



June 5, 2019

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Re: Definition of a Written Binding Contract for Purposes of the Application of Section 162(m) as Revised by the Tax Cuts and Jobs Act

Dear Messrs. Kautter, Desmond, LaGarde, Enkishev and Tackney and Ms. Judson:

The American Institute of CPAs (AICPA) appreciates the efforts of the Department of the Treasury (“Treasury”) and the Internal Revenue Service (IRS) to address the need for guidance related to the changes to section 162(m)¹ as enacted under Pub. L. No. 115-97, commonly referred to as the Tax Cuts and Jobs Act (TCJA or “the Act”).

On August 21, 2018, Treasury and the IRS issued Notice 2018-68 – Guidance on the Application of section 162(m) (the “Notice”). On November 6, 2018 the AICPA submitted a letter² in response to the Notice. We are writing to provide additional feedback on the Notice, and more specifically, to address the need for a safe harbor to determine whether a contract in effect on November 2, 2017 is a written binding contract within the meaning of section 13601(e)(2) of the TCJA.

¹ Unless otherwise indicated, hereinafter, all section references are to the Internal Revenue Code of 1986, as amended, or to the Treasury Regulations promulgated thereunder.

² <https://www.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/20181106-aicpa-comments-notice2018-68-sec-162m.pdf>.

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Overview

The Notice provides that a contract is a written binding contract that was in effect on November 2, 2017 only if the corporation is obligated under applicable local law (for example, state contract law) to pay the remuneration under such contract if the employee performs services or satisfies the applicable vesting conditions. The use of applicable local law to determine the existence of a written binding contract requires taxpayers to undertake a legal analysis that is not typically performed by taxpayers in the normal course of business when determining the tax treatment of specific items. In addition, we do not believe that such an analysis is normally performed by IRS agents when examining a tax return, making the provision difficult to enforce.

Recommendation

The AICPA recommends that Treasury and the IRS issue guidance providing for a safe harbor to allow compensation contracts in existence on November 2, 2017, for which any cost³ has been recognized under Generally Accepted Accounting Principles in the United States of America (“U.S. GAAP”) in the corporation’s audited annual financial statements for the fiscal year that included November 2, 2017, or in a prior fiscal year to qualify as a written binding contract for purposes of section 162(m). The safe harbor rule should not be limited to the amount of the cost recognized in the annual financial statements, but instead should apply to all deferred compensation ultimately payable per the contract.

U.S. GAAP is the common set of accepted accounting principles, standards and procedures applied by public companies to prepare their financial statements, which are audited by their independent registered public accounting firms (CPAs). U.S. GAAP includes well-established principles and standards used by these companies to determine when a cost should be recognized with respect to compensation contracts, which takes into account, among other considerations, the companies’ obligation to pay the compensation. Our recommended safe harbor allows public companies to rely on the position taken in their audited financial statements regarding whether a compensation contract results in a cost that represents an obligation to pay the compensation. Under the safe harbor, any arrangement that existed on November 2, 2017 is treated as a written binding contract if a cost for compensation to be paid pursuant to that contract is recognized in the audited annual financial statements for the fiscal year that included November 2, 2017, or in a prior fiscal year.

³ Our recommendation uses the term “cost” because the terms “liability” and “expense” do not capture all costs associated with a compensation contract. While liabilities are often recognized for compensation costs that will be paid in a future year, liabilities are not recognized for most forms of equity-based compensation that vest or are paid in a future year. The term “expense” is not appropriate because some costs associated with compensation are required to be capitalized under U.S. GAAP in the year the cost is incurred, resulting in no expense in the year the cost is incurred. The term “cost” more appropriately reflects the costs of compensation for purposes of this safe harbor recommendation.

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Analysis

The U.S. GAAP standards are organized and presented in the Financial Accounting Standard Board (FASB) Accounting Standards Codification (ASC). ASC Topic 710, *Compensation – General* (ASC 710), includes the accounting guidance for general compensation matters, such as deferred compensation arrangements (including bonuses but excluding most equity-based compensation). ASC Topic 718, *Compensation – Stock Compensation* (ASC 718), includes the accounting guidance for equity-based compensation, such as share-based payment transactions with employees.

I. Deferred compensation arrangements (including bonuses) – ASC 710

Under ASC 710, deferred compensation contracts, which include bonuses earned in one year and paid in a future year, are accounted for individually on an accrual basis in accordance with the terms of the underlying contract. Under the recognition guidance for deferred compensation arrangements, to the extent the terms of the contract attribute all or a portion of the expected future benefits to an individual year of an employee’s service, the cost of those benefits should be recognized in that individual year. Specifically, to the extent the terms of the contract attribute all or a portion of the expected future benefits to a period of service greater than one year, the cost of those benefits shall be accrued over the period of the employee’s service in a systematic and rational manner.⁴ The amounts to be accrued periodically under the guidance in ASC 710-10-25-9 should result in an accrued amount at the full eligibility date equal to the then present value of all of the future benefits expected to be provided to the employee, any beneficiaries and covered dependents in exchange for the employee’s services to that date.⁵

Cash bonus plans or other deferred compensation contracts might also condition payment on achieving specified performance (such as an earnings target) or market (such as attaining a stock price) conditions. Cash bonus plans that include performance conditions are also subject to the guidance in ASC 710. The cost of those benefits should be accrued over the period of service when management considers the achievement of the performance condition probable.⁶ The term “probable” is defined in ASC 450-20-20 as “[t]he future event or events are likely to occur.” This determination is made by reviewing all the facts and circumstances, including but not limited to the likelihood that payment will be enforced based on the provisions of the contract.

⁴ See ASC 710-10-25-9.

⁵ See ASC 710-10-30-1 and 30-2.

⁶ See ASC 718-10-25-29.

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II. Equity-based compensation – ASC 718

The accounting guidance for equity-based compensation is included in ASC 718. Under this guidance, the cost of services received by an entity as consideration for equity instruments issued (or liabilities incurred) in equity-based compensation transactions with employees should be measured based on the fair value of the equity instruments issued.⁷ The cost associated with the employee equity-based compensation arrangement is then recognized over the requisite service period.⁸ To determine the amount of compensation cost to be recognized in each accounting period, the employer bases initial accruals of compensation cost on the estimated number of instruments for which it is probable the requisite service will be rendered. The employer must revise that estimate if subsequent information indicates that the actual number of instruments is likely to differ from previous estimates.⁹

Accruals of compensation cost for an award with a performance condition should be based on the probable outcome of that performance condition; compensation cost should be accrued if it is probable that the performance condition will be achieved and should not be accrued if it is not probable that the performance condition will be achieved.¹⁰ Thus, for example, the compensation cost for a performance-based vesting restricted stock award is recognized during a reporting period only if the employer determines that it is probable that the performance condition will be met, which would result in the nonvested shares actually vesting. As discussed above, the term “probable” is defined in ASC 450-20-20 as “[t]he future event or events are likely to occur.”

III. Cost recognized in the audited annual financial statements for the fiscal year that includes November 2, 2017, or in a prior fiscal year

We recommend that the safe harbor applies if any of the cost associated with the contract was recognized in accordance with U.S. GAAP in the corporation’s audited annual financial statements for the fiscal year that includes November 2, 2017, or in a prior fiscal year. As discussed above, when a company determines whether it is appropriate under U.S. GAAP to recognize a cost related to a compensatory contract, it must make certain assertions, including whether it is probable that the applicable vesting condition(s) will be met.

The determination of whether a cost should be recognized under U.S. GAAP during a particular financial statement reporting period is typically made after the conclusion of the reporting period. Thus, it would not typically be the case that a determination of the cost would have been made on November 2, 2017. For this reason, we recommend basing this safe harbor on whether the cost

⁷ See ASC 718-10-30-2.

⁸ See ASC 718-10-25-2.

⁹ See ASC 718-10-35-3.

¹⁰ See ASC 718-10-25-20.

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was recognized in the annual financial statements for the fiscal year that includes November 2, 2017, or in a preceding fiscal year.

IV. Unlikely to allow for abuse

Our recommended safe harbor does not create a rule that lends itself to abuse by taxpayers. The contractual benefits eligible for this safe harbor must otherwise satisfy the section 162(m) grandfathering requirements but might be subject to a “negative discretion” provision under the section 162(m) shareholder approved plan. The fiscal year under U.S. GAAP that includes November 2, 2017 has closed for all taxpayers and, with very few exceptions, the audited financial statements have been released. Thus, taxpayers do not have the ability to recognize cost in these financial statements that they would not otherwise have recognized in order to take advantage of this safe harbor. Taxpayers have already reached a conclusion under U.S. GAAP without regard to the recommended safe harbor, concerning whether a cost should have been recognized with respect to a contract in the fiscal year that includes November 2, 2017, or in a prior fiscal year.

In addition, there is a natural tension between a corporation recognizing a cost under U.S. GAAP associated with the arrangement, and obtaining a tax deduction for the cost that was recognized. If U.S. GAAP requires that the corporation recognize the cost, the corporation’s net income in its financial statements is reduced to the extent the cost is recognized as an expense. Since this recommended safe harbor applies hindsight to determine whether a written binding contract existed on November 2, 2017, it is a reasonable assumption that the corporation applied U.S. GAAP appropriately in recognizing a cost in the audited annual financial statements for the fiscal year that included November 2, 2017, or in a prior annual reporting period.

V. Examples

The following examples illustrate the application of the recommended safe harbor rule:

Example 1

Corporation A, a calendar-year taxpayer, entered into a written performance-based compensation contract (otherwise satisfying the section 162(m) performance-based compensation requirements) with a covered employee prior to November 2, 2017, and the contract was not materially modified on or after that date. Cash bonuses are payable pursuant to the contract for the 2017 calendar year during 2018 if certain performance criteria (such as an earnings target for 2017) are met and if the covered employee remains employed until the payment date. Corporation A determines under U.S. GAAP that it is probable that the vesting requirements will be met, and the cash bonuses will be paid in 2018. In Corporation A’s audited

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annual financial statements for the fiscal year ended December 31, 2017, Corporation A recognizes a cost in accordance with U.S. GAAP associated with the cash bonuses payable pursuant to the contract. Under the recommended safe harbor rule, this contract is a written binding contract in effect on November 2, 2017 because a cost was recognized under U.S. GAAP for payments pursuant to the contract in Corporation A's audited annual financial statements for the fiscal year that included November 2, 2017. Therefore, none of the compensation paid pursuant to this contract is subject to the amendments made to section 162(m) by section 13601 of the TCJA.

Example 2

Corporation B, a calendar-year taxpayer, awarded a covered employee nonvested restricted stock in 2016 that vests on December 31, 2018 but only if certain performance conditions (such as an earnings target for the period ending December 31, 2018) are met as of December 31, 2018. The plan under which the restricted stock was awarded allows Corporation B's compensation committee to exercise its discretion to reduce the number of restricted shares that vest to zero, even if the applicable performance conditions are met. The fair value of the restricted stock award on the grant date was \$900,000. Under U.S. GAAP, the compensation cost related to the restricted stock is recognized over the service period, but only to the extent it is probable the vesting condition(s) will be met. In 2017 Corporation B determines that it is probable that the performance conditions will be met, and it recognizes compensation cost under U.S. GAAP in its annual financial statements for the fiscal year ended December 31, 2017. On December 31, 2018, when the fair market value of the restricted stock is \$1,000,000, the performance conditions are met, and Corporation B is otherwise entitled to a \$1,000,000 tax deduction in its taxable year ended December 31, 2018. Under the recommended safe harbor rule, the restricted stock is a written binding contract in effect on November 2, 2017 because Corporation B recognized a cost with respect to the restricted stock under U.S. GAAP in its audited annual financial statements for the fiscal year that included November 2, 2017. Therefore, the \$1,000,000 tax deduction associated with the restricted stock is not subject to the amendments made to section 162(m) by section 13601 of TCJA.

Example 3

Corporation C awarded to a covered employee a deferred compensation agreement on January 2, 2017 that will vest on December 31, 2019 if certain performance metrics (such as an earnings target for the period ended December 31, 2019) are

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met as of that date. For purposes of its annual financial statements for the period ended December 31, 2017, Corporation C determined that it was probable that the performance conditions will be met, and the requisite services will be provided. Therefore, a portion of the total cost under the arrangement was recognized in its 2017 audited annual financial statements. The cost recognized in 2017 includes a portion of the aggregate amount of deferred compensation Corporation C will ultimately pay when it is ultimately determined that the vesting requirements are met. Under the recommended safe harbor rule, the deferred compensation arrangement is a written binding contract in effect on November 2, 2017, and none of the deferred compensation paid to the covered employee pursuant to the agreement is subject to the amendments made to section 162(m) by section 13601 of TCJA. The application of the recommended safe harbor rule is not limited to the amount of the cost recognized in the annual financial statements for the period ended December 31, 2017, but instead applies to all deferred compensation ultimately payable pursuant to the contract in existence on November 2, 2017.

In each of the above examples, the corporation determined, that an amount was probable to be paid under the contract under U.S. GAAP and recognized the appropriate amount in its audited financial statements. Therefore, under the safe harbor, the contracts qualify as written binding contracts. All payments under the contracts should qualify as payments pursuant to a written binding contract and not subject to the amendments made to section 162(m) by section 13601 of the TCJA.

We recognize that U.S. GAAP and income taxes are separate systems with disparate goals, and thus, it is not always appropriate to follow U.S. GAAP for income tax reporting purposes. Nonetheless, following U.S. GAAP in this instance provides an administrable rule with which taxpayers can easily comply and the IRS can easily enforce. In this instance we recommend relying on U.S. GAAP to define a term, providing certainty for taxpayers and the IRS.

The AICPA is the world's largest member association representing the accounting profession, with more than 429,000 members in the United States and worldwide, and a history of serving the public interest since 1887. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. If you have any questions, please contact Jeffrey Martin, Chair, AICPA Employee Benefits Taxation Technical Resource Panel at (202)-521-1526, Jeffrey.martin@us.gt.com;

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Kristin Esposito, Senior Manager – AICPA Tax Policy & Advocacy, at (202) 434-9241, or kristin.esposito@aicpa-cima.com; or me at (612) 397-3071, or chris.hesse@CLAconnect.com.

Sincerely,

A handwritten signature in blue ink that reads "Christopher W. Hesse".

Christopher W. Hesse, CPA
Chair, AICPA Tax Executive Committee

cc: The Honorable Charles P. Rettig, Commissioner, Internal Revenue Service