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VIA E-MAIL (notice.comments@irscounsel.treas.gov)

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Re: Notice 2018-68 and Section 162(m)(3) Definition of Covered Employee

Gentlemen:

We write to offer comments regarding the Service's proposed definition of "covered employee." Notice 2018-68 proposes a definition of "covered employee" that contradicts the statutory text, as revised by the Tax Cut and Jobs Act (the "TCJA"). Specifically, the Service disregards statutory language requiring that a "covered employee" be an "employee" – *i.e.*, an individual who is an employee at some point during the tax year.

Section II.B of the Notice correctly restates the statutory language, noting that "covered employee" includes only an "employee" who was a covered employee for a preceding year. However, Section III.A of the Notice errantly reads the word "employee" out of the definition of "covered employee" and expands covered employee to include any "individual" who was a covered employee in a prior year. Although a leading tax treatise has questioned this errant interpretation,[1] it has become encapsulated in the widely repeated shorthand "*Once a Covered Employee, Always a Covered Employee*." This approach would rely on a slice of legislative history to override the plain statutory language of Section 162(m)(3). There is no basis for doing so. The Service should defer to the plain statutory text and recognize that a covered employee ceases to be covered by Section

[1] *See* Ginsburg, Levin, and Rocap, *Mergers, Acquisitions, and Buyouts* (April 2018 edition) § 1509.1.4.1, at 15-358 ("It can certainly be argued that since the former employee is not 'any employee of the taxpayer' during the payment year . . ., his compensation paid in such post-employment year is not covered by §162(m).").

162(m) no later than the end of the taxable year in which he or she ceases to be an employee. Only a technical correction or other legislative action could override the plain statutory meaning.

As a result of this plain meaning, payments delayed until after the year in which a covered employee ceases to be an employee should not be subject to Section 162(m)'s deduction limit. These include the vast majority of non-qualified retirement plans, severance arrangements, and equity pay exercised after termination of employment. Excluding these arrangements from the reach of Section 162(m) is consistent with the TCJA's goal of promoting a more simplified Tax Code. It would also ease tax administration for the Service, including with respect to some otherwise difficult applications of the Section 162(m) grandfather rule. At the same time, exempting these arrangements may well not materially affect tax revenues related to deferred compensation. This is because taxpayers can also avoid the reach of Section 162(m) to deferred compensation arrangements by delaying payment, subject to certain limitations.[2] Such a delay would postpone U.S. Treasury receipt of the bulk of the related tax revenues, given the current difference between individual and corporate income tax rates.

Plain Statutory Text Applies Disallowance Only to "Employees"

The operative introductory clause of the definition of "covered employee" has remained unchanged, including by the TCJA, since its 1993 promulgation:

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

The text clearly requires that, *in addition to* being in one of the enumerated categories, the covered employee must be an "employee" of the taxpayer.[4] The terms "employee" and "individual" (as used in Notice 2018-68) are of course not interchangeable. Significantly, a former employee is almost always an "individual" but, by definition, has stopped being an "employee."

The Service's replacement of the word "employee" with "individual" in Notice 2018-68 is unexplained and unsupportable but is admittedly not unprecedented. The Service made the same unexplained terminology substitution in the existing regulatory definition of "covered

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[2] *See* Treas. Reg. § 1.409A-2(b)(7)(i).

[3] Code § 162(m)(3) (emphasis added); Omnibus Budget Reconciliation Act of 1993, P.L. 103-66, § 13211(a).

[4] This reading is reinforced with references to "such employee" in subparagraphs (A) and (B) of the definition, as well as to "any employee" in the new flush text following subparagraph (C) setting forth the catch-all applicable when SEC reporting is not required. The only subparagraph not to repeat the "employee" term is subparagraph (C), which contains a drafting error. As written, the sentence including subparagraph (C) is grammatically incoherent, and it seems likely that the words "such employee" are missing from the beginning of subparagraph (C).

employee."[5] However, in those regulations, the definition otherwise precludes its application to former employees. This is because the regulations specifically include a requirement that a covered employee be such "on the last day of the taxable year."[6] Accordingly, the Service never previously interpreted "employee" under Section 162(m)(3) to include former employees.

New subparagraph (C) provides no basis for inclusion of former employees. Subparagraph (C) does not change the general structure of Section 162(m)(3) post-TCJA: it still requires a year-by-year determination of who is a "covered employee." Each year, a taxpayer identifies its "covered employees" starting with the universe of all employees. Within that universe, new subparagraph (C) treats an employee as a "covered employee" if the employee was a "covered employee" in a preceding year. Subparagraph (C) thereby looks back to prior years, but the lookback would not even apply if the person is not an employee in the first place.[7]

Other TCJA Provisions Support Plain Language Interpretation

The statutory evidence suggests that Congress specifically *rejected* a broad definition of "covered employee" that would apply to former employees. Elsewhere in the TCJA, Congress distinguished between current-year employees and individuals who were employees in prior years. The TCJA introduced an excise tax on tax-exempt organizations that pay executives more than $1 million per year. This new Section 4960 mimics the disallowance under Section 162(m). Under Section 4960, Congress specified that "covered employee" means "any employee *(including any former employee)* . . . if the employee" is a top-five highest paid or was a covered employee in a prior year.[8] Congress thus knows – and demonstrates it knows right in the TCJA – how to include former employees if it wanted to do so. In fact, this different statutory language appears to be intentional: the explained rationale for new Section 4960 identifies particular Congressional concern that "excessive severance packages" for senior executives of tax-

[5] Treas. Reg. § 1.162-27(c)(2)(i) ("A covered employee means any *individual* who, on the last day of the taxable year, is (A) The [CEO], or (B) Among the four highest compensated officers (other than the [CEO]).") (emphasis added).

[6] The last day of the year employment requirement was included in the regulations with respect to the top-3 highest paid officers even though the then (pre-TCJA) statutory text did not apply the last day of the year rule to Code § 162(m)(3)(B). In now proposing to remove the last day of the year employment requirement for top-3 highest paid officers, Notice 2018-68 relies on new flush language following Code § 162(m)(3)(C) ("Such term shall include any employee who would be described in subparagraph (B) if the reporting described in such subparagraph were required as so described."). This language provides no basis for expanding the definition of "covered employee" to include non-employees. To the contrary, the new language repeats that "covered employee" means only an "employee" of the taxpayer.

[7] New subparagraph (C) often *results* in carrying forward covered employee status to future years. Hence, the "*Once a Covered Employee, Always a Covered Employee*" shorthand and Committee Report explanations. However, the provision's logic is not based on "carrying forward" covered employee status; as we explain above, it is based on looking back. The shorthand therefore inaccurately states the logic of the rule. An alternative shorthand does not come easy. Our best attempt to date is subtle rather than catchy: "An Employee, Once Covered, Remains Covered."

[8] Code § 4960(c)(2) (emphasis added).

exempt organizations should not be tax-subsidized.[9] There is no apparent evidence of similar concern regarding publicly-traded companies; if anything, Congress seems to have been focused on bonuses paid to such executives.[10] Section 162(m)(3) should not be read to add words that Congress omitted.[11]

Other Tax Code Provisions Also Support Plain Language Interpretation

Although the TCJA's modifications to the Tax Code are the most recent, and therefore the most relevant, evidence of similar statutory construction, other Tax Code provisions also show that the term "employee" is not inclusive of "former employees." For example, in Section 79(e), Congress felt it necessary to specify that "[f]or purposes of [Section 79], the term 'employee' includes a former employee." Similarly, Congress needed to expand the definition of "employee" for the purposes of Section 132(a)(1) and (2) to "include" certain individuals formerly employed by the employer.[12] And, in a deduction limitation within Section 162 itself, Congress listed "any former employee" alongside "any employee"; there would have been no reason to do so if the latter included the former.[13] The Tax Code contains numerous other examples.[14] If the term "employee" itself already encompassed former employees, we would expect to see at least a Tax Code provision or two referring to "employee" but where Congress needed to carve out "former employees" from its scope. We are not aware of any such provision.

Legislative History Not Relevant Because Statute is Not Ambiguous

Statutory interpretation "begins with the language of the statute. . . . And where the statutory language provides a clear answer, it ends there as well."[15] Exceptions to this rule are reserved for those rare circumstances in which the plain language might "lead to absurd or impractical consequences"[16] or "turn out to be 'untenable in light of [the statute] as a

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[9] H.R. Rep. No. 115-409, at 333 (2017).

[10] *See id.* at 331 (concern that a shift to performance pay "has led to perverse consequences resulting from the focus of such executives and businesses on quarterly results, rather than the long-term success of the company and its rank-and-file workers").

[11] *See INS v. Cardoza-Fonseca*, 480 U.S. 421, 432 (1987) ("[W]here Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion.") (citations omitted).

[12] *See* Code § 132(h)(1).

[13] *See* Code § 162(n)(3) (defining a group health plan to include those plans providing health care "to any employee, any former employee, the employer, or any other individual associated or formerly associated with the employer in a business relationship, or any member of their family").

[14] *E.g.*, Code § 414(q)(6) (application of highly compensated employee rule to former employees); Code §§ 4376(c)(2) & 5000(b)(1) (health plans defined to cover plans benefitting employees or former employees). *Cf.* Code §§ 280G & 409A (terms of art "disqualified individual" and "service provider" when Congress wants a more expansive term).

[15] *Harris Trust & Savings Bank v. Salomon Smith Barney Inc.*, 530 U.S. 238, 254 (2000) (*quoting Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432, 438 (1999)); *see also INS v. Cardoza-Fonseca*, 480 U.S. 421, 452–53 (1987) (Scalia, concurring in judgment) ("Judges interpret laws rather than reconstruct legislators' intentions. Where the language of those laws is clear, we are not free to replace it with an unenacted legislative intent.").

[16] *United States v. Mo. Pac. Ry. Co.*, 278 U.S. 269, 278 (1929).

whole.'"[17] The statutory definition of "covered employee" is clear and unambiguous in limiting its application to employees of the taxpayer. No part of the definition extends to former employees or non-employees. Legislative history and intent thus should be irrelevant.

Even assuming Section 162(m)(3)'s references to "employee" were ambiguous, the legislative history is mixed on whether Congress preferred that it also refer to former employees. The Conference Report offers the most direct support for the "*Once a Covered Employee, Always a Covered Employee*" approach:

> In addition, if an individual is a covered employee with respect to a corporation for a taxable year beginning after December 31, 2016, the individual remains a covered employee for all future years. Thus, 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.[18]

This language admittedly seems inconsistent with the plain reading we describe above of Section 162(m)(3) and its new lookback definition of "covered employee." However, it is not entirely irreconcilable, particularly considering ambiguities – and likely some imprecision – in the Conference Report explanation. For example, the second sentence is still an accurate statement under the plain reading of Section 162(m)(3) that we describe above; the sentence could be read just to require removal of the last day of the year rule. The first sentence of the Conference Report quoted above is overbroad in its reference to "all future years," but the language is overbroad in another respect also: it does not clearly limit covered employee status in future years in relation only to the taxpayer; read literally, the Conference Report seems to say that a covered employee of Taxpayer A will in future years be a covered employee (even of unrelated Taxpayer B), even though the statute is again clear to the contrary. This suggests that the Conference Report may have been imprecise rather than a reliable reflection of legislative intent.

It is impossible to prove a negative – in this case, a lack of legislative intent for TCJA to extend "covered employee" status to former employees. However, we have not found any stated legislative purpose to evidence this intent. The most significant policy concern related to Section 162(m) was articulated in a Committee Report for which the same explanatory language used in the Conference Report was first drafted. The report noted:

> The Committee believes that the significant exceptions to the limit on deductible executive compensation by publicly traded corporations have resulted in a shift away from cash compensation paid to senior executives in favor of stock options and other forms of performance pay. The Committee further believes this shift has led to perverse consequences

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[17] *King v. Burwell*, 576 U.S. ___, 135 S.Ct. 475 (2015) (*quoting Dept. of Revenue of Ore. v. ACF Industries, Inc.*, 510 U.S. 332, 343 (1994)).

[18] H.R. Rep. No. 115-466, at 489 (2017).

> resulting from the focus of such executives and businesses on quarterly results, rather than the long-term success of the company and its rank-and-file workers.[19]

If anything, this stated legislative purpose suggests that Congress might want to preserve the deduction of non-qualified deferred compensation which, by its nature as an unfunded promise, focuses executives on the long-term success and viability of the company.

Finally, other legislative history, particularly prior legislative proposals, also would weigh against the Conference Report explanation. Congress considered expanding Section 162(m) for a decade before enacting the TCJA. These efforts trace back to a 2007 proposal passed by the Senate but not passed into law at the time. The proposal explicitly sought to add a "O*nce a Covered Employee, Always a Covered Employee*" rule.[20] The 2007 proposed language would have changed the "covered employee" definition to say that "the term 'covered employee' means, with respect to any taxpayer for any taxable year, an *individual* who" was in one of the enumerated categories, including being a covered employee in a prior year.[21] Although this same construction appeared in various bills after 2007,[22] the term "individual" was not the approach taken in the 2014 tax reform proposal, which used the language that found its way into the TCJA.[23] Without a doubt, the term "individual" would more readily include employees together with former employees (and likely even people who were never employees). The prior legislation suggests that Congress may have considered and specifically rejected such an approach.

Employment Requirement Is Consistent with Other 2017 Changes to Section 162(m)

The definition of "covered employee" being applicable only to "employees" (and not former employees) is consistent with other changes made to Section 162(m) in the TCJA. The Service therefore should not be concerned about this plain meaning introducing ambiguity elsewhere in Section 162(m).

First, the new category of covered employees looking back to prior years retains meaning and still expands the deduction disallowance compared to pre-TCJA law. This is because for many companies, CEOs, CFOs, and other top-3 paid officers stay at the company upon ceasing to be in those roles. So long as they remain employed by the company, the new law results in them remaining "covered employees" subject to the disallowance.

Second, Section 162(m)(4)(F) also retains meaning. The provision states that "[r]emuneration shall not fail to be applicable employee remuneration merely because it is

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[19] H.R. Rep. 115-409, at 331 (2017).

[20] H.R. Rep. 110-1, at 68-69 (2007). This approach was widely criticized at the time by many stakeholders. *See* Hearing Serial No. 110-10 (March 14, 2007), at 22, 55, 62, 76, 78-79 & 84.

[21] Small Business and Work Opportunity Act of 2007, S.349, § 214 (emphasis added).

[22] *See* Fair Minimum Wage Act of 2007, H.R. 2 (EAS), 110th Cong. (2007), § 234; Stop Subsidizing Multimillion Dollar Corporate Bonuses Act, S. 1476, 113th Cong. (2013), § 2 (subsequently reintroduced as H.R. 3970, 113th Cong. (2013), S. 1127, 114th Cong. (2015), H.R. 2103, 114th Cong. (2015), S. 82, 115th Cong. (2016), and H.R. 399, 115th Cong. (2016)).

[23] *See* Tax Reform Act of 2014, H.R. 1, 113th Cong. (2014), § 3802.

includible in the income of, or paid to, a person other than the covered employee, including after the death of the covered employee." This provision simply provides that Section 162(m)'s deduction disallowance remains applicable regardless of the compensation's recipient. It most directly addresses assignment of income problems arising in contexts such as divorce settlements.[24] To the extent that this special rule refers to post-death payments, it is simply consistent with the elimination of the last day of the year employment rule and does not require redefining the term "employee."[25]

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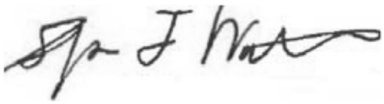
Thank you for the opportunity to share our comments. We welcome the opportunity to discuss these issues further. We note that, although a number of our clients have an interest in the subject matter of these comments, we are not writing this letter on behalf of any particular client.

Respectfully submitted,

Kevin P. O'Brien



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[24] Congress might have been focused on this particularly because of the TCJA's change in the tax treatment of alimony. *See* TCJA, § 11051 (alimony taxed at rates applicable to the payor rather than recipient spouse).

[25] We note that this provision does not compel the Service to impose its proposed elimination of the last day of the year employment rule for Code § 162(m)(3)(B) covered employees (top-3 highest paid officers). Congress very well could have included Code § 162(m)(4)(F) due to TCJA's statutory elimination of the last day of the year employment rule for Code § 162(m)(3)(A) covered employees (CEOs and CFOs).