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Exec Pay Rules May Make Private Cos. Hesitate To Go Public

By **Amy Lee Rosen**

Law360 (January 8, 2020, 4:13 PM EST) -- Private companies have a new reason to pause before going public due to recently proposed rules by the IRS that would eliminate the ability of newly public companies to deduct certain executive compensation from corporate income.

The Internal Revenue Service in mid-December issued proposed rules broadening what types of companies are subject to a $1 million tax deduction limit on executive pay under Section 162(m) of the Internal Revenue Code. Those rules eliminated a provision that gave newly public companies transition relief before they fall under the executive pay deduction limit.

Rules proposed by the IRS last month would do away with a provision allowing newly public companies temporary relief from a limit on deductions of executive compensation. (Getty)

In the proposed rules, the U.S. Department of the Treasury rejected the idea that recently public companies needed time to adjust pay arrangements to take into account Section 162(m), which now means some private companies may think twice before going public, according to Michael S. Melbinger, a partner at Winston & Strawn LLP.

“I believe there will be some companies where it’s a really close call and they’re weighing the factors and they’ll say this is just one more negative factor that weighs on the scale and weighs against going public,” Melbinger said. “This is just one more reason not to go public.”

Not being able to deduct executive pay once a business goes public adds another cost on top of the expense of complying with securities laws to be listed on a publicly traded exchange, which was already significant, Melbinger said.

Section 162(m) was enacted in 1993 to prohibit public companies from deducting executive pay in excess of $1 million, but Congress exempted performance-based pay, or payments made for meeting certain performance-based company goals. Executive pay exceeding $1 million could be deducted under the statute as long as performance goals were determined by a compensation committee, the material terms of the payments were disclosed and approved by shareholders, and the committee certified that the performance goals were met.

However, privately held companies that had just become public were exempt from the $1 million tax deduction limit — typically for about three years — if the pay plan was approved by shareholders before the company went public and the pay arrangements were not materially altered thereafter.

In the Tax Cuts and Jobs Act of 2017, Congress eliminated the exception for performance-based pay from the $1 million deduction limit. Then, in 2018, Treasury published initial guidance to clarify some of the changes to Section 162(m), but that that notice was silent on whether the previously granted transition relief would remain available for newly formed public companies.

Ron Aizen, a partner at Morrison & Foerster LLP, told Law360 that he and other practitioners had hoped the transition relief would remain in effect, but that idea was shut down when the government issued the Section 162(m) proposed regulations in December.

“Overall they were disappointing ... from the perspective of looking at it from my clients who would prefer it would be more taxpayer-friendly,” Aizen said. “Pretty much any hope we had of maybe the IRS taking a more pro-taxpayer approach was quashed.”

Originally when companies first went public, they needed more time to figure out how to create complicated performance-based pay packages that could be excluded from the Section 162(m) deduction limit, he said. But because the TCJA did away with the exclusion for performance pay, it makes sense that newly public companies no longer need that allowance.

“I think the thinking of the IRS is that now we don’t have the qualified performance-based exception, the reason to give newly public companies this relief is not there anymore,” he said. “This just means that newly public companies need to be ready to face that much of their compensation will not be deductible from the get-go, whereas before they had this three-year period where they got a free pass on it.”

Section 162(a)(1) of the IRC allows a deduction for ordinary and necessary expenses paid or incurred in carrying out a trade or business for “a reasonable allowance for salaries or other compensation for personal services actually rendered.” This means that private companies can deduct reasonable executive pay from taxable income.

However, Aizen told Law360 he could not think of any specific cases in which the IRS denied such a business deduction as unreasonable. Not being able to deduct executive pay after a company completes an initial public offering could be another factor in deciding whether to go public, at least for some companies, he said.

“I could see somebody trying to quantify and have their internal and external tax advisers advise on the impact of this change,” Aizen said.

However, the TCJA's reduction of the corporate tax rate to 21% from 35% and access to public markets are other things a private company would consider when deciding to go public and may outweigh the disadvantage of not being able to deduct executive pay, according to Regina Olshan, a partner at Skadden Arps Slate Meagher & Flom LLP. When a tax rate is lower, a deduction is less valuable, since the amount of tax collected is already lower, Olshan said.

“The deduction limitation is less significant in an environment where the tax rates are relatively low,” she said. “If the tax rates were to increase, then the impact of the deduction limitation would be greater.”

Usually companies look at going public if their private investments are not significant, if there is a desire for investment from a much larger group of shareholders, or if the business wants more liquidity by making its shares purchasable in a public market, Olshan said. But it’s conceivable that the removal of IPO transition relief may still be a factor for organizations that have large amounts of executive pay that is tied to bonuses or equity awards, she added.

“Perhaps the deduction limitation limit may make a difference in the financial modeling,” Olshan said.

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