AMERICAN BENEFITS COUNCIL

February 5, 2018

Thomas A. Barthold
Chief of Staff
The Joint Committee on Taxation
502 Ford House Office Building
Washington, DC 20515

Mark A. Prater
Chief Tax Counsel
Senate Finance Committee
219 Dirksen Senate Office Building
Washington, DC 20510

Barbara M. Angus
Chief Tax Counsel
House Ways and Means Committee
1102 Longworth House Office Building
Washington, DC 20510

RE: H.R. 1, Section 13601 (changes to Internal Revenue Code Section 162(m))

Dear Mr. Barthold, Mr. Prater, and Ms. Angus:

The American Benefits Council (the "Council") appreciates the opportunity to provide comments to the Joint Committee on Taxation as it develops its next Blue Book. The Council is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.

We are writing to bring to your attention an issue in need of clarification in the Blue Book. The issue has to do with the "written binding contract" grandfather rule in Section 13061 of H.R. 1, which makes changes to Internal Revenue Code Section 162(m). We understand that this grandfather rule serves a number of purposes, including protecting arrangements put in place by entities that were not previously subject to Section 162(m), and compensation paid to executives who would not have been covered under prior law. The explanation of the rule in the Conference Report does not, however, provide sufficient certainty and guidance to companies that have been subject to Section 162(m). These companies have structured their compensation arrangements as performance-based compensation exempt from Section 162(m) in reliance on the prior provisions in Section 162(m), but the current explanation of the written binding contract provision does not adequately address how the rule applies to companies' outstanding performance-based compensation. In addition, many compensation

1501 M Street NW Suite 600 Washington, DC 20005 202-289-6700 Facsimile 202-289-4582 www.americanbenefitscouncil.org

arrangements were put in place with no expectation that the individual would be covered by 162(m) when the compensation is paid.

The input of the Joint Committee is critical. Due to the significant changes that H.R. 1 makes to the Code, the Internal Revenue Service and the Treasury Department will be tasked with issuing and modifying a large volume of regulatory guidance, and certain projects will need to be prioritized over others. In the event that the Treasury Department is not able to make guidance on the written binding contract grandfather rule one of its early priorities, a clarification on the issue in the Blue Book would provide a measure of comfort to businesses that have structured their performance-based compensation in reliance on the prior Section 162(m) rules.

Need to cover existing arrangements

The clear goal of the grandfather provision in H.R. 1 was to preserve plans and contracts in existence before November 2, 2017. As applied to public companies that had in the past structured compensation consistent with the exception for performance-based compensation, Congress surely meant for the grandfather rule to apply to performance-based compensation already in place in reliance on prior law (and to avoid loopholes for *new* arrangements). We do not believe Congress intended to prevent plans and contracts with certain common features found in most performance-based compensation plans from taking advantage of the grandfather provision.

The discussion in the Conference Report, interestingly, closely tracks the transition rule included in the Section 162(m) regulations. But that prior transition rule served a different purpose. Here the grandfather provision is in place for *performance-based compensation that was created in reliance on the prior 162(m) regulations*. Accordingly, the H.R. 1 grandfather provision should be interpreted to cover such arrangements.

Compensation arrangements other than performance-based pay

While our letter focuses on performance-based compensation in existence prior to H.R. 1, it is important for the Blue Book to explain that the grandfather provision is not available only for performance-based compensation in effect on November 2, 2017. Section 13601(e)(2) of H.R. 1 states that *none* of the amendments made by H.R. 1 apply to remuneration provided pursuant to a written binding contract which was in effect on November 2, 2017, and which is not modified in any material respect on or after such date. Section 13601 not only removed the exception for performance-based compensation but also (a) expanded the group of executives covered by Section 162(m); (b) provided that an individual, once in the covered group in 2017 or later, continues to be a covered individual indefinitely; and (c) expanded the group of companies that are subject to the deduction limit in Section 162(m). In other words, for any remuneration

pursuant to a written contract in effect on November 2, 2017, and which is not later modified, such remuneration is evaluated using the version of Section 162(m) in effect prior to enactment of H.R. 1. If an individual would not have been a covered individual under prior law, the remuneration is not counted toward the $1 million limit.

Plans versus contract

While the statutory provision refers to binding "contracts," most performance-based compensation is paid through a plan,[1] with each participating employee either receiving a grant or award under the plan or being covered automatically by operation of the plan terms. In other words, it is highly unusual for an executive to participate in a compensation plan and to have the plan terms or individual grants or awards under the plan described in the executive's employment contract. Instead, once a plan or awards are established for a performance period, they create legally binding rights for participating employees. Even if the plan or grant contains some features described below that place certain conditions on the ultimate payment of the performance-based compensation, those conditions do not prevent the characterization of a legally binding right and should not take the plan and the grants made prior to November 2, 2017, out of H.R. 1's grandfather provision.

Negative discretion issue

Treasury's regulations under Section 162(m) provide that compensation payable based upon subjective criteria generally will not qualify as performance-based compensation. Those regulations provide that objective goals and formulas must be used and that such formulas must preclude discretion to increase the award. However, discretion to reduce awards is specifically permitted. Accordingly, many companies' plans include a "negative discretion" clause, under which the executive is awarded a maximum bonus based on pre-established criteria, but the compensation committee can use its discretion to lower the bonus amount based on such factors as it deems appropriate, including subjective factors. These clauses have been established precisely in reliance on the Treasury regulations and are often viewed as critical to proper governance. The Conference Report could be read to mean that any plan with a negative discretion clause is not eligible for the grandfather provision. We do not think this is what Congress intended because that would render many – even most – of the plans that Congress intended to grandfather not eligible for the grandfather provision.

---

[1] In some cases, the public company may have in place an "omnibus" plan approved by shareholders that allows for a variety of compensation, cash bonuses, stock options, restricted stock, and other types of compensation. These omnibus plans may not themselves provide legal binding remuneration, but they would be implemented by individual plans, awards, or grants that would be binding for purposes of the grandfather provision.

The statutory language simply refers to a contract being (a) written; (b) binding; and (c) in effect on November 2, 2017. Awards and plans with negative discretion are viewed as binding. While the compensation committee may have discretion to lower the award, the committee generally must have some justifiable reason to do so (e.g., in the case of a dispute with an executive). Employees work towards their bonus award with the expectation that any such discretion will be reasonably and judiciously applied. In the case of performance-based equity awards, in particular, employers almost never actually use any reserved negative discretion, and instead pay the awards if the performance goals are met, but retain negative discretion in the event of a catastrophic circumstance. The retention of the right to exercise negative discretion in an award or plan and the actual exercise of such negative discretion on or after November 2, 2017, should not disqualify grandfathering for any performance-based plans or awards in effect before that date. For plans and awards that are designed to make use of negative discretion, as countenanced by the Section 162(m) Treasury regulations in effect when designed, this use of a common Section 162(m) plan design should not disqualify a plan or award in effect on November 2, 2017, from grandfathering. Similarly, the existence or exercise of negative discretion with respect to an award in effect as of November 2, 2017, should be irrelevant for grandfathering purposes because the applicable Treasury regulations at that time allowed such exercises of discretion and employers relied on that regulatory authorization when they established plans and awards before November 2, 2017.

Common plan features

The following features, all of which are extremely common, should not prevent a plan, award, grant, or contract from being eligible for the grandfather provision:

- ***Clawback for financial restatement*:** Many plans, awards, and contracts include a provision allowing the claw back of compensation in the case of a financial restatement.

- ***Clawback for non-competition*:** Many plans, awards, and contracts include a provision clawing back compensation if the executive engages in competition or solicits customers.

- ***Administration of financial targets:*** In many cases, the performance-based compensation is tied to complex financial targets, which can require interpretation and adjustments by the company.

- ***Prospective termination:*** Almost all compensation plans, whether equity, deferred compensation, or bonus, can be terminated prospectively, although existing awards are generally not terminated. The fact that the plan can be terminated prospectively should not disqualify the awards or other

compensation granted prior to such termination from eligibility for the grandfather provision.

- ***Award acceptance:*** Some plans require an executive to formally "accept" an award at or shortly after grant. Other plans treat an award as accepted if it has not been rejected within a specified period (e.g., 30 days). Other plans do not require acceptance or rejection by the participant. In all cases, the award should be viewed as "in effect" once it has been made by the employer, since at that point, the employer is not able to unilaterally renege on the grant once made.

Interpretative issues

In addition to the critical issues described above, there are a number of other interpretive questions on which guidance is necessary:

- ***Types:*** The grandfather provision should be available for all compensation that would have been excluded under prior law, including options, performance-based restricted stock units, and annual performance-based bonuses, as long as these arrangements are considered performance-based compensation under prior law.

- ***Meaning of "in effect":*** The grandfather provision is only available for arrangements "in effect" on November 2, 2017. The Conference Agreement states that the "fact that a plan was in existence on November 2, 2017 is not by itself sufficient to qualify the plan for the exception for binding written contracts." But we believe that a grant under a plan would be considered in effect if a plan was in existence on November 2, 2017, with respect to (a) performance periods that begin pursuant to a plan, as well as grants made under a plan, in either case if done before November 2; and (b) grants made prior to November 2 but not yet vested or paid.

- ***Vesting:*** Many performance-based compensation arrangements contain service-based vesting conditions, that is, while the individual has a legally binding right to the compensation, he or she may need to complete a period of additional service for the employer, and will forfeit the compensation if he or she terminates employment prior to the end of the vesting period. (This service-based vesting period often lasts *after* the performance period ends.) The Council specifically requests clarification that a vesting period that extends beyond November 2, 2017, does not, by itself, cause performance-based compensation to lose its grandfather status.

- ***Earnings on deferrals:*** Most deferred compensation plans provide for interest or earnings on deferrals. We believe that these earnings are grandfathered to the extent the underlying deferral is grandfathered.

* * *

The Council believes it is important to clarify in the Blue Book that Congress intended for the written binding contract exception to protect the reasonable expectations of businesses that structured their compensation in reliance on the previous performance-based compensation exception to Section 162(m). Accordingly, we respectfully request a meeting with our legal experts to discuss the issues raised in this letter together.

Sincerely,

Lynn D. Dudley
Senior Vice President, Global Retirement and Compensation Policy

cc: Mike Evans, Chief Counsel (Minority Staff), Senate Finance Committee
Kara Getz, Chief Counsel (Minority Staff), House Ways and Means Committee
Robert Neis, Benefits Tax Counsel
William Paul, Deputy Chief Counsel, IRS
Stephen Tackney, Deputy Associate Chief Counsel, IRS