Client Alert

January 2020

Unexpected Provision in Proposed Section 162(m) Regulations May Affect Compensation Deductibility for UPREITs

Included within recently proposed Treasury regulations under Section 162(m) of the Internal Revenue Code (the "Proposed Regulations") is a provision that reverses the result of four executive compensation private letter rulings previously granted to UPREITs. Under the prior private letter rulings, compensation expense paid by an operating partnership owned by a REIT was not subject to the $1 million deduction limitation of Section 162(m). Under the Proposed Regulations, a REIT's distributive share of any compensation deduction paid to its "covered employees" by the REIT's operating partnership would become subject to the Section 162(m) limitation at the REIT level.

This provision of the Proposed Regulations is proposed to apply to compensation deductible in tax years ending on or after December 20, 2019, other than compensation paid pursuant to a written binding contract that is in effect on December 20, 2019 and that is not materially modified or renewed or cancelable by the company after that date. In general, if the employer has discretion to reduce the payment or change the conditions for receiving the payment, then the payment may not qualify under this grandfather provision. As many REITs set performance targets for performance pay on an annual basis, the setting of new targets for 2020 may not be eligible for the grandfather treatment for 2020 performance pay.

Based on the private letter rulings and a technical reading of the prior regulations, many REITs had taken the position that Section 162(m) did not apply to compensation paid by an operating partnership. These Proposed Regulations represent an unexpected and significant change in the IRS's position. Coupled with the elimination of the exception for performance-based pay in the 2017 tax bill, many REITs are facing a materially different executive compensation landscape if the Proposed Regulations are finalized in their current form.

Given these differences, REITs may want to consider implementing (or increasing the use of) operating partnership profits interests, such as long-term incentive profits interests ("LTIPs"), as part of their executive compensation plans. While LTIPs do not provide a compensation deduction, the lack of a deduction is no longer a disadvantage if Section 162(m) would disallow a deduction for other types of compensation. Moreover, LTIPs can provide tax benefits to executives in terms of both timing and character. Other techniques such as limiting "executive officer" status and using installment payments for severance packages may also be beneficial.

If you would like more information about these Proposed Regulations, including application of the grandfather provisions, or LTIPs generally, please contact one of the attorneys listed below.

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