AMERICAN BENEFITS COUNCIL

February 18, 2020

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Internal Revenue Service
CC:PA:LPD:PR
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20004

RE: Proposed Regulations Under Internal Revenue Code Section 162(m) (REG-122180-18)

Dear Sir or Madam:

The American Benefits Council ("the Council") appreciates the opportunity to comment on the proposed regulations released by the Internal Revenue Service and the Department of the Treasury (collectively, "IRS") to implement changes made to Section 162(m) of the Internal Revenue Code ("Code") by the Tax Cuts and Jobs Act (TCJA).

The Council is a Washington D.C.-based employee benefits public policy organization. The Council advocates for employers dedicated to the achievement of best-in-class solutions that protect and encourage the health and financial well-being of their workers, retirees and families. Council members include over 220 of the world's largest corporations and collectively either directly sponsor or support sponsors of health and retirement benefits for virtually all Americans covered by employer-provided plans.

Set forth below are the Council's comments on the proposal.

GRANDFATHERED CONTRACTS AND NEGATIVE DISCRETION

Before the passage of the TCJA, public companies structured their executive compensation arrangements consistent with the then-existing exception under Section 162(m) for performance-based compensation. In enacting the grandfather rule as part of the TCJA's changes to Section 162(m), Congress's clear goal was for the grandfather rule to apply to compensation arrangements that were already in place in reliance on prior law. Congress surely did not intend to prevent plans and contracts with various common features from taking advantage of the grandfather provision. Under the grandfather rule, the amendments made to Section 162(m) do not apply to remuneration provided pursuant to 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. Notice 2018-68 explains that the remuneration is payable under a written binding contract that was in effect on November 2, 2017, only to the extent that the corporation is obligated under "applicable law" to pay the remuneration under such contract if the employee performs services or satisfies the applicable vesting conditions. This guidance was carried over to the proposed regulations.

In our comments on Notice 2018-68, we pointed out that although the Notice provides several examples illustrating the application of the grandfather rule, these examples fail to meaningfully illustrate what a written binding contract is. Moreover, the examples inherently assume the existence of a written binding contract that was in effect on November 2, 2017. We had urged the IRS to provide additional guidance on how to determine whether a written binding contract existed on November 2, 2017.

In this regard, the proposed regulations do provide two important clarifications, which we support. First, the proposed regulation clarify that the grandfather rule applies when a participant has a right to participate in a plan as of November 2, 2017, even if the employee was not yet eligible for the plan as of November 2, 2017. Second, the proposed regulations provide that if a corporation is obligated or has the right to recover compensation based on the future occurrence of a condition that is objectively outside of the corporation's control, then that right to recovery is disregarded for purposes of determining the grandfathered amount for the taxable year. Thus, for example, if a plan provides that compensation will be recovered if the executive commits a crime, this does not automatically disqualify the plan from the grandfather rule.

We continue to believe, however, that there are circumstances under which it is very unclear that negative discretion in a plan or contract could actually be exercised "under applicable law." Many plans and contracts entered into before enactment of TCJA included the right to reduce compensation precisely because companies were invited to do so by the prior regulations under Section 162(m), and as a matter of good corporate governance. In practice, actually exercising that negative discretion without some action by the executive that amounts to misconduct will quickly lead to a lawsuit, with uncertain results. Thus, we urge the IRS to confirm that if a corporation concludes that its negative discretion could only be clearly exercised in the case of misconduct by the executive or other event outside of the control of the company, even if that is not specifically provided for in the terms of the plan or contract, the plan or contract is still considered binding for purposes of the grandfather rule.

Grandfathered Contracts and Earnings

The proposed regulations interpret the grandfather rule as not applying to "earnings" on otherwise grandfathered amounts unless earnings are required to be paid under "applicable law." While that standard is consistent with the overall definition of a written, binding contract, the proposed regulations further interpret the written, binding contract standard as applying only to 12 months of earnings where the corporation maintains the right to prospectively terminate the plan. The 12 months of earnings reflects the IRS's acknowledgement that a corporation would not choose to pay out earlier than allowed under the deferred compensation rules of Section 409A, which generally requires a 12 month delay in payments when plans are terminated.

The Council urges the IRS to reconsider its interpretation. The Council is not aware of any deferred compensation plan that does not include either explicitly or implicitly the right to a future termination. The IRS's interpretation that earnings on such plans are grandfathered only for 12 months assumes the narrowest possible application of the grandfather rule. Moreover, it is not the best interpretation of the employees' rights to earnings and the corporation's obligation to pay earnings under "applicable law." Final regulations should clarify that if the corporation is obligated to provide earnings on grandfathered amounts as long as the grandfathered amounts remained deferred, then such earnings are themselves grandfathered.

Such a rule would recognize that the basic parameter of the contractual arrangement is for the deferred compensation amount to be adjusted by its present value. The existing rules under Section 162(m) prior to the TCJA amendments recognized that deemed investment earnings did not increase the underlying compensation; rather, deemed investment earnings reflect that the underlying promise of the corporation – i.e., the written, binding contract – is to deliver the present value of the benefit (either as an account balance or a defined benefit) whenever such amount becomes payable.

Existing guidance under Treas. Reg. 1.162-27(h) did not treat the deferral of compensation along with investment earnings as an "increase" in that compensation that would have caused an amount to fail to be grandfathered for purposes of the OBRA 1993 grandfather rule. Under the principles in Treas. Reg. 1.162-27(h), the continued accrual of earnings is consistent with the corporation's obligation to pay the present value of the grandfathered benefit.[1] Inherent in the concept of a present value payment is that future earnings will accrue to reflect the deferral of the underlying payment or, in the case of an accelerated payment, earnings will cease because the

[1] Those regulations state at Treas. Reg. §1.162-27(h)(1)(iii)(B): "A modification of the contract that accelerates the payment of compensation will be treated as 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 in excess of the amount that was originally payable to the employee under the contract will not be treated as a material modification if the additional amount is based on either a reasonable rate of interest or ore or more predetermined actual investments."

amounts have been paid out. Both Notice 2018-68 and the proposed regulations indicate that the principles in OBRA 1993 are to be followed for purposes of the TCJA changes.

Accordingly, final regulations should clarify that earnings based on a deemed investment or reasonable rate of interest will continue to be grandfathered while such amounts are deferred. The underlying "contract" is the promise that grandfathered amounts will accrue deemed earnings as long as the grandfathered amounts remain deferred. Put another way, it is highly unlikely that a corporation could simply eliminate all deemed earnings on deferred grandfathered amounts. Such a promise should be eligible for grandfather treatment.

DIRECTOR COMPENSATION

The proposed regulations take the surprising position that compensation paid to a non-employee for services as something other than an employee is covered by the $1 million deduction limit in Section 162(m). In other words, despite the fact that the term applicable employee remuneration in Section 162(m)(4) refers to "remuneration for services performed by such employee," payments made to individuals who are not employees at all (but once were) are taken into account. In support of this position, the proposal cites the 1993 legislative history, which is not consistent with the text of the statute, and the prior proposed regulations. But the prior legislative history and regulations are inapposite.

Under prior law, compensation paid to an individual who was no longer an employee (and thus no longer a covered employee) *was not subject to the deduction limitation at all*. Thus, it is not correct, as the preamble implies, that under prior law a covered employee who terminates employment and provides non-employee services, such as serving as a director, would have those fees counted towards the $1 million deduction limit.[2] Rather, under prior law, the question was whether a covered employee who was being paid for both employee and non-employee services should have all compensation taken into account for that taxable year.

The statute could not be more clear on this point. An individual is only a covered employee if he or she is an "employee" (see Section 162(m)(3)) and applicable employee remuneration relates solely to amounts allowable as a deduction "for remuneration for services performed by such employee (whether or not during the taxable year)" (see Section 162(m)(4)). Thus, while it is clear that, because of the amendments made by TCJA, deferred compensation payable for services *as an employee* but paid in a year after the individual is no longer an employee is "applicable employee remuneration," it is

[2] By this logic, if a covered employee terminated employment, and opened a restaurant in the first floor of the company's headquarters, compensation paid in the form of fees by the corporation for catering its events would be subject to the $1 million deduction limit.

equally clear that compensation for services in a capacity other than as an employee is not "applicable employee remuneration."

There is an important policy reason not to count director's compensation toward the $1 million limit. CEOs and other key executives often serve on a corporation's board after retirement; this allows the board to harness the knowledge of people who know the company. Many of these individuals will be receiving deferred compensation that already puts them over the $1 million deduction limit. Making it *more expensive*, from a corporate tax standpoint, to place *knowledgeable* directors on the board, harms the shareholders of that company.

RETROACTIVE EFFECTIVE DATES AND GOOD FAITH RELIEF

The proposed regulations include a number of provisions that are proposed to apply *retroactively*. For example, the definition of covered employee is proposed to apply to taxable years ending on or after September 10, 2018. The rules regarding corporations that become publicly held is proposed to apply to corporations that become publicly held on or after December 20, 2019. Certain rules relating to partnership compensation is proposed to apply to compensation paid pursuant to a written binding contract that is in effect on December 20, 2019 and that is not materially modified after that date. Finally, the proposed regulations' rules regarding grandfathered contracts are proposed to apply to taxable years on or after September 10, 2018. None of these dates come from the statutory language, and they all amount to rules that will be retroactive when the regulations are finalized.

We believe that, until regulations are finalized, it is not appropriate to apply a rule that is still the subject of notice and comment. Rather, historically the IRS provides that, until final regulations are issued, taxpayers may rely on a good faith interpretation of the law. Guidance such as a Notice or proposed regulations often provide that following the guidance will be treated as a good faith interpretation of the law, and that taxpayers can rely on them. But we do not believe the IRS should impose rules *retroactively* unless a compelling case will be made that this is necessary to prevent tax evasion.

DETERMINATION OF COVERED EMPLOYEES

The proposed regulations indicate that an individual becomes a "covered employee" if he or she serves as the principal executive officer (PEO) or principal financial officer (PFO) during the taxable period or if he or she is one of the top three most highly compensated executive officers for the period. The Council urges the IRS to modify the rules in the proposed regulations to make clear that if a publicly-held corporation is subject to the proxy disclosure rules for a taxable period, the covered employee include only the PEO, PFO and the individuals who appear as one of the top three most highly compensated officers on that proxy statement (in addition to any individuals who were previously identified in prior taxable periods.) Where a corporation is actually subject to the proxy disclosure rules, it appears overly complex for the corporation to identify their covered employees in a different manner.

The proposed regulations confirm that the definition of an executive officer and the measurement of compensation are determined under the disclosure rules for the Securities and Exchange Act of 1934. Because of the changes made by the TCJA, it is acknowledged that some publicly-held companies that are not obligated to disclose executive compensation on a proxy statement or other report will be required to create such a listing for purposes of identifying their covered employees and applying Section 162(m). The Council recognizes that such a rule is required to carry out the TCJA statutory changes.

With respect to companies that are filing proxy statements, the Council urges the IRS to amend the rules to allow companies to rely on their proxy disclosure for determining the top three most highly compensated employees. As illustrated in the examples to the proposed regulations, executive officers could depart during a taxable period and not appear on the proxy statement under current disclosure requirements. Such a fact pattern suggests that IRS examiners may be asking companies to verify that they have affirmatively ruled out any other employees who were not listed on the proxy. We submit that tasking the corporation's tax department and IRS examiners to determine when a departing executive would have been potentially subject to proxy disclosure rules imposes undue complexity. Companies that file proxies should simply be allowed to rely on the proxy disclosure to identify the top three most highly compensated officers. We see little opportunity for "gaming" on these facts and such a rule would simplify administration for both taxpayers and the IRS.

AFFILIATED GROUPS AND PARTNERSHIP ALLOCATIONS

The proposed regulations impose new rules applying the deduction limitation to partnerships in which one of the partners is a publicly-held corporation. Moreover, the proposed regulations propose that this new rule take effect as of the 2019 calendar year. Nothing in the TCJA statutory changes or legislative history suggests that Congress intended this new interpretation of the rules.

Specifically, Prop. Reg. §1.162-33(c)(3)(ii) states that compensation of a covered employee "includes an amount equal to a publicly held corporation's distributive share of a partnership's deduction for compensation expense attributable to the remuneration paid by the partnership for services performed by a covered employee of the publicly held corporation." Example 3 at Prop. Reg. §1.162-33(c)(3)(iv)(D) illustrates the application of the rule.

The proposed regulations' application of Section 162(m) to the partnership's compensation deductions raises many questions about the fundamental principles of Section 162 and how ordinary and necessary business expenses are allocable to each entity's trade or business. The proposed regulations do not address the principle that compensation paid by a partnership to its employees is for services rendered in the trade or business of the partnership. The proposed regulations' new rule is creating further confusion given that, elsewhere in the regulations, the definition of a publicly-held corporation is specifically defined to exclude a partnership. The proposed regulations retain the same Section 1504 definition of a public company affiliate that has been in place since the original definition was proposed in 1993. That definition excludes partnerships.

If, under the proposed regulations, a partnership continues to be an entity that is itself not deemed to be a publicly-held corporation, the partners should continue to be entitled to their distributive share of the partnership's compensation deductions when those deductions arise in the course of employees performing services for the partnership. This analysis is consistent with the basic principles of Section 162, which provide compensation deductions to the trade or business being served. It is also consistent with numerous private letter rulings previously issued by IRS Chief Counsel.[3] If the IRS has determined that a new interpretation is appropriate, further explanation about the underlying principles of the compensation deduction allocation and the definition of a "publicly-held corporation" under Section 1504 is appropriate. Imposing such a rule for 2019 when the Proposed Regulations were issued on December 20, 2019 should be reconsidered.

Coordinating Section 162(m) and Section 409a

The preamble to the proposed regulations describes relief under Section 409A for payments of deferred compensation that would be delayed until such amounts are deductible under Section 162(m). The preamble notes that in light of the fundamental changes to Section 162(m), further changes may be warranted to deferred compensation payment terms without causing a violation of Section 409A. The Council's members welcome the preamble's relief. However, the Council requests that IRS clarify the scope of this relief and, in particular, clarify that the relief applies equally to deferrals that are grandfathered under Section 162(m) as well as non-grandfathered amounts.

[3] See e.g., in PLRs 200614002, 200727008, 200725014, and 200837024, the IRS addressed the application of Section 1504 in the context of a real estate investment trust (REIT) that was structured as a publicly-held corporation that owned an operating partnership. The REIT's covered employees provided only a small portion of their services to the REIT and the majority of their services to the partnership. In each of the rulings, the IRS concluded that the Section 162(m) deduction limitation was inapplicable to compensation paid by the partnership for services provided to the partnership.

Many affected employers have reason to want to accelerate the payment of grandfathered deferrals without continuing an existing Section 162(m) delay. Continuing to track such amounts creates an administrative burden that may not have been anticipated prior to the changes to Section 162(m) and concerns will arise about inadvertent Section 409A operational errors. When employers stop applying Section 162(m) delays to non-grandfathered deferrals, they will have much less reason to continue to undertake the substantial administrative challenge of applying such a delay on an ongoing basis, given that the pool of grandfathered deferrals will be inexorably declining. In addition, some affected employers are interested in paying both grandfathered and non-grandfathered deferrals without any Section 162(m) delay, because they believe that will make it much easier to explain the future payment rules for deferrals to affected covered employees. Accordingly, we suggest clarifying that transition relief cover employers that stop applying Section 162(m) delays to both non-grandfathered and grandfathered amounts and that this transition relief includes those grandfathered amounts that have previously been subjected to a Section 162(m) delay in payment.

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Thank you for your consideration of our comments. Should you have any questions or wish to discuss our comments further, please contact me at (202) 289-6700 or by email at jjacobson@abcstaff.org.

Sincerely,

Jan Jacobson
Senior Counsel, Retirement Policy