



Section 162(m) Audit Technique Guide

\$1 Million Salary Deduction Limitation

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The taxpayer names and addresses shown in this publication are hypothetical.

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I. Overview

- (1) Internal Revenue Code (IRC) Section 162(m) limits a publicly held corporation's deduction to \$1 million per year for compensation paid to its covered employees.
- (2) The \$1 million annual deduction limit under section 162(m) is only applicable for corporations that are publicly held on the last day of their taxable year. "Covered employees" are the corporation's principal executive officer (PEO) and principal financial officer (PFO), its three highest paid executive officers other than the PEO or PFO and a covered employee of the taxpayer (or any predecessor) for any preceding taxable year beginning after December 31, 2016.
- (3) The American Rescue Plan Act (ARPA) revised the definition of covered employees. For tax years beginning after December 31, 2026, ARPA increased the covered employees by the next five highest compensated employees. The next five compensated employees are determined for each taxable year and could change from year to year.

A. Background / History

- (1) Congress enacted section 162(m) in the Internal Revenue Code as part of the Omnibus Budget Reconciliation Act of 1993, P.L. 103-66. Significant changes were made to section 162(m) effective for tax years beginning after December 31, 2017, by P.L. 115-97, the Tax Cuts and Jobs Act (TCJA). For taxable years beginning prior to January 1, 2018, or for remuneration paid pursuant to a binding written contract in effect on November 2, 2017, that is not modified in any material respect on or after such date, the rules of IRC § 162(m) prior to TCJA's amendment apply.
- (2) The TCJA made significant amendments to §162(m), such as:
 - Expanded the definition of a covered employee.
 - Broadened the definition of a publicly held corporation subject to the limitation.
 - Eliminated the exemption for commissions and qualified performance-based executive compensation but included a transition rule applicable to certain outstanding compensatory arrangements (commonly referred to as the grandfather rule)
 - Eliminated the initial public offering (IPO) transition rule for private companies that become publicly traded.
- (3) Prior to TCJA, a common exception to the \$1 million deduction limitation was for performance-based compensation. This exception generally was the primary focus of the examination. IRC § 162(m)(4)(C) and Treasury Regulation § (Treas. Reg.) 1.162-27(e)(2) through (e)(5) contain these rules. The

performance-based compensation exception under prior law may still be applicable because TCJA includes a transition rule which grandfathers some incentive plans if they so qualify.

- (4) This guide is intended to be used for evaluation of post-TCJA tax years. For pre-TCJA tax years, refer to section 162(m) in effect prior to TCJA's amendments and Treas. Reg. § 1.162-27.

B. Relevant Terms

B.1. Publicly Held Corporation

- (1) Effective for taxable years beginning after December 31, 2017, a "publicly held corporation" means, under section 162(m)(2), any corporation which is either:
 - An issuer (as defined in Section 3 of the Securities Exchange Act of 1934, as amended (Exchange Act) of securities that are required to be registered under Section 12 of the Exchange Act or
 - An issuer that is required to file reports under Section 15(d) of the Exchange Act.
- (2) For taxable years beginning prior to January 1, 2018, publicly held corporations are defined in accordance with the rules in § 1.162-27(c)(1).

B.2. Covered Employee

- (1) Effective for taxable years beginning after December 31, 2017, a "covered employee" means, under section 162(m)(3), any employee of the taxpayer who:
 - Is the principal executive officer (PEO) or principal financial officer (PFO) of the taxpayer at any time during the taxable year (or was an individual acting in such a capacity).
 - The three highest compensated executive officers of the publicly held corporation for the taxable year (other than the principal executive officer or principal financial officer, or an individual acting in such capacity), regardless of whether the executive officer is serving at the end of the publicly held corporation's taxable year, and regardless of whether the executive officer's compensation is subject to disclosure for the last completed fiscal year under the executive compensation disclosure rules under the Exchange Act.
 - Was a covered employee of the taxpayer (or any predecessor) for any taxable year beginning after December 31, 2016.
- (2) For taxable years beginning prior to January 1, 2018, covered employees are identified in accordance with the rules in § 1.162-27(c)(2).

B.3. Applicable Employee Remuneration

- (1) Compensation for section 162(m) purposes, as defined in 162(m)(4), is the aggregate amount paid to the executive:
 - For services performed by a covered employee in any capacity.
 - Allowable as a deduction to the publicly held corporation under chapter 1 of the Internal Revenue Code for the taxable year (determined without regard to the \$1 million limit imposed by Section 162(m)).
 - Regardless of whether the services were performed during the taxable year.
- (2) Prior to the TCJA amendments, applicable employee remuneration did not include remuneration payable on a commission basis (as defined in the pre-TCJA version of IRC §162(m)(4)(B)) or qualified performance-based compensation (as defined in the pre-TCJA version described in IRC §162(m)(4)(C)).
- (3) The TCJA includes a transition rule for written binding contracts that were in effect on November 2, 2017. Therefore, the performance-based compensation exception may still apply for compensation paid pursuant to certain arrangements in tax years beginning after December 31, 2017. Arrangements that qualify under the transition rule can continue to operate in the same manner, and compensation will continue to qualify as performance-based compensation, if the arrangement is not materially modified and the requirements of the exception are met. Notice 2018-68 discusses these and other transition rules in greater detail.

B.4. Transition Rule

- (1) The TCJA provides for transition relief, meaning, the amendments to IRC §162(m) shall not apply to remuneration which is paid pursuant to a written binding contract which was in effect on [or before] November 2, 2017, and which was not modified in any material respect on or after such date.

B.5. Negative Discretion

- (1) Compensation may only be grandfathered to the extent that as of November 2, 2017, the corporation was and remains obligated under applicable law (for example, state contract law) to pay the compensation under the contract if the employee performs services or satisfies the applicable vesting conditions. Meaning, if a corporation retained negative discretion, that is, the legal right not to pay all or a portion of the compensation under an arrangement or plan, those amounts would not be eligible to be grandfathered.

B.6. Material Modification

- (1) The transition rule which grandfathers some incentive plans requires that compensation must be payable pursuant to a written binding contract that was

in effect on November 2, 2017, that is not materially modified on or after that date.

- (2) If a written binding contract is modified on or after November 2, 2017, the plan no longer qualifies for grandfathering. A “material modification” occurs when a written binding contract is amended or modified to:
- Increase the amount of compensation payable to the employee.
 - Accelerate the payment of compensation unless the amount of compensation paid is discounted to reasonably reflect the time value of money.
 - Defer the payment of compensation, unless the amount of compensation paid or to be paid at a later date that is in excess of the amount originally payable to the employee under the contract is based on either: (1) a reasonable rate of interest, or (2) an actual rate of return on a predetermined actual investment, including any decrease, as well as any increase, in the value of the investment (whether or not assets associated with the amount originally owed are actually invested therein).

B.7. Qualified Performance-Based Compensation

- (1) Qualified performance-based compensation which is payable under a written binding contract that was in effect on November 2, 2017, and that is not modified in any material respect on or after that date is not included in applicable employee remuneration subject to section 162(m). Qualified performance-based compensation is compensation that meets all the following requirements:
- Compensation must be paid solely on account of the attainment of one or more preestablished, objective performance goals.
 - The performance goal under which the compensation is paid must be established by a compensation committee comprised solely of two or more outside directors.
 - The material terms of the performance goal under which the compensation is to be paid must be disclosed to and subsequently approved by the shareholders of the publicly held corporation before the compensation is paid.
 - The compensation committee must certify in writing prior to payment of the compensation that the performance goals and any other material terms were in fact satisfied.

C. Law/Authority

- P.L. 115-97, The Tax Cut and Jobs Act, effective December 22, 2017

- Notice 2018–68, Guidance on the Application of Section 162(m), applicable for any taxable year ending on or after September 10, 2018
- IRC § 162, Trade or business expenses, effective December 22, 2017, to March 10, 2021, and March 11, 2021 (Current)
- Proposed Regulations (REG-122180-18), (84 FR 70356), Proposed amendments to the Income Tax Regulations (26 CFR part 1) under section 162(m), published December 20, 2019
- Treas. Reg. § 1.162-27, Certain employee remuneration in excess of \$1,000,000 not deductible for taxable years beginning on or after January 1, 1994, and for taxable years beginning prior to January 1, 2018
- Treas. Reg. § 1.162-33, Certain employee remuneration in excess of \$1,000,000 not deductible for taxable years beginning after December 31, 2017, effective December 30, 2020

II. \$1 Million Annual Deduction Limitation for Applicable Executive Compensation of Publicly Held Corporations Under Section 162(m)

A. Description of Issue

- (1) Section 162(m)(1) disallows a deduction by any publicly held corporation for applicable employee remuneration paid or otherwise deductible with respect to any covered employee to the extent that such remuneration for the taxable year exceeds \$1,000,000.
- (2) The \$1 million deduction limitation is only applicable to publicly held corporations. In most instances, a corporation's publicly held status is clear however, sometimes this determination can be complicated. An evaluation of the Securities Exchange Act of 1934 and Treas. Reg. Section 1.162-33(c)(1) may be required to arrive at the correct classification.
- (3) If the corporation is publicly held only its "covered employees" are subject to the \$1 million deduction limitation. Covered employees are the corporation's principal executive officer and principal financial officer, its three highest paid executive officers other than the PEO or PFO and a covered employee of the taxpayer (or any predecessor) for any preceding taxable year beginning after December 31, 2016. For tax years beginning after December 31, 2026, ARPA increased the covered employees by the next five highest compensated employees.
- (4) The TCJA expanded the definition of covered employees to include any individual who was a covered employee for any taxable year beginning after Dec. 31, 2016. Therefore, any individual who was a covered employee for a publicly held corporation's tax year beginning after December 31, 2016, will forever be a covered employee of that corporation. Under prior law, covered

employees would change from year to year depending on their status on the last day of the corporation's taxable year.

- (5) After the proper identification of the publicly held corporation's covered employees, the "applicable employee remuneration" for each must be ascertained to properly apply the \$1 million deduction limitation. Employee remuneration is all compensation paid for services of a covered employee that would otherwise be deductible for the tax year, regardless of whether the services were performed during that year.
- (6) Prior to the TCJA, applicable employee remuneration did not include remuneration payable on a commission basis or qualified performance-based compensation. The TCJA and the new subsequent section 162(m) rules provide transition relief for compensation payable pursuant to a written binding contract that was in effect on November 2, 2017, and not materially modified on or after that date. Therefore, for certain compensation arrangements which qualify as grandfathered, the arrangement must then be evaluated under section 162(m), that was in effect prior to TCJA's amendments to determine if the compensation should properly be excluded from applicable employee remuneration.

III. Corporations Subject to Section 162(m)

A. Publicly Held Corporation

- (1) A "publicly held corporation" means any corporation that issues securities required to be registered under the Securities Exchange Act of 1934 (Exchange Act) or that is required to file reports under section 15(d) of the Exchange Act. In addition, a publicly held corporation means any S corporation that issues securities that are required to be registered under section 12(b) of the Exchange Act, or that is required to file reports under section 15(d) of the Exchange Act.
- (2) Whether a corporation is publicly held is determined based solely on if, as of the last day of its taxable year, the securities issued by the corporation are required to be registered under section 12 of the Exchange Act or the corporation is required to file reports under section 15(d) of the Exchange Act.
- (3) A publicly traded partnership that is treated as a corporation under section 7704 (or otherwise) is a publicly held corporation if, as of the last day of its taxable year, its securities are required to be registered under section 12 of the Exchange Act or it is required to file reports under section 15(d) of the Exchange Act.
- (4) A publicly held corporation includes an affiliated group of corporations, as defined in section 1504 (determined without regard to section 1504(b)), that includes one or more publicly held corporations. In the case of an affiliated group that includes two or more publicly held corporations, each member of the affiliated group that is a publicly held corporation is separately subject to section 162(m), and, due to having at least one member that is a publicly held

corporation, the affiliated group as a whole is subject to section 162(m). If an individual is a covered employee of both subsidiaries, each subsidiary has its own \$1 million deduction limitation with respect to that covered employee. Furthermore, each subsidiary has its own set of covered employees.

- (5) If, in a taxable year, a covered employee of one member of an affiliated group is paid compensation by more than one member of the affiliated group, compensation paid by each member of the affiliated group is aggregated with compensation paid to the covered employee by all other members of the affiliated group, excluding compensation paid by any other publicly held corporation in the affiliated group of which the individual is also a covered employee. The amount disallowed as a deduction is determined separately with respect to each publicly held corporation of which the individual is a covered employee. Any amount disallowed as a deduction by Section 162(m) must be prorated among the payor corporations.
- (6) A publicly held corporation includes a corporation that owns an entity that is disregarded as an entity separate from its owner within the meaning of § 301.7701-2(c)(2)(i) if the disregarded entity issues securities required to be registered under section 12(b) of the Exchange Act or is required to file reports under section 15(d) of the Exchange Act.
- (7) A publicly held corporation includes an S corporation that owns a qualified subchapter S subsidiary as defined in section 1361(b)(3)(B) (QSub) if the QSub issues securities required to be registered under section 12(b) of the Exchange Act or is required to file reports under section 15(d) of the Exchange Act.
- (8) A publicly held corporation includes a real estate investment trust as defined in section 856(a) that owns a qualified real estate investment trust subsidiary as defined in section 856(i)(2) (QRS), if the QRS issues securities required to be registered under section 12(b) of the Exchange Act or is required to file reports under section 15(d) of the Exchange Act.

A.1. Law / Authority related to Publicly Held Corporation

- (1) IRC § 162(m)(2) definition of publicly held corporation
- (2) Treas. Reg. § 1.162-33(c)(1)(i) General rule
- (3) Treas. Reg. § 1.162-33(c)(1)(ii) Affiliated groups
- (4) Treas. Reg. § 1.162-33(c)(1)(iii) Disregarded entities
- (5) Treas. Reg. § 1.162-33(c)(1)(iv) Qualified Subchapter S subsidiaries
- (6) Treas. Reg. § 1.162-33(c)(1)(v) Qualified real estate investment trust subsidiaries

IV. Audit Considerations

A. Covered Employees

- (1) If a corporation is publicly held, correctly identifying their covered employees is a critical component to determine whether the \$1 million deduction limitation was properly applied under section 162(m).
- (2) A covered employee means any of the following:
 - The principal executive officer or principal financial officer of the publicly held corporation serving at any time during the taxable year, including individuals acting in either such capacity.
 - The three highest compensated executive officers of the publicly held corporation for the taxable year (other than the principal executive officer or principal financial officer, or an individual acting in such capacity), regardless of whether the executive officer is serving at the end of the publicly held corporation's taxable year, and regardless of whether the executive officer's compensation is subject to disclosure for the last completed fiscal year under the executive compensation disclosure rules under the Exchange Act. The amount of compensation used to identify the three most highly compensated executive officers for the taxable year is determined pursuant to the executive compensation disclosure rules under the Exchange Act.
 - In the case of taxable years beginning after December 31, 2026, such employee is among the 5 highest compensated employees for the taxable year other than any individual described in subparagraph (A) or (B), or
 - Any individual who was a covered employee of the publicly held corporation, or any predecessor of a publicly held corporation, as described in (A) or (B), for any preceding taxable year beginning after December 31, 2016. For taxable years beginning prior to January 1, 2018, covered employees are identified in accordance with the rules in § 1.162–27(c)(2).
- (3) A predecessor of a publicly held corporation includes a publicly held corporation that, after becoming a privately held corporation, again becomes a publicly held corporation for a taxable year ending before the 36-month anniversary of the due date for the corporation's U.S. Federal income tax return (disregarding any extensions) for the last taxable year for which the corporation was previously publicly held.
- (4) If a publicly held corporation owns an entity that is disregarded as an entity separate from its owner under IRC § 301.7701–2(c)(2)(i), the executive officers of the entity that is disregarded are neither covered employees of the entity nor of the publicly held corporation unless they meet the definition of covered employee with respect to the publicly held corporation, in which case they are covered employees for its taxable year.
- (5) If a publicly held corporation owns an entity that is a QSub under section 1361(b)(3)(B), The executive officers of the QSub are neither covered employees of the QSub nor of the publicly held corporation unless they meet

the definition of covered employee with respect to the publicly held corporation, in which case they are covered employees for the taxable year of the publicly held corporation.

- (6) A person who is identified as a covered employee for a publicly held corporation's taxable year is also a covered employee for the taxable year of an affiliated group treated as a publicly held corporation.

A.1. Law / Authority Related to Covered Employee

- (1) IRC § 162(m)(3) definition of covered employee
- (2) Treas. Reg. § 1.162-33(c)(2)(i) General rule
- (3) Treas. Reg. § 1.162-33(c)(2)(ii) Predecessor of a publicly held corporation.
- (4) Treas. Reg. § 1.162-33(c)(2)(iii) Disregarded entities
- (5) Treas. Reg. § 1.162-33(c)(2)(iv) Qualified Subchapter S subsidiaries
- (6) Treas. Reg. § 1.162-33(c)(2)(v) Qualified real estate investment trust subsidiaries
- (7) Treas. Reg. § 1.162-33(c)(2)(vi) Covered employee of an affiliated group.

B. Qualified Performance Based Compensation

- (1) Examiners should verify amounts deducted in excess of \$1 million for covered employees of a publicly held corporation were appropriate. The TCJA eliminated the exemption for qualified performance-based executive compensation but included a transition rule applicable to certain outstanding compensatory arrangements. Therefore, the performance-based compensation exception may still apply for compensation paid pursuant to certain arrangements in tax years beginning after December 31, 2017.
- (2) Applicable employee remuneration subject to IRC § 162(m) does not include compensation payable pursuant to a written binding contract that was in effect on November 2, 2017, and that it is not modified in any material respect on or after that date, which meets all of the requirements for qualified performance-based compensation in paragraphs (e)(2) through (e)(5) of Treas. Reg. § 1.162-27 (grandfathered amount).

B.1. Performance Goal Requirement

- (1) Qualified performance-based compensation must meet the performance goal requirement in Treas. Reg. § 1.162-27(e)(2). To meet this requirement, the qualified performance-based compensation must be paid solely on account of the attainment of one or more preestablished, objective performance goals. A performance goal is considered preestablished if it is established in writing by the compensation committee not later than 90 days after the commencement of the period of service to which the performance goal relates, provided that the

outcome is substantially uncertain at the time the compensation committee actually establishes the goal. Performance goals can be based on one or more business criteria that apply to the individual, a business unit, or the corporation as a whole.

- (2) A performance goal does not include the mere continued employment of the covered employee. In addition, compensation does not satisfy the performance goal requirement if the facts and circumstances indicate that the employee would receive all or part of the compensation regardless of whether the performance goal is attained.
- (3) A preestablished performance goal must state, in terms of an objective formula or standard, the method for computing the amount of compensation payable to the employee if the goal is attained.
- (4) The terms of an objective formula or standard must preclude discretion to increase the amount of compensation payable that would otherwise be due upon attainment of the goal. A performance goal is not discretionary merely because the compensation committee reduces or eliminates the compensation or other economic benefit that was due upon attainment of the goal. However, the exercise of negative discretion with respect to one employee is not permitted to result in an increase in the amount payable to another employee.
- (5) Compensation attributable to a stock option or a stock appreciation right is deemed to satisfy the performance goal requirement if the grant or award is made by the compensation committee; the plan under which the option or right is granted states the maximum number of shares with respect to which options or rights may be granted during a specified period to any individual employee; and, under the terms of the option or right, the amount of compensation the employee may receive is based solely on an increase in the value of the stock after the date of the grant or award. If the amount of compensation the employee may receive under the grant or award is not based solely on an increase in the value of the stock after the date of grant or award (for example, in the case of restricted stock, or an option that is granted with an exercise price that is less than the fair market value of the stock as of the date of grant), none of the compensation attributable to the grant or award is qualified performance-based compensation.
- (6) The determination of whether compensation attributable to a stock option or stock appreciation right is deemed to satisfy the performance goal requirement shall be made on a grant-by-grant basis without regard to the terms of any other option grant, or other grant of compensation, to the same or another employee.
- (7) Compensation attributable to a stock option, stock appreciation right, or other stock-based compensation does not fail to satisfy the performance goal requirement to the extent that a change in the grant or award is made to reflect a change in corporate capitalization, such as a stock split or dividend, merger, any reorganization or any partial or complete liquidation.

- (8) Compensation attributable to a stock option or stock appreciation right does not satisfy the performance goal requirement to the extent that the number of options granted exceeds the maximum number of shares for which options may be granted to the employee as specified in the plan.

B.2. Outside Directors Requirement

- (1) Qualified performance-based compensation must meet the outside directors requirement in Treas. Reg. § 1.162-27(e)(3). To meet this requirement, the performance goal under which compensation is paid must be established by a compensation committee comprised solely of two or more outside directors. A director is an outside director if the director-
- Is not a current employee of the publicly held corporation;
 - Is not a former employee of the publicly held corporation who receives compensation for prior services (other than benefits under a tax-qualified retirement plan) during the taxable year;
 - Has not been an officer of the publicly held corporation; and
 - Does not receive remuneration from the publicly held corporation, either directly or indirectly, in any capacity other than as a director. For this purpose, remuneration includes any payment in exchange for goods or services.
- (2) Remuneration is received, directly or indirectly, by a director in each of the following circumstances:
- If remuneration is paid, directly or indirectly, to the director personally or to an entity in which the director has a beneficial ownership interest of greater than 50 percent.
 - If remuneration, other than de minimis remuneration, was paid by the publicly held corporation in its preceding taxable year to an entity in which the director has a beneficial ownership interest of at least 5 percent but not more than 50 percent.
 - If remuneration, other than de minimis remuneration, was paid by the publicly held corporation in its preceding taxable year to an entity by which the director is employed or self-employed other than as a director.
- (3) Whether a director is an employee, or a former officer is determined on the basis of the facts at the time that the individual is serving as a director on the compensation committee. Thus, a director is not precluded from being an outside director solely because the director is a former officer of a corporation that previously was an affiliated corporation of the publicly held corporation. However, an outside director would no longer be an outside director if a corporation in which the director was previously an officer became an affiliated corporation of the publicly held corporation.

- (4) Officer means an administrative executive who is or was in regular and continued service. The term implies continuity of service and excludes those employed for a special and single transaction. An individual who merely has (or had) the title of officer but not the authority of an officer is not considered an officer. The determination of whether an individual is or was an officer is based on all the facts and circumstances in the particular case.

B.3. Shareholder Approval Requirement

- (1) Qualified performance-based compensation must meet the shareholder approval requirement in Treas. Reg. § 1.162-27(e)(4). The material terms of the performance goal under which the compensation is to be paid must be disclosed to, and subsequently, approved by the shareholders of the publicly held corporation before the compensation is paid. These requirements are not satisfied if the compensation would be paid regardless of whether the material terms are approved by shareholders. The material terms include the employees eligible to receive compensation; a description of the business criteria on which the performance goal is based; and either the maximum amount of compensation that could be paid to any employee or the formula used to calculate the amount of compensation to be paid to the employee if the performance goal is attained.
- (2) Disclosure of the employees eligible to receive compensation need not be so specific as to identify the particular individuals by name. A general description of the class of eligible employees by title or class is sufficient.
- (3) Disclosure of the business criteria on which the performance goal is based need not include the specific targets that must be satisfied under the performance goal. In the case of a plan under which employees may be granted stock options or stock appreciation rights, no specific description of the business criteria is required if the grants or awards are based on a stock price that is no less than current fair market value.
- (4) Disclosure may be satisfied even though information that otherwise would be a material term of a performance goal is not disclosed to shareholders, provided that the compensation committee determines that the information is confidential commercial or business information, the disclosure of which would have an adverse effect on the publicly held corporation. The ability not to disclose confidential information does not eliminate the requirement that disclosure be made of the maximum amount of compensation that is payable to an individual under a performance goal. Confidential information does not include the identity of an executive or the class of executives to which a performance goal applies or the amount of compensation that is payable if the goal is satisfied.
- (5) Disclosure as to the compensation payable under a performance goal must be specific enough so that shareholders can determine the maximum amount of compensation that could be paid to any individual employee during a specified period.

- (6) The material terms of a performance goal are approved by shareholders if, in a separate vote, a majority of the votes cast on the issue (including abstentions to the extent abstentions are counted as voting under applicable state law) are cast in favor of approval. Once the material terms of a performance goal are disclosed to and approved by shareholders, no additional disclosure or approval is required unless the compensation committee changes the material terms of the performance goal.

B.4. Compensation Committee Certification Requirement

- (1) Qualified performance-based compensation must meet the compensation committee certification requirement in Treas. Reg. § 1.162-27(e)(5). The compensation committee must certify in writing prior to payment of the compensation that the performance goals and any other material terms were in fact satisfied. For this purpose, approved minutes of the compensation committee meeting in which the certification is made are treated as a written certification. Certification by the compensation committee is not required for compensation that is attributable solely to the increase in the value of the stock of the publicly held corporation.

B.5. Law / Authority Related to Performance Based Compensation

- (1) Treas. Reg. § 1.162-27(e)(1) General rule
- (2) Treas. Reg. § 1.162-27(e)(2) Performance goal requirement
- (3) Treas. Reg. § 1.162-27(e)(3) Outside directors
- (4) Treas. Reg. § 1.162-27(e)(4) Shareholder approval requirement
- (5) Treas. Reg. § 1.162-27(e)(5) Compensation committee certification

C. Transition Rules

- (1) Compensation payable under a written binding contract that was in effect on November 2, 2017, and that is not modified in any material respect on or after that date, is a grandfathered amount subject to the pre-TCJA rules under Treas. Reg. § 1.162-27.
- (2) Compensation is a grandfathered amount only to the extent that as of November 2, 2017, the corporation was and remains obligated under applicable law (for example, state contract law) to pay the compensation under the contract if the employee performs services or satisfies the applicable vesting conditions.

C.1. Contracts That Are Terminable or Cancelable

- (1) If a written binding contract is renewed after November 2, 2017, Treas. Reg. § 1.162-33, and not Treas. Reg. § 1.162-27 applies to any payments made after the renewal. A written binding contract that is terminable or cancelable by the

corporation without the employee's consent after November 2, 2017, is treated as renewed as of the earliest date that any such termination or cancellation, if made, would be effective.

- (2) If the corporation will remain legally obligated by the terms of a contract beyond a certain date at the sole discretion of the employee, the contract will not be treated as renewed as of that date if the employee exercises the discretion to keep the corporation bound to the contract.
- (3) A contract is not treated as terminable or cancelable if it can be terminated or canceled only by terminating the employment relationship of the employee.
- (4) A contract is not treated as renewed if upon termination or cancellation of the contract the employment relationship continues but would no longer be covered by the contract. However, if the employment continues after the termination or cancellation, payments with respect to the post-termination or post-cancellation employment are not made pursuant to the contract (and, therefore, are not grandfathered amounts).

C.2. Compensation Payable Under a Plan or Arrangement

- (1) If a compensation plan or arrangement is a written binding contract in effect on November 2, 2017, the deduction for the amount that the corporation is obligated to pay to an employee pursuant to the plan or arrangement is not subject to Treas. Reg. § 1.162-33 solely because the employee was not eligible to participate in the plan or arrangement as of November 2, 2017, provided the employee was employed on November 2, 2017, by the corporation that maintained the plan or arrangement, or the employee had the right to participate in the plan or arrangement under a written binding contract as of that date.

C.3. Compensation Subject to Recovery by Corporation

- (1) If the corporation is obligated or has discretion to recover compensation paid in a taxable year only upon the future occurrence of a condition that is objectively outside of the corporation's control, then the corporation's right to recovery is disregarded for purposes of determining the grandfathered amount for the taxable year. Whether or not the corporation exercises its discretion to recover any compensation does not affect the amount of compensation that the corporation remains obligated to pay under applicable law.

C.4. Compensation Payable from an Account Balance Plan

- (1) Except as otherwise provided in Treas. Reg. § 1.162-33(g), the grandfathered amount of payments from an account balance plan (as defined in § 1.409A-1(c)(2)(i)(A)) that is a written binding contract in effect as of November 2, 2017, is the amount that the corporation is obligated to pay pursuant to the terms of

the account balance plan in effect as of that date, as determined under applicable law.

- (2) If under the terms of the account balance plan in effect as of November 2, 2017, the corporation may terminate the contract and distribute the account balance to the employee, then the grandfathered amount would be the account balance determined as if the corporation had terminated the plan on November 2, 2017 or, if later, the earliest possible date the plan could be terminated in accordance with the terms of the plan (termination date).
- (3) If under the terms of the account balance plan in effect as of November 2, 2017, the corporation has no right to terminate the plan, but may discontinue future contributions and distribute the account balance in accordance with the terms of the plan, then the grandfathered amount would be the account balance determined as if the corporation had exercised the right to discontinue contributions on November 2, 2017, or, if later, the earliest permissible date the corporation could exercise that right in accordance with the terms of the plan (the freeze date).

C.5. Compensation Payable from a Non-account Balance Plan

- (1) Except as otherwise provided Treas. Reg. § 1.162-33(g), the grandfathered amount of payments from a non-account balance plan (as defined in § 1.409A-1(c)(2)(i)(C)) that is a written binding contract in effect as of November 2, 2017, is the amount that the corporation is obligated to pay pursuant to the terms of the non-account balance plan in effect as of that date, as determined under applicable law.
- (2) If under the terms of the non-account balance plan in effect as of November 2, 2017, the corporation may terminate the plan and distribute the total benefit to the employee, then the grandfathered amount would be the present value of the total benefit (lump sum value) determined as if the corporation had terminated the plan on November 2, 2017 or, if later, the earliest possible date the plan could be terminated in accordance with the terms of the plan (termination date).
- (3) Whether an increase or decrease in the lump sum value after the termination date, through the earliest possible date the lump sum value could have been distributed to the employee, is grandfathered depends on whether the terms of the plan require the corporation to increase or decrease the lump sum value through the distribution date.
- (4) The determination of the lump sum value may not take into account the likelihood that payments will not be made (or will be reduced) because of the unfunded status of the plan, the risk that the employer, the trustee, or another party will be unwilling or unable to pay, the possibility of future plan amendments, the possibility of a future change in the law, or similar risks or contingencies.

- (5) If under the terms of the non-account balance plan in effect as of November 2, 2017, the corporation has no right to terminate the plan, but may discontinue future accruals of benefits and distribute the benefit in accordance with the terms of the plan, then the grandfathered amount would be the lump sum value of the total benefit (lump sum value) determined as if the corporation had exercised the right to discontinue the future accrual of benefits on November 2, 2017, or, if later, the earliest permissible date the corporation could exercise such right in accordance with the terms of the plan (the freeze date).

C.6. Grandfathered Amount Limited to a Particular Plan or Arrangement

- (1) The grandfathered amount under a plan or arrangement applies solely to the amounts paid under that plan or arrangement, so that regardless of whether all of the grandfathered amount is paid to the participant (for example, regardless of whether some or all of the grandfathered amount under the plan is forfeited under the terms of the plan), no portion of that grandfathered amount may be treated as a grandfathered amount under any other separate plan or arrangement in which the employee is a participant.

C.7. Ordering Rule

- (1) If a portion of the amount payable under a plan or arrangement is a grandfathered amount and a portion is subject to Treas. Reg. § 1.162-33, and payment under the plan or arrangement is made in a series of payments (including payments as a life annuity), the grandfathered amount is allocated to the first payment of an amount under the plan or arrangement that is otherwise deductible. If the grandfathered amount exceeds the initial payment, the excess is allocated to the next payment of an amount under the plan or arrangement that is otherwise deductible, and this process is repeated until the entire grandfathered amount has been paid.

C.8. Material Modifications

- (1) If a written binding contract is modified on or after November 2, 2017, Treas. Reg. § 1.162-33 (and not Treas. Reg. § 1.162-27) applies to any payments made after the modification. A material modification occurs when the contract is amended to increase the amount of compensation payable to the employee. If a written binding contract is materially modified, it is treated as a new contract entered into as of the date of the material modification. Thus, amounts received by an employee under the contract before a material modification are not affected, but amounts received subsequent to the material modification are treated as paid pursuant to a new contract, rather than as paid pursuant to a written binding contract in effect on November 2, 2017.
- (2) A modification of the contract that accelerates the payment of compensation is a material modification unless the amount of compensation paid is discounted

to reasonably reflect the time value of money. If the contract is modified to defer the payment of compensation, any compensation paid or to be paid that is in excess of the amount that was originally payable to the employee under the contract will not be treated as resulting in a material modification if the additional amount is based on applying to the amount originally payable either a reasonable rate of interest or the rate of return on a predetermined actual investment as defined in IRC § 31.3121(v)(2)–1(d)(2)(i)(B).

- (3) If compensation attributable to an option to purchase stock (other than an incentive stock option described in IRC § 422 or a stock option granted under an employee stock purchase plan described in IRC § 423) or a stock appreciation right is grandfathered, an extension of the exercise period that is extended in compliance with IRC § 1.409A–1(b)(5)(v)(C)(1) will not be treated as a material modification and the amount of compensation paid upon the exercise of the stock option or stock appreciation right will be grandfathered.
- (4) The adoption of a supplemental contract or agreement that provides for increased compensation, or the payment of additional compensation, is a material modification of a written binding contract if the facts and circumstances demonstrate that the additional compensation to be paid is based on substantially the same elements or conditions as the compensation that is otherwise paid pursuant to the written binding contract. However, a material modification of a written binding contract does not include a supplemental payment that is equal to or less than a reasonable cost-of-living increase over the payment made in the preceding year under that written binding contract.
- (5) If a grandfathered amount is subject to a substantial risk of forfeiture (as defined in IRC § 1.409A–1(d)), then a modification of the contract that results in a lapse of the substantial risk of forfeiture is not considered a material modification.

C.9. Law / Authority Related to Transition Rules

- (1) Treas. Reg. § 1.162-33(g)(1)(i) General rule
- (2) Treas. Reg. § 1.162-33(g)(1)(ii) Contracts that are terminable or cancelable
- (3) Treas. Reg. § 1.162-33(g)(1)(iii) Compensation payable under a plan or arrangement
- (4) Treas. Reg. § 1.162-33(g)(1)(iv) Compensation subject to recovery by corporation
- (5) Treas. Reg. § 1.162-33(g)(1)(v) Compensation payable from an account balance plan
- (6) Treas. Reg. § 1.162-33(g)(1)(vi) Compensation payable from a non-account balance plan
- (7) Treas. Reg. § 1.162-33(g)(1)(vii) Grandfathered amount limited to a particular plan or arrangement

- (8) Treas. Reg. § 1.162-33(g)(1)(viii) Ordering rule
- (9) Treas. Reg. § 1.162-33(g)(2) material modifications

V. Examination Techniques

A. Overview

- (1) The annual \$1 million compensation deduction limitation under IRC § 162(m) is only applicable to publicly held corporations, therefore, the determination of a corporation's status as publicly held should be evaluated first. If the corporation is publicly held, then correctly identifying all the corporation's covered employees subject to the limitation should be the second step. Lastly, the applicable employee remuneration paid to each covered employee should be examined to verify the correct amount of compensation was properly subjected to the limitation under section 162(m).

B. Publicly Held

- (1) Since IRC § 162(m) only applies to corporations that are publicly held, the first step is to determine whether the corporation is publicly held as defined by IRC § 162(m)(2) and Treas. Reg. § 1.162-33(c)(1). There may be no doubt that a subchapter C corporation traded on a major stock exchange is a publicly held corporation for purposes of IRC § 162(m) but for other corporations, further examination may be required.
- (2) The key in determining whether a corporation is publicly held is whether it issues securities required to be registered under section 12 of the Securities Exchange Act of 1934 or whether it is required to file reports under section 15(d) of the Exchange Act. A corporation that issues securities under section 12 of the Exchange Act or files reports under section 15(d) of the Exchange Act is NOT a publicly held corporation for purposes of IRC § 162(m) if it is not required to do so. Hence, sections 12 and 15(d) of the Exchange Act may need to be studied to determine if the corporation is required to register securities or file reports, respectively.
- (3) Sections 12 and 15(d) of the Exchange Act include provisions that corporations with a modest amount of total assets or a limited number of owners are not required to issue securities or file reports, respectively. For example, Section 12(g)(1) of the Exchange Act provides, in part:
- (4) (g)(1) Every issuer which is engaged in interstate commerce, or in a business affecting interstate commerce, or whose securities are traded by use of the mails, or any means or instrumentality of interstate commerce shall—
 - within 120 days after the last day of its first fiscal year ended on which the issuer has total assets exceeding \$10,000,000 and a class of equity security (other than an exempted security) held of record by either—

- 2,000 persons, or
 - 500 persons who are not accredited investors (as such term is defined by the Commission), and
 - in the case of an issuer that is a bank, a savings and loan holding company (as defined in section 10 of the Home Owners' Loan Act), or a bank holding company, as such term is defined in section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841), not later than 120 days after the last day of its first fiscal year ended after the effective date of this subsection, on which the issuer has total assets exceeding \$10,000,000 and a class of equity security (other than an exempted security) held of record by 2,000 or more persons, register such security by filing with the Commission a registration statement...
- (5) Likewise, Section 15(d) of the Exchange Act provides, in part: "...The duty to file under this subsection shall also be automatically suspended as to any fiscal year, other than the fiscal year within which such registration statement became effective, if, at the beginning of such fiscal year, the securities of each class, other than any class of asset-backed securities, to which the registration statement relates are held of record by less than 300 persons, or, in the case of a bank, a savings and loan holding company (as defined in section 10 of the Home Owners' Loan Act), or a bank holding company, as such term is defined in section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841), 1,200 persons..."
- (6) Some foreign corporations issue American Depositary Receipts ("ADRs") that are traded in the over-the-counter market through depository banks. If the foreign corporation qualifies for an exemption from registration of its securities under section 12(g) of the Exchange Act pursuant to 17 CFR 240.12g3-2(b) (Rule 12g3-2(b) under the Exchange Act), it may not qualify as a publicly held corporation under IRC § 162(m) even though the depository bank is required to register the ADRs under the Securities Act.
- (7) Sections 12 and 15(d) of the Exchange Act should be thoroughly reviewed if there is any doubt as to whether a corporation issues securities required to be registered under section 12 or whether the entity is required to file reports under section 15(d).
- (8) The determination of whether an entity is publicly held for purposes of IRC § 162(m) is always made on the last day of its taxable year.

C. Covered Employees

- (1) Covered employees include the taxpayer's principle executive officers (PEOs), principle financial officers (PFOs), three highest compensated executive officers, all the former for any preceding taxable years beginning after December 31, 2016, and for taxable years beginning after December 31, 2026, the five highest compensated employees who are not PEOs, PFOs or included

in the three highest compensated executive officers. Note that the five highest compensated employees who are not PEO's, PFOs or included in the three highest compensated executive officers must be separately determined for each taxable year beginning after December 31, 2016, and do not carry over as covered employees in subsequent taxable years.

- (2) Since the covered employees include all people who were covered employees in taxable years beginning after December 31, 2016, the number of covered employees will increase every tax year. The audit risk is that the taxpayer's computation of its adjustment under IRC § 162(m) will not include all its covered employees who received applicable employee remuneration.
- (3) It is quite plausible that a taxpayer could inadvertently exclude covered employees from its computation under IRC § 162(m). For example, covered employees include all PEOs and PFOs at any time during the taxable year or any individual acting in such capacity. Hence, there could be more than one PEO or PFO during the taxable year due to personnel changes, acquisitions, retirements, et. or individuals acting in such capacity, such as on a temporary basis. Applicable employee remuneration received by a covered employee is still subject to IRC § 162(m) even if the covered employee is no longer employed by the taxpayer. In addition, applicable employee remuneration is subject to IRC § 162(m) if it is received by the estate of a deceased covered employee.
- (4) The taxpayer's computation of its adjustment under IRC § 162(m) should identify the names of each of its covered employees, their position and include a description and the amount of each type of applicable employee remuneration included in their Form W-2, box 1. The covered employees included in the taxpayer's computation of its adjustment under IRC § 162(m) should be compared to the executives included in the taxpayer's proxies, SEC Form DEF-14A, and with disclosure of officers' compensation in SEC Forms 10-K, for taxable years beginning after December 31, 2016. A follow up should be made with the taxpayer for any officer who appears to be a covered employee in taxable years beginning after December 31, 2016, who is not included in the taxpayer's computation of its adjustment under IRC § 162(m). If there is any doubt as to whether the taxpayer has included all its covered employees in its computation under IRC § 162(m), or any doubt as to who is or should be included, the taxpayer may be asked to identify all its covered employees in each taxable year beginning after December 31, 2016.

D. Applicable Employee Remuneration

- (1) Applicable employee remuneration means, with respect to any covered employee for any taxable year, the aggregate amount allowable as a deduction under Chapter 1, normal taxes, and surtaxes, of the IRC determined without regard for IRC § 162(m) for remuneration for services performed by such employee, whether or not during the taxable year. Remuneration includes any remuneration, including benefits, in any medium other than cash but does not

include remuneration covered in IRC § 3121(a)(5)(A) through (D) concerning remuneration that is not treated as wages for purposes of the Federal Insurance Contributions Act. Hence, the starting point for determining applicable employee remuneration is the covered employee's Form W-2, box 1.

- (2) The taxpayer's computation of its adjustment under IRC § 162(m) should include a description and the amount of each type of applicable employee remuneration and should be reconciled to the covered employee's Form W-2, box 1. The types and amounts of applicable employee remuneration for each covered employee should also be compared with the types and amounts of compensation reported for the covered employees in the summary of executive compensation included in the taxpayer's proxies, SEC Form DEF-14A, and with disclosure of officers' compensation in SEC Forms 10-K. Follow up should be made with the taxpayer concerning omissions of or discrepancies between applicable employee remuneration reported in these SEC filings and the types and amounts of applicable employee remuneration included in the taxpayer's computation under IRC § 162(m).
- (3) For taxable years beginning after December 31, 2026, covered employees include the five highest compensated employees who are not PEO's, PFOs or included in the three highest compensated executive officers. Information concerning the compensation of these five highest compensated employees may not be included in the taxpayer's proxies or SEC Form 10-K. Therefore, the agent may need to review the taxpayer's compensation plans and employment contracts to determine these employees' applicable employee remuneration.
- (4) The greatest audit risk concerning applicable employee remuneration is the exclusion of qualified performance-based compensation. For qualified performance-based compensation to be excluded from applicable employee remuneration, it must meet all the requirements for qualified performance-based compensation under Treas. Reg. § 1.162-27(e)(2) through (5) and it must meet the transition rules under Treas. Reg. § 1.162-33(g).
- (5) Treas. Reg. § 1.162-27(e)(2) provides, in part, that qualified performance-based compensation must be paid solely on account of the attainment of one or more preestablished, objective performance goals established by the compensation committee not later than 90 days after the commencement of the period of service to which the performance goals relate. The minutes and resolutions of the compensation committee which establish the performance goal should be reviewed to determine whether this requirement is met. The information included in the minutes and resolutions of the compensation committee should be compared to the information concerning the performance goal disclosed in the taxpayer's proxy and SEC Form 10-K. Follow up with the taxpayer concerning any discrepancies.
- (6) Treas. Reg. § 1.162-27(e)(3) provides, in part, that the performance goal under which compensation is paid must be established by a compensation committee comprised solely of two or more outside directors. A director is an outside

director if he or she is not a current or former employee of the publicly held corporation, has not been an officer of the publicly held corporation and does not receive remuneration from the publicly held corporation either directly or indirectly, in any capacity other than as a director. Each director's relationship with the company should be researched to determine whether he or she has or had a prohibited relationship with the publicly held company. Information concerning the director's relationship with the company may be found in Accurint, SEC filings including proxies and 10-Ks, the taxpayer's website and other publicly available information. If any member of the taxpayer's compensation committee has or had a relationship with the taxpayer that is prohibited, then the outside director requirement under Treas. Reg. § 1.162-27(e)(3) is not met and the compensation is not qualified performance-based compensation excludable from applicable employee remuneration.

- (7) Treas. Reg. § 1.162-27(e)(4) provides, in part, that the material terms of the performance goal under which the compensation is to be paid must be disclosed to and subsequently approved by the shareholders of the publicly held corporation before the compensation is paid. The material terms include the employees eligible to receive the compensation; a description of the business criteria on which the performance goal is based; and either the maximum amount of compensation that could be paid to any employee or the formula used to calculate the amount of compensation to be paid to the employee if the performance goal is attained. The ballot and other materials presented to the shareholders should be reviewed to determine whether the material terms of the performance goal were adequately disclosed in accordance with Treas. Reg. § 1.162-27(e)(4). The ballot, minutes and other materials should be compared to the information concerning the performance goal disclosed in the taxpayer's proxy and SEC Form 10-K and to determine if it was approved. Follow up with the taxpayer concerning any discrepancies.
- (8) Treas. Reg. § 1.162-27(e)(5) provides, in part, that the compensation committee must certify in writing prior to payment of the compensation that the performance goals and any other material terms were in fact satisfied. Certification by the compensation committee is not required for compensation that is attributable solely to the increase in the value of the stock of the publicly held corporation (i.e., non-qualified stock options with a purchase price equal to the fair market value at the date of grant). The approved minutes of the compensation committee meeting in which the certification is made should be reviewed and compared to the disclosure of this approval in the taxpayer's proxy and SEC Form 10-K. Follow up with the taxpayer concerning any discrepancies.
- (9) Even if all the requirements under Treas. Reg. § 1.162-27(e)(2) through (5) are met, qualified performance-based compensation may not be excluded from applicable employee remuneration for taxable years beginning after December 31, 2017, unless the transition rules under Treas. Reg. § 1.162-33(g) are met.

The following summarizes some of the more pertinent provisions concerning the transition rules and some basic audit techniques.

- (10) Treas. Reg. § 1.162-33(g)(1)(i) provides, in part, that the post-TCJA rules that do not allow qualified performance-based compensation to be excluded from applicable employee remuneration do not apply to compensation payable under a written binding contract that was in effect on November 2, 2017, and that is not modified in any material respect on or after that date (a grandfathered amount). Compensation is a grandfathered amount only to the extent that as of November 2, 2017, the corporation was and remains obligated under applicable law (for example, state contract law) to pay the compensation under the contract if the employee performs services or satisfies the applicable vesting conditions.
- (11) Contracts of each covered employee for which the taxpayer has excluded qualified performance-based compensation from applicable employee remuneration in a taxable year beginning after December 31, 2017, should be reviewed. A determination should be made as to whether the contract was in effect on November 2, 2017, and whether the corporation remains obligated under applicable law to pay the compensation if the employee performs services or satisfies applicable vesting conditions. Counsel should be consulted if there is any question as to whether the corporation remains obligated under applicable law.
- (12) Treas. Reg. § 1.162-33(g)(1)(ii) provides, in part, if a written binding contract is renewed after November 2, 2017, the payments made after renewal are subject to the post-TCJA rules and therefore will not be grandfathered as qualified performance-based compensation. A written binding contract that is terminable or cancelable by the corporation without the employee's consent after November 2, 2017, is treated as renewed as of the earliest date that any such termination or cancellation, if made, would be effective. If the corporation will remain legally obligated by the terms of a contract beyond a certain date at the sole discretion of the employee, the contract will not be treated as renewed as of that date if the employee exercises the discretion to keep the corporation bound to the contract.
- (13) Treas. Reg. § 1.162-33(g)(2)(i) provides, in part, that if a written binding contract is modified on or after November 2, 2017, the post-TCJA rules that do not allow qualified performance-based compensation to be excluded from applicable employee remuneration apply to any payments made after the modification. A material modification occurs when the contract is amended to increase the compensation payable to the employee. Amounts received before the material modification are not affected but amounts received subsequent to the material modification are treated as paid pursuant to a new contract, rather than paid pursuant to a written binding contract in effect on November 2, 2017.
- (14) Treas. Reg. § 1.162-33(g)(2)(ii) provides, in part, that a modification of the contract that accelerates the payment of compensation is a material

modification unless the amount of compensation paid is discounted to reasonably reflect the time value of money. If the contract is modified to defer the payment of compensation, any compensation paid or to be paid that is in excess of the amount that was originally payable to the employee under the contract will not be treated as resulting in a material modification if the additional amount is based on applying to the amount originally payable either a reasonable rate of interest or the rate of return on a predetermined actual investment.

- (15) Treas. Reg. § 1.162-33(g)(2)(iii) provides, in part, that the adoption of a supplemental contract or agreement that provides for increased compensation, or the payment of additional compensation, is a material modification of a written binding contract if the facts and circumstances demonstrate that the additional compensation to be paid is based on substantially the same elements or conditions as the compensation that is otherwise paid pursuant to the written binding contract. However, a material modification of a written binding contract does not include a supplemental payment that is equal to or less than a reasonable cost-of-living increase over the payment made in the preceding year under that written binding contract. In addition, if the taxpayer has the discretion to reduce or eliminate the compensation or other economic benefit otherwise due upon attainment of a performance goal, ie. “negative discretion”, then only the amount the taxpayer is obligated to pay is eligible to be grandfathered.
- (16) The contracts, amendments and supplemental contracts for each covered employee should be reviewed to determine if they have been renewed or whether there has been a material modification. In addition, proxies and SEC Forms 10-K for periods ending on or after November 2, 2017, should be reviewed for disclosure of renewal or material modification of covered employees’ compensation contracts. If the taxpayer has treated compensation paid to a covered employee that has been renewed or materially modified on or after November 2, 2017, as qualified performance-based compensation, and excluded it from applicable employee remuneration, follow up with the taxpayer concerning their position.

E. Additional Information

- (1) IRC § 162(m) limits the deduction of otherwise deductible compensation paid to covered employees to \$1,000,000. IRC § 162(a)(1) allows a deduction for a reasonable allowance for salaries or other compensation for personal services actually rendered in carrying on any trade or business. Whether compensation is reasonable is determined by considering various factors, which differ depending on the circuit in which the taxpayer is located. Compensation must be deductible under IRC § 162(a)(1) before the limitation under IRC § 162(m)(1) is applied to the compensation paid to covered employees.