Office of Chief Counsel
Internal Revenue Service

memorandum

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RARappazzo

date: March 10, 1999

to: Bendall Gard, Revenue Agent, Group 1202
William Kennedy, Group Manager, Group 1202

from: District Counsel, Southwest District, Phoenix

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subject: [redacted]
Compensation Deduction Limitation per I.R.C. § 162(m)

DISCLOSURE STATEMENT

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ISSUE

Is District Counsel able to support a proposed audit adjustment relying on I.R.C. § 162(m) to disallow [redacted]'s deducting more than $[redacted] in compensation paid to its Chief Executive Officer (hereafter "CEO").

ANSWER

After researching this matter as well as coordinating this issue with Robert Misner of the National Office of Chief Counsel, we are unable to support such an adjustment based on I.R.C. § 162(m). However, we recommend further developing the facts of this matter to determine whether an adjustment is possible under I.R.C. § 162(a) and/or I.R.C. § 280G.

FACTS

The Service is currently examining [redacted]'s [redacted], [redacted], and [redacted] tax years. [redacted] (hereafter "[redacted]") filed a short year return for the [redacted] tax year, reporting only [redacted] days of activity. On [redacted] and its subsidiaries were acquired by [redacted]. [redacted] is an Australian corporation that is currently listed on the New York Stock Exchange (hereafter "NYSE"). For the short year at issue, [redacted] was also listed on the NYSE and was registered under the 1934 Securities and Exchange Commission Act (hereafter "the 1934 Act").

On the short year return, [redacted] included in its computation of cost of goods sold, an $[redacted] deduction for compensation paid to its CEO. In the course of performing the audit, the examining large case agent identified a potential issue with respect to this compensation deduction; namely whether the deduction runs afoul of the provisions of I.R.C. § 162(m).

DISCUSSION

For compensation that is otherwise deductible by a corporation in a taxable year beginning after 1993, the Revenue Reconciliation Act of 1993 limited a publicly held corporation's deduction for compensation paid or accrued with respect to a "covered employee" to $1 million per year. I.R.C. § 162(m)(1). The change does not modify the reasonableness requirement, which continues to apply in addition to the $1 million limit. See P.L. 103-66, § 13211 redesignating I.R.C. § 162(m) as § 162(n) and adding new § 162(m).

A corporation is publicly held if it has a class of common stock that must be registered under section 12 of the 1934 Act. I.R.C. § 162(m)(2). As stated above, because [redacted] was required to register its stock under the 1934 Act, [redacted] is considered publicly held for purposes of applying this statute. See also Treas. Reg. § 1.162-27(c)(1)(i).

A "covered employee" includes the CEO, as well as any other individual whose compensation is required to be reported to the Securities and Exchange Commission (hereafter "SEC") by reason of that individual being among the four highest compensated officers for the taxable year (other than the CEO), as of the end of the corporation's taxable year. I.R.C. § 162(m)(3); Treas. Reg. § 1.162-27(c)(2)(A).

Performance-based compensation and certain other compensation is not subject to the deduction limitation of I.R.C. § 162(m). See I.R.C. § 162(m)(4)(C). Compensation is also excluded from the deduction limitation of I.R.C. § 162(m) if it is paid under a binding written contract that was in existence on February 17, 1993. I.R.C. § 162(m)(4)(D). In addition, in accordance with the legislative history, the proposed regulations are exempt from the limitation compensation that is paid under an arrangement that existed before the corporation became publicly held, to the extent that the arrangement is disclosed in the initial public offering.

While we have not been provided with any facts indicating that any of the above-stated exceptions would be applicable in this case, for the foregoing reasons, we believe that I.R.C. § 162(m) is not applicable in this case and should not be used as a basis for disallowing any of the compensation paid by [redacted] to its CEO.

Application of SEC Rules and I.R.C. § 162(m)

As stated above, the compensation deduction limitation applies only to "covered employees." A covered employee includes the CEO. Whether an individual is the CEO is determined pursuant to the executive compensation disclosure rules under the 1934 Act. Treas. Reg. § 1.162-27(c)(2)(ii). Per SEC Regulation S-K, Item 402(a)(3)(i), disclosure is required for "All individuals serving as the registrant's chief executive officer . . . during the last **completed** fiscal year" (emphasis added). SEC Rule 405 defines "fiscal year" as the annual accounting period or, if no closing date has been adopted, the calendar year ending December 31.

Due to the interplay of the SEC regulations and related rules, an argument can be made that [redacted] was under no obligation to report the compensation of its CEO to the SEC during the short taxable year ending [redacted]. That is, the filing requirement with respect to the CEO's salary is only triggered by the completion of a full fiscal (or calendar) year. As a result of there being no filing requirement with the SEC in the short tax year, the CEO of [redacted] is thereby removed from the definition

of "covered employee" and the parameters of I.R.C. § 162(m) no longer remain applicable to his compensation. As such, I.R.C. § 162(m) cannot be used as a basis for disallowing the CEO's compensation for being in excess of $1 million.

We realize that this is a very technical loophole and a somewhat liberal reading of both the Code and the SEC rules and regulations. However, it has been explained to this office by Mr. Misner that I.R.C. § 162(m) is a very easy provision for taxpayers to maneuver around. There are a lot of technical ways to circumvent its application. Mr. Misner also stated that I.R.C. § 162(m) was not enacted as a generator of revenue, i.e., was not enacted simply to disallow deductions.

Given this background, we are unable to recommend proceeding forward with this issue. However, while I.R.C. § 162(m) may not be applicable in the instant case, the agent is not without options. Two other areas of the law may provide possible inroads.

I.R.C. § 162(a) - Reasonable Compensation

Section 162(a) invokes the concept of reasonableness as the major qualification for compensation deductions. The Treasury Regulations have provided that:

> [T]he test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.

Thus, the regulations form the principal issues as: (1) whether the amount of the payment is reasonable in relation to the services performed - the amount test; and (2) whether the payment is in fact made for services rendered - the intent test.

Here, based upon the facts as presented by the examining agent, we believe that the taxpayer may have problems arguing that the payment to its CEO was reasonable and/or for services actually rendered. In essence, [redacted] would have to argue that for his [redacted] days of work in [redacted], the CEO provided services worth more than $[redacted]. Accordingly, we suggest gathering additional information to determine whether an adjustment under I.R.C. § 162(a) is possible.[1]

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[1]It should be noted, however, that the Service has a poor record in cases involving the reasonableness of compensation paid to an officer of a publicly held corporation. This is because an arm's length relationship between the officer and the corporation

Such additional information could include: (1) documentation of the amount and nature of the services rendered by the CEO during the short tax year; (2) the salary history of the CEO; (3) the salary scale for the other highly paid executives of [redacted]; (4) the salary scale in the industry, etc.

Golden Parachutes: Sections 280G and 4999

The Tax Reform Act of 1984 extended the issues of reasonable compensation into new areas by instituting rules designed to penalize "golden parachutes" agreements, which are generally defined as contracts under which substantial severance payments are made to corporate executives in the event of a corporate takeover. Section 280G denies a corporation a deduction for any excess parachute payment, and I.R.C. § 4999 imposes on the recipient a nondeductible 20% excise tax, in addition to the regular income and Social Security taxes. I.R.C. § 4999(a).

It is possible that an argument could be made that the payment to the CEO in the short tax year was more akin to a "golden parachute." However, this is a very technical area of the law and additional factual development would be required before we could determine whether such provisions are applicable. While an extended discussion of the operation of the Golden Parachute rules is beyond the scope of this memorandum, we nevertheless mention these sections as reference for the examining agent should she choose to explore this area further.

CONCLUSION

We are not able to support the disallowance of the compensation deduction based on the principles of I.R.C. § 162(m). As stated above, due to the interaction of I.R.C. § 162(m) and the SEC rules and regulations, the $1 million limitation prescribed by I.R.C. § 162(m) is not applicable to a short tax year. Despite this, we have presented two other avenues by which the examining agent may choose to explore the proposed disallowance: (1) the general reasonableness requirements of I.R.C. § 162(a); and (2) the technical requirements of the Golden Parachute provisions of the Code.

Should the large case team choose to pursue either of these possible theories, District Counsel is available to provide any needed assistance. Additionally, if the large case team wishes to pursue the I.R.C. § 162(m) issue further, they could request Technical Assistance from the National Office. As always, this office is available to help with this process.

Please note, we consider the opinions expressed in this memorandum to be significant large case advice. Therefore, we request that you refrain from acting on this memorandum for ten (10) working days to allow the Assistant Chief Counsel (Field Service) an opportunity to comment.

Since nothing further is required of this office at this time, we are closing our files as of the date of this memorandum. Should you have any questions or need additional information, please contact me at (602) 207-8061.

/s/ RICHARD A. RAPPAZZO

RICHARD A. RAPPAZZO
Attorney

APPROVED:

/s/ J. ROBERT CUATTO

J. ROBERT CUATTO
Assistant District Counsel

cc: Deborah A. Butler,
Assistant Chief Counsel (Field Service)

Margaret K. Hebert
Assistant Regional Counsel (LC), Western Region

Milton B. Blouke,
Associate District Counsel, Southwest District