April 20, 2006

Applying Section 162(m) To Partnership Remuneration

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The Internal Revenue Code (the "Code") has since its earliest days allowed a deduction in computing taxable income for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered." In 1993, Congress, finding that the "amount of compensation received by corporate executives has been the subject of scrutiny and criticism" and believing that "executive compensation will be reduced if the deduction for compensation (other than performance-based compensation) paid to the top executives of publicly held corporations is limited," added section 162(m) to the Code. Section 162(m) limits the deductibility of compensation paid by a "publicly held corporation" to its chief executive officer and to its four most highly paid officers other than its chief executive officer, as reported on the corporation's summary compensation table under disclosure rules issued by the SEC under the Securities Exchange Act of 1934 (each a "covered employee") to $1.000,000 per year. The limitation is subject to certain exceptions, including one for "performance-based" compensation.

For purposes of section 162(m), a "publicly held corporation" is any corporation issuing a class of common stock or other common equity securities that is required to be registered under section 12 of the 1934 Act. The Treasury Regulations under section 162(m) provide that a publicly held corporation includes an "affiliated group" of corporations as defined in Code section 1504, if the parent corporation of the group (or, to a more limited extent, any subsidiary member of the group is a publicly held corporation). Thus, for example, if a covered employee is paid compensation by more than one member of an affiliated group which is a publicly held corporation, the compensation paid by each employer to the covered employee is aggregated for purposes of determining whether the $1,000,000 deduction limit applies.

Neither section 162(m) nor the Regulations thereunder address the applicability of section 162(m) to compensation paid to a covered employee of a publicly held corporation by a partnership in which the publicly held corporation owns an interest. Under Code section 702(a), each partner of a partnership is required to take into account its distributive share of the partnership's items of income and deduction, and under Treasury Regulation section 1.702-1(a)(8)(ii), each partner must take into account "separately the partner's distributive share of any partnership item which, if separately taken into account by any partner, would result in an income tax liability for that partner ... different from that which would result if that partner did not take the item into account separately." Code 702(b) adds that the character of any item that is required to be taken into account by a partner is determined as if such item were incurred by the partner in the same manner as incurred by the partnership. In view of these rules and of the "abuse of entity treatment" rule of Treasury Regulation section 1.701-2(e), under which the Internal Revenue Service claims the power to treat a partnership as an aggregate of its partners, rather than as a separate entity, unless the ultimate tax results of entity treatment with respect to a particular Code provision are "clearly contemplated" by that provision, it might be expected that the Service would apply section 162(m) to a publicly held corporation's distributive share of a partnership deduction for compensation expense relating to a covered employee of the corporation as if that share had been incurred and paid directly by the corporation.

A recently issued IRS private letter ruling, however, relating to a real estate investment trust ("REIT") and to a partnership in which the REIT owned an interest, concluded that the deduction limitation of section 162(m) applied neither to the partnership nor to the publicly held corporation with respect to its share of partnership income that reflected compensation expense of covered employees attributable to services performed by them as employees of the partnership.

PLR 200614002

The circumstances described in Private Letter Ruling 200614002 (Dec. 14, 2005) are straightforward. In the ruling, a corporation that has elected to be taxed as a REIT under Code section

856 owns what is described as a "general partnership interest" in a partnership and also owns preferred units in the same partnership.

The corporation is subject to the 1934 Act and the compensation of each of its CEO and four other most highly compensated officers (collectively, the "Executive Officers") is required to be reported on the corporation's summary compensation table under the rules issued by the SEC under the 1934 Act. Accordingly, each of the Executive Officers is a covered employee for purposes of section 162(m). However, the Executive Officers provide only a small portion of their services as employees of the REIT; the remainder of their services is performed in their capacity as officers and employees of the partnership. The Executive Officers receive compensation from both entities, which is allocated between the REIT and the partnership based on the services performed for each. The partnership reports the compensation paid by it to each of the Executive Officers on Form W-2 and withholds Federal and state taxes with respect to the payments made by the partnership to them.

It is expected that the total compensation of one or more of the Executive Officers for services performed as an employee of the partnership will exceed $1,000,000 and will not qualify for the exception for "performance-based" compensation. The taxpayer therefore requested a ruling that the deduction limitation of section 162(m) does not apply with respect to the compensation paid by the partnership.

The ruling reviews certain basic provisions of section 162(m) and related Code provisions, including the definition of a "covered employee" as a CEO of the publicly held corporation or a person whose compensation is required to be reported under 1934 Act rules by reason of being among the four highest compensated officers for the taxable year other than the CEO. The ruling further notes that an affiliated group is defined in Code section 1504(a) as one more chains of includible corporations connected through stock ownership meeting an 80% voting power and 80% value standard. An entity classified as a partnership for income tax purposes is not a corporation, and a partnership therefore cannot be a member of an affiliated group.

The ruling then concludes, without further discussion (and without citation of the provisions governing the taxation of partners and partnerships summarized above), that the deduction limitation of section 162(m) does not apply to the partnership, with respect to amounts paid to an Executive Officer for services provided as an employee of the partnership. It further concludes that section 162(m) also does not apply to the REIT with respect to the REIT's distributive share of the income or loss of the partnership that includes the compensation expense relating to Executive Officers for services provided by them as employees of the partnership.

Observations

The ruling appears to reflect a literal interpretation of section 162(m) and related provisions. The drafter or drafters of the ruling (apparently issued by the Executive Compensation branch of the IRS National Office) may have reasoned that section 162(m) limits deductions for compensation paid to covered employees *of a publicly held corporation*, including amounts paid by other members of the same affiliated group; that an entity classified as a partnership for tax purposes cannot be either a stand-alone publicly held corporation or a member of an affiliated group as defined in IRC section 1504(a); and, therefore, that section 162(m) does not apply to compensation paid by and otherwise deductible by a partnership, or to a corporation's distributive share thereof. One is left to wonder what input, if any, the partnership taxation specialists in the IRS National Office had in the issuance of the ruling.

It may be significant that the ruling deals with a REIT. Many REIT's own property and conduct business activities through an operating partnership controlled by the REIT. The interests in such a partnership are typically owned by the REIT and by others who transferred property to the partnership in tax-deferred transactions facilitated by the operating partnership structure. Although this structure may be largely motivated by tax considerations, it has not historically been motivated by a desire to ameliorate or avoid the impact of section 162(m).

Notwithstanding the particular circumstances of this ruling, however, it is interesting to speculate whether a similar structure could be established by any other corporation that has not historically conducted its business operations through a partnership and that pays, or expects to pay, compensation the deduction of which is likely to be disallowed in part by section 162(m). If the principal purpose of establishing a partnership and of transferring the business operations of the publicly held corporation and its subsidiaries to the partnership appeared to be the avoidance of the disallowance of deductions under section 162(m), perhaps the IRS would seek to apply the "abuse of entity treatment" rule or other principles of partnership taxation so as to apply section 162(m) to the corporation's share of the partnership's compensation expense as though the partnership did not exist. However, if there are other substantial reasons for conducting business operations through one or more partnerships and the publicly held corporation structures the compensation of covered employees so that the partnership, rather than the corporation, pays the covered employees for services rendered by them to the partnership, perhaps the apparent rationale and favorable result of the ruling would apply as well outside the REIT context.

Given, however, that a private letter ruling may be relied upon only by the taxpayer who obtains it and, by its own terms, cannot be cited as precedent, any similarly situated REIT or other publicly held corporation desiring to rely on the conclusions set forth in this ruling to compensation paid by a partnership would be well advised to consider applying for its own ruling.