makes a payment of \$1,000 to an entity described in section 170(c). In return for the payment, *B* expects to receive a local tax credit equal to 80 percent of the amount of this payment (\$800) to be applied to *B*'s local real property tax liability. Under paragraph (a)(3)(i) of this section, *B* may treat \$800 as an expense of carrying on a trade or business under section 162. The treatment of the remaining \$200 will depend upon the facts and circumstances and is not affected by paragraph (a)(3)(i) of this section.

(C) *Example 3: Partnership that receives or expects to receive dollar-for-dollar state or local tax credit.* *P* is a limited liability company classified as a partnership for Federal income tax purposes under §301.7701-3 of this chapter. *P* is engaged in a trade or business and makes a payment of \$1,000 to an entity described in section 170(c). In return for the payment, *P* expects to receive a dollar-for-dollar state

tax credit to be applied to *P*'s state excise tax liability incurred by *P* in carrying on its trade or business. Under applicable state law, the state's excise tax is imposed at the entity level (not the owner level). Under paragraph (a)(3)(ii) of this section, *P* may treat the \$1,000 as an expense of carrying on a trade or business under section 162.

(D) *Example 4: S corporation that receives or expects to receive percentage-based state or local tax credit.* *S* is an S corporation engaged in a trade or business and is owned by individuals *C* and *D*. *S* makes a payment of \$1,000 to an entity described in section 170(c). In return for the payment, *S* expects to receive a local tax credit equal to 80 percent of the amount of this payment (\$800) to be applied to *S*'s local real property tax liability incurred by *S* in carrying on its trade or business. Under applicable state and local law, the real property tax is imposed at the entity level (not the owner level). Under paragraph (a)(3)(ii) of this section, *S* may treat \$800 of the payment as an expense of carrying on a trade or business under section 162. The treatment of the remaining \$200 will depend upon the facts and circumstances and is not affected by paragraph (a)(3)(ii) of this section.

(v) *Applicability of section 170 to payments in exchange for state or local tax benefits.* For rules regarding the availability of a charitable contribution deduction under section 170 where a taxpayer makes a payment or transfers property to or for the use of an entity described in section 170(c) and receives or expects to receive a state or local tax benefit in return for such payment, see §1.170A-1(h)(3).

(4) *Applicability dates.* Paragraphs (a)(1) and (2) of this section, regarding the application of section 162 to taxpayers making payments or transfers to entities described in section 170(c), apply to payments or transfers on or after December 17, 2019. However, taxpayers may choose to apply paragraphs (a)(1) and (2) to payments and transfers on or after January 1, 2018. Paragraph (a)(3) of this section, regarding the safe harbors for C corporations and specified passthrough entities making payments to section 170(c) entities in exchange for state or local tax credits applies to payments made by these entities on or after December 17, 2019. However, taxpayers may choose to apply the safe harbors of paragraph (a)(3) to payments on or after January 1, 2018.

\* \* \* \* \*

Par. 3. Section 1.164-3 is amended by adding paragraph (j) to read as follows:

*§1.164-3 Definitions and special rules.*

\* \* \* \* \*

(j) *Safe harbor for payments by individuals in exchange for state or local tax credits—(1) In general.* An individual

who itemizes deductions and who makes a payment to or for the use of an entity described in section 170(c) in consideration for a state or local tax credit may treat as a payment of state or local tax for purposes of section 164 the portion of such payment for which a charitable contribution deduction under section 170 is disallowed under §1.170A-1(h)(3). This treatment as payment of state or local tax under section 164(a) is allowed in the taxable year in which the payment is made to the extent that the resulting credit is applied, consistent with applicable state or local law, to offset the individual's state or local tax liability for such taxable year or the preceding taxable year.

(2) *Credits carried forward.* To the extent that a state or local tax credit described in paragraph (j)(1) of this section is not applied to offset the individual's applicable state or local tax liability for the taxable year of the payment or the preceding taxable year, any excess state or local tax credit permitted to be carried forward may be treated as a payment of state or local tax under section 164(a) in the taxable year or years for which the carryover credit is applied in accordance with state or local law.

(3) *Limitation on individual deductions.* Nothing in this paragraph (j) may be construed as permitting a taxpayer who applies this safe harbor to avoid the limitations of section 164(b)(6) for any amount paid as a tax or treated under this paragraph (j) as a payment of tax.

(4) *No safe harbor for transfers of property.* The safe harbor provided in this paragraph (j) applies only to a payment of cash or cash equivalent.

(5) *Coordination with other deductions.* An individual who deducts a payment under section 164 may not also deduct the same payment under any other Code section.

(6) *Examples.* In the following examples, assume that the taxpayer is an individual who itemizes deductions for Federal income tax purposes.

(i) *Example 1.* In year 1, Taxpayer *A* makes a payment of \$500 to an entity described in section 170(c). In return for the payment, *A* receives a dollar-for-dollar state income tax credit. Prior to application of the credit, *A*'s state income tax liability for year 1 was more than \$500. *A* applies the \$500 credit to *A*'s year 1 state income tax liability. Under paragraph (j)(1) of this section, *A* treats the \$500 payment as a payment of state income tax in year 1. To determine *A*'s deduction amount, *A* must apply the provisions of

section 164 applicable to payments of state and local taxes, including the limitation in section 164(b)(6). See paragraph (j)(3) of this section.

(ii) *Example 2.* In year 1, Taxpayer *B* makes a payment of \$7,000 to an entity described in section 170(c). In return for the payment, *B* receives a dollar-for-dollar state income tax credit, which under state law may be carried forward for three taxable years. Prior to application of the credit, *B*'s state income tax liability for year 1 was \$5,000; *B* applies \$5,000 of the \$7,000 credit to *B*'s year 1 state income tax liability. Under paragraph (j)(1) of this section, *B* treats \$5,000 of the \$7,000 payment as a payment of state income tax in year 1. Prior to application of the remaining credit, *B*'s state income tax liability for year 2 exceeds \$2,000. *B* applies the excess credit of \$2,000 to *B*'s year 2 state income tax liability. For year 2, under paragraph (j)(2) of this section, *B* treats the \$2,000 as a payment of state income tax under section 164. To determine *B*'s deduction amounts in years 1 and 2, *B* must apply the provisions of section 164 applicable to payments of state and local taxes, including the limitation under section 164(b)(6). See paragraph (j)(3) of this section.

(iii) *Example 3.* In year 1, Taxpayer *C* makes a payment of \$7,000 to an entity described in section 170(c). In return for the payment, *C* receives a local real property tax credit equal to 25 percent of the amount of this payment (\$1,750). Prior to application of the credit, *C*'s local real property tax liability in year 1 was more than \$1,750. *C* applies the \$1,750 credit to *C*'s year 1 local real property tax liability. Under paragraph (j)(1) of this section, for year 1, *C* treats \$1,750 of her \$7,000 payment as a payment of local real property tax for purposes of section 164. To determine *C*'s deduction amount, *C* must apply the provisions of section 164 applicable to payments of state and local taxes, including the limitation under section 164(b)(6). See paragraph (j)(3) of this section.

(7) *Applicability date.* This paragraph (j) applies to payments made to section 170(c) entities on or after June 11, 2019. However, a taxpayer may choose to apply this paragraph (j) to payments made to section 170(c) entities after August 27, 2018.

Par. 4. Section 1.170A-1 is amended as follows:

1. Paragraph (c)(5) is revised.
2. In paragraph (h)(1), remove the cross-references to “§1.170A-13(f)(6)” and “§1.170A-13(f)(5)” and add in their places “paragraph (h)(4)(i) of this section” and “paragraph (h)(4)(ii) of this section”, respectively.
3. Paragraphs (h)(2)(i)(B) and (h)(3)(iii) are revised.
4. Paragraph (h)(3)(viii) is redesignated as paragraph (h)(3)(x).
5. New paragraph (h)(3)(viii) and paragraph (h)(3)(ix) are added.
6. Paragraphs (h)(4) through (6) are redesignated as paragraphs (h)(5) through (7).

7. New paragraph (h)(4) is added.

The revisions and additions read as follows:

*§1.170A-1 Charitable, etc., contributions and gifts; allowance of deduction.*

\* \* \* \* \*

(c) \* \* \*

(5) For payments or transfers to an entity described in section 170(c) by a taxpayer carrying on a trade or business, see §1.162-15(a).

\* \* \* \* \*

(h) \* \* \*

(2) \* \* \*

(i) \* \* \*

(B) The fair market value of the goods or services received or expected to be received in return.

\* \* \* \* \*

(3) \* \* \*

(iii) *In consideration for.* For purposes of paragraph (h) of this section, the term *in consideration for* has the meaning set forth in paragraph (h)(4)(i) of this section.

\* \* \* \* \*

(viii) *Safe harbor for payments by C corporations and specified passthrough entities.* For payments by a C corporation or by a specified passthrough entity to an entity described in section 170(c), where the C corporation or specified passthrough entity receives or expects to receive a state or local tax credit that reduces the charitable contribution deduction for such payments under paragraph (h)(3) of this section, see §1.162-15(a)(3) (providing safe harbors under section 162(a) to the extent of that reduction).

(ix) *Safe harbor for individuals.* Under certain circumstances, an individual who itemizes deductions and makes a payment to an entity described in section 170(c) in consideration for a state or local tax credit may treat the portion of such payment for which a charitable contribution deduction is disallowed under paragraph (h)(3) of this section as a payment of state or local taxes under section 164. See §1.164-3(j), providing a safe harbor for certain payments by individuals in exchange for state or local tax.

\* \* \* \* \*

(4) *Definitions.* For purposes of this paragraph (h), the following definitions apply:

(i) *In consideration for.* A taxpayer receives goods or services in consideration

for a taxpayer's payment or transfer to an entity described in section 170(c) if, at the time the taxpayer makes the payment to such entity, the taxpayer receives or expects to receive goods or services from that entity or any other party in return.

(ii) *Goods or services*. Goods or services means cash, property, services, benefits, and privileges.

(iii) *Applicability date*. The definitions provided in this paragraph (h)(4) are applicable for amounts paid or property transferred on or after December 17, 2019.

\* \* \* \*

#### ***§1.170A-13 [Amended]***

Par. 5. Section 1.170A-13(f)(7) is amended by removing the cross-reference to “§1.170A-1(h)(5)” and adding in its place “§1.170A-1(h)(6).”

Sunita Lough

*Deputy Commissioner for Services  
and Enforcement.*

(Filed by the Office of the Federal Register on December 13, 2019, 4:15 p.m., and published in the issue of the Federal Register for December 17, 2019, 84 F.R. 68833)

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 Enkishev 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 sec-

tion 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 issu-

ing 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

<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).

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 examples illustrating whether a corporation, as of the last day of its taxable year, is subject to the reporting obligations 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 Depository 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 depositary (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 cor-

<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).

<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.

poration 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 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

<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.

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)

<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.

may qualify as a covered employee. Because the SEC executive compensation disclosure rules that 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>

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 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.

<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.

<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.”

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 predeces-

sors 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 includable 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 includable 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> Stakeholders have asked

<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 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.

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 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)

<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).

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 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. Accord-

ingly, 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 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

<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.

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 mod-

ification 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 (includ-

ing 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 of 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 §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 nec-

essary 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 Treas-

sury 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

<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 15<sup>th</sup> 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.

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 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 REGIS-

TER]. With respect to the rules that apply to corporations that change from publicly held to privately held status or visa-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 cur-

rently 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 record-keeping 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.

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(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).

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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)—(I) 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)—(I) 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 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)—(I) 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)—(I) 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)—(I) 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)—(I) Facts*. Corporation A has a class of securities registered un-

der 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)—(I) 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)—(I) 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)—(I) 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)—(I) 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)—(I) 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)—(I) 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)—(I) 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)—(I) 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)—(I) 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 x \$2,000,000/\$3,000,000). Corporation O has a nondeductible compensation expense of \$600,000 (\$900,000 x \$2,000,000/\$3,000,000).

(P) *Example 16 (Affiliated group composed of two corporations, one of which is a publicly held corporation)—(I) 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)(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. 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)—(I) 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 prorating 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)—(I) 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)—(I) 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 x \$2,000,000/\$3,000,000). Corporation Q has a nondeductible compensation expense of \$600,000 (\$900,000 x \$2,000,000/\$3,000,000). Corporation R has a nondeductible compensation expense of \$400,000 (\$600,000 x \$2,000,000/\$3,000,000).

(T) *Example 20 (Affiliated group composed of three corporations, one of which is a publicly held corporation)—(I) 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)—(I) 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)—(I) 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 x \$1,100,000/\$2,100,000), and Corporation R has a nondeductible compensation expense of \$314,285 (\$600,000 x \$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 x \$500,000/\$1,500,000), and Corporation R has a nondeductible compensation expense of \$200,000 (\$600,000 x \$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)—(I) 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)—(I) 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)—(I) 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)—(I) 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 ex-

ecutive 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)(I) 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)—(I) 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)—(I) 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)—(I) 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)(B) 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)—(I) 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)—(I) 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)—(I) 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)—(I) 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)—(I) 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)—(I) 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)—(I) 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)—(I) 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 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)—(I) 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)—(I) 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 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)—(I) 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 em-

ployee 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)—(I) 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)—(I) 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)—(I) 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)—(I) 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)—(I) 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)—(I) 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)—(I) 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 Corpora-

tion 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)—(I) 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)—(I) 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)—(I) 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)—(I) 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)—(I) 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 HHH 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))—(I) 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 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)—(I) 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, Corpora-

tion 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)(ii) 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)—(I) 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)—(I) Facts.* Corporations UUU and

WWW 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 remuner-

ation 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 includable 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, Corpo-

ration 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—(I) 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 Depository Receipt (ADR).* An American Depository 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 E'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 non-deductible, 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 a 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 pre-

determined 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 §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 ar-

rangement 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 cov-

ered 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 in-

crease 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, 2107, 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 contendre* 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 contendre* 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 Corpora-

tion 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 pay-

ment. 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.

(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

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 ap-

ply 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.

(Filed by the Office of the Federal Register on December 16, 2019, 4:15 p.m., and published in the issue of the Federal Register for December 20, 2019, 84 F.R. 70356)

# Definition of Terms

*Revenue rulings and revenue procedures (hereinafter referred to as “rulings”) that have an effect on previous rulings use the following defined terms to describe the effect:*

*Amplified* describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

*Clarified* is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

*Distinguished* describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

*Modified* is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the

new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

*Obsoleted* describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

*Revoked* describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

*Superseded* describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the

new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

*Supplemented* is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

*Suspended* is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

# Abbreviations

*The following abbreviations in current use and formerly used will appear in material published in the Bulletin.*

*A*—Individual.  
*Acq.*—Acquiescence.  
*B*—Individual.  
*BE*—Beneficiary.  
*BK*—Bank.  
*B.T.A.*—Board of Tax Appeals.  
*C*—Individual.  
*C.B.*—Cumulative Bulletin.  
*CFR*—Code of Federal Regulations.  
*CI*—City.  
*COOP*—Cooperative.  
*Ct.D.*—Court Decision.  
*CY*—County.  
*D*—Decedent.  
*DC*—Dummy Corporation.  
*DE*—Donee.  
*Del. Order*—Delegation Order.  
*DISC*—Domestic International Sales Corporation.  
*DR*—Donor.  
*E*—Estate.  
*EE*—Employee.  
*E.O.*—Executive Order.  
*ER*—Employer.

*ERISA*—Employee Retirement Income Security Act.  
*EX*—Executor.  
*F*—Fiduciary.  
*FC*—Foreign Country.  
*FICA*—Federal Insurance Contributions Act.  
*FISC*—Foreign International Sales Company.  
*FPH*—Foreign Personal Holding Company.  
*F.R.*—Federal Register.  
*FUTA*—Federal Unemployment Tax Act.  
*FX*—Foreign corporation.  
*G.C.M.*—Chief Counsel’s Memorandum.  
*GE*—Grantee.  
*GP*—General Partner.  
*GR*—Grantor.  
*IC*—Insurance Company.  
*I.R.B.*—Internal Revenue Bulletin.  
*LE*—Lessee.  
*LP*—Limited Partner.  
*LR*—Lessor.  
*M*—Minor.  
*Nonacq.*—Nonacquiescence.  
*O*—Organization.  
*P*—Parent Corporation.  
*PHC*—Personal Holding Company.  
*PO*—Possession of the U.S.  
*PR*—Partner.  
*PRS*—Partnership.

*PTE*—Prohibited Transaction Exemption.  
*Pub. L.*—Public Law.  
*REIT*—Real Estate Investment Trust.  
*Rev. Proc.*—Revenue Procedure.  
*Rev. Rul.*—Revenue Ruling.  
*S*—Subsidiary.  
*S.P.R.*—Statement of Procedural Rules.  
*Stat.*—Statutes at Large.  
*T*—Target Corporation.  
*T.C.*—Tax Court.  
*T.D.*—Treasury Decision.  
*TFE*—Transferee.  
*TFR*—Transferor.  
*T.I.R.*—Technical Information Release.  
*TP*—Taxpayer.  
*TR*—Trust.  
*TT*—Trustee.  
*U.S.C.*—United States Code.  
*X*—Corporation.  
*Y*—Corporation.  
*Z*—Corporation.

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<sup>1</sup>A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2018-27 through 2018-52 is in Internal Revenue Bulletin 2018-52, dated December 27, 2018.

## **Finding List of Current Actions on Previously Published Items<sup>1</sup>**

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<sup>1</sup> A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2018–27 through 2018–52 is in Internal Revenue Bulletin 2018–52, dated December 27, 2018.

# **Internal Revenue Service**

## **Washington, DC 20224**

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## **INTERNAL REVENUE BULLETIN**

The Introduction at the beginning of this issue describes the purpose and content of this publication. The weekly Internal Revenue Bulletins are available at [www.irs.gov/irb/](http://www.irs.gov/irb/).

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### **We Welcome Comments About the Internal Revenue Bulletin**

If you have comments concerning the format or production of the Internal Revenue Bulletin or suggestions for improving it, we would be pleased to hear from you. You can email us your suggestions or comments through the IRS Internet Home Page ([www.irs.gov](http://www.irs.gov)) or write to the Internal Revenue Service, Publishing Division, IRB Publishing Program Desk, 1111 Constitution Ave. NW, IR-6230 Washington, DC 20224.