November 6, 2018

The Honorable David J. Kautter
Assistant Secretary for Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Mr. William M. Paul
Acting Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Mr. Ilya Enkishev
Associate Chief Counsel
Office of Chief Counsel (TEGE)
Internal Revenue Service
1111 Constitution Ave, NW
Washington, DC 20224

Re: Notice 2018-68 – Guidance on the Application of Section 162(m)

Dear Messrs. Kautter, Paul and Enkishev:

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"). This letter is in response to the request by the IRS and Treasury for comments on the rules described in the Notice.

Specifically, the AICPA provides recommendations on the following issues related to the changes to section 162(m):

I. Covered Employee
   1. Corporate Restructuring
   2. Calculation of Compensation
   3. Definition of Officer
   4. Treatment of Director's Fees

II. Transition Relief
   1. Related to Becoming a Publicly Held Corporation
   2. Nonqualified Deferred Compensation Plans with Set Formulas

[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.

1455 Pennsylvania Ave. NW, Washington, DC 20004-1081
T: +1 202.737.6600 F: +1 202.638.4512
aicpaglobal.com | cimaglobal.com | aicpa.org | cgma.org

The AICPA is the world's largest member association representing the accounting profession with more than 431,000 members in 137 countries and territories, 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 Jeff Martin, Chair, AICPA Employee Benefits Taxation Technical Resource Panel at (703) 946-4467, Jeffrey.martin@us.gt.com; Kristin Esposito, Senior Manager – AICPA Tax Policy & Advocacy, at (202) 434-9241, or kristin.esposito@aicpa-cima.com; or me at (408) 924-3508, or annette.nellen@sjsu.edu.

Sincerely,

Annette Nellen, CPA, CGMA, Esq.
Chair, AICPA Tax Executive Committee

cc: The Honorable Charles P. Rettig, Commissioner, Internal Revenue Service
Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation
Mr. Robert Neis, Benefits Tax Counsel, Department of the Treasury
Mr. Stephen LaGarde, Attorney-Advisor, Office of Benefits Tax Counsel, Department of the Treasury
Mr. Christopher W. Call, Attorney-Advisor (Tax Legislation), Office of Tax Policy, Department of the Treasury
Ms. Veena Murthy, Legislation Counsel, Joint Committee on Taxation

AMERICAN INSTITUTE OF CPAs

Notice 2018-68 – Guidance on the Application of Section 162(m)

November 6, 2018

BACKGROUND

Section 162(m) of the Internal Revenue Code (IRC) places a $1 million limitation on the amount of compensation related to a "covered employee" that a "publicly held corporation" can deduct in a taxable year.

Prior to the passage of the Tax Cuts and Jobs Act (TCJA), under section 162(m) ("old section 162(m)")[2] and Notice 2007-49 – Covered Employees Under Section 162(m)(3), the term "covered employee" included the principal executive officer (PEO) as of the last day of the taxable year as well as the three highest paid officers excluding the PEO and principal financial officer (PFO) on the last day of the taxable year. The compensation of the PFO was not subject to the section 162(m) limitation. Qualified performance-based compensation and commission-based compensation were exempt from the $1 million limit. In addition, the term "publicly held corporation" referred to an entity with publicly traded equity.

Under section 162(m) as amended by the TCJA ("new section 162(m)"),[3] the definition of a "covered employee" was broadened to include the PEO and PFO at any time during the year (not just the last day of the year), and the three other most highly compensated officers for a minimum of five covered employees. The TCJA also added section 162(m)(3)(C) which mandates that individuals who are covered employees of the employer or any predecessor employer in any tax year beginning after December 31, 2016 are covered employees in all future years (including in retirement and after death). The TCJA also repealed the exceptions for qualified performance-based compensation and commission-based compensation.

The definition of a publicly held corporation was expanded to include certain foreign corporations[4] as well as private corporations and S corporations that are required to file reports under section 15(d) of the Securities Exchange Act of 1934.[5]

New section 162(m) is effective for tax years beginning after December 31, 2017. Additionally, the Act provides a transition rule excepting from new section 162(m) compensation payable pursuant to a written binding contract in effect on November 2, 2017 and not materially modified after that date.

[2] For purposes of this letter, all references to "old section 162(m)" are to section 162(m) prior to the Tax Cuts and Jobs Act.
[3] For purposes of this letter, all references to "new section 162(m)" are to section 162(m) as amended by the Tax Cuts and Jobs Act.
[4] Foreign corporations publicly traded through American depository receipts.
[5] Section 15(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act") provides that any issuer who registers a class of securities under the Securities Act of 1933, as amended (the "Securities Act") is subject to periodic reporting requirements under Section 13(a) of the Exchange Act.

SPECIFIC COMMENTS

I. Covered Employee

1. Corporate Restructuring

Overview

New section 162(m)(3)(C) requires any covered employee of the taxpayer or predecessor of the taxpayer for any taxable year beginning after December 31, 2016 to remain a covered employee in all future years. It is unclear which individuals are considered covered employees under this new rule in the case of an asset acquisition or disposition of a publicly held entity. Under the new rules, it appears that certain corporate restructurings can significantly increase the number of individuals whose compensation is subject to the deduction limitation, providing an economic advantage to private companies that are not constrained with regard to compensation deductions.

Additionally, it is unclear whether an individual is considered a covered employee through their employment with a private company not subject to section 162(m).

Recommendation

The AICPA recommends that Treasury and the IRS provide guidance defining the term "predecessor employer" for purposes of determining who is a covered employee under new section 162(m)(3)(C).

In the case of a public company (acquirer) that purchases a private company (or the assets of a private company) (target) where certain officers of the target company become officers of the acquirer, we suggest that the guidance state that the private company is not considered a predecessor employer since it was not subject to section 162(m) prior to its acquisition by the public company.

In the case of a publicly held corporation (acquirer) that purchases an insubstantial portion of the assets of another publicly held corporation (target), we suggest providing guidance stating that the target company's assets are not treated as assets of a predecessor employer and any executives hired by the acquirer as part of the asset acquisition are not treated as covered employees based on their status at the prior employer.

Analysis

The expansion of the covered employee group to include any employee who was a covered employee of the taxpayer or a predecessor of the taxpayer increases the number of individuals for whom compensation deductions are limited by section 162(m). Taxpayers require a precise definition of predecessor employer to determine the correct number of covered employees to include in the calculation of the compensation limitation of section 162(m). While the purchase of a public company appears to fall within the definition of a predecessor employer, it is unclear under certain fact patterns (e.g., the purchase of a limited portion of the assets of a company) if the employees joining the acquirer as part of a purchase are automatically considered covered employees of the purchaser.

In many cases, an acquirer of assets is not considered to "stand in the shoes of" the prior employer (e.g., in certain asset acquisitions the purchaser is not entitled to take a tax deduction for a vested benefit earned for services to the prior employer and paid by the purchase after acquisition).[6] The target of an acquisition of a limited portion of a target's assets, whether or not the target is publicly held, should not establish the target as a predecessor employer for purposes of section 162(m). However, it is possible that an officer could become a covered employee of the acquirer based on the compensation the officer earns for services to the acquirer *after* the asset purchase.

We do not believe that a private company (or the assets of a private company) that is purchased by a publicly held company is a predecessor employer since it was not subject to section 162(m) before the purchase. However, an officer hired as part of the purchase of a private company who is not considered a covered employee at the time of hire is not precluded from becoming a covered employee after the purchase, based on his or her service to and compensation earned from the buyer.

Example 1

Corporation X is calendar year taxpayer and a domestic publicly held corporation within the meaning of new section 162(m)(2). In June 2019, Corporation X acquires a single division of Corporation Y (a division that is less than 50 percent of the total assets, revenue and employees of Corporation Y) and employs several individuals who work for the purchased division of Corporation Y. Corporation Y is not publicly traded at the time of the sale of a portion of its assets to Corporation X. Employees H, I and J are officers of Corporation Y before the transaction and hired by Corporation X as part of the purchase of Corporation Y's assets. Since Corporation Y is not a public company when a portion of its assets are acquired by Corporation X, it has no covered employees in 2019. Employees H, I and J are not covered employees of Corporation X based on their status as officers of Corporation Y at the time of the purchase. However, one or more of these employees could become covered employees of Corporation X after the transaction, based only on the position at or compensation earned by the individuals for services to X after X's purchase of a portion of the assets of Corporation Y.

Example 2

Assume the same facts as Example 1, except that Corporation Y was a publicly held corporation at the time of the purchase. The result is the same as in Example 1 because Corporation X purchased less than a substantial portion of Corporation Y's assets. Employees H, I and J are not covered employees of Corporation X based on their status as officers of or compensation earned for services to Corporation Y after the purchase.

[6] *David R. Webb Company, Inc. v. Commissioner*, 708 F .2d 1254 (7th Cir. 1983).

Example 3

Corporation X is a publicly held company under new section 162(m)(2) which acquires substantially all the assets of Corporation Y, a publicly held corporation subject to section 162(m). As part of the acquisition, Employee A, the PEO of Corporation Y, is employed by Corporation X. Employee A is a covered employee of Corporation X since Corporation X purchased substantially all the assets of Corporation Y and is a predecessor corporation of Corporation X.

2. Calculation of Compensation

Overview

New section 162(m) broadened the definition of a covered employee and widened the scope of the type of entity subject to the new rules to include individuals whose compensation is not reported on Securities and Exchange Commission (SEC) filings. Under the Notice, section 162(m) also applies to short tax years and to tax years for which the company is publicly traded although not required to provide SEC summary compensation tables or other SEC information. In addition, it is possible that an officer is a covered employee even if there is no requirement to report the officer's compensation in SEC filings. For these companies, it is difficult for a taxpayer to accurately determine which officers are the highest paid other than the PEO and PFO.

Recommendation

The AICPA recommends that Treasury and the IRS provide taxpayers with a safe harbor method for calculating compensation for purposes of determining the three highest paid officers other than the PEO and PFO. We suggest basing the safe harbor on either the amount of an employee's compensation otherwise deductible under new section 162(a) in the taxable year or, alternatively, the amount of compensation an employee actually or constructively receives during the taxable year.

Analysis

Under the Notice, the determination of the three most highly compensated employees subject to the new section 162(m) limitation is no longer based on compensation reported in SEC filings. A safe harbor method for determining an officer's compensation will assist taxpayers in accurately identifying the three most highly compensated employees subject to new section 162(m) other than the PEO and the PFO. Either of the suggested safe harbor methods are easy to apply since the information is readily available to taxpayers.

3. Definition of Officer

Overview

The deduction limitation under section 162(m) applies to compensation paid to covered employees. Under new section 162(m), a covered employee includes the PEO and the PFO of the corporation[7] and the three highest compensated officers other than the PEO and PFO.[8] Under old section 162(m), only the PEO and the three highest compensated officers (other than the PEO and PFO) were considered covered employees if they served in that capacity as of the last day of the taxable year.

Regulations interpreting the term "covered employee" for purposes of old section 162(m) provide that the determination of who was considered an officer was based on the executive compensation disclosures under the Securities Exchange Act.[9] Under this rule, individuals could only qualify as covered employees if they were disclosed in the SEC Summary Compensation Table[10] as an officer (and met certain other criteria).

The TCJA added language to section 162(m)(3) indicating that a covered employee includes "officers of a corporation not required to file a proxy statement but which otherwise falls within the revised definition of a publicly held corporation."[11] As a result, and as stated in the Notice, it is possible that an employee is a covered employee even though they are not reported on the Summary Compensation Table (e.g., a company may delist its securities and thus not have a reporting requirement). Therefore, it is difficult for taxpayers to determine who is a covered employee since they can no longer look to the SEC reporting for the information.

Recommendation

The AICPA recommends that Treasury and the IRS provide guidance regarding which employees are considered officers of a publicly held company for new section 162(m) purposes by reference to the SEC definition of officer.[12]

Analysis

Due to the change in the law, taxpayers need guidance to help determine which individuals are in the group of employees who are subject to new section 162(m). Limiting this group of individuals to those meeting the SEC definition of an officer will provide taxpayers with clarity and consistency in determining which employees are officers. The SEC definition is settled law and determinable with assistance from SEC experts where there is a question as to an individual's status as an officer.

[7] IRC section 162(m)(3)(A).
[8] IRC section 162(m)(3)(B).
[9] Treasury Reg. § 1.162-27(c)(2)(ii).
[10] The Summary Compensation Table is a required disclosure by the SEC on executive compensation. The table contains the total compensation of the PEO, PFO and the next three highest compensated officers of a company for the past three fiscal years. It also includes a breakout of the components of the compensation for the last fiscal year.
[11] House Conf. Rpt. 115-466, 489.
[12] Section 240.3b-7 of the Securities Exchange Act of 1934 provides the following definition for an executive officer: "The term *executive officer*, when used with reference to a registrant, means its president, any vice president of the registrant in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions for the registrant. Executive officers of subsidiaries may be deemed executive officers of the registrant if they perform such policy making functions for the registrant."

4. Treatment of Director's Fees

Overview

Under the new definition of covered employee, an individual remains a covered employee after termination of their service as an employee. However, it is not clear whether remuneration earned by a covered employee after termination of employment, for post-termination services, is subject to the section 162(m) limits.

In contrast, compensation earned by an employee for services performed while the individual is an employee and paid to the individual after the individual's employment is terminated should fall within the definition of compensation and the section 162(m) limitation.

Recommendation

The AICPA recommends that Treasury and the IRS provide guidance excluding director's fees earned after an individual terminates service as an employee, from the definition of compensation for purposes of section 162(m). We also suggest implementing the requirement that in order for the exclusion from section 162(m) to apply, the former covered employee who terminated service must receive reasonable compensation for any services rendered post-employment.

Analysis

Treasury Reg. § 1.162-27(c)(3) provides that "for purposes of the deduction limitation, compensation means the aggregate amount allowable as a deduction…for remuneration for services performed by a covered employee, whether or not the services were performed in the taxable year."

Under old section 162(m), once a covered employee terminated service as an employee, compensation earned by the individual in a subsequent year for services provided as a non-employee after termination (e.g., services to the company as a non-employee director) were not treated as compensation for purposes of section 162(m).

The language in Treas. Reg. § 1.162-27(c)(3) noting that any remuneration for services performed as a covered employee is treated as compensation under old section 162(m), requires clarification under the new rules since an individual remains a "covered employee" even after terminating service as an employee.

New section 162(m)(4)(A) provides that the term "applicable employee remuneration" with respect to any covered employee for any taxable year is the aggregate amount allowable as a deduction "for remuneration *for services performed by such employee*…." It appears from this language that Congress did not intend to include amounts earned for services performed by a former employee as a non-employee director after termination of services as an employee. However, the employee must receive compensation for service as a director commensurate with director compensation paid to directors who are not former employees of the company.

Example

Employee Z is a covered employee of Public Company. Public Company established a new retirement plan for executives in 2018. The retirement plan provides for the distribution of benefits over a five-year period beginning after an officer terminates service. Employee Z terminates employment in 2020 and becomes a member of Public Company's board of directors in 2021. Employee Z will receive $75,000 for his services as a board member in 2021. Other non-employee members of the board of directors who serve on the same committees (and who have never served as Public Company employees) also receive $75,000 for their annual board service.

Employee Z will receive a 2021 Form W-2 reporting $700,000 related to the annual retirement payment from Public Company and reporting a $400,000 bonus earned in 2020 and paid in 2021. Employee Z will receive a 2021 Form 1099-MISC reporting $75,000 in box 7 as non-employee compensation for his board service. The $700,000 executive retirement payment and the $400,000 bonus is included in Employee Z's 2021 compensation for purposes of section 162(m). Public Company does not include the $75,000 board service payment in Employee's Z's 2021 compensation for purposes of section 162(m) since it was earned by Employee Z for his services as a nonemployee director after termination of his status as an employee.

II. Transition Relief

1. Related to Becoming a Publicly Held Corporation

Overview

Currently, Treas. Reg. § 1.162-27(f) provides a transition period, for companies that become publicly held through initial public offerings, spinoffs, and similar transactions, during which the deduction limit of section 162(m) does not apply to remuneration paid under plans or agreements that existed prior to the corporation becoming publicly held. This reliance period provides newly publicly held companies time to adjust to the application of section 162(m) and to consider its effects on new remuneration agreements.

Recommendation

The AICPA recommends that Treasury and the IRS retain Treas. Reg. § 1.162-27(f) in its current form.

Analysis

The Notice requests comments "on the application of section 162(m) to corporations immediately after they become publicly held either through an initial public offering or a similar business transaction." The existing transition relief in Treas. Reg. § 1.162-27(f) provides a newly public company a transition period in which it can react to the legal and regulatory requirements applicable to a public entity. The transition period provides companies valuable time to understand how newly applicable rules apply to them. They also use this time to adjust their compensation plans to those of a public company, specifically addressing comments made by public shareholders regarding how employees are most appropriately compensated.

While the need to obtain certain shareholder votes under the performance-based pay exception is no longer applicable under new section 162(m) and may have been a consideration in granting the transition relief in Treas. Reg. § 1.162-27(f), companies still must determine who the covered employees are under a broader definition. Private companies that have never had to consider section 162(m) may not have this information readily available.

The new legislation does not limit the application of existing transition relief under Treas. Reg. § 1.162-27(f). Further, the written binding contract exception was provided in the legislation to give existing public companies time to transition to the new section 162(m) rules. It is equitable to also provide private companies a transition period. The relief in Treas. Reg. § 1.162-27(f) similarly applies to plans or arrangements that were in place prior to the applicability of the new rules.

2. Transition Relief for Nonqualified Deferred Compensation (NQDC) Plans with Set Formulas

<u>Overview</u>

There is an exception from new section 162(m) for compensation payable pursuant to a written binding contract that was in effect on November 2, 2017 and not materially modified after that date. Certain nonqualified retirement savings plans, including many excess benefit plans, contain rigid formulas under which the benefits are not changed on a year-by-year basis, though the amount of an accrual may change slightly based on an employee's years of service or increases in salary. The plans are contracts between the eligible employees and the employer to pay retirement benefits, often in conjunction with a qualified plan.

The following examples illustrate these nonqualified retirement savings plans with set formulas:

> *<u>Example 1</u>*
>
> An excess benefit plan is tied to an employer's defined benefit plan. The formula mirrors the defined benefit formula in the qualified retirement plan; however, the benefit is based solely on an employee's compensation in excess of the section 401(a)(17) or without regard to the section 415 limits.
>
> *<u>Example 2</u>*
>
> A nonqualified defined contribution plan's contribution formula is tied to an employer's qualified profit-sharing plan formula. The qualified plan provides a defined contribution benefit equal to 6 percent of an employee's compensation, and the nonqualified defined contribution plan provides for 6 percent of the employee's compensation in excess of the section 401(a)(17) limit or without regard to the section 415 limits.

Example 3

Certain highly compensated employees are excluded from an employer's qualified retirement plan due to discrimination testing concerns. The employer provides the excluded employees a separate nonqualified retirement benefit, equal to 5 percent of employee compensation that accrues each year until retirement and distributes payments annually for 5 years after the employee's retirement.

In each of the plan formulas in the examples, there are no "renewal" provisions and no yearly changes incorporated in the plan. The employer generally retains the right to modify or terminate the plan in the future, but such plans generally have a clause prohibiting the employer from cutting back any benefits accrued before the date the plan is modified or terminated.

In contrast, it is possible that other retirement plans, including excess benefit plans that are based on qualified 401(k) elective and matching contributions are affected by the employee's annual right to decide the amount to contribute each year (even if the employee does not elect to change the contributions).

Recommendation

The AICPA recommends that Treasury and the IRS issue guidance related to nonqualified deferred compensation plans with set formulas stated in the plan that are not subject to employee contribution choices. We suggest that the guidance provide that if such a plan was in existence before November 2, 2017, the benefits accruing under the plan, both before and after November 2, 2017 should remain under the transition rule unless and until the set formula is materially modified. The transition rule would only apply to employees eligible for the plan as of November 2, 2017.

Analysis

The Act provides a transition rule which grandfathers certain compensation paid pursuant to a plan "provided that the right to participate in the plan is part of a written binding contract with the covered employee in effect on November 2, 2017"… "and the corporation does not have the right to amend materially the plan or terminate the plan (*except on a prospective basis before any services are performed with respect to the applicable period for which compensation is to be paid*)."[13] [Emphasis added]

There are various types of benefits covered under the transition rule protection. A promise to pay a stated amount (plus market rate interest during the deferral period) after retirement (if put in place before November 2, 2017) is protected under the transition rule since it is a written binding contract and the corporation does not have the right to materially amend the promise. An employment contract signed before November 2, 2017 which provides that the PFO will receive a salary of $800,000 for each of the next seven years with an escalation clause based on a stated

[13] See page 490 of the Joint Explanatory Statement of the Committee of the Conference (Conference Report) for the TCJA.

market rate increase is also protected by the transition rule until the agreement is subject to renewal or is materially modified.

Under the rigid structures in excess benefit plans and other set-formula nonqualified deferred compensation plans, neither party expects to change the formula or renegotiate the terms, even though the employer has the right to terminate the plan in the future. Under these plans, the employer does not have the right to rescind the benefits "*except on a prospective basis before any services are performed with respect to the applicable period for which compensation is to be paid*."[14] With regard to employees eligible for the benefit on November 2, 2017, such plans fit within the transition rule language until the plan formula is materially modified or the plan is terminated.

[14] See page 490 of the Joint Explanatory Statement of the Committee of the Conference (Conference Report) for the TCJA.