TAX SECTION
State Bar of Texas

February 17, 2020

Via Federal eRulemaking Portal at *www.regulations.gov*

CC:PA:LPD:PR (REG–122180–18)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

RE: ***Comments Regarding Proposed Regulations on Certain Employee Remuneration in Excess of $1,000,000 under Internal Revenue Code Section 162(m)***

Ladies and Gentlemen:

On behalf of the Tax Section of the State Bar of Texas ("Tax Section"), I am pleased to submit the enclosed response to the request of the United States Department of the Treasury (the "Treasury Department") and the Internal Revenue Service (the "Service") for comments pertaining to the proposed rulemaking in Certain Employee Remuneration in Excess of $1,000,000 Under Internal Revenue Code Section 162(m), 84 Federal Register 70356, published in 84 Fed. Reg. 70356–70391 (December 20, 2019), adding certain proposed regulations (the "Proposed Regulations") under section 162(m) of the Internal Revenue Code of 1986, as amended (the "Code").

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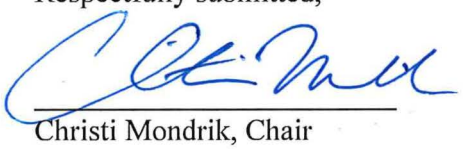
(512) 427-1463 or (800) 204-2222

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend the Treasury Department and the Service for the time and thought that have been put into preparing the Proposed Regulations, and we appreciate being extended the opportunity to participate in this process. We specifically request that Henry Talavera, on behalf of the Tax Section, be permitted to participate in the public hearing scheduled for March 9, 2020, to discuss the topic raised below. Mr. Talavera is simultaneously providing a brief outline as part of this comment submission.

Respectfully submitted,



Christi Mondrik, Chair
State Bar of Texas, Tax Section

Enclosure

COMMENTS ON PROPOSED REGULATIONS ADDRESSING CERTAIN EMPLOYEE REMUNERATION IN EXCESS OF $1,000,000 UNDER SECTION 162(m) OF THE CODE

These comments on the Proposed Regulations ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafters of these Comments were Jessica S. Morrison, Vice-Chair of the Employee Benefits Committee of the Tax Section, and Henry Talavera, Treasurer of the Tax Section; Rafael Ramos Aguirre assisted with drafting these Comments.[1] The Committee on Government Submissions of the Tax Section has approved these Comments. James Griffin, Chair of the Employee Benefits Committee of the Tax Section, and Mark A. Bodron, member of the Tax Section, also reviewed the Comments and provided substantive suggestions.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: February 17, 2020

[1] Mr. Aguirre is an associate in Mr. Talavera's law firm, though he is not a member of the State Bar of Texas.

I. INTRODUCTION

These Comments are provided in response to the request of the Treasury Department and the Service for comments regarding the Proposed Regulations addressing certain employee remuneration in excess of $1,000,000 under section 162(m) of the Code, as amended by section 13601 of Public Law 115-97 (the "Act"). We appreciate the opportunity to comment on the Proposed Regulations.

II. SUMMARY

We are commenting on only one topic: the meaning of "negative discretion" under the "grandfather" rule of the Act. We respectfully recommend that the Service clarify that a compensation committee of the board of directors of a corporation or other responsible body ("Compensation Committee") will not be deemed to have the right to exercise negative discretion solely because the applicable plan or other document governing an award (the "plan") had a provision in effect on or prior to November 2, 2017, giving negative discretion to the Compensation Committee to reduce the amount of compensation that the corporation is obligated to pay, but will only not be deemed to have that right if the following was also accurate as of such date:

> Such negative discretion was limited by one or more provisions in the plan that (when read together) required (or in all material respects required) compliance with the requirements for the payment of qualified performance-based compensation under section 162(m) of the Code.

In such case and consistent with applicable state law, we respectfully suggest that the Compensation Committee should not be considered to have a right to exercise negative discretion. Therefore, any provision purporting to give such negative discretion (without further action of the Compensation Committee) should be disregarded in determining the amount of compensation that a corporation is obligated to pay pursuant to a written binding contract.

III. WE SUGGEST THAT A PLAN PROVISION REQUIRING COMPLIANCE WITH SECTION 162(m) SHOULD EFFECTIVELY LIMIT NEGATIVE DISCRETION OTHERWISE PROVIDED FOR BY A PLAN.

Section 13601(e) of the Act provides that amendments made by the Act to section 162(m) of the Code "shall not apply to remuneration which is provided pursuant to a written binding contract which was in effect on November 2, 2017, and which was not modified in any material respect on or after such date." This "grandfather" rule is further described in Proposed Regulation § 1.162-33(g)(1)(i), which provides:

> Remuneration is a grandfathered amount only to the extent that as of November 2, 2017, the corporation was and remains obligated under applicable law (for example, state contract law) to pay the remuneration under the contract if the employee performs services or satisfies the applicable vesting conditions.

In the Preamble to the Proposed Regulations, the Service specifically addresses the application of this rule to compensation subject to negative discretion:

> Under the definition of written binding contract in Notice 2018–68 and these proposed regulations, applicable law (such as state contract law) determines the amount of compensation that a corporation is obligated to pay pursuant to a written binding contract in effect on November 2, 2017. Some commenters suggested that negative discretion be completely disregarded in determining the amount of compensation that a corporation is obligated to pay pursuant to a written binding contract. The proposed regulations do not adopt this approach, because it is contrary to the statutory text and the legislative history. See House Conf. Rpt. 115–466, 490 (2017). The Treasury Department and the IRS are aware, however, that compensation arrangements may purport to provide the corporation with a wider scope of negative discretion than applicable law permits the corporation to exercise. ***In that case, the negative discretion is taken into account only to the extent the corporation may exercise the negative discretion under applicable law***.

Preamble to Proposed Regulations, 84 Fed. Reg. 70365 (emphasis added).

The Proposed Regulations also include an example illustrating the negative discretion concept in Proposed Regulation § 1.162-33(g)(3)(xvi) ("*Example 16*"*)*, which provides:

> *Example (16).* (Performance bonus plan with negative discretion).
>
> (A) *Facts.* Employee E serves as the PEO of Corporation V for the 2017 and 2018 taxable years. On February 1, 2017, Corporation V establishes a bonus plan, under which Employee E will receive a cash bonus of $1,500,000 if a specified performance goal is satisfied. The compensation committee retains the right, if the performance goal is met, to reduce the bonus payment to no less than $400,000 if, in its judgment, other subjective factors warrant a reduction. On November 2, 2017, under applicable law which takes into account the employer's ability to exercise negative discretion, the bonus plan established on February 1, 2017, constitutes a written binding contract to pay $400,000. On March 1, 2018, the compensation committee certifies that the performance goal was satisfied, but exercises its discretion to reduce the award to $500,000. On April 1, 2018, Corporation V pays $500,000 to Employee E. The payment satisfies the requirements of §1.162-27(e)(2) through (5) as qualified performance-based compensation.
>
> (B) *Conclusion.* If this §1.162-33 applies, Employee E is a covered employee for Corporation V's 2018 taxable year. Because the February 1, 2017, plan is a written binding contract to pay Employee E $400,000 if the performance goal is satisfied, this section does not apply (and §1.162-27

> does apply) to the deduction for the $400,000 portion of the $500,000 payment. Furthermore, the failure of the compensation committee to exercise its discretion to reduce the award further to $400,000, instead of $500,000, does not result in a material modification of the contract. Pursuant to §1.162-27(e)(1), the deduction for the $400,000 payment is not subject to section 162(m)(1) because the payment satisfies the requirements of §1.162-27(e)(2) through (5) as qualified performance-based compensation. The deduction for the remaining $100,000 of the $500,000 payment is subject to this section (and not §1.162-27) and therefore the status as qualified performance-based compensation is irrelevant to the application of section 162(m)(1) to this remaining portion.

84 Fed. Reg. 70389.

We suggest that this *Example 16* does not provide sufficient guidance to corporations; as a result, this *Example 16* can perhaps be interpreted to "un-grandfather" many plans that should be grandfathered because in practice there is not unlimited and impermissible negative discretion as contemplated by the Service. In these Comments, we address a common type of provision that, in our experience, exists in many plans. We respectfully suggest that negative discretion (and whether it can be exercised) should be determined based upon the overall provisions of a plan and not simply a provision (out of context) that may appear to grant full and complete "negative discretion" to a Compensation Committee.

We note that provisions granting negative discretion to a Compensation Committee have been used and adopted widely by plans. We suggest that this is likely because Treasury Regulation § 1.162-27(e)(2)(iii) expressly provided that the Compensation Committee, in compliance with the requirements under section 162(m) of the Code for the payment of qualified performance-based compensation (the "Section 162(m) Requirements"), may retain the discretion to eliminate or reduce an amount of compensation or other economic benefit that was due upon attainment of a performance goal.

We respectfully suggest that the extent of any "negative discretion" should be determined based on all of the underlying documentation and provisions related to a plan, including, but not limited to, provisions that limit a Compensation Committee's ability to exercise any negative discretion. Just as negative discretion is widely used and useful in compensation plan design, it has been very common in our experience for plans also to include provisions that require a Compensation Committee to comply with the Section 162(m) Requirements as a precondition for the payment of amounts intended to be qualified performance-based compensation. Indeed, publicly traded corporations often represent in applicable SEC filings that compliance with the Section 162(m) Requirements will be achieved. Even if a plan does not expressly limit any negative discretion, in such context the Compensation Committee can never exercise its negative discretion in a manner that would violate the Section 162(m) Requirements without violating the express terms of other plan provisions.

We suggest that all of the provisions of a plan should be read in context. As the Second Restatement of Contracts provides, "[a] writing is interpreted as a whole, and all writings that are part of the same transaction are interpreted together." Restatement (Second) of Contracts § 202(2). The Texas Supreme Court has stated that, "[i]n construing a written contract, the primary concern of the court is to ascertain the true intentions of the parties as expressed in the instrument," and "[t]o achieve this objective, courts should examine and consider *the entire writing* in an effort to harmonize and give effect to *all the provisions* of the contract so that none will be rendered meaningless." *Coker v. Coker*, 650 S.W.2d 391, 393 (Tex. 1983). Further, "[n]o single provision taken alone will be given controlling effect; rather, all the provisions must be considered with reference to the whole instrument." *Id.*

If the Proposed Regulations are not revised to require a holistic interpretation of all provisions of a plan in this context, it is possible that a negative discretion provision as outlined in the Proposed Regulations would lead to the retroactive and automatic loss of grandfathered status of many plans. A plan provision that, taken out of context, appears to provide discretion to a Compensation Committee to reduce an award to zero (or any other amount), does not necessarily give a Compensation Committee unfettered discretion to make such a reduction.

As described above, in many cases, such discretion is effectively limited by provisions of a plan that mandate compliance with the Section 162(m) Requirements. In such a circumstance, we respectfully suggest that any awards in place on November 2, 2017, that require compliance with Section 162(m) Requirements became binding pursuant to such requirement and state law once the Act required that a binding contract be in place on that date in order for the Section 162(m) Requirements to remain satisfied after that date. As long as the Compensation Committee did not (and does not) actually exercise such negative discretion in a manner contrary to other plan provisions that mandate compliance with the Section 162(m) Requirements, then we suggest that grandfathered status should not be lost.

We also suggest that incorporation of the Section 162(m) Requirements into a plan should be viewed in light of the broad interpretive authority that, in our experience, most plans give the Compensation Committee. A Compensation Committee's typically broad authority to interpret a plan arguably permits it to disregard a negative discretion provision that, when read in context with other plan provisions requiring compliance with the Section 162(m) requirements, should have no effect after November 2, 2017, so that the plan should remain grandfathered. In other words, if the Compensation Committee interprets the plan as providing a binding promise, we respectfully suggest that the Service should respect that this interpretation governs absent facts and circumstances to the contrary.

The approach advanced in these Comments is consistent with provisions of the Code requiring "binding" rights in other contexts. In particular, the regulations under section 409A of the Code provide the following:

> A service provider does not have a legally binding right to compensation to the extent that compensation may be reduced unilaterally or eliminated by

> the service recipient or other person after the services creating the right to the compensation have been performed. However, if the facts and circumstances indicate that the discretion to reduce or eliminate the compensation is available or exercisable only upon a condition, ***or the discretion to reduce or eliminate the compensation lacks substantive significance***, a service provider will be considered to have a legally binding right to the compensation. Whether the discretion to reduce or eliminate the compensation lacks substantive significance depends on all the relevant facts and circumstances."

Treas. Reg. § 1.409A-1(b)(1) (emphasis added).

We respectively suggest that negative discretion lacks substantive significance in circumstances in which such negative discretion is limited by the Section 162(m) Requirements (i.e., in situations in which a Compensation Committee's exercise of negative discretion after the enactment of the Act effectively would cause amounts to be non-deductible).

Further, a contract may be presumed to be a "binding agreement" even if all of the terms of such contract are not fixed. The Second Restatement of Contracts provides that "the actions of the parties may show conclusively that they have intended to conclude a binding agreement, even though one or more terms . . . are left to be agreed upon," and that "[i]n such cases courts endeavor, if possible, to attach a sufficiently definite meaning to the bargain." Restatement (Second) of Contracts § 33, cmt. b; *see also Fischer v. CTMI, L.L.C.*, 479 S.W.3d 231, 239 (Tex. 2016) (citing the Restatement (Second) of Contracts provision cited above as a guiding principle for determining whether a contract is enforceable under Texas law).

We respectfully recommend that the Proposed Regulations be modified as we describe below to confirm that when a Compensation Committee's ability to exercise negative discretion is effectively limited by one or more provisions that require compliance with the Section 162(m) Requirements, the Compensation Committee will not be considered to have a right to exercise negative discretion because any such exercise of discretion is effectively limited to meet the requirements of the Proposed Regulations and the Act. We respectfully suggest that any other result could effectively eviscerate grandfathered status for many similar plans. Further, we respectfully submit that the position of the Service in *Example 16* is unfair in that there is nothing a corporation or Compensation Committee could have done before November 2, 2017, to protect the corporation (and its shareholders) from this problem that results from a change in the law. We respectfully assert that Congress intended to mitigate this problem with the inclusion of the grandfather rule as discussed above, but the current version of the Proposed Regulations would appear to grandfather relatively few plans. Therefore, in the absence of other facts and circumstances and state law to the contrary, we respectfully recommend that a negative discretion provision should be disregarded in determining the amount of compensation that a corporation is obligated to pay pursuant to an otherwise written binding contract.

We respectfully suggest that Proposed Regulation § 1.162-33(g)(3) be amended to include a revised *Example 16* and an additional example (new *Example 17*) set forth below (our proposed additions to the current provisions are underlined below):

Example (16). (Performance bonus plan with negative discretion).

(A) *Facts.* Employee E serves as the PEO of Corporation V for the 2017 and 2018 taxable years. On February 1, 2017, Corporation V establishes a bonus plan, under which Employee E will receive a cash bonus of $1,500,000 if a specified performance goal is satisfied. The compensation committee retains the right, if the performance goal is met, to reduce the bonus payment to no less than $400,000 if, in its judgment, other subjective factors warrant a reduction, and the bonus plan does not include any provisions that would otherwise require the compensation committee to exercise its discretion in a manner so that bonus payments satisfy the requirements of §1.162-27(e)(2) through (5) as qualified performance-based compensation. On November 2, 2017, under applicable law which takes into account the employer's ability to exercise negative discretion, the bonus plan established on February 1, 2017, constitutes a written binding contract to pay $400,000. On March 1, 2018, the compensation committee certifies that the performance goal was satisfied, but exercises its discretion to reduce the award to $500,000. On April 1, 2018, Corporation V pays $500,000 to Employee E. The payment satisfies the requirements of §1.162-27(e)(2) through (5) as qualified performance-based compensation.

(B) *Conclusion.* If this §1.162-33 applies, Employee E is a covered employee for Corporation V's 2018 taxable year. Because the February 1, 2017, plan is a written binding contract to pay Employee E $400,000 if the performance goal is satisfied, this section does not apply (and §1.162-27 does apply) to the deduction for the $400,000 portion of the $500,000 payment. Furthermore, the failure of the compensation committee to exercise its discretion to reduce the award further to $400,000, instead of $500,000, does not result in a material modification of the contract. Pursuant to §1.162-27(e)(1), the deduction for the $400,000 payment is not subject to section 162(m)(1) because the payment satisfies the requirements of §1.162-27(e)(2) through (5) as qualified performance-based compensation. The deduction for the remaining $100,000 of the $500,000 payment is subject to this section (and not §1.162-27) and therefore the status as qualified performance-based compensation is irrelevant to the application of section 162(m)(1) to this remaining portion.

Example (17). (Performance bonus plan with negative discretion that has been restricted by provision requiring satisfaction of the qualified performance-based compensation requirements).

(A) *Facts.* The facts are the same as in paragraph (g)(3)(xvi) of this section (*Example 16*), except that the bonus plan includes a provision that

requires (or in all material respects requires) the compensation committee to exercise its discretion in a manner so that bonus payments satisfy the requirements of §1.162-27(e)(2) through (5) as qualified performance-based compensation, and so the compensation committee did not reduce the award and Corporation V paid the full $1,500,000 cash bonus to Employee E.

(B) *Conclusion.* If this §1.162-33 applies, Employee E is a covered employee for Corporation V's 2018 taxable year. Although the bonus plan contained a provision permitting the compensation committee to reduce the bonus payment to no less than $400,000, such discretion was limited by another provision in the bonus plan that in all material respects required compliance with the requirements of §1.162-27(e)(2) through (5) as a precondition for the payment of bonus payments, and in fact, the compensation committee complied with the requirements of §1.162-27(e)(2) through (5) and did not exercise its discretion to reduce the amount. Because the February 1, 2017, plan is a written binding contract to pay Employee E $1,500,000 if the performance goal is satisfied, this section does not apply (and §1.162-27 does apply) to the deduction for any portion of the $1,500,000 payment. Furthermore, the compensation committee's ability alone to exercise its discretion to reduce the award does not result in a material modification of the contract. Pursuant to §1.162-27(e)(1), the deduction for the $1,500,000 payment is not subject to section 162(m)(1) because the payment satisfies the requirements of §1.162-27(e)(2) through (5) as qualified performance-based compensation.