Ivins Phillips Barker
CHARTERED

February 18, 2020

Ilya E. Enkishev
Internal Revenue Service
1111 Constitution Avenue NW., Room 5039
Washington, DC 20224

VIA REGULATIONS.GOV

RE: REG-122180-18: Section 162(m) Deduction Disallowance and the "Once-Always" Status of Covered Employees

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"). These comments focus on the Proposed Regulations' definition of "covered employee" and its impact on deferred compensation plans.

For the reasons explained in our November 9, 2018 comment letter on Notice 2018-68, and the additional reasons provided herein, we recommend that the term "covered employee" be defined in accordance with the statutory text as an "employee" – i.e., an individual who is an employee at some point during the tax year for which the deduction would be available but for the potential application of Section 162(m).[1] Accordingly, payments pursuant to deferred compensation plans in years subsequent to a covered employee's termination of employment should not be subject to the disallowance under Section 162(m).

[1] The statutory language requires that, in addition to being in one of the enumerated categories, the covered employee must be an "employee" of the taxpayer : "For purposes of this subsection, the term 'covered employee' means *any employee* of the taxpayer if [he or she is – (A) CEO or CFO, (B) a top-3 highest-paid other officer, or (C) a covered employee in a prior year]." IRC § 162(m)(3) (emphasis added).

Deferred Compensation Plans Align Management's Incentives with Long-Term Company Performance, But Would Be Discouraged by the Proposed Regulations

Nonqualified deferred compensation plans provide benefits to management and executive employees well after they are earned – often in installments over a period of years beginning after retirement. Nonqualified deferred compensation plans have several valuable features:

- To the extent funded, amounts set aside for such benefits are subject to the company's creditors in the event of bankruptcy. These plans therefore serve to align management's incentives with those of long-term shareholders and do not reward executives for focusing only on short-term quarterly results.

- In addition to their natural long-term incentive effect, performance features can readily be built into deferred compensation plans. For example, contribution credits or vesting may be based on company or management performance.

- For established and start-up companies alike, deferred compensation arrangements allow corporations to use compensation otherwise paid to management in order to earn a higher return on these amounts than the individuals would otherwise achieve, encouraging management to invest in the company in furtherance of both their and the company's future performance.

- While deferred compensation can provide state and federal tax advantages to both the company and management, amounts are ultimately taxed at ordinary income rates rather than capital gains rates, which is beneficial to the U.S. Treasury.

These various features make deferred compensation plans valuable. They can be particularly valuable to long-term company shareholders and to other company stakeholders – including lower level employees whose livelihoods depend on the long-term viability of the company, not its short-term stock market value. Deferred compensations plans are therefore worth encouraging.

Unfortunately, deferred compensation plans would be discouraged under the proposed Section 162(m) regulations – and there could be much broader effect from the Proposed Regulations than might initially be apparent. One might conclude that, if a company's top executive pay is going to exceed the Section 162(m) one-million-dollar limit annually, companies and executives would be relatively indifferent between current pay and deferred pay. After all, unless there are significant changes in corporate income tax rates, a tax deduction lost tomorrow is basically the same as a tax deduction lost today. Furthermore, because Section 162(m) applies to relatively few management employees, it would not seem to affect the vast majority of deferred compensation plan participants. That is not the case, however, given the patterns of employment histories for executives at publicly traded companies.

Consider an individual who is hired or promoted to an Assistant Treasurer management role at a publicly traded company. She receives a significant raise and becomes eligible for the company's deferred compensation plan in which she can choose to defer some portion of her annual salary and bonus. The individual's pay is still well below the $1,000,000 Section 162(m) limit, she not an executive officer of the company, and even if she were, she would not be in the top 100 highest-paid employees, let alone the top five. She likely is still 5-10 years away from a promotion to Treasurer and perhaps another 5-10 years away from a potential promotion to CFO.

With potential promotions on her mind, this individual probably should avoid participating in the deferred compensation plan. If she were to participate, she would begin accruing a balance that could grow over time and interfere with her ability to get promoted. After all, any significant balance that she might accrue over 20 years in middle management would be an encumbrance when the company seeks to find a new CFO. Paired against an outside CFO candidate, promotion of this individual would result in a significant loss of deduction for the company – the individual's entire deferred compensation plan benefit. Furthermore, there is no way for her or the company to mitigate this issue; Section 409A rules prevent accelerating payment.

Such penalties on participation in deferred compensation arrangements do not further the purpose of Section 162(m) expressed either at enactment or upon revision by the TCJA. When enacting Section 162(m), Congress was focused on excessive executive pay:

> Recently, the amount of compensation received by corporate executives has been subject of scrutiny and criticism. The Committee believes that excessive compensation will be reduced if the deduction for compensation (other than performance-based compensation) paid to the top employees of publicly held corporations is limited to $1 million per year.[2]

Applying the disallowance to a post-retirement deferred compensation balance accumulated over a 30-year career just because the individual spends one final year of her career in an executive role does not further this stated purpose.

In enacting the TCJA, Congress expressed no concerns about deferred compensation. Quite the opposite in fact. Congress expressed concern that publicly traded companies had overemphasized performance pay, which "has led to perverse consequences resulting from the focus of such executives and businesses on quarterly results, rather than the long-term

[2] Ways and Means Committee Report (May 18, 1993), at 209; Senate Finance Committee Report, at 69.

success of the company and its rank-and-file workers."[3] Deferred compensation is precisely the tool that focuses management on long-term success of the company. Accordingly, it would make little sense for Treasury and the Service to accomplish by regulation what Congress did not seek to accomplish by statute.

The Section 162(m) regulations should not penalize participation in deferred compensation arrangements or discourage companies from adopting them, given the significant benefits deferred compensation arrangements provide to shareholders and other stakeholders, and the Congressional intent to support such arrangements.

The Section 162(m)(4) Definition of "Covered Employee" Unambiguously Applies Only to Employees, Not Former Employees

The Final Regulations can be easily drafted to exempt deferred compensation from the reach of Section 162(m). In fact, the unambiguous reading of the statutory text does so. The operative introductory clause of the definition of "covered employee" accomplishes this:

> For purposes of this subsection, the term "covered employee" means *any employee* of the taxpayer if [he or she is – (A) CEO or CFO, (B) a top-3 highest-paid other officer, or (C) a covered employee in a prior year].[4]

The text requires that, in addition to being in one of the enumerated categories, the covered employee must be an "employee" of the taxpayer.

In support of our November 9, 2018 comment letter analyzing this text, we enclose for consideration an excerpt from the May 2019 edition of the Ginsburg treatise covering tax considerations of mergers and acquisitions. The authors of this preeminent treatise reinforce our conclusions by pointing out that "the Committee Report can't override § 162(m)(3)'s statutory language."[5]

The Preamble to the Proposed Regulations addressed the definition of "covered employee" by stating that "[t]he statute gives no indication that the term 'employee' is limited to a current employee."[6] To the contrary, right in Section 162, the term "former employee" is used, indicating that Congress knew (or should have known) that "*current* employee" would be

[3] H.R. Rep. No. 115-409, at 331 (2017).

[4] IRC § 162(m)(3) (emphasis added).

[5] Ginsburg, et al., *Mergers , Acquisitions, and Buyouts: A Transactional Analysis of the Governing Tax, Legal, and Accounting Considerations* (May 2019 edition), at 15-352.

[6] Preamble, 84 Fed. Reg. at 70,361 (Dec. 20, 2019).

redundant.[7] Furthermore, right in the next section of the TCJA, adding Section 4960, the Code specifically adds in "former employees" because Congress deemed it necessary to do so.

In support of its conclusion, the Preamble also explains that "a reference in the Code to an 'employee' has frequently been interpreted in regulations as a reference to a current or a former employee."[8] To support this statement, the Preamble cites to Treasury Regulations under Section 105(h), which apply nondiscrimination requirements to employees and former employees as a condition of non-taxation of certain medical benefits, even though Section 105 itself only uses the term "employee."

The comparison to Section 105 is inapt in more than one way. First, the term "employee" in Section 162(m) appears in a definition section. Canons of statutory interpretation provide that such definition sections should be read assuming the drafters wrote them carefully and with precision.[9] Second, Section 105 itself contains evidence that "employee" includes individuals other than employees; the definition of ":highly compensated individual" under Section 105(h) specifically includes certain non-employees. Finally, Section 105 – dating back to the 1954 Internal Revenue Code – includes a broad authorization to prescribe regulations to carry out its provisions, which is not included in Section 162(m).[10]

To the Extent There Is Any Statutory Ambiguity, the Most Compelling Legislative History Counsels in Favor of Requiring a Current Employment Relationship

To the extent there is any ambiguity in the term "covered employee," the most compelling legislative history counsels in favor of requiring a covered employee to have a current employment relationship. The Preamble to the Proposed Regulations cites to the House Conference Report 115-466 and to the Blue Book for support of the "once/always" interpretation. As explained in our November 9, 2018, letter, there is more compelling evidence in the legislative history suggesting that the "once/always" interpretation should apply only while there is an employment relationship. This evidence includes the legislation itself (adding new Code Section 4960 and applying it specifically to "employees (including former employees)") and prior proposed legislation under Section 162(m) from which the language in the TCJA deviated.

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[7] Section 162(n)(3).

[8] Preamble, 84 Fed. Reg. at 70,361 (Dec. 20, 2019) (citing to, as an example, Treas. Reg. § 1.105–11(c)(3)(iii), noting that the nondiscrimination rules of section 105(h)(3) apply to former employees even though the Code uses only the term "employees").

[9] Antonin Scalia & Bryan A. Garner, *Reading Law: The Interpretation of Legal Texts* 225-33 (2012) ("Definition sections and interpretation clauses are to be carefully followed.").

[10] See Section 105(h)(8).

Recommendations

On statutory grounds and in support of strong policy goals, we recommend that the term "covered employee" be defined in accordance with the statutory text as an "employee" – i.e., an individual who is an employee at some point during the tax year for which the deduction would be available but for the potential application of Section 162(m). Accordingly, payments pursuant to deferred compensation plans in years subsequent to a covered employee's termination of employment should not be subject to the disallowance under Section 162(m).

If the final regulations do not adopt this plain meaning of the definition of "covered employee," the Service's interpretation should be effective only prospectively, not retroactive to the date of the TCJA. Taxpayers should be able to have reasonably relied on the plain meaning of "covered employee" prior to the issuance of the regulations. In addition, the Service should offer relief to mitigate the negative impacts of this interpretation on deferred compensation plans. For example, the Preamble focused on application of Section 409A to circumstances in which companies may want to delay payment. The Service should also provide mechanisms under Section 409A to allow companies more flexibility to accelerate payouts to avoid the actual or potential application of Section 162(m).

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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,

Kevin P. O'Brien

Spencer F. Walters
Ivins, Phillips & Barker, Chartered

Mergers, Acquisitions, and Buyouts

A Transactional Analysis of the Governing Tax, Legal, and Accounting Considerations

May 2019 Edition

Martin D. Ginsburg
Georgetown University Law Center

Jack S. Levin
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¶1509.1.4 Exception #3: Non-Covered Employee

¶1509.1.4.1 In General

§162(m)'s $1 million deduction limit applies only to compensation paid to an executive who is a "covered employee."

(1) Post-2017 Code. For a tax year beginning after 12/31/17, Code §162(m) defines a "covered employee" as "any employee of the taxpayer if"—

"(A) such employee is the principal executive officer [CEO] or principal financial officer [CFO] of the taxpayer [corporation] at any time during the taxable year, or was an individual acting in such a capacity,

"(B) the total compensation of such employee for the taxable year is required to be reported to shareholders under the . . . [1934 Act] by reason of such employee being among the 3 highest compensated officers for the taxable year (other than . . . [the CEO or CFO]), or

"(C) was a covered employee [under the pre-2018 covered employee definition[37]] of the taxpayer (or any predecessor) for any preceding taxable year beginning after December 31, 2016."[38]

A murky sentence at the end of this covered employee definition states that a covered employee includes "any employee who would be described in subparagraph (B) if the reporting [to shareholders under the 1934 Act] described in such subparagraph were required as so described." According to the 12/17 Joint Committee Statement, this is intended to cover executives of a corporation which is not required to file a proxy statement that "otherwise falls within the revised definition of a publicly held corporation,"[39] which includes:

(i) a corporation covered by 1934 Act §15(g) (i.e., a reporting company) which is not covered by 1934 Act §12(b) or §12(g) (i.e., is not a registered company), thus not required to comply with SEC's proxy rules,

(ii) a corporation that "would otherwise have been required to file a proxy statement for the year . . . but for the fact that the corporation delisted its securities or underwent a transaction that resulted in the non-application of the proxy statement requirement,"[40] and

(iii) an employee whose compensation is not required to be disclosed under SEC rules by reason of not being an executive officer of the corporation at the end of its fiscal year may nevertheless be a covered employee if the executive officer fell within one of post-2017 Code §162(m)(3)'s

[37]Notice 2018-68 §III.A., 2018-36 I.R.B. 418.
[38]Code §162(m)(3).
[39]12/17 Joint Committee Statement at 344.
[40]12/17 Joint Committee Statement at 344.

> definitions at some point during the corporation's taxable year that ended with or within such fiscal year.[41]

A publicly held corporation may have more (in some cases, many more) than 5 covered employees in any given tax year under the post-2017 covered employee definition. For example, where a corporation replaces its CEO (or acting CEO) or its CFO (or acting CFO) during a tax year, both the former and the new executive are covered employees (by virtue of the "at any time during the taxable year" language in (A) above). Also, under subparagraph (C)'s once-covered-post-2016-always-covered rule, changes from year to year in the composition of the 3 highest compensated officers post-2016 (as well as in the CEO, CFO, acting CEO, and acting CFO from year to year post-2016) add to the corporation's list of covered employees, including (subject to the ambiguities described in the next several paragraphs) with respect to determining the deductibility of both compensation for current year services and deferred compensation to a former (post-2016) covered employee (to the extent exceeding $1 million), even if deceased at the time of the payment.[42]

There is an ambiguity in the 2017 Act's broadening of the group of executives covered by §162(m). What if a person who had been a covered employee for 2017 or thereafter is no longer an "employee" (of any type) during the payment year—e.g., the former covered employee is (in the payment year) merely a (i) *non-employee consultant* receiving a consulting payment for current year services or (ii) a completely *retired* former covered employee receiving deferred compensation for prior year services? §162(m)(3) (as revised by the 2017 Act) states that "the term 'covered employee' means any *employee* of the [corporate] taxpayer if . . . (C) . . . a covered employee of the [corporation] . . . for any preceding taxable year beginning after December 31, 2016" (emphasis added). It can certainly be argued that since the former employee is not "any employee of the taxpayer" during the payment year (i.e., he is a non-employee consultant or is completely retired), his compensation paid in such post-employment year is not covered by §162(m).

However, the 12/17 Joint Committee Statement, at 344, states that "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" (emphasis added). Thus, the Joint Committee Statement views §162(m) as continuing to cover a person who was previously a covered employee (during a year beginning after 12/31/16) although no longer an employee of any kind in the payment year.

However, the Committee Report can't override §162(m)(3)'s statutory language which clearly states that "covered employee means any *employee* of the taxpayer"

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[41] Notice 2018-68 §III.A example 3, 2018-36 I.R.B. 418.

[42] Code §162(m)(4)(F) states that "Remuneration shall not fail to be [covered] . . . merely because . . . includible in the income of, or paid to, a person other than the covered employee, including after the death of the covered employee."

meeting criteria specified in (A) through (C) (emphasis added). Indeed the 2017 Tax Act (which adopted the revised §162(m) covered employee definition for a public corporation with an executive earning more than $1 million) also enacted an excise tax [Code §4960] on a tax-exempt organization with a "covered executive" earning more than $1 million, in which Congress chose to define "covered employee" (for purposes of Code §4960) as meaning "any employee (*including any former employee*)" who was 1 of the top 5 highest paid for such year or who was a prior-year covered employee. However Congress did not choose to add the "any former employee" language to Code §162(m).[43]

Nor does the language (quoted in a footnote above) from Code §162(m)(4)(F)—that "Remuneration shall not fail to be [covered] merely because . . . includible in income of, or paid to, a person other than the covered employee, including after the death of the covered employee"—demonstrate that Congress meant §162(m) to apply to a person who was no longer an employee at any time during the taxable year, since this language may have been intended to make clear that payments to a person who was an employee at some time *during* the payment year were covered even if paid to the deceased employee's estate or beneficiary subsequent to his death.

(2) Pre-2018 Code. For a tax year beginning before 1/1/18, Code §162(m) defined a "covered employee" as:

(a) "the chief executive officer ["CEO"] . . . or . . . an individual acting in such a capacity" "as of the close of the taxable year,"[44] plus

(b) the *four* officers (other than the CEO) whose "total compensation . . . for the taxable year is required to be reported to shareholders under the [1934 Act] by reason of such [officer] being among the 4 highest compensated officers for the taxable year (other than the [CEO])."[45]

(3) Tax regulations. Because no regulations (or proposed regulations) have been issued since the 12/17 enactment of the 2017 Tax Act, the following discussion reflects regulations issued prior to the 2017 Tax Act's enactment.

Although pre-2018 §162(m) explicitly contained an "as of the close of the taxable year" concept for the CEO, pre-2018 §162(m) did not explicitly contain this concept for the four highest compensated officers. However, the tax regulations issued under pre-2018 §162(m) did add such a concept, stating that a person who is not "the chief executive officer [or acting in such capacity]" or "among the four highest compensated officers" "on the last day of the taxable year" is not a covered employee.[46]

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[43] Indeed there are numerous other places in the Code where Congress over the years has used the words "former employee" in provisions aimed mainly at employees.

[44] Pre-2018 Code §162(m)(3)(A).

[45] Pre-2018 Code §162(m)(3)(B). IRS has ruled privately that where two individuals serve as co-CEOs of a publicly held corporation the more-highly compensated of the two co-CEOs is treated as the corporation's CEO for purposes of Code §162(m)(3)(A) and the other co-CEO is a covered employee under Code §162(m)(3)(B) if he is one of the four highest compensated officers (excluding the individual treated as the CEO). IRS Letter Ruling 199921032 (2/25/99).

[46] Reg. §1.162-27(c)(2) and (c)(6) example (1).

As a result, under pre-2018 Code §162(m), if an executive ceased to be CEO (for category (a) above) or ceased to be an officer (for category (b) above) before the last day of the corporation's taxable year (even though such person continued to provide services for the corporation, even as an employee), pre-2018 Code §162(m)'s $1 million deduction limit did not apply to compensation to such executive which was deductible in such year or a subsequent year (so long as such executive did not thereafter again become an officer on the last day of such deduction year). (This was true even for an executive whose compensation was disclosed in the proxy statement as compensation paid to a former executive under post-1993 SEC disclosure regulations described in ¶1509.1.4.2 requiring disclosure of a *former* officer's compensation under certain circumstances.[47])

In at least one circumstance—where a person ceased to be the corporation's CEO *on* (but before the midnight close of) the last day of the corporation's taxable year—there could be a conflict between the pre-2018 statutory language (CEO "as of the close of the taxable year") and the language of the tax regulations (CEO "on the last day of the taxable year").

See ¶1509.1.4.2(3) for discussion of IRS Notice 2007-49 providing guidance on the conflict between the tax and SEC rules in identifying covered employees (and effectively reducing the number of covered employees from 5 to 4 for a corporation's tax years beginning prior to 1/1/18 by deleting the CFO as a covered employee regardless of compensation). But see ¶1509.1.4.2(4) for discussion of IRS Memorandum 201543003 holding that, notwithstanding Notice 2007-49, the CFO of a "smaller reporting company" may be a covered employee for a corporation's tax years beginning prior to 1/1/18 based on compensation.

¶1509.1.4.2 Coordination with 1934 Securities Exchange Act

In general, Code §162(m)'s reference to compensation "required to be reported to shareholders" under the 1934 Act refers to disclosure in the corporation's annual proxy statement. The 1934 Act requires a publicly held corporation (i.e., a corporation with a class of equity securities registered with SEC under 1934 Act §12(b) or §12(g)—see ¶1702.8.6) to disclose the compensation of its CEO and certain other highly paid executive officers[48] in its proxy statement issued to shareholders

[47]IRS Letter Ruling 199910011 (12/4/98). IRS Letter Ruling 199928014 (4/13/99); IRS Letter Ruling 199928015 (4/13/99). These rulings were conditioned on the assumption that no intent exists on the part of the corporation or the officers in question "to resume their duties as officers at any time in the foreseeable future."

[48]SEC Rule 3b-7 under the 1934 Act defines "executive officer" as a company's "president, any vice president . . . in charge of a principal business unit, division or function (such as sales, administration, or finance), any other officer who performs a policymaking function or any other person who performs similar policymaking functions . . . . Executive officers of subsidiaries may be deemed executive officers of the [parent] if they perform such policymaking functions for the [parent]."

Under Code §162(m) any "officer" (not merely an executive officer) is a potential "covered employee." However, an officer can be a Code §162(m) covered employee only if his

(*footnote continues*)