July 30, 2020

Mr. Ilya Enkishev
Associate Chief Counsel
Office of Chief Counsel (TEGE)
Internal Revenue Service
1111 Constitution Ave, NW
Washington, DC 20224

Re: Notice of Proposed Rulemaking Regarding Certain Employee Remuneration in Excess of $1,000,000 Under Internal Revenue Code Section 162(m) – [REG 122180-18]

The American Institute of CPAs (AICPA) appreciates the efforts of the Department of the Treasury (“Treasury”) and the Internal Revenue Service (IRS) to address the need for guidance related to the changes to section 162(m) as enacted under Pub. L. No. 115-97, commonly referred to as the Tax Cuts and Jobs Act (TCJA).

On August 21, 2018, Treasury and the IRS issued Notice 2018-68 – Guidance on the Application of Section 162(m) (the “Notice”). The AICPA submitted comments in response to the Notice.2 Subsequently, on December 16, 2019, Treasury and the IRS issued notice of proposed rulemaking [REG 122180-18] (the “proposed regulations”). This letter is in response to the proposed regulations.

Specifically, the AICPA provides recommendations in the following areas related to the proposed regulations:

I. Effective Date / Applicability Date: Compensation Paid by a Partnership to a Covered Employee

II. New Publicly Held Corporation / Continuation of Initial Public Offering Exception

III. Covered Employee: Definition of Executive Officer

IV. Affiliated Group

V. Predecessor Corporation: Asset Acquisition

VI. Grandfathering Rules: Material Modifications – Investment Options

1 Unless otherwise indicated, hereinafter, all section references are to the Internal Revenue Code of 1986, as amended, or to the Treasury Regulations promulgated thereunder.

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We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. If you have any questions, please contact Deborah Walker, Chair, AICPA Employee Benefits Taxation Technical Resource Panel, at (202) 257-5609, or dwalker@cbh.com; or Kristin Esposito, Senior Manager – AICPA Tax Policy & Advocacy, at (202) 434-9241, or kristin.esposito@aicpa-cima.com; or me at (612) 397-3071, or chris.hesse@CLAconnect.com.

Sincerely,

Christopher W. Hesse, CPA
Chair, AICPA Tax Executive Committee

cc: The Honorable David J. Kautter, Assistant Secretary for Tax Policy, Department of the Treasury
    The Honorable Charles P. Rettig, Commissioner, Internal Revenue Service
    The Honorable Michael J. Desmond, Chief Counsel, Internal Revenue Service
    Mr. Thomas West, Tax Legislative Counsel, Department of the Treasury
    Ms. Amber Salotto, Attorney Advisor, Department of the Treasury
    Mr. Stephen Tackney, Deputy Associate Chief Counsel, Office of Chief Counsel, Employee Benefits, Exempt Organizations, and Employment Taxes, Internal Revenue Service
Notice of Proposed Rulemaking Regarding Certain Employee Remuneration in Excess of $1,000,000 Under Internal Revenue Code Section 162(m) – [REG 122180-18]

July 30, 2020

BACKGROUND

Section 162(m) of the Internal Revenue Code (IRC) places a $1 million limitation on the amount of compensation related to a covered employee that a publicly held corporation can deduct in a taxable year.

Prior to the passage of the TCJA, under section 162(m) (“old section 162(m)”)

3 and Notice 2007-49 – Covered Employees Under Section 162(m)(3), the term “covered employee” included the principal executive officer (PEO) as of the last day of the taxable year as well as the three highest paid officers excluding the PEO and principal financial officer (PFO) on the last day of the taxable year. The compensation of the PFO was not subject to the section 162(m) limitation. Qualified performance-based compensation and commission-based compensation were exempt from the $1 million limit. In addition, the term “publicly held corporation” referred to an entity with publicly traded equity.

Under section 162(m) as amended by the TCJA (“new section 162(m)”)

4 the definition of “covered employee” was broadened to include the PEO and PFO at any time during the year (not just the last day of the year), and the three other most highly compensated officers, for a minimum of five covered employees. The TCJA also added section 162(m)(3)(C) which mandates that individuals who are covered employees of the employer or any predecessor employer in any tax year beginning after December 31, 2016 are covered employees in all future years (including in retirement and after death). The TCJA also repealed the exceptions for qualified performance-based compensation and commission-based compensation.

The definition of a publicly held corporation was expanded to include certain foreign corporations

5 as well as private corporations and S corporations that are required to file reports under section 15(d) of the Securities Exchange Act of 1934 (SEA).

6

New section 162(m) is effective for tax years beginning after December 31, 2017. However, the TCJA provides a transition rule excepting from new section 162(m) compensation payable pursuant to a written binding contract in effect on November 2, 2017 and not materially modified after that date.

3 For purposes of this letter, all references to “old section 162(m)” are to section 162(m) prior to the TCJA.

4 For purposes of this letter, all references to “new section 162(m)” are to section 162(m) as amended by the TCJA.

5 Foreign corporations publicly traded through American depository receipts.

6 Section 15(d) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”) provides that any issuer who registers a class of securities under the Securities Act of 1933, as amended (the “Securities Act”) is subject to periodic reporting requirements under Section 13(a) of the Exchange Act.
SPECIFIC COMMENTS

I. Effective Date / Applicability Date: Compensation Paid by a Partnership to a Covered Employee

Overview

The proposed regulations address the application of section 162(m) to compensation paid by a partnership to a covered employee of a corporation that owns an interest in the partnership. Proposed Reg. § 1.162-33(c)(3)(ii) provides that for purposes of determining compensation subject to the section 162(m) $1 million limit, “compensation includes an amount equal to a publicly held corporation’s distributable share of a partnership’s deduction for compensation expense attributable to the remuneration paid by the partnership for services performed by a covered employee of the publicly held corporation.”

Proposed Reg. § 1.162-33(h)(2)(i) provides a general applicability date of taxable years beginning on or after the date the regulations are finalized and published in the federal register. However, Prop. Reg. § 1.162-33(h)(2)(ii)(C) states that the definition of compensation in Prop. Reg. § 1.162-33(c)(3)(ii) relating to the allocable share of partnership deductions for compensation paid to a covered employee applies to any deduction for compensation that is otherwise allowable for a taxable year ending on or after December 20, 2019. The proposed regulations include transition relief for compensation paid pursuant to a written binding contract in effect on December 20, 2019, and that has not been materially modified after that date.

Recommendation

The AICPA recommends that Treasury and the IRS provide that the definition of compensation in Prop. Reg. § 1.162-33(c)(3)(ii) applies to taxable years ending on or after the date the regulations are finalized and published in the federal register.

We also recommend that the final regulations retain in its current form, the transition relief provided for in Prop. Reg. § 1.162-33(h)(2)(ii)(C), which provides that the definition of compensation in Prop. Reg. § 1.162-33(c)(3)(ii) does not apply to compensation paid pursuant to a written binding contract in effect on December 20, 2019, and that is not materially modified after that date.

Analysis

Proposed Reg. § 1.162-33(c)(3)(ii) requires a publicly held corporation to include in compensation subject to section 162(m), its distributive share of a partnership’s deduction for compensation expense attributable to the remuneration paid by the partnership for services performed by a covered employee of the publicly held corporation. This proposed regulation does not reflect a change made by the TCJA to the statutory language of section 162(m). Instead, it reflects a change to the IRS’s interpretation of the definition of compensation for purposes of section 162(m).
The IRS issued several private letter rulings (PLRs) between 2006 and 2008 in which it concluded that section 162(m) did not apply to a publicly held corporation’s distributive share of a partnership deduction for compensation paid by the partnership to a covered employee of the publicly held corporation. While only the taxpayer requesting the PLR may rely on the conclusions reached in it, many taxpayers took positions substantially similar to the conclusion reached by the IRS in the PLRs. Taxpayers took the position that their distributive share of a partnership’s compensation deduction for compensation paid by a partnership to its covered employees was not subject to section 162(m) because an interpretation of the statute and final regulations supported that position independent of the PLRs. It was not unreasonable for taxpayers to reach this conclusion.

Proposed Reg. § 1.162-33(c)(3)(ii) changes the IRS’s published position regarding the treatment of compensation paid by a partnership. In addition, it alters the existing authority on which taxpayers relied to take a position on their tax return that the compensation paid by the partnership is not subject to section 162(m).

The change to the IRS’s position in Prop. Reg. § 1.162-33(c)(3)(ii) is similar to the amendment made to Treas. Reg. § 1.162-27(f)(3) by T.D. 9716. The amendment to Treas. Reg. § 1.162-27(f)(3) addresses the extent to which stock-based compensation is eligible for the transition relief afforded to new publicly held corporations in Treas. Reg. § 1.162-27(f). Prior to the amendment to Treas. Reg. § 1.162-27(f)(3), the IRS issued PLRs in which it concluded that the new public company transition relief in Treas. Reg. § 1.162-27(f)(1) applied to phantom stock and restricted stock units granted prior to the expiration of the reliance period, regardless of whether the amounts paid with respect to the phantom stock and restricted stock units were paid before the expiration of the reliance period. Similar to the partnership compensation issue addressed in Prop. Reg. § 1.162-33(c)(3)(ii), many taxpayers took positions similar to the conclusions reached by the IRS in these PLRs. Thus, the amendment made to Treas. Reg. § 1.162-27(f)(3) by T.D. 9716 significantly affects positions taken by taxpayers based on the published conclusions reached by the IRS on substantially similar facts.

T.D. 9716 includes Treas. Reg. § 1.162-27(j)(2)(vi), which provides that the amendment to Treas. Reg. § 1.162-27(f)(3) by T.D. 9716 is applicable to restricted stock units, phantom stock and similar equity-based compensation granted after the date the amendment was finalized even though the amendment was included in the proposed regulations [REG-137125-08] published on June 24, 2011. Making the amendment to Treas. Reg. § 1.162-27(f)(3) applicable to grants occurring after T.D. 9716 was published was reasonable and appropriate because the amendment reflected a change to the IRS’s published interpretation of the existing regulations, which significantly affected positions taken by taxpayers.

Proposed Reg. § 1.162-33(c)(3)(ii) is similar to the amendment made to Treas. Reg. § 1.162-27(f)(3) by T.D. 9716 because they both change the IRS’s published positions. As a result, Prop. Reg. § 1.162-33(c)(3)(ii) should have a similar applicability date as the amendment to Treas. Reg. § 1.162-27(f)(3) in 2015. Thus, we recommend that Prop. Reg. § 1.162-33(c)(3)(ii) if finalized, should apply to taxable years ending on or after the date the final regulations are published in the federal register.
II. New Publicly Held Corporation / Continuation of Initial Public Offering Exception

Overview

The limitations on deductions imposed by section 162(m) apply to publicly held corporations. The term “publicly held corporation” is defined in Prop. Reg. § 1.162-33(c)(1). If a corporation does not qualify as publicly held, the limitations of section 162(m) do not apply.

The final regulations currently in effect contain an exception for certain corporations that have previously been privately held that subsequently become publicly held, including by way of an initial public offering (IPO). This exception applied for a limited period following the date the corporation becomes publicly held. The proposed regulations remove this exception and provide that the limitation applies to all publicly held corporations.

Recommendation

The AICPA recommends that the final regulations include an exception similar to the exception that exists in the current final regulations for new publicly held corporations.

To reflect the new policies that underlie section 162(m) as a result of the changes made by the TCJA, we suggest the following exceptions:

- Any compensation paid during the year that the company becomes publicly held but paid prior to the date it becomes publicly held (e.g., the date of the IPO) should be exempt from the limitations under section 162(m).

- If there is compensation paid pursuant to a plan or agreement in effect prior to the date the corporation became publicly held, the limitations of section 162(m) should not apply to any compensation paid pursuant to such arrangement for the year that the corporation became publicly held or the following year.

Analysis

The limitations of section 162(m) apply to publicly held corporations. Under new section 162(m), a corporation is considered publicly held if it is either subject to a registration requirement under Section 12 of the SEA or, following the amendments to section 162(m), is required to file a registration statement pursuant to Section 15 of the SEA.

Old section 162(m) provided two exceptions to the deduction limitations: 1) compensation paid on a commissions basis; and 2) qualified performance-based compensation. The current final regulations reflect both of these exceptions. In addition, the current final regulations (though not the statute itself) provide for an exception for corporations that were private that became publicly held.

The new public corporation exception was not included in the statutory language of section 162(m) prior to its amendment by the TCJA. However, the current final regulations include such an
exception. This exception accomplishes two objectives. First, it helps private companies transition into public companies. While private, the company is not subject to 162(m), and therefore, was not set up to comply with section 162(m) limitations. Second, because the company had been private, the company was not subject to the Securities and Exchange Commission (SEC) reporting requirements that served as the vehicle for meeting the shareholder disclosure and approval requirements for qualified performance-based compensation. The IPO exception under the current final regulations allows the company that has become public a transition period until it has regular SEC filings that allow it to disclose compensation to secure the shareholder approval necessary to qualify for the performance-based compensation exception.

The TCJA amended section 162(m) to eliminate the exception for qualified performance-based compensation. Thus, the need to disclose details of compensation arrangements to shareholders as a condition for obtaining a tax deduction no longer exists. Prior to becoming publicly held, a company was not under an obligation to disclose compensation arrangements to shareholders as a condition for qualifying for a tax deduction.

One purpose served by the new public corporation exception is to provide a formerly private company a transition period that allows it to come into compliance with the shareholder disclosure requirements associated with the performance-based exception. However, we believe that this transition period is not the sole policy purpose served by the new publicly held corporation exception. The new publicly held corporation exception applies to compensation paid pursuant to arrangements created while the company was privately held. In many cases, such arrangements were entered into without any thought that the company would later become public. If the new publicly held corporation exception did not exist, remuneration paid to covered employees for the year the corporation becomes publicly held would be subject to section 162(m) limitations, even if the compensation was paid and otherwise deductible before the corporation became publicly held. A company could not easily rid itself of these obligations and in many cases, may not be able to adjust the arrangements without significant adverse tax consequences to the employer. Any deduction disallowance under section 162(m) would apply to compensation otherwise deductible during the entire tax year, even the portion of the year preceding the date the corporation became publicly held. This result is a hinderance to a company seeking access to the public capital markets.

III. Covered Employee: Definition of Executive Officer

Overview

Section 162(m) limits the amount of compensation paid to a covered employee of a publicly held corporation. Under section 162(m)(3), the term “covered employee” includes the three highest compensated officers other than those who served as the PEO or PFO at any time during the taxable year. The proposed regulations provide that the highest compensated officers must be executive officers. The preamble to the proposed regulations includes the definition of executive officer under the SEC rules. However, the proposed regulations do not include a definition of executive officer.
Recommendation

The AICPA recommends including the definition of executive officer in the final regulations and not solely in the preamble.

Analysis

Section 162(m)(3) defines the term “covered employee” as any employee of the taxpayer if: (a) the employee is the PEO or PFO of the taxpayer 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 SEA by reason of such employee being among the three highest compensated officers for the taxable year (other than the PEO and PFO); or (c) the individual was a covered employee of the taxpayer (or any predecessor) for any preceding tax year beginning after December 31, 2016. A covered employee includes any employee whose total compensation for the taxable year placed the individual among the three highest compensated officers for the taxable year (other than any individual who is the PEO or PFO of the taxpayer at any time during the tax year or was an individual acting in such capacity) even if the compensation for the office is not required to be reported to shareholders.

The proposed regulations provide that the three highest paid executive officers are covered employees. The term “executive officer” is used throughout the proposed regulations, but there is no definition of executive officer contained in the proposed regulations.

The preamble to the proposed regulations provides that the SEC executive compensation disclosure rules require disclosure of compensation for certain executive officers. The term executive officer is defined in 17 CFR 240.3b-7:

The term executive officer, when used with reference to a registrant, means its president, any vice president of the registrant in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions for the registrant. Executive officers of subsidiaries may be deemed executive officers of the registrant if they perform such policy making functions for the registrant.

The definition of executive officer cited in the preamble should be stated in the final regulations.

IV. Affiliated Group

Overview

According to Prop. Reg. § 1.162-33(c)(1)(ii)(A), a publicly held corporation includes an affiliated group of corporations, as defined in section 1504 (determined without regard to section 1504(b)) that includes one or more publicly held corporations. Proposed Reg. § 1.162-33(c)(2)(i) states: “with respect to a publicly held corporation as defined in [section 1.162-33(c)(1)] (without regard to [section 1.162-33(c)(1)(ii)]), for a publicly held corporation’s taxable year, a covered employee means…”
It is not clear in Proposed Reg. § 1.162-33(c)(2) how to determine whether an officer of a member of an affiliated group is a covered employee of the publicly held corporation that is a member of the affiliated group. The preamble to the proposed regulations includes language that indicates that executive officers of a subsidiary may be executive officers of a publicly held corporation if they perform certain policy making functions for the publicly held corporation.

**Recommendation**

The AICPA recommends that the final regulations state (within the regulations as opposed to the preamble) how to determine whether an employee of a subsidiary member of an affiliated group is a covered employee of the publicly held corporation member of the affiliated group.

We also recommend that the final regulations state that an officer of a privately held member of an affiliated group is not a covered employee of the publicly held member of the affiliated group unless that officer is also an officer of the publicly held corporation.

**Analysis**

Section III. C. of the preamble to the proposed regulations refers to the SEC executive compensation disclosure rules and their definition of executive officer in CFR 240.3b-7, which states that “[e]xecutive officers of subsidiaries may be deemed executive officers of the registrant if they perform such policy making functions for the registrant.” We recommend including similar language in the body of Prop. Reg. § 1.162-33, if finalized, to clarify that an employee must be an officer of the public held corporation in order to be a covered employee.

There has been uncertainty regarding whether an officer of a privately held member of an affiliated group that includes a publicly held corporation can be a covered employee of the affiliated group as a whole, or whether such employee must be an officer of the publicly held corporation in order to be a covered employee. For example, an officer of a privately held subsidiary may be one of the three highest paid officers of all corporations included in the affiliated group, other than the PEO and PFO. The preamble to the proposed regulations indicates that unless the officer of the subsidiary is also an officer of the publicly held member of the affiliated group, that officer cannot be a covered employee. This uncertainty in Prop. Reg. § 1.162-33 should be eliminated in the final regulations by providing additional detail regarding the determination of covered employees in an affiliated group.

**V. Predecessor Corporation: Asset Acquisition**

**Overview**

The limitations in new section 162(m) apply to the remuneration paid to covered employees of a publicly held corporation. For this purpose, under the proposed regulations, an individual is considered a covered employee if the individual is a covered employee of the corporation itself, or of any predecessor corporation.
The proposed regulations include rules for identifying predecessor corporations in the case of corporate acquisitions, corporate divestitures, and the acquisition of assets from another publicly held corporation. In the case of an acquisition of assets from another corporation, the proposed regulations provide that if 80% or more of the assets are acquired, the selling corporation will be considered a predecessor corporation for purposes of identifying the covered employees of the acquiring corporation. The proposed regulations provide that the acquisition is determined over either a twelve-month period, or the period in which there is an agreement to buy the assets.

Recommendation

The AICPA recommends that Treasury and the IRS provide final regulations clarifying that in the determination of whether an entity is considered a predecessor corporation when there has been an asset acquisition, the 80% asset test is applied on the basis of total gross assets.

Analysis

In order to determine if a corporation is a predecessor corporation in terms of who is considered a covered employee, the proposed regulations provide rules in the case of an acquisition. In terms of asset acquisitions, the proposed regulations state that if at least 80% of the operating assets of a publicly traded target corporation are acquired, then the target corporation is deemed to be a predecessor corporation. However, the proposed regulations do not define operating assets in terms of net assets or gross assets (the term “net assets” typically refers to total assets reduced by the total amount of liabilities of the corporation). We believe that the IRS intended to refer to gross assets, however, clarification is needed.

VI. Grandfathering Rules: Material Modifications – Investment Options

Overview

There is an exception from new section 162(m) for compensation payable pursuant to a written binding contract that was in effect on November 2, 2017 and not materially modified after that date. The proposed regulations state that if a contract is modified to provide the deferral of compensation, any compensation paid in excess of the original amount is not treated as resulting in a material modification if the additional amount paid is based either on a reasonable rate of interest or the rate of return on a predetermined actual investment as defined in Treas. Reg. § 31.3121(v)(2)-1(d)(2)(i)(B). The preamble to the proposed regulations provides that the payment of earnings is not a material modification of a grandfathered contract, even if the earnings are not grandfathered. An example in the proposed regulations addresses making a change in investment between two specified predetermined actual investments, but does not address the addition of new predetermined actual investments.

Recommendation

The AICPA recommends that the final regulations provide an example clarifying that the addition of a new investment feature, which is a predetermined actual investment, is not a material modification of a nonqualified deferred compensation arrangement.
The AICPA also recommends that the applicable example provides that the change of investment is not a material modification similar to Example 12 in Prop. Reg. § 1.162-33(g)(3), which outlines that choosing between two investments is not a material modification.

Analysis

The proposed regulations provide that a material modification occurs when the contract is amended to increase the amount of compensation payable to the employee. The preamble specifies that the payment of earnings will not result in the contract being materially modified, even if the earnings may not be grandfathered. Earnings are grandfathered only if the corporation was required to pay the earnings under the written binding contract as of November 2, 2017.

If the contract is modified to defer the payment of compensation, any compensation paid or to be paid that is in excess of the amount that was originally payable to the employee under the contract will not be treated as a material modification if the additional amount is based on applying to the amount originally payable either a reasonable rate of interest or the rate of return on a predetermined actual investment as defined in Treas. Reg. §31.3121(v)(2)-1(d)(2)(i)(B). There is no material modification regardless of whether assets associated with the amount originally owed are actually invested in the specified investment, as long as the amount payable by the employer at the later date is based on the reasonable rate of interest or the actual rate of return on the predetermined actual investment.

The proposed regulations provide an example of the effect of changing an election between two predetermined investment choices.

Example 12 (Election to defer bonus).

(A) Facts. On December 31, 2015, Employee C, an employee of Corporation Y, makes an election under a NQDC plan to defer the entire amount that would otherwise be paid to Employee C on December 31, 2016, under Corporation Y’s 2016 annual bonus plan. Pursuant to the NQDC plan, the earnings on the deferred amount may be based on either of the following two investment choices (but not the greater of the two): Annual total shareholder return for Corporation Y or Moody’s Average Corporate Bond Yield. On a prospective basis, Employee C may change the investment measure. The deferred amount and the earnings thereon are to be paid in a lump sum at Employee C’s separation from service. Employee C initially elects to have earnings based on annual total shareholder return for Corporation Y. On December 31, 2018, Employee C elects to have earnings based on Moody’s Average Corporate Bond Yield. The bonus plan provides that Corporation Y may not reduce the bonus or any applicable earnings. Employee C earns a $200,000 bonus for the 2016 taxable year. Under applicable law, the deferred compensation agreement constitutes a written binding contract in effect on November 2, 2017, to pay the $200,000 bonus plus earnings. Specifically, Corporation Y is obligated to pay earnings on the $200,000 deferred pursuant to the deferral election Employee C makes on December 31, 2015. On January 1, 2018, Employee C is promoted to serve as PEO of Corporation Y and becomes a
covered employee for the first time. On December 15, 2020, Employee C separates from service and Corporation Y pays $225,000 (the deferred $200,000 bonus plus $25,000 in earnings) to Employee C.

(B) Conclusion. If this § 1.162-33 applies, Employee C is a covered employee for Corporation Y’s 2020 taxable year because Employee C served as the PEO of Corporation Y during the taxable year. The December 31, 2015, agreement is a written binding contract to pay the $200,000 bonus plus earnings. Furthermore, Employee C’s December 31, 2018 election to change the earnings measure does not constitute a material modification. Accordingly, this section does not apply (and § 1.162-27 does apply) to the deduction for the $225,000 payment from Corporation Y to Employee C. Pursuant to § 1.162-27(c)(2), Employee C is not a covered employee because Employee C did not serve as the PEO at the close of the Corporation Y’s taxable year, so the deduction for the $225,000 payment is not subject to section 162(m)(1).

We propose that the final regulations include an additional example similar to example 12, with the exception that the plan is amended to add a third predetermined actual investment option, such as a Total Stock Market index. The addition of the third investment option and selection of the new options going forward would not be a material modification as the investment is a predetermined actual investment under Treas. Reg. § 31.3121(v)(2)-1(d)(2)(i)(B). Selection between any of the three investment options is not material modification because it is not an increase in the amount payable and any earnings are based on a predetermined actual investment option.