Deloitte.

Tax Accounting Perspectives

ASC 740 implications of new limitations on excessive employee compensation
March 14, 2018

U.S. tax legislation, enacted on December 22, 2017, modifies Internal Revenue Code ("IRC") Section 162(m) for compensation deductions of certain highly compensated officers and employees. Interim and year-end tax provision processes should include consideration of legislative changes on current and deferred tax accounting, including whether existing deferred tax assets or liabilities should be adjusted.

What's new?

Changes to deduction of compensation and share-based payment awards

Tax legislation commonly known as the Tax Cuts and Jobs Act (the "Act") modifies IRC Section 162(m) for compensation paid under contracts entered into after November 2, 2017. Changes to Section 162(m) expands the employers subject to the limitation, expands the definition of covered employee, and removes certain exceptions. Changes do not apply to payments made under a written binding contract in effect on November 2, 2017, unless contract has been materially modified.

Highlights

New limitations on deductions for excessive compensation

Under previous law, IRC Section 162(m) limited the compensation deduction paid to covered employees to no more than $1 million per year. Covered employees included the CEO and the next three other highest-paid employees as disclosed in SEC filings. The limitation did not apply to certain performance-based compensation and commissions and status as a covered employee was determined each year.

The Act (1) modifies covered employees to include CEO, CFO, and next three highest paid employees; (2) provides that an individual who is a covered employee for any taxable year beginning after December 31, 2016 will remain a covered employee for all future tax years; (3) removes exceptions for commissions and performance-based compensation and (4) expands definition of an applicable employer to include entities that are issuers required to file reports under Section 15(d) of the Exchange Act

What does this mean for you

Impact on deferred taxes

The deferred tax asset ("DTA") recorded for share-based payment awards granted after November 2, 2017 could be less than what would have been recorded under prior law. Since the Act eliminates the exclusion applicable to performance-based compensation, all compensation is subject to the $1 million deduction limitation. For awards granted after 11/2/2017, a DTA is only recorded if the compensation expense is expected to be deductible.

When compensation is expected to be limited by IRC Section 162(m), there are three approaches commonly applied in practice regarding the accounting for deferred taxes:

1. Deductible compensation is allocated to cash compensation first – A DTA would not be recorded for stock-based compensation if cash compensation is expected to exceed the limit.

2. Deductible compensation is allocated to earliest compensation recognized for financial statement purposes — Because stock-based compensation is typically expensed over a multiple-year vesting period but deductible when fully vested or exercised, and cash-based compensation is generally deductible in the period it is expensed for financial statement purposes, stock-based compensation is generally considered the earliest compensation recognized for financial statement purposes, and a DTA would be recorded up to the deductible limit.

3. Limitation is allocated pro rata between stock-based compensation and cash compensation – A partial DTA may result on the basis of the expected ratio of stock-based compensation to cash compensation.

The choice of which approach to apply is a policy election that should be applied consistently. While the Act modifies IRC Section 162(m), we believe the three approaches remain acceptable

Impact of valuation allowance analysis

An entity may have additional unfavorable permanent adjustments as a result of the new rules. Future taxable income projections should take into account expected limitations when analyzing whether a valuation allowance on deferred tax assets is needed.

Other considerations

The Act contains explicit wording that indicates material modifications made to a binding contract on or after November 2, 2017 will cause the agreement to become subject to the updated IRC Section 162(m). Judgment may be required to determine whether an agreement meets the binding contract exception or if a modification is material. If a plan is materially modified or the binding contract exception does not apply, existing deferred tax assets may require adjustment.

For share-based payment awards with performance conditions, entities should consider whether the probability assessment is impacted by tax reform. For example, is tax reform considered a "one-time" or unusual event under the terms of the plan.

Note: Modifications to existing contracts should be closely monitored to avoid unintended tax consequences.

Refer to Deloitte's Financial Reporting Alert 18-1, FAQ About Tax Reform, Sections 8.3 – 8.6 and Chapter 10 of the 2017 Deloitte Roadmap to Accounting for Income Taxes for further guidance on stock-based compensation.

Deloitte perspective

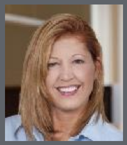
Understand impact on estimated Annual Effective Tax Rate ("AETR")

Companies should evaluate the impact on the AETR of permanent differences attributable to new covered employees, commissions and performance-based payments not previously limited, and whether transition rules or material modifications create non-deductible items that impact the AETR. The impact of material modifications on existing DTAs could be treated differently.

Contact Elizabeth Drigotas (edrigotas@deloitte.com) or Grace Melton (gmelton@deloitte.com), partners in our Washington National Tax Group specializing in compensation and benefits.

Contacts

National Tax Accounting Group



Vickie Carr
+1.214.840.1457
vcarr@deloitte.com

Pete O'Grady
+1.203.708.4587
pogrady@deloitte.com

Samantha Pietsch
+1.213.996.4304
spietsch@deloitte.com

Washington National Tax Group - Accounting for Income Taxes

Patrice Mano
+1.415.783.6079
pmano@deloitte.com

Paul Vitola
+1.602.234.5143
pvitola@deloitte.com

Chris Barton
+1.703.885.6300
cbarton@deloitte.com

Alice Loo
+1.415.783.6118
aloo@deloitte.com