Committee Reports

COMREP ¶ 1621.00048 Special rules for tax treatment of executive compensation of employers participating in the troubled assets relief program. (Emergency Economic Stabilization Act of 2008, , PL 110-343, 10/3/2008)

Joint Committee on Taxation Report — JCX-79-08

Present Law

In general

An employer generally may deduct reasonable compensation for personal services as an ordinary and necessary business expense. Sections 162(m) and 280 provide explicit limitations on the deductibility of compensation expenses in the case of corporate employers.

Section 162(m)

In general

The otherwise allowable deduction for compensation paid or accrued with respect to a covered employee of a publicly held corporation [5] is limited to no more than $1 million per year. [6] The deduction limitation applies when the deduction would otherwise be taken. Thus, for example, in the case of compensation resulting from a transfer of property in connection with the performance of services, such compensation is taken into account in applying the deduction limitation for the year for which the compensation is deductible under section 83 (i.e., generally the year in which the employee's right to the property is no longer subject to a substantial risk of forfeiture).

5

A corporation is treated as publicly held if it has a class of common equity securities that is required to be registered under section 12 of the Securities Exchange Act of 1934.

6

Sec. 162(m) . This deduction limitation applies for purposes of the regular income tax and the alternative minimum tax.

Covered employees

Section 162(m) defines a covered employee as (1) the chief executive officer of the corporation (or an individual acting in such capacity) as of the close of the taxable year and (2) the four most highly compensated officers for the taxable year (other than the chief executive officer). Treasury regulations under section 162(m) provide that whether an employee is the chief executive officer or among the four most highly compensated officers should be determined pursuant to the executive compensation disclosure rules promulgated under the Securities Exchange Act of 1934 (“Exchange Act”).

In 2006, the Securities and Exchange Commission amended certain rules relating to executive compensation, including which executive officers' compensation must be disclosed under the Exchange Act. Under the new rules, such officers consist of (1) the principal executive officer (or an individual acting in such capacity), (2) the principal financial officer (or an individual acting in such capacity), and (3) the three most highly compensated executive officers, other than the principal executive officer or financial officer.

In response to the Securities and Exchange Commission's new disclosure rules, the Internal Revenue Service issued updated guidance on identifying which employees are covered by section 162(m) . [7]

The new guidance provides that "covered employee" means any employee who is (1) the principal executive officer (or an individual acting in such capacity) defined in reference to the Exchange Act, or (2) among the three most highly compensated officers for the taxable year (other than the principal executive officer), again defined by reference to the Exchange Act. Thus, under current guidance, only four employees are covered under section 162(m) for any taxable year. Under Treasury regulations, the requirement that the individual meet the criteria as of the last day of the taxable year applies to both the principal executive officer and the three highest compensated officers. [8]

[7]

[8]

Treas. Reg. sec. 1.162-27(c)(2).

Compensation subject to the deduction limitation

In general.—Unless specifically excluded, the deduction limitation applies to all remuneration for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash. If an individual is a covered employee for a taxable year, the deduction limitation applies to all compensation not explicitly excluded from the deduction limitation, regardless of whether the compensation is for services as a covered employee and regardless of when the compensation was earned. The $1 million cap is reduced by excess parachute payments (as defined in sec. 280G , discussed below) that are not deductible by the corporation.

Certain types of compensation are not subject to the deduction limit and are not taken into account in determining whether other compensation exceeds $1 million. The following types of compensation are not taken into account: (1) remuneration payable on a commission basis; (2) remuneration payable solely on account of the attainment of one or more performance goals if certain outside director and shareholder approval requirements are met ("performance-based compensation"); (3) payments to a tax-qualified retirement plan (including salary reduction contributions); (4) amounts that are excludable from the executive's gross income (such as employer-provided health benefits and miscellaneous fringe benefits (sec. 132)); and (5) any remuneration payable under a written binding contract which was in effect on February 17, 1993. In addition, remuneration does not include compensation for which a deduction is allowable after a covered employee ceases to be a covered employee. Thus, the deduction limitation often does not apply to deferred compensation that is otherwise subject to the deduction limitation (e.g., is not performance-based compensation) because the payment of compensation is deferred until after termination of employment.

Performance-based compensation.—Compensation qualifies for the exception for performance-based compensation only if (1) it is paid solely on account of the attainment of one or more performance goals, (2) the performance goals are established by a compensation committee consisting solely of two or more outside directors, [9](3) the material terms under which the compensation is to be paid, including the performance goals, are disclosed to and approved by the shareholders in a separate vote prior to payment, and (4) prior to payment, the compensation committee certifies that the performance goals and any other material terms were in fact satisfied.

[9]

A director is considered an outside director if he or she is not a current employee of the corporation (or related entities), is not a former employee of the corporation (or related entities) who is receiving compensation for prior services (other than benefits under a tax-qualified retirement plan), was not an officer of the corporation (or related entities) at any time, and is not currently receiving compensation for personal services in any capacity (e.g., for services as a consultant) other than as a director.

Compensation (other than stock options or other stock appreciation rights) is not treated as paid solely on account of the attainment of one or more performance goals unless the compensation is paid to the particular executive pursuant to a pre-established objective performance formula or standard that precludes discretion. Stock options or other stock appreciation rights generally are treated as meeting the exception for performance-based compensation, provided that the requirements for outside director and shareholder approval are met (without the need for certification that the performance standards have been met), because the amount of compensation attributable to the options or other rights received by the executive would be based solely on an increase in the corporation's stock price. Stock-based compensation is not treated as performance-based if it is dependent on factors other than corporate performance. For example, if a stock option is granted to an executive with an exercise price that is less than the current fair market value of the stock at the time of grant, then the executive would have the right to receive compensation on the exercise of the option even if the stock price decreases or stays the same. In contrast to options or other stock appreciation rights, grants of restricted stock are not inherently performance-based because the executive may receive compensation even if the stock price decreases or stays the same. Thus, a grant of restricted stock does not satisfy the definition of performance-based compensation unless the grant or vesting of the restricted stock is based upon the attainment of a performance goal and otherwise satisfies the standards for performance-based compensation.

Section 280G

In general

In some cases, a compensation agreement for a corporate executive may provide for payments to be made if there is a change in control of the executive's employer, even if the executive does not lose his or her job as part of the change in control. Such payments are sometimes referred to as “golden parachute payments.” The Code contains limits on the amount of certain types of such payments, referred to as “excess parachute payments.” Excess parachute payments are not deductible by a corporation. [10]In addition, an excise tax is imposed on the recipient of any excess parachute payment equal to 20 percent of the amount of such payment. [11]

[10] Sec. 280G .

[11] Sec. 4999 .

Definition of parachute payment

A “parachute payment” is any payment in the nature of compensation to (or for the benefit of) a disqualified individual which is contingent on a change in the ownership or effective control of a corporation or on a change in the ownership of a substantial portion of the assets of a corporation (“acquired corporation”), if the aggregate present value of all such payments made or to be made to the disqualified individual equals or exceeds three times the individual's “base amount.”

The individual's base amount is the average annual compensation payable by the acquired corporation and includible in the individual's gross income over the five-taxable years of such individual preceding the individual's taxable year in which the change in ownership or control occurs.

The term parachute payment also includes any payment in the nature of compensation to a disqualified individual if the payment is made pursuant to an agreement which violates any generally enforced securities laws or regulations.

Certain amounts are not considered parachute payments, including payments under a qualified retirement plan, and payments that are reasonable compensation for services rendered on or after the date of the change in control. In addition, the term parachute payment does not include any payment to a disqualified individual with respect to a small business corporation or a corporation no stock of which was readily tradable, if certain shareholder approval requirements are satisfied.

Disqualified individual

A disqualified individual is any individual who is an employee, independent contractor, or other person specified in Treasury regulations who performs personal services for the corporation and who is an officer, shareholder, or highly compensated individual of the corporation. Personal service corporations and similar entities generally are treated as individuals for this purpose. A highly compensated individual is defined for this purpose as an employee (or a former employee) who is among the highest-paid one percent of individuals performing services for the corporation (or an affiliated corporation) or the 250 highest paid individuals who perform services for a corporation (or affiliated group).

Excess parachute payments

In general, excess parachute payments are any parachute payments in excess of the base amount allocated to the payment. The amount treated as an excess parachute payment is reduced by the portion of the payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered before the change in control.

Explanation of Provision

Section 162(m)

In general

Under the provision, the section 162(m) limit is reduced to $500,000 in the case of otherwise deductible compensation of a covered executive for any applicable taxable year of an applicable employer.

An applicable employer means any employer from which one or more troubled assets are acquired under the “troubled assets relief program” (“TARP”) established by the bill if the aggregate amount of the assets so acquired for all taxable years (including assets acquired through a direct purchase by the Treasury Department, within the meaning of section 113(c) of Title I of the bill) exceeds $300,000,000. However, such term does not include any employer from which troubled assets are acquired by the Treasury Department solely through direct purchases (within the meaning of section 113(c) of Title I of the bill). For example, if a firm sells $250,000,000 in assets through an auction system managed by the Treasury Department, and $100,000,000 to the Treasury Department in direct purchases, then the firm is an applicable employer. Conversely, if all $350,000,000 in sales take the form of direct purchases, then the firm would not be an applicable employer.

Unlike section 162(m) , an applicable employer under this provision is not limited to publicly held corporations (or even limited to corporations). For example, an applicable employer could be a partnership if the partnership is an employer from which a troubled asset is acquired. The aggregation rules of Code section 414(b) and (c) apply in determining whether an employer is an applicable employer. However, these rules are applied disregarding the rules for brother-sister controlled groups and combined groups in sections 1563(a)(2) and (3) . Thus, this aggregation rule only applies to parent-subsidiary controlled groups. A similar controlled group rule applies for trades and businesses under common control.

The result of this aggregation rule is that all corporations in the same controlled group are treated as a single employer for purposes of identifying the covered executives of that employer and all compensation from all members of the controlled group are taken into account for purposes of applying the $500,000 deduction limit. Further, all sales of assets under the TARP from all members of the controlled group are considered in determining whether such sales exceed $300,000,000.

An applicable taxable year with respect to an applicable employer means the first taxable year which includes any portion of the period during which the authorities for the TARP established under the bill are in effect (the “authorities period”) if the aggregate amount of troubled assets acquired from the employer under that authority during the taxable year (when added to the aggregate amount so acquired for all preceding taxable years) exceeds $300,000,000, and includes any subsequent taxable year which includes any portion of the authorities period.

A special rule applies in the case of compensation that relates to services that a covered executive performs during an applicable taxable year but that is not deductible until a later year (“deferred deduction executive remuneration”), such as nonqualified deferred compensation. Under the special rule, the unused portion (if any) of the $500,000 limit for the applicable tax year is carried forward until the year in which the compensation is otherwise deductible, and the remaining unused limit is then applied to the compensation.

For example, assume a covered executive is paid $400,000 in cash salary by an applicable employer in 2008 (assuming 2008 is an applicable taxable year) and the covered executive earns $100,000 in nonqualified deferred compensation (along with the right to future earnings credits) payable in 2020. Assume further that the $100,000 has grown to $300,000 in 2020. The full $400,000 in cash salary is deductible under the $500,000 limit in 2008. In 2020, the applicable employer's deduction with respect to the $300,000 will be limited to $100,000 (the lesser of the $300,000 in deductible compensation before considering the special limitation, and $500,000 less $400,000, which represents the unused portion of the $500,000 limit from 2008).

Deferred deduction executive remuneration that is properly deductible in an applicable taxable year (before application of the limitation under the provision) but is attributable to services performed in a prior applicable taxable year is subject to the special rule described above and is not double-counted. For example, assume the same facts as above, except that the nonqualified deferred compensation is deferred until 2009 and that 2009 is an applicable taxable year. The employer's deduction for the nonqualified deferred compensation for 2009 would be limited to $100,000 (as in the example above). The limit that would apply under the provision for executive remuneration that is in a form other than deferred deduction executive remuneration and that is otherwise deductible for 2009 is $500,000. For example, if the covered executive is paid $500,000 in cash compensation for 2009, all $500,000 of that cash compensation would be deductible in 2009 under the provision.

Covered executive

The term covered executive means any individual who is the chief executive officer or the chief financial officer of an applicable employer, or an individual acting in that capacity, at any time during a portion of the taxable year that includes the authorities period. It also includes any employee who is one of the three highest compensated officers of the applicable employer for the applicable taxable year (other than the chief executive officer or the chief financial officer and only taking into account employees employed during any portion of the taxable year that includes the authorities period).

The determination of the three highest compensated officers is made on the basis of the shareholder disclosure rules for compensation under the Exchange Act, except to the extent that the shareholder disclosure rules are inconsistent with the provision. [12]Such shareholder disclosure rules are applied without regard to whether those rules actually apply to the employer under the Exchange Act. If an employee is a covered executive with respect to an applicable employer for any applicable taxable year, the employee will be treated as a covered executive for all subsequent applicable taxable years (and will be treated as a covered executive for purposes of any subsequent taxable year for purposes of the special rule for deferred deduction executive remuneration).

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For example, the shareholder disclosure rules require the reporting of the compensation of the three most highly compensated executive officers (other than the principal executive officer and the principal financial officer) who were serving as executive officers at the end of the last completed fiscal year and up to two additional individuals from whom disclosure would have been provided but for the fact that the individual was not serving as an executive officer at the end of the last completed fiscal year. 17 C.F.R. sec. 229.402(a)(3)(iii), (iv). For purposes of the provision, the term “officer” is intended to mean those “executive officers” whose compensation is subject to reporting under the Exchange Act. Under the provision, however, an individual's status as one of the three most highly compensated officers takes into account only executive officers employed during the authorities period, regardless of whether the individual serves as an executive officer at year end. Additionally, the shareholder disclosure rules measure compensation for purposes of determining “high three” status by reference to total compensation for the last completed fiscal year, and compensation is measured without regard to whether the compensation is includible in an executive officer's gross income. It is intended that this broad measurement of compensation apply for purposes of the provision; however, the measurement period for purposes of the provision is the applicable taxable year for which “high three” status is being determined.

Executive remuneration

The provision generally incorporates the present law definition of applicable employee remuneration. However, the present law exceptions for remuneration payable on commission and performance-based compensation do not apply for purposes of the new $500,000 limit. In addition, the new $500,000 limit only applies to executive remuneration which is attributable to services performed by a covered executive during an applicable taxable year. For example, assume the same facts as in the example above, except that the covered executive also receives in 2008 a payment of $300,000 in nonqualified deferred compensation that was attributable to services performed in 2006. Such payment is not treated as executive remuneration for purposes of the new $500,000 limit.

Other rules

The modification to section 162(m) provides the same coordination rules with disallowed parachute payment and stock compensation of insiders in expatriated corporations as exist under present law section 162(m) . Thus, the $500,000 deduction limit under this section is reduced (but not below zero) by any parachute payments (including parachute payments under the expanded definition under this provision) paid during the authorities period and any payment of the excise tax under section 4985 for stock compensation of insiders in expatriated corporations.

The modification authorizes the Secretary of the Treasury to prescribe such guidance, rules, or regulations as are necessary to carry out the purposes of the $500,000 deduction limit, including the application of the limit in the case of any acquisition, merger, or reorganization of an applicable employer.

Section 280G

The provision also modifies section 280G by expanding the definition of parachute payment in the case of a covered executive of an applicable employer. For this purpose, the terms “covered executive,” “applicable taxable year,” and “applicable employer” have the same meaning as under the modifications to section 162(m) (described above).

Under the modification, a parachute payment means any payments in the nature of compensation to (or for the benefit of) a covered executive made during an applicable taxable year on account of an applicable severance from employment during the authorities period if the aggregate present value of such payments equals or exceeds an amount equal to three times the covered executive's base amount. An applicable severance from employment is any severance from employment of a covered executive (1) by reason of an involuntary termination of the executive by the employer or (2) in connection with a bankruptcy, liquidation, or receivership of the employer.

Whether a payment is on account of the employee's severance from employment is generally determined in the same manner as under present law. Thus, a payment is on account of the employee's severance from employment if the payment would not have been made at that time if the severance from employment had not occurred. Such payments include amounts that are payable upon severance from employment (or separation from service), vest or are no longer subject to a substantial risk of forfeiture on account of such a separation, or are accelerated on account of severance from employment. As under present law, the modified definition of parachute payment does not include amounts paid to a covered executive from certain tax qualified retirement plans.

A parachute payment during an applicable taxable year that is paid on account of a covered executive's applicable severance from employment is nondeductible on the part of the employer (and the covered executive is subject to the section 4999 excise tax) to the extent of the amount of the payment that is equal to the excess over the employee's base amount that is allocable to such payment. For example, assume that a covered executive's annualized includible compensation is $1 million and the covered executive's only parachute payment under the provision is a lump sum payment of $5 million. The covered executive's base amount is $1 million and the excess parachute payment is $4 million.

The modifications to section 280G do not apply in the case of a payment that is treated as a parachute payment under present law. The modifications further authorize the Secretary of Treasury to issue regulations to carry out the purposes of the provision, including the application of the provision in the case of a covered executive who receives payments some of which are treated as parachute payments under present law section 280G and others of which are treated as parachute payments on account of this provision, and the application of the provision in the event of any acquisition, merger, or reorganization of an applicable employer. The regulations shall also prevent the avoidance of the application of the provision through the mischaracterization of a severance from employment as other than an applicable severance from employment. It is intended that the regulations prevent the avoidance of the provision through the acceleration, delay, or other modification of payment dates with respect to existing compensation arrangements.

Effective Date

The provision is effective for taxable years ending on or after date of enactment, except that the modifications to section 280G are effective for payments with respect to severances occurring during the authorities period.