PART II: COMPENSATION

In General

3515. What are the limits on an employer's ability to deduct compensation paid to an employee?

An employer may deduct all ordinary and necessary business expenses including "a reasonable allowance for salaries or other compensation for personal services actually rendered."[1] "Reasonable" compensation is "such amount as would ordinarily be paid for like services by like enterprises under like circumstances."[2] A salary that exceeds what is customarily paid for such services is considered unreasonable or excessive. Items other than wages may be considered in determining whether compensation is excessive. For example, the amount of loans forgiven on key person insurance policies for two top executives when the policies were transferred to them was used in determining whether their compensation was unreasonable.[3] Compensation generally is the total amount of compensation paid to an employee, rather than that paid to all employees as a group.[4]

The issue of reasonable compensation has been almost exclusively a problem in connection with employee-shareholders of closely-held companies. If the IRS finds compensation to be unreasonable, it may reclassify it as a dividend if it had been paid to an employee-shareholder.[5] The fact that the corporation had never declared a dividend was a factor in determining whether amounts paid to an individual who was president, director, and sole shareholder were actually disguised dividends.[6] Bonuses that are disproportionately high in relation to salaries actually may be dividends in disguise, especially if the employee receiving the "bonus" is the company's sole or majority shareholder.[7]

3516. Is there an upper limit on the amount of executive compensation that a publicly-traded corporation may deduct?

Code Section 162(m) mandates an upper limit on the amount that a publicly-traded corporation may deduct for compensation paid to certain executives, even though it may well otherwise be reasonable.[8] No deduction is permitted for "applicable employee remuneration" in excess of $1 million paid to any "covered employee" by any "publicly-held corporation."[9]

A "covered employee" is the corporation's principal executive officer or any other employee who is one of the corporation's three highest compensated officers (other than the corporation's

1. IRC Sec. 162(a)(1).
2. Treas. Reg. §1.162-7(b)(3).
3. *Avis Indus. Corp. v. Comm.*, TC Memo 1995-434.
4. *L. Schepp Co.*, 25 BTA 419 (1932).
5. See Treas. Reg. §1.162-7(b)(1).
6. *Eberl's Claim Serv., Inc. v. Comm.*, 249 F.3d 994 (10th Cir. 2001).
7. *Rapco, Inc. v. Comm.*, 96-1 USTC ¶50,297 (2nd Cir. 1996); *Labelgraphics, Inc. v. Comm.*, TC Memo 1998-343, aff'd 2000-2 USTC ¶50,648 (9th Cir. 2000). But see *Exacto Spring Corp. v. Comm.*, 196 F. 3d 833, 99-2 USTC ¶50,964 (7th Cir. 1999).
8. IRC Sec. 162(m).
9. IRC Sec. 162(m)(1).

principal financial officer).[1] This determination is made under the executive compensation disclosure rules of the Securities Exchange Act of 1934.[2]

A "publicly-held corporation" is any corporation that issues a class of common equity securities and is required to be registered under Section 12 of the Securities Exchange Act of 1934. The determination is made on the last day of the corporation's taxable year.[3]

"Applicable employee remuneration" is the aggregate amount of remuneration paid to an employee for services performed (whether or not during the taxable year) that would be deductible if not for this limitation.[4] Amounts not considered to be wages for FICA under IRC Sections 3121(a)(5)(A) through 3121(a)(5)(D), including payments to or from any qualified plan, SEP, or Section 403(b) tax sheltered annuity, are not included.[5] Pension plan payments received by a chief executive officer who retired and then returned to work within the same tax year were not considered applicable employee remuneration.[6] Also excluded are any benefits provided to an employee that are reasonably believed to be excludable from his or her gross income and salary reduction contributions described in IRC Section 3121(v)(1) (Q 3842).[7]

Specifically excluded from the definition of applicable employee remuneration are commission payments, which generally are defined as any remuneration paid on a commission basis solely due to income generated directly by the employee's performance.[8]

Certain other performance-based compensation (e.g., stock options and stock appreciation rights) payable solely on the attainment of at least one performance goal also is excluded, but only if (1) the goals are set by a compensation committee of the corporation's board of directors, made up solely of at least two outside directors, (2) the terms under which the compensation will be paid are disclosed to the corporation's shareholders and approved by a majority vote prior to the time of payment, and (3) the compensation committee certifies that the performance goals have been attained before payment is made.[9]

A plan will not be considered performance-based compensation, however, if payment will be made when the employee is terminated or retires regardless of whether or not the goal was met.[10]

Amounts paid under a binding contract in effect on February 17, 1993, and not modified before the remuneration is paid, also are excluded.[11] If a contract entered into on or before February 17, 1993 is renewed after this date, it becomes subject to the deduction limitation.[12]

1. IRC Sec. 162(m)(3); Notice 2007-49, 2007-25 IRB 1429.
2. Treas. Reg. §1.162-27(c)(2)(ii).
3. Treas. Reg. §1.162-27(c)(1)(i).
4. IRC Sec. 162(m)(4).
5. Treas. Reg. §1.162-27(c)(3)(ii)(A).
6. Let. Rul. 9745002.
7. Treas. Reg. §1.162-27(c)(3)(ii)(B).
8. IRC Sec. 162(m)(4)(B).
9. IRC Sec. 162(m)(4)(C).
10. Rev. Rul. 2008-13, 2008-10 IRB 518.
11. IRC Sec. 162(m)(4)(D); Treas. Reg. §1.162-27(h)(1)(iii).
12. Treas. Reg. §1.162-27(h)(1)(i).

The IRS has concluded that a proposed supplemental executive retirement plan ("SERP") (Q 3532) affecting employees subject to pre-1993 employment contracts did not provide for increased compensation or the payment of additional compensation under substantially the same elements and conditions covered under the employment agreements and thus was not considered a material modification of those agreements pursuant to Treasury Regulation section 1.162-27(h)(1)(iii)(C).[1]

Revenue Ruling 2008-13

In Revenue Ruling 2008-13, the IRS took the new position that agreements providing for vesting acceleration on performance-based equity or cash awards following an executive's termination without cause, without good reason, or due to retirement, or if the plan or agreement does not pay remuneration solely on account of the attainment of one or more performance goals and regardless of actual performance, will cause the plan to fail the requirements of Section 162(m), even if the accelerated vesting and payout is never triggered under the plan.

In effect, the IRS said that provisions in a plan for vesting and payment accelerations upon terminations without cause, for good reason, or due to involuntary retirement are not permissible payment events under Section 162(m) regulations and the provisions alone thereby cause loss of the compensation deduction, even if the acceleration of vesting and payment never occurs. Under the ruling, the IRS gave employers until January 1, 2009, to modify performance-based plans and agreements with "covered employees" to comply for years after 2009.

3517. Did the TARP program place any limitations on the deductibility of executive compensation?

The Emergency Economic Stabilization Act of 2008 added new rules to limit the deductibility of compensation paid to certain executives of companies participating in the federal government's Troubled Assets Relief Program ("TARP"). These companies generally may not deduct more than $500,000 in compensation, including deferred compensation.[2]

In effect, the compensation in excess of the limit is taxed twice. It is taxed once when the employee pays tax on the compensation, and it is taxed again to the extent the employer cannot deduct the compensation in excess of the limit.

3518. Do the health care reform laws place any limitations on the deductibility of executive compensation?

The Patient Protection and Affordable Care Act ("PPACA") has added new rules to limit the deductibility of compensation paid to certain executives of certain "health care insurers" as defined under the law (and applying the controlled group rules). The definition of "health care insurers" includes insurance companies, health maintenance organizations, and any other entity that receives premiums for providing "health insurance coverage." The PPACA places a

1. Let. Rul. 9619046.
2. IRC Sec. 162(m)(5), as added by EESA 2008.

$500,000 limit on the deduction of compensation that otherwise would be deductible to each employee during an applicable tax year. This limit includes any deferred compensation amounts earned in that tax year, even if it will not be paid until a later year. The deduction then would not be available when the deferred compensation is later paid if it is used up.

In effect, the compensation in excess of the limit is taxed twice. It is taxed once when the employee pays tax on the compensation, and it is taxed again to the extent the employer cannot deduct the compensation in excess of the limit.

This limit is effective for compensation earned in 2013 and later tax years, but includes compensation earned in 2010 or later tax years and deferred until later than 2012.

3519. Did the Dodd-Frank Act place any limitations on the deductibility of executive compensation?

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("DFA") added new law to prohibit any covered financial institution (those not already covered by TARP restrictions) from offering any type of incentive-based compensation arrangement that encourages inappropriate risk by providing "excessive compensation, fees or benefits," or would lead to "material loss" to the covered financial institution.

A "covered financial institution" is one that has assets greater than $1 billion and is:

(1) a depository institution or depository holding institution;

(2) a broker-dealer;

(3) a credit union;

(4) an investment advisor;

(5) the Federal National Mortgage Association;

(6) the Federal Loan Mortgage Corporation; or

(7) any other financial institution that federal regulators determine should be treated as a covered financial institution.

Many of these new prohibition rules could look very much like those already in place for TARP-covered financial institutions. It is important to see the final regulations for the details of the operation of this broad and vague compensation limiting prohibition.

3520. Did the Temporary Pension Contribution Relief Act place any limitations on the deductibility of executive compensation?

Although not a deduction limitation, the Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010 ("BPRA") indirectly impacts an employer's compensation deductions (and it impacts the employer's cash and accounting in other ways).

The law added new rules to permit employers to amortize any qualified pension contribution shortfalls – from the required amount – over a longer time period. A public or private company must give up portions of its annual pension contribution relief permitted under the BPRA, based on "excess compensation" paid to employees (not just executives) of companies. Under the BPRA, there is a formula for calculating the permitted relief reduction in the annual pension contribution; the formula requires the employer to offset certain amounts (i.e., to make an add-back adjustment), primarily stock redemptions, dividends, and so-called "excess compensation." Under the BPRA, "excess compensation" is defined as all taxable compensation of an employee from the employer during a year exceeding $1 million, including all nonqualified deferred compensation as defined by Section 409A, which includes a broad segment of an employee's compensation under current law.

The definition of "excess compensation" also includes certain amounts that are not currently taxable to an employee. The BPRA requires an employer to include in "excess compensation" employer contributions made to any trust (or similar arrangement) to fund any nonqualified deferred compensation plan, even though these employer contribution amounts are not currently taxable. Although it is not yet clear, this requirement could include premium payments made to EOLI/COLI or annuities acquired in connection with an employer's nonqualified deferred compensation plan. Although excess compensation cannot ever exceed the permitted temporary reduction, it could cancel the benefit of the reduction for a year. Moreover, there is some concern that, subject to getting the IRS interpretation from further guidance on the statutory language, the formula and its operation with regard to excess compensation actually could cost the employer a $2 increase in pension contribution for each $1 of excess compensation.

In summary, a public or private employer seeking to take advantage of the temporary qualified pension contribution relief law will need to evaluate both the alternative schedules of pension contribution relief offered by the BPRA, and also then consider the potential impact of various scenarios of excess compensation, taking account of both taxable compensation and non-taxable employer contributions to nonqualified plans on that schedule.

3521. What are "excess parachute payments" and how are they taxed?

Agreements providing a generous package of severance and benefits to top executives and key personnel in the event of a takeover or merger are commonly referred to as "golden parachutes." "Excess parachute payments," as defined in IRC Section 280G, are subject to the following two tax sanctions: (1) no employer deduction is allowed; and (2) the recipient is subject to a 20 percent penalty tax.[1] Note that this tax penalty is not the same 20 percent penalty imposed by plans covered by and failing IRC Section 409A requirements (Q 3532).

A "parachute payment" is defined in the IRC as any payment in the nature of compensation to a disqualified individual that is (1) contingent on a change in the ownership or effective control of the corporation or a substantial portion of its assets and the present value of the payments contingent on such change equals or exceeds three times the individual's average

1. IRC Secs. 280G, 4999.

annual compensation from the corporation in the five taxable years ending before the date of the change, or (2) pursuant to an agreement that violates any generally enforced securities laws or regulations.[1] The present value of the payments contingent on the change in ownership or control is to be determined as of the date of the change, using a discount rate equal to 120 percent of the applicable federal rate.[2] A transfer of property will be treated as a payment and taken into account at its fair market value.[3]

A "disqualified individual" is any employee, independent contractor, or other person specified in the regulations who performs personal services for a corporation and who is an officer, shareholder, or highly compensated individual of the corporation. For this purpose, "highly compensated individual" only includes an individual who is a member of the group consisting of the highest paid 1 percent of the employees of the corporation or, if less, the highest paid 250 employees of the corporation.

A payment generally will not be considered contingent if it is substantially certain at the time of the change that the payment would have been made whether or not the change occurred. If a payment is made under a contract entered into or amended within one year of a change in ownership or control, it is presumed to be a parachute payment, unless it can be shown "by clear and convincing evidence" that the payment was not contingent on the change in ownership or control.[4]

The term "parachute payment" does not include:

(1) any payment to a disqualified individual with respect to a "small business corporation" as defined in IRC Section 1361(b) (which does not have more than one class of stock and not more than 100 stockholders, all of whom are generally individuals but none of whom are nonresident aliens),

(2) any payment to a disqualified individual with respect to a corporation if, immediately before the change, no stock was readily tradable on an established securities market or otherwise and shareholder approval of the payment was obtained after adequate and informed disclosure by a vote of persons, who, immediately before the change, owned more than 75 percent of the voting power of all outstanding stock of the corporation, or

(3) any payment to or from a qualified pension, profit sharing or stock bonus plan, a tax sheltered annuity plan, or a simplified employee pension plan.[5]

IRC Section 280G applies to agreements entered into or amended after June 14, 1984.[6]

1. IRC Sec. 280G(b)(2).
2. IRC Sec. 280G(d)(4).
3. IRC Sec. 280G(d)(3).
4. IRC Sec. 280G(b)(2)(C).
5. IRC Secs. 280G(b)(5) and (6).
6. Treas. Reg. §1.280G-1, Q&A 47.

See Q 3522 for a discussion of how to calculate the nondeductible portion of a parachute payment.

Section 409A Impact

Because Section 280G and Section 409A both can cover a plan providing severance/separation benefits in the case of a change in control, and Section 280G and Section 409A have separate definitions of what constitutes a change in control (Section 409A imposing a narrower definition), it is necessary to carefully coordinate the plan provisions when both IRC sections might apply (Q 461).

3522. How is the nondeductible amount of a parachute payment calculated?

The amount of a parachute payment that is nondeductible and subject to the excise tax (i.e., the "excess parachute payment," see Q 3521) is the amount of the payment in excess of the portion of the base amount allocable to that payment.

The "base amount" is the average of the individual's annual compensation paid by the corporation undergoing the change in ownership and includable in the gross income of the individual in the most recent five taxable years ending before the date on which the change in ownership or control occurs. If the individual has been employed by the corporation for fewer than five years, then his or her base amount is figured using the annual compensation for the years actually employed. Compensation of individuals employed for a portion of a taxable year should be annualized (i.e., $30,000 in compensation for four months of employment with the corporation would be $90,000 on an annual basis).

To determine the "excess parachute payment," the base amount is multiplied by the ratio of the present value of the parachute payment to the present value of all parachute payments expected; the result is then subtracted from the amount of the parachute payment.

$$\text{excess parachute payment} =$$

$$\text{parachute payment} - \frac{\text{present value of the parachute payment}}{\text{present value of all parachute payments expected}} \times \text{base amount}$$

The present value is to be determined at the time the contingency occurs, using a discount rate of 120 percent of the applicable federal rate.

Any amount the taxpayer can prove is "reasonable compensation" will not be treated as a parachute payment.[1] See Q 3515 for a general discussion on standards for "reasonable compensation."

1. IRC Sec. 280G(b)(4); Treas. Reg. §1.280G-1, Q&A 40-44.

Planning Point: The original documentation should allow the sponsor the option to pay the maximum amount payable (2.99 x average annual compensation) without equaling or exceeding the total amount that would make some portion "excess compensation," which would cause loss of a portion of the deduction. This option often may result in the participant ultimately receiving a larger dollar amount than if the participant had received "excessive compensation," after consideration for income taxes in both cases. In addition, the sponsor will have retained its compensation deduction for the payment.