Does Exec Comp Limitation Really Go Beyond the Grave?

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By Stephanie Cumings

Some tax practitioners are questioning the assumption that the revamped $1 million deduction limitation for executive compensation follows employees after the loss of both their job and their life.

The key issue is whether the term "employee" really includes former employees, Spencer F. Walters of Ivins, Phillips & Barker Chtd. told *Tax Notes* November 13.

"There are similar sections in the code where Congress explicitly referred to 'former employees,'" Walters said. "If employee means former employee, you wouldn't have to refer to former employees."

While this ghoulish scenario seems a bit late for Halloween, tax professionals have been struggling with the question since passage of the Tax Cuts and Jobs Act (P.L. 115-97). The 2017 law eliminated the performance-based compensation deduction under section 162(m), putting the deduction limitation at $1 million without exception. But the TCJA also expanded the definition of covered employees, mandating that it apply to "any employee … [that] was a covered employee of the taxpayer (or any predecessor) for any preceding taxable year beginning after December 31, 2016."

In Notice 2018-68, 2018-36 IRB 418, the IRS used the word "individual" in place of "employee," which Ivins said in a November 9 comment letter was "unexplained and unsupportable." Walters said that based on the plain meaning of the statute, a covered employee can only remain as such as long he is still an employee of the taxpayer.

Imperfect Legislative History

According to the conference report on the TCJA, "an individual remains a covered employee with respect to compensation otherwise deductible for subsequent years, including for years during which the individual is no longer employed by the corporation and years after the individual has died." It goes on to say that compensation doesn't escape the deduction limitation "merely because the compensation is includible in the income of, or paid to, another individual, such as compensation paid to a beneficiary after the employee's death, or to a former spouse pursuant to a domestic relations order."

Walters said the report is perhaps an "imperfect summary of how the statutory text actually works." The Ivins letter argues that "only a technical correction or other legislative action could override the plain statutory meaning."

Government officials also seem to be taking it as a given that section 162(m) will haunt executives' families after their loved ones have passed.

Some people think the once-a-covered-employee, always-a-covered-employee policy ends at death, Stephen Tackney, deputy associate chief counsel (employee benefits), IRS Office of Associate Chief Counsel (Tax-Exempt and Government Entities), said November 8 at an American Bar Association conference in Washington. "Actually, the payments to the beneficiary after you die are also subject to the limitation. They're treated as if they were paid to a covered employee."

Stephen LaGarde, attorney-adviser, Treasury Office of Benefits Tax Counsel, agreed that position appears to be "stated explicitly in the statute."

Compelling Evidence

Not all practitioners agree.

Some of the most compelling evidence that covered employee status ends when you're no longer an employee can be found in new section 4960, said Kevin P. O'Brien, also of Ivins. The TCJA created an excise tax on executive compensation over $1 million for tax-exempt organizations, which was intended to mirror the changes to section 162(m). The excise tax in section 4960 specifically uses the phrase "former employee" in defining a covered employee, Ivins noted.

Walters said one of the reasons the once-a-covered-employee, always-a-covered-employee interpretation may have gained traction is that it's a proposal that's been around for a while. "But the language in those proposals was actually different," Walters said, noting that they used the word "individual" instead of "employee."

Walters and O'Brien both agreed that interpreting the definition of a covered employee more narrowly would alleviate some of the administrative issues associated with tracking former employees, as well as render moot many of the questions surrounding deferred compensation.