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Internal Revenue Service
1111 Constitution Avenue N.W., Room 5039
Washington, DC 20224

VIA REGULATIONS.GOV

RE: REG-122180-18: Section 162(m) Deduction Disallowance and its Application to Consulting Arrangements

Dear Mr. Enkishev:

Thank you for the opportunity to comment on the Proposed Regulations under Section 162(m) intended to implement changes made by the 2017 Tax Cut and Jobs Act (the "TCJA"). We write on behalf of a US publicly traded corporation client regarding the application of these regulations to payments under consulting arrangements before or after employment as an executive officer. In summary:

- The Proposed Regulations deviate from prior IRS guidance regarding whether consulting fees are included in "applicable employee remuneration."

- The TCJA does not provide a basis or evidence of legislative intent to change the definition of "applicable employee remuneration" to include non-employee remuneration.

- We recommend that the final regulations specify that applicable employee remuneration includes only pay attributable to an employment relationship (and not an independent contractor relationship).

Proposed Regulations Would Expand Applicable Employee Remuneration to Include Independent Contractor Pay

The Preamble to the Proposed Regulations discusses whether the Section 162(m) disallowance applies to compensation for services in a capacity other than an executive officer. The Preamble states that "Since the enactment of section 162(m) in 1993, director fees were considered applicable employee remuneration for purposes of section 162(m)(4)." It further provides that "in enacting section 162(m), Congress did

not exclude compensation for services not performed as a covered employee from the deduction limitation," and therefore "[c]ompensation earned by a covered employee through a non-employee position, such as director fees . . . has always been considered applicable employee remuneration for which the deduction is limited by section 162(m)."

To support this broad reading of the definition of applicable employee remuneration, the Preamble cites the 1993 House Conference Report:

> Unless specifically excluded, the deduction limitation applies to all remuneration for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash. If an individual is a covered employee for a taxable year, the deduction limitation applies to all compensation not explicitly excluded from the deduction limitation, regardless of whether the compensation is for services as a covered employee and regardless of when the compensation was earned.[1]

The Preamble does not accurately describe pre-TCJA law and does not point to any specific existing IRS guidance for support. In fact, the Service's interpretation is inconsistent with Section 162(m)(4).

Proposed Expansion to Include Non-Employee Pay Is Inconsistent with Section 162(m)(4)

Section 162(m)(4) defines applicable employee remuneration as:

> with respect to any covered employee for any taxable year, the aggregate amount allowable as a deduction under this chapter for such taxable year (determined without regard to this subsection) for remuneration for services performed by such employee (whether or not during the taxable year).[2]

This definition of "applicable employee remuneration" cannot reasonably be read to include pay in a non-employee capacity. Indeed, the term denotes *employee* remuneration, and refers to "remuneration for services performed *by such employee*" (emphasis added). Remuneration for services performed by an employee logically means remuneration for services performed in that capacity.

The IRS recognizes that an individual may simultaneously provide services to a given recipient as both an employee and an independent contractor.[3] As an IRS webpage

[1] Preamble, 84 Fed. Reg. at 70,364 (Dec. 20, 2019).

[2] Section 162(m)(4).

[3] *See, e.g.*, IRS, *When would I provide a Form W-2 and a Form 1099 to the same person?*, available at: https://www.irs.gov/government-entities/federal-state-local-governments/when-would-i-

explains, a man who works as a custodial employee of a school may also serve as an independent contractor in providing snow plowing services to that same school. The school must issue him both a Form W-2 and a Form 1099-MISC.

This follows from the fundamental principle that a person's trades or businesses are treated as separate unless a specific aggregation rule applies. This is true even when those trades or businesses provide services to the same recipient, and even when one of those trades or businesses is providing services as an employee.

This also arises in the context of qualified plan aggregation. An individual who serves a company as both an employee and an independent contractor may accrue benefits with respect to a company-sponsored retirement plan and a self-sponsored retirement plan.[4] The individual's two trades or businesses – those of providing services as an employee and of providing services as an independent contractor – are respected as separate.

Without drawing upon or establishing an aggregation rule, the Proposed Regulations aggregate remuneration to an employee with respect to the trade or business of providing services as an employee and with respect to the trade or business of providing services as an independent contractor. This is a key flaw.

Applying the Proposed Regulations' approach to other areas of the Code suggests its implausibility. For example, Section 181 allows expensing of costs relating to qualified film or television productions and qualified live theatrical productions. Qualified film or television productions and qualified live theatrical productions must meet requirements including that "75 percent of the total compensation of the production [must be] qualified compensation."[5] In turn, ""qualified compensation' means compensation for services performed in the United States by actors, production personnel, directors, and producers."[6]

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provide-a-form-w-2-and-a-form-1099-to-the-same-person ("Joe is a custodian who works for a county public school. The county views him as an employee and issues him a Form W-2 for these services. He also has a business that he owns and operates that provides snow plowing services on nights and weekends. Any snow plowing services he performs for the county are separate and distinct from his services as a custodian. Therefore the county should treat him as an independent contractor for his snow plowing business. The county reports this income on a Form 1099-Misc in Box 7, Nonemployee Compensation.")

[4] *Cf.* 52 Fed. Reg. 32502, 32517 (Aug. 27, 1987) (since-withdrawn Prop. Treas. Reg. § 1.414(o)-1(g), which would have aggregated an inside director's own plan with the company's employee plan by treating the director's plan as an "employee" plan for aggregation purposes).

[5] IRC §§ 181(d)(1), 181(e)(1).

[6] IRC § 181(d)(3)(A).

If the Proposed Regulations' logic were applied to Section 181, a film, television or live theatrical production could qualify for expensing by spending 75 percent of its compensation budget paying actors, production personnel, directors and producers to mine coal. The absurdity of this position is laid bare: clearly, "compensation for services performed . . . by actors, production personnel, directors, and producers" means compensation for services performed by actors, production personnel, directors, and producers *in those capacities*. Similarly, Section 162(m)'s reference to "remuneration for services performed by such employee" means remuneration for services performed by an employee *in that capacity*.

A statutory exception to "applicable employee remuneration" further supports the conclusion that remuneration is limited to employee pay. Payments referred to in Section 3121(a)(5)(A)–(D) are excluded from the term "remuneration."[7] Those provisions describe payments to "an employee or his beneficiary" with respect to certain savings and pension plans, and do not include self-employed persons within their scope. We are left with two interpretations of Section 162(m): one in which "applicable employee remuneration" describes remuneration with respect to employment, with an exception for certain savings and pension payments; and one in which "applicable employee remuneration" describes even remuneration with respect to services as an independent contractor, but does not provide an exception for services in that capacity with respect to savings and pension payments. There is no indication that Congress intended the inconsistent, second result, and Section 162(m) should not be read to provide that treatment.

Even if the House Report cited in the Preamble contradicted this result, legislative history cannot override plain statutory text. In fact, the House Report was previously interpreted in the Section 162(m) regulations simply to provide a very broad temporal rule – that the disallowance applies even if payments were earned in a year other than when the employee was a covered employee.[8] It did not address non-employee pay, nor did the original Section 162(m) regulations rely on it to address non-employee pay.

Expansion to Include Non-Employee Pay Contradicts Longstanding IRS Guidance

The Preamble to the Proposed Regulations does not accurately describe pre-TCJA law and does not point to any specific existing IRS guidance for support. In fact, it appears that the IRS directly addressed the application of Section 162(m) to non-employee pay only once, reaching the opposite conclusion of that in the Preamble.

[7] IRC § 162(m)(4)(C)(i).

[8] *See* Treas. Reg. § 1.162-27(c)(3)(1).

LTR 9745002 addressed a publicly traded taxpayer whose CEO, in a single taxable year, retired, provided paid consulting services to the taxpayer, was paid for services as a director of the taxpayer, and resumed serving as CEO after his successor resigned. With respect to the consulting services, the IRS ruled that "[p]rovided the $e in consulting fees received by CEO 1 was not in consideration for services performed as an employee of Taxpayer, the $e is not applicable employee remuneration." The IRS also stated that "[t]he director's fees received by CEO 1 were not in consideration for services performed as an employee of Taxpayer. They were received for services performed as a Director of Taxpayer. Therefore the $f is not applicable employee remuneration." This ruling was provided even though the consulting and directorship fees were earned and paid in a year in which the individual was a covered employee by reason of again becoming the CEO.

We are not aware of any other IRS guidance specifically addressing this issue, despite the Preamble's suggestion that the IRS position has been consistent since Section 162(m)'s adoption.[9]

Companies Have Reasonably Treated Non-Employee Pay as Exempt from Section 162(m) Disallowance

Based on the logic of the statute and regulations, practitioners' common understanding is that applicable employee remuneration excludes non-employee pay. For example, the Ginsburg Mergers & Acquisition treatise's section on executive compensation explains as follows:

> It follows that payments made to an individual other than for services performed as an employee are not subject to the $1 million deduction limit, even where the individual is at the same time rendering services to the publicly

[9] Subsequent to its adoption, Section 162(m) was expanded to include non-employees and non-employee compensation in limited circumstances. In particular, the special rule for health insurance issuers in Section 162(m)(6) applies to "applicable individuals," which includes non-employees. IRC § 162(m)(6)(F). For that provision, Congress created a new term – "applicable individual remuneration," which therefore must include remuneration as an individual not just as an employee. *See* IRC § 162(m)(6)(D). We understand that subsequent Treasury regulations defined "applicable individual remuneration" by reference to the general Section 162(m) definition of "applicable employee remuneration." *See* Treas. Reg. § 1.162-31(b)(9). This does not mean, however, that "applicable employee remuneration" includes non-employee remuneration for purposes of the disallowance for covered employee pay under Treas. Reg. § 1.162-27. Rather, the fact that Congress created a new defined term "applicable individual remuneration" suggests that it recognized such term needed to be broader than the existing definition of "applicable employee remuneration."

held corporation in her capacity as an employee of the corporation making the payment.[10]

Corporations have reasonably concluded that payment attributable to a period of consulting services before or after status as a covered employee was not subject to the Section 162(m) disallowance. A similar conclusion should apply to a separate independent contractor relationship that is concurrent to a period as a covered employee – although, in practice, such concurrent arrangements are relatively uncommon at large publicly traded corporations and sometimes difficult to establish as truly "separate."[11]

TCJA Changes Do Not Support Any Change to the General Definition of Applicable Employee Remuneration

The TCJA removed several exceptions to the definition of "applicable employee remuneration." However, the TCJA did not change the general definition of "applicable employee remuneration." In particular, the very structure of the definition remains that it applies to "employee remuneration," i.e. "remuneration for services performed by such employee." Accordingly, there is no basis for changing the general meaning of the term as a result of TCJA and no basis for changing it to include pay for services as something other than an employee.

Consulting Arrangements Were Not the Target of Section 162(m) and Do Not Raise Concerns for Potential Abuse

There are various common situations in which an executive officer of a publicly traded company provides non-employee services. For example:

- A retiring executive officer is asked to provide individual consulting services to the company after retirement to ease the transition of a new officer into that role.

[10] Ginsburg, et al., *Mergers , Acquisitions, and Buyouts: A Transactional Analysis of the Governing Tax, Legal, and Accounting Considerations* (volume current through May 15, 2019), at 15-353.

[11] The most common situation in which an executive could serve in both an employee and non-employee role is when the executive is an employee officer and simultaneously a member of the corporation's Board of Directors. However, such individuals usually do not receive the directors' fees that non-employee directors receive and instead receive a compensation package based on their employment. Furthermore, often in these situations the executive automatically leaves the Board of Directors if the executive terminates employment, suggesting that the role as a director is tied to the employment role.

- A non-employee outside director is hired by a publicly traded company as an interim CEO or CFO.

- An individual providing consulting or other independent contractor services to the company (either directly or through a corporation or partnership, such as a law firm) is hired by the company as an executive officer on an interim or permanent basis.

- An executive officer retires or otherwise terminates employment from a publicly traded company. The officer later joins a consulting firm, accounting firm, or law firm that provides services to the publicly traded company and either directly or indirectly supports these services.

Prior to the TCJA, Section 162(m) would not have limited the deduction for non-employee payments in these examples, whether the individual received consulting payments in the same year that they were a covered employee or not. There is no indication that the TCJA intended to change the results in these scenarios. Congress's focus with Section 162(m) was, and remains, excessive executive *employee* pay and not pay to independent contractors or consultants.

To be clear, we are not aware of any basis for the IRS to conclude that Section 162(m) could disallow payments by a publicly traded corporation to another unrelated corporation or partnership of which a covered employee might be a principal or employee. Such payments are not remuneration for services by the covered employee – to the extent that they are payments for services, they are for services performed by the unrelated corporation or partnership.[12]

In our view, there is no good policy reason under Section 162(m) for distinguishing between independent contractor services provided indirectly through a corporation or partnership and independent contractor services provided by a sole proprietor. In neither case are the services tied to the person's status as an employee or covered employee of the publicly traded corporation. The Section 162(m) rules should instead continue to distinguish between pay as an employee versus pay as a non-employee.

We understand that the IRS is concerned about potential abuse by taxpayers seeking to circumvent the disallowance under Section 162(m).[13] Consulting and independent

[12] Even if the IRS were proposing that Section 162(m) disallows some portion of payments that ultimately result in remuneration to a covered employee, such a rule would not be administrable. In many cases – for example, a former CFO who has become a principal at an accounting firm, or former General Counsel who has become a partner at a law firm – the corporation will be in no position to know what portion, if any, of their payment to the accounting or law firm results in remuneration to the individual.

[13] See Preamble, at n. 10 and accompanying text.

contractor arrangements have not been, and could not practically become, a significant strategy for avoiding Section 162(m). SEC rules contemplate only "individual" executive officers, so there is very little chance of replacing executive pay with consulting pay (without the IRS likely being in a strong position to challenge the executive's status as an employee). Given the proposed rule that "covered employee" status lasts forever even after termination of employment, one might imagine that companies and executives will seek to replace deferred compensation with post-termination of employment consulting agreements. This is not a practical concern. In particular, most executives leave companies to become executives at other companies and do not want and cannot continue to provide consulting services thereafter.

Recommendations

For the reasons explained above, we recommend that the final regulations specify that applicable employee remuneration includes only pay attributable to an employment (and not an independent contractor) relationship. This conclusion is supported by the existing statutory and regulatory language, unchanged by the TCJA. It is also supported by past IRS guidance and the common understanding of practitioners.

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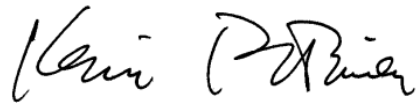
Thank you for the opportunity to share our comments. We welcome the opportunity to discuss these issues further and request the opportunity to do so at a public hearing.

Respectfully submitted,



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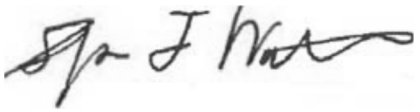

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