Section 162(m) Public Company Deduction Disallowance Section 4960 Tax Exempt Excise Tax

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Comparison of Sections 4960 (tax-exempt entities) and 162(m) (public companies)

- Guidance:
  - Section 4960: Notice 2019-09 and proposed regulations
  - Section 162(m): Notice 2018-68 and proposed regulations
- Effective date:
  - Section 4960: Taxable years beginning after December 31, 2017
  - Section 162(m): Taxable years beginning after December 31, 2017
- Ramification:
  - Section 4960: 21% excise tax on remuneration over $1,000,000 and excess parachute payments
  - Section 162(m): No deduction for compensation in excess of $1,000,000

Comparison of Sections 4960 (tax-exempt entities) and 162(m) (public companies)

- Covered Employee:
  - Section 4960: Five highest paid of the organization currently or any time after December 31, 2016, excluding certain "shared employees," and excluding remuneration for which Section 162(m) applies
  - Section 162(m): Any individual who was ever the CEO, CFO, and three highest paid after 2017, or CEO and three highest paid after 2016
- "Grandfathering":
  - Section 4960: Vested balances as of effective date, generally January 1, 2018
  - Section 162(m): Amounts paid pursuant to written binding contract in place on November 2, 2017 are taxable as if paid under pre-TCJA law

Section 162(m) Overview

- Section 162(m) disallows the deduction of more than $1,000,000 of compensation per taxable year with respect to Covered Employees by a Public Company
- The TCJA eliminated the performance-based compensation exception from Section 162(m) (as well as the less-utilized commission-based compensation exception).
- More Companies Subject to Section 162(m). The TCJA extends Section 162(m)'s $1,000,000 limit on deductible compensation to any corporation that files SEC reports.

Section 162(m) – Changes under TCJA

- Section 162(m) Now Applies to the CFO.
- Once a Covered Employee, Always a Covered Employee – TCJA amends Section 162(m) to provide that any individual who is treated as a "covered employee" under the new rules as described below for any taxable year beginning after December 31, 2016, would continue to be considered a "covered employee" with respect to that company so long as the company continues to provide any remuneration to such individual.

Introduction: Section 162(m)

Post Tax Act Section 162(m) Deduction Flowchart

1.	Employee of Public Company under new expanded definition including reporting companies?	1	Yes	No
2.	Covered employee under new law, e.g. PFO, or formerly Covered Employee under old law in 2017, or new law in 2018, or thereafter?	2	Yes	No
3.	Amount paid pursuant to written binding contract terms as of November 2, 2017 and not pursuant to the amounts paid attributable to *services* after the date of any renewal or termination effective date, automatic or otherwise, other than that attributable solely to employee?	3	Yes	
4.	Amounts paid pursuant to written binding contract as above and not after the date of a material modification?	4	Yes	
5.	Would Pre-Tax Act rules have allowed deduction due to employee: 1. not being a covered employee, 2. no longer being a covered employee, 3. not being an employee of a public company under old law, or 4. or the compensation being performance or commission based?.	5	Yes	
6.	Add Post-Tax Act ongoing exclusions of qualified plan contributions and tax free fringe benefits.	6	$______	
7.	Add $1,000,000	7	$1,000,000	
8.	Add all amounts paid to employees not covered in Box 1 and 2	8	$____________	
9.	**AMOUNT DEDUCTIBLE POST TAX-ACT**	**9**	**$____________**	

Guidance: Notice 2018-68 and Proposed Regulations

- IRS Notice 2018-68 followed by Proposed Regulations, provide guidance on the circumstances under which certain compensation amounts and payments promised or awarded by a company on or before November 2, 2017, but paid in 2018 or later, could be grandfathered and not subject to the compensation deductibility limits of Code Sec. 162(m).
- The guidance principally addresses the following three key issues:
  - Who is a covered employee?
  - What is a written binding contract?
  - What is a material modification?

Who is a Covered Employee?

- Covered employees include a company's principal executive officer ("PEO" or "CEO") and, after 2017, the CFO or any individual acting in such a capacity, at any time during the year.
- Covered employees also include the company's next 3 highest-compensated executive officers (other than the CEO and CFO), whose total compensation for the taxable year is required to be reported to stockholders in the proxy statement under the Securities Exchange Act of 1934.
- No End of Year Employment Requirement.

Compensation Under a Written Binding Contract in Effect on November 2, 2017

- Most public companies have entered into employment agreements with their senior executive officers. Some companies may have entered into change-in-control agreements or severance agreements instead of or in addition to the employment agreements.
- The interpretation of amounts paid under a written binding contract under the TCJA's transition rule is unexpectedly harsh.
- The grandfather rule allows deductibility for applicable employee remuneration paid to a covered employee under a written binding contract in effect on November 2, 2017, which is not materially modified after that date.
- The proposed regulations provide helpful examples of payments that may or may not be grandfathered, depending on the particular facts.

Contractual Promise of Future Participation

- While the legally binding written contract must have been in effect as of November 2, 2017, the employee did not have to be eligible to participate in the arrangement or plan as of that date. However, the covered employee must have been employed by the company, or otherwise had a legally binding right to later participation in the arrangement, as of November 2, 2017.

Contracts that Give the Company Discretion to Reduce Amounts

- Many November 2, 2017 arrangements provided significant discretion for companies to adjust executive compensation in light of changing circumstances or include unlimited “negative discretion” which, taken to the extreme, would allow the company to reduce the payment amount to zero, even when performance and service requirements were met. To the extent that an executive’s compensation is legally binding and enforceable, the grandfather rule may apply to protect the company’s deduction. However, to the extent that compensation is subject to employer discretion, the grandfather rule is far less likely to apply unless such amounts are legally enforceable under state or other applicable law, e.g. “Good Faith and Fair Dealing.”

Contracts that Give the Company Discretion to Reduce Amounts

- Example: In February 2017, a company establishes a bonus plan under which the CEO will receive a cash bonus of $1,500,000 if a specified performance goal is satisfied. The compensation committee retains the right, even if the performance goal is met, to reduce the bonus payment to not less than $400,000 if, in its judgment, other subjective factors warrant a reduction. In 2018, the compensation committee reduces the award to $500,000. In this example, only $400,000 of the $500,000 payment is deductible, but the failure of the compensation committee to exercise negative discretion to reduce the award to $400,000, instead of $500,000, does not result in a material modification of the contract.

“Renewal” of a Legally Binding Contract

- A legally binding written contract that is considered “renewed” after November 2, 2017, is outside the grandfather rule. The Notice makes clear that a renewal can occur actively or passively and covers a range of fact patterns.
- Example: A CFO is a party to a three-year employment agreement providing an annual salary of $2,000,000, beginning on January 1, 2018, and the terms of the agreement provide 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 (or subsequent) term. Termination of the employment agreement does not require the termination of the CFO’s employment relationship with the company.

“Renewal” of a Legally Binding Contract

- The CFO’s annual salary of $2,000,000 for the 2018, 2019, and 2020 taxable years [before the end of the 3-year term/renewal] would not be subject to the 162(m) deduction limit.
- However, the employment agreement would be treated as renewed on January 1, 2021, and 162(m) would apply to any payments made under it on or after that date.

- Note that the $2,000,000 only need be promised. It did not have to be performance-based compensation because the CFO was not a covered employee under prior law.

“Renewal” of a Legally Binding Contract

- However, there are three exceptions where renewals do not cause the contract to fall outside the grandfather rule:
  - If the company is legally obligated by the contract at the sole discretion of the employee;
  - If the contract may only be terminated by the employee no longer being employed; or
  - If upon termination or cancelation of the contract the employment relationship continues but is no longer covered by the contract. However, in the situation where a covered employee continues employment beyond the duration of the contract, compensation after the contract expires will not be grandfathered, but compensation paid pursuant to the contract could remain grandfathered.

Material Modification

- The grandfather rule permits a deduction for compensation paid to covered employees under a written binding contract in effect as of November 2, 2017, unless the contract is materially modified after that date.
- A legally binding contract that is materially modified is treated as a new contract as of the date of the modification.
  - Compensation actually paid pursuant to the contract's terms prior to the material modification would remain grandfathered and subject to "old" Sec. 162(m).
  - Compensation paid after the date of the modification would not be grandfathered.

Material Modification

- The Notice defines a material modification as one that increases the amount of compensation payable to the employee.
- If the contract is modified to accelerate the payment of compensation, a material modification will not have occurred where the payment amount is reasonably discounted for the time value of money.
- If the contract is modified to defer payment of the compensation, an increase in the payment amount would not be a material modification if it is based on either a reasonable rate of interest or the performance of predetermined investments.

Material Modification

- Example: In January 2017, a CFO signs a 5-year employment agreement providing for a salary of $1,800,000 per year. In 2018, the CFO became a covered employee as a result of the TCJA's amendments. In 2019, the company increases the CFO's compensation with a supplemental payment of $40,000. On January 1, 2020, the company increases the CFO's salary to $2,400,000.

Material Modification

- The $1,800,000 salary is paid under a written binding contract signed when the CFO was not subject to 162(m) and, therefore, is grandfathered unless the change in her compensation in either 2019 or 2020 is a material modification.
- The $40,000 supplemental payment in 2019 does not constitute a material modification of the written binding contract because the $40,000 payment is less than or equal to a reasonable cost-of-living increase from 2017. The $40,000 supplemental payment is, however, subject to the deduction limitation of Sec. 162(m).
- The $560,000 salary increase to $2,400,000 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 compensation that is otherwise paid pursuant to the written binding contract, and it is greater than a reasonable, annual cost-of-living increase.

Material Modification

- Because written binding contract is materially modified as of January 1, 2020, all compensation paid to the CFO in 2020 and thereafter will be subject to the $1 million deduction limit.
- If the CFO had received a restricted stock grant instead of a salary increase, there would not have been a material modification of the written binding contract (although the restricted stock grant would be subject to the deduction limitation).
- The additional compensation paid under the grant is based on the stock price and the CFO’s continued service, not paid on the basis of substantially the same elements and conditions as the CFO’s salary.

Non-Qualified Deferred Compensation

- Many companies maintain a non-qualified deferred compensation plan and/or a supplemental executive retirement plan (SERP).
- Under a non-qualified deferred compensation plan or SERP, distribution of a participant's account balance or accrued benefit usually does not occur until after the participant has terminated employment. Therefore, under Code Sec. 162(m) prior to the TCJA amendments, distributions would be fully deductible.

Non-Qualified Deferred Compensation

- The TCJA amendments will make any distribution of non-qualified plan benefits to a participant who is or ever was a covered employee under 162(m) subject to the $1 million deductibility cap, even if the distribution is made after the participant's death, disability, retirement or other termination of employment.
- However, the account or benefit of a covered employee under a non-qualified plan as of November 2, 2017 (and in some cases additional accruals and contributions after that date) could be grandfathered and not subject to the $1 million cap.

Non-Qualified Deferred Compensation

- Example: Under a deferred compensation plan, an employee who was not a covered employee in 2015 elected to defer the entire amount, $200,000, of her 2016 annual bonus.
  - The bonus, plus earnings based on a predetermined actual investment, will be paid in a lump sum at her separation from service. In 2018, she is promoted to CEO.
  - In 2020, she separates from service and receives $225,000 (the deferred $200,000 bonus plus $25,000 in earnings).
  - The full $225,000 payment is grandfathered and not subject to the 162(m) deduction limit.

Non-Qualified Deferred Compensation

- Ability to Amend or Terminate.
- Most non-qualified plans provide that the company may, at any time, in its discretion, amend the plan to either stop or reduce the amount of future credits to participants' account balances or benefit accruals, but such amendment may not deprive participants of any amount or benefit accrued before the date of the amendment.
- This commonplace reservation of rights in the company has a significant adverse effect on the amount of benefit that will be grandfathered.

Action Items to Preserve Grandfathering Protection

- Inventory all compensation plans, policies, and agreements that could be grandfathered, including employment, change-in-control, severance, and equity award agreements; and non-qualified, short- and long-term incentive plans; and severance plans.
- List employees covered under any plan or agreement as of November 2, 2017 (not just current NEOs).
- Legal advice on the extent to which each plan and agreement creates a legally binding obligation for the company to pay a specific amount of compensation, including for use by auditors to calculate the Deferred Tax Asset on the company's balance sheet.

Action Items to Preserve Grandfathering Protection

- For how long will the grandfather protection be available to these amounts?
- Do not make any changes or amendments or provide for any compensation increases without carefully considering whether they could constitute a material modification.
- Continue to maintain compensation committee of “outside directors.”
- Continue to have compensation committee determine and certify achievement of performance goals.

Action Items to Preserve Grandfathering Protection

- Public companies must track any and all covered employees each year from and after 2017, and retain that information until all payments have been made to any such employee, former employee, or the beneficiaries of a former employee.
- Compensation committees and tax departments may need to periodically review the list to be certain the record is being updated and that its consequences are incorporated into compensation decisions and tax reporting.

Action Items to Preserve Grandfathering Protection

- The company should not just apply this process to its current NEOs. The TCJA dramatically expanded the universe of employees and former employees who are or can become subject to the deductibility cap and the period of time during which they are subject to it.
  - An employee who is well below the NEO threshold in 2017 also may have accrued benefits or an account balance under a non-qualified plan of the company, which are paid out 5, 10, or even 20 years later, after the employee has become a covered employee.

Overview: Code Section 4960

- Added to the Code by the TCJA
- Restricts compensation that can be paid to executives of tax-exempt organizations
- Imposes excise tax equal to the rate of tax imposed on corporations (currently 21%) on remuneration > $1,000,000 and any excess parachute payment paid by an "applicable tax exempt organization" (ATEO) and related organizations to a covered employee
- Intended to have same economic impact as loss of deduction for compensation over $1 million applicable to public companies under Code Section 162(m) or loss of deduction for excess parachute payments under Code Section 280G applicable to for-profit corporations

Notice 2019-09 and Proposed Regulations

- IRS issued interim guidance on December 31, 2018 (Notice 2019-09) and proposed regulations in June 2020
  - What is an ATEO?
  - Who is a “covered employee”?
  - What is the “applicable year” for excise tax purposes?
  - Who is liable for the excise tax and how is it reported and paid?
  - How is liability for the excise tax allocated among related organizations?
  - What is remuneration and how is excess remuneration calculated?
  - What is an “excess parachute payment” under Code Section 4960 and how is it computed?

Applicable Tax-Exempt Organizations

- What is an ATEO?
  - Exempt from taxation under Code Section 501(a);
  - Farmers' cooperative organization described in Code Section 521(b)(1);
  - Has income excluded from taxation under Code Section 115(1); or
  - Is a political organization described in Code Section 527(e)
- "Related organization"
  - Controls or is controlled by the ATEO
  - Controlled by one or more persons who control the ATEO
  - Support organization or supporting organization
  - For an ATEO that is a VEBA, establishes, maintains or makes contributions to the VEBA

Governmental and Foreign Entities as ATEOs

- Governmental entity (including state college/university) without a tax-exempt status determination letter and that does not exclude income from gross income under Code Section 115(1) cannot be an ATEO
  - But may still be liable for excise tax if qualifies as related organization to an ATEO
- Foreign organization that qualifies as ATEO is an ATEO unless excluded from application of certain excise taxes under Code Section 4948(b)

Section 4960 Covered Employee

- Employee (or former employee) of ATEO who either:
  - Is one of the five most highly compensated employees of the organization for the taxable year (no minimum dollar threshold)
  - Was a covered employee of the organization (or any predecessor) for any taxable year beginning after December 31, 2016
- Once a covered employee, always a covered employee
- Determination is made based on remuneration for services performed as an employee of the ATEO, including any related organization
  - Performed separately for each ATEO
  - Group of related organizations may have more than five covered employees

Exceptions to "Covered Employee" Designation

- Limited hours exception
  - Employees who provide services to both an ATEO and a related organization will be disregarded in determining ATEO's top 5 if nomore than 10% of time is spent providing services to the ATEO
- Employee of taxable organization
  - Shared employee disregarded if he or she is not paid by the ATEO itself (or related organization), where employee's services are primarily provided to the non-exempt organization

Year Used for Calculating Excise Tax

- Code Section 4960 refers to remuneration paid for the "taxable year"
- Notice 2019-09 and proposed regulations clarified that excise tax is calculated based on excess remuneration paid and excess parachute payments made during the calendar year ending with or within the ATEO's taxable year (i.e., the "applicable year")
  - Applicable year also used to identify the highest-compensated employees/covered employees of the ATEO
- If there is a short year…
  - First year an organization becomes an ATEO—applicable year begins on date it becomes an ATEO and ends on December 31 of that calendar year
  - Year in which ATEO status terminates—applicable year begins on January 1 and ends on date ATEO status terminates

Who is Liable?

- Common-law employer liable for excise tax under Code Section 4960
- Payment to employee from related entity for services rendered to common-law employer is considered paid to employee from the employer
- If employee is employed by <u>both</u> an ATEO and a related organization, *each employer is liable for its proportionate share of the excise tax under Code Section 4960*
- Reporting
  - Form 4720 – Return of Certain Excise Taxes under Chapters 41 and 42 of the Internal Revenue Code
  - Each ATEO and related organization would file separately

Applicable and Excess Remuneration

- "Remuneration"
  - Wages under Code Section 3401(a), other than contributions to 401(k) or 403(b) plan
  - Amounts counted when no longer subject to substantial risk of forfeiture (even if paid later and even if a short-term deferral exempt from Code Section 457(f))
  - Includes compensation payable by a related organization
  - Excludes remuneration paid for medical or veterinary services
- Excess of the remuneration that is paid for an applicable year, other than any excess parachute payment, by an ATEO (including a related organization), over $1 million for the taxable year is subject to excise tax
  - Parachute payments are considered remuneration, but not subject to tax as excess remuneration if also subject to tax as excess parachute payment

Grandfathering under Code Section 4960

- No actual grandfather rule under Section 4960
- Certain provisions have effect of grandfathering—these amounts are not considered remuneration:
  - Non-qualified deferred compensation that vested before the first day of the first taxable year of the ATEO beginning after December 31, 2017, including vested but unpaid earnings
  - Vested deferred compensation from years before taxable year in which employee first becomes covered employee, including vested but unpaid earnings
- Earnings that subsequently accrue or vest <u>will</u> be treated as remuneration and could be subject to excise tax

Excess Parachute Payments under 4960

- Payment in the nature of compensation that is contingent on covered employee's separation from employment and aggregate present value exceeds 3x "base amount"
  - Average annualized compensation for five taxable years prior to separation or period of employment, if shorter
- If separation payments > 3x base amount:
  - Excess parachute payments = excess of total amount of parachute payments over 1x base amount
  - Excise tax is 21% of all excess parachute payments paid by an ATEO or related organization to a covered employee

Separation from Employment

- Generally same meaning under 4960 as "separation from service" under 409A, but includes change in status from employee to independent contractor
- Payment contingent on separation if facts and circumstances indicate that employer wouldn't make payment in absence of termination
- "Payment in the nature of compensation"
  - Wages and salary
  - Bonuses
  - Severance pay
  - Fringe benefits
  - Life insurance
  - Pension benefits/deferred compensation
  - Cash when paid
  - Value of right to receive cash (e.g., value of accelerated vesting or transfer of property)

Parachute Payments: 4960 vs. 280G/4999

- Rules are very similar, but for…
- When excise tax applies:
  - 280G: compensatory payment in connection with a change in control
  - 4960: separation payment, whether or not there is a change in control
- Who pays:
  - 280G: company loses deduction and employee liable for excise tax under Code Section 4999
  - 4960: only company liable for excise tax (same as the cost of a lost deduction)