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2017 Tax Act Impact on Employee Benefits and Executive Compensation

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The tax reform legislation enacted in late 2017, formerly known as the Tax Cuts and Jobs Act (Pub. L. No. 115-97) (the Tax Act), made relatively few far-reaching and substantive changes in the area of executive compensation and employee benefits. These changes, summarized in this practice note, primarily focus on (1) the non-deductibility of "excessive" employee compensation by publicly held corporations under I.R.C. § 162(m), (2*)* a new tax deferral option for certain qualified equity grants by private corporations, (3) the imposition of a new excise tax on "excessive" compensation paid by tax-exempt organizations, and (4) a few adjustments to existing tax-advantaged benefits provisions. However, from an executive compensation and employee benefits perspective, what may be most significant about the Tax Act is what was left out. The original legislative proposals introduced in both houses of Congress would have effectively eliminated the continuing use of nonqualified deferred compensation (NQDC) arrangements. Although the implications of the Tax Act are relatively few in the employee benefit and executive compensation area, the changes that were made are significant, albeit for limited audiences. The new rules described below are generally effective for tax years beginning after December 31, 2017.

Changes to Section 162(m) Deduction Limit

Section 162(m) provides that no deduction is allowed to a publicly held corporation for compensation paid to certain covered employees in excess of $1 million. Prior to the Tax Act, an exception to the disallowance of a deduction for excessive compensation applied to qualified performance-based compensation or compensation payable on a commission basis. To qualify as performance-based compensation, the corporation had to maneuver through a labyrinth of conditions to ensure that such incentive compensation arrangements were solely conditioned on the achievement of performance criteria established and certified by a duly constituted compensation committee and approved by company shareholders.

Impact of the Tax Act on Section 162(m)

The Tax Act substantially amends Section 162(m) by (1) significantly expanding the definition of covered employee, (2) eliminating the performance-based compensation exception (other than for grandfathered arrangements), and (3) broadening the limitation's application to corporations required to report under the Securities Exchange Act of 1934 (the Securities Act). Pub. L. No. 115-97, § 13601.

Expanded Definition of Covered Employee

Under Section 13601 of the Tax Act, the universe of potential covered employees has been greatly expanded. Under prior law, the term included the chief executive officer of the corporation and the four highest compensated named executive officers for the taxable year, other than the chief financial officer. (The CFO was excluded because of a technical conflict between the IRC and Securities and Exchange Commission rules. I.R.S. Notice 2007-49, 2007-1 C.B. 1429.)

A covered employee now includes:

- Any individual serving as principal executive officer or principal financial officer during the tax year
- The three highest compensated named executive officers for the tax year, other than the principal executive officer and the principal financial officer –and–
- Any individual who was a covered employee for a tax year beginning after December 31, 2016

I.R.C. § 162(m)(3).

Importantly, the time for identifying covered CEOs and CFOs no longer occurs as of the close of the year. Instead, the determination is now made continuously throughout the year. Thus, for example, a former CFO, interim CFO, and replacement CFO could all become covered employees in the same tax year. Further, the covered employee designation sticks to and remains with an individual throughout his or her life (and even thereafter, as I.R.C. §162(m)(4)(F) now provides that "[r]emuneration shall not fail to be applicable employee remuneration merely because it is includible in the income of, or paid to, a person other than the covered employee, including after the death of the covered employee.")

Under the new rules, once a covered employee, always a covered employee. For example, an officer who is one of the three highest compensated officers during 2018 will remain a covered employee, even if she no longer qualifies as one of the three highest remunerated officers in a subsequent year. Moreover, she continues to be classified as a covered employee after her separation from service and even after death. Therefore, if in retirement she exercises options resulting in a gain exceeding $1 million, her former employer would not be permitted a corresponding deduction for the excess amount (as was allowed under prior law).

In view of the stickiness of the covered employee designation, publicly held corporations must be keenly aware that severance pay, deferred compensation, and other post-separation remuneration may be subject to the deduction ceiling. In this regard, they may look to design severance and other post-separation related plans to spread payments over multiple years to avoid, or at least mitigate, the effect of the cap.

Elimination of Performance-Based Compensation Exception

The Tax Act eliminates the nearly quarter-century-old exception to Section 162(m) allowing for the deduction of qualified performance-based compensation and commissions, including non-discounted stock options and stock appreciation rights. Many companies relied extensively on this exception and organized their incentive compensation programs around the rule's qualification requirements. A narrow transition rule permits companies to continue to deduct performance-based compensation over the $1 million threshold if it is paid under a written binding contract in effect on November 2, 2017, so long as the terms of the contract are not modified in any material way after that date. Pub. L. No. 115-97, § 13601(e)(2).

Some commenters have suggested that publicly held corporations will now revert to non-equity-linked forms of compensation, such as straight cash bonuses. For instance, according to news reports, covered employees at Netflix will now be paid straight cash bonuses regardless of company performance. On the other hand, publicly held corporations may wish to retain their existing performance-based compensation arrangements. The popularity of pay-for-performance principles among boards of directors, proxy advisory firms, and shareholders to appropriately incentivize executives is unlikely to wane. Objectively administered performance-based compensation models have become an integral tool for structuring executive compensation arrangements. Moreover, those companies that continue to emphasize incentive-based pay will have a freer hand since the administrative burdens of complying with Section 162(m)'s qualified performance-based compensation conditions are no longer applicable.

Of course, corporations continuing to rely on performance-based grants as a substantial element of total compensation may need to retain certain governance practices, regardless of their loss of tax relevance. For example, the NYSE and NASDAQ, as well as other exchanges, require listed corporations to maintain an independent compensation committee with the responsibility for setting executive compensation or making recommendations to the board regarding executive compensation. Moreover, disclosing such arrangements to shareholders and seeking their pre-approval remains a best practice in shareholder relations that should not be lightly discarded.

Expanded Application of Section 162(m)

Finally, the universe of corporations subject to Section 162(m) has expanded under the Tax Act. The definition of "publicly held corporation" has been broadened to include any corporation required to file reports under Section 15(d) of the Securities Act. Previously, the rule applied only to issuers of registered common equity securities. This means that companies not listed on any securities exchange or that have not crossed the size threshold of Section 12(g) of the Securities Act, but which issue equity or debt securities to the public in an offering registered with the SEC, are now subject to Section 162(m). As a result, many private equity firms along with certain foreign entities that are publicly traded in the U.S. using an American Depository Receipt (e.g., Alibaba Group Holding Ltd.) will now find that compensation paid to covered employees in excess of $1 million dollars is no longer deductible for U.S. federal tax purposes.

For more information, see IRC Section 162(m): Navigating Tax Deduction Limitations for Executive Compensation.

Tax Deferral Election for Qualified Equity Grants

New I.R.C. § 83(i) allows certain individuals to elect to defer recognizing income on qualified stock options and restricted stock units for up to five years. The new rule evolved from a 2016 Senate bill sponsored by Senators Mark Warner and Dean Heller, the

Empowering Employees Through Stock Ownership Act (SB3152) and a companion House bill (HR5719). The purpose was to provide an extended deferral period of up to seven years for employees who exercise options to buy the stock of private companies to ease the tax burden arising from equity grants covering shares that are not publicly traded. Although the bills had bipartisan support, Congress failed to act on them until the material portions of those bills were included in Section 13603 of the Tax Act.

Historical Treatment of Options and RSUs

Under long-standing rules, if a nonqualified stock option (NQSO) does not have a readily ascertainable fair market value at the time the option is granted (which is usually the case), the grant of the NQSO is generally not subject to tax until the option is exercised. Upon exercise, the option holder will generally be subject to tax on the spread between the fair market value of the shares received and the exercise price (also known as the strike price) of the NQSO.

The obvious problem for employees of private companies is the illiquid nature of private company stock. Since a public market does not generally exist, an employee exercising an NQSO usually cannot make a cashless exercise and must go out of pocket for the federal and state taxes imposed on the receipt of private company shares. A similar problem exists for stock-settled restricted stock units (RSUs). RSUs are typically taxed on the fair market value of the award as it becomes vested (i.e., no longer subject to a substantial risk of forfeiture). However, even if a stock-settled RSU award is settled upon vesting, the grantee must come up with the cash for the associated taxes. This can also be a cashflow issue for the company because it will need to withhold and remit income and employment taxes at the time of NQSO exercise or stock-settled RSU vesting, but it is not transferring any cash to the grantee from which it can withhold those amounts.

The new section 83(i) election is designed to alleviate, or at least postpone, the foregoing dilemma. As further described below, if the grantee timely makes a section 83(i) election, the income tax, but not the employment tax, owed at the time of exercise or vesting will be deferred (the deferred amount). The deferred amount will ultimately be subject to income tax at ordinary rates along with employment taxes. However, any appreciation above the deferral amount will be taxed as capital gain, similar to the tax consequences of a section 83(b) election. Although it is possible for the deferral period to expire before the maximum five-year deferral, the deferral period nonetheless allows for more time during which a liquidity event could occur or other source of funds become available.

Conditions for Section 83(i) Elections

Pursuant to new I.R.C. § 83(i), if "qualified stock" is transferred to a "qualified employee" who makes an election with respect to such stock, income that would have previously been recognized upon exercise (or vesting, for RSUs) is deferred for five years, or earlier upon any of the following events:

- The first date the qualified stock becomes transferable (including becoming transferable to the employer)
- The date the employee first becomes an "excluded employee"
- The first date on which any stock of the corporation issuing the qualified stock becomes readily tradeable on an established market –or–
- The date on which the employee revokes the deferral election

The term "qualified stock" means the stock of a corporation which is the employer of the qualified employee making the election if all of the following conditions are met:

- The stock is received in connection with the exercise of an option or in settlement of an RSU.
- The option or RSU was granted by the corporation for the performance of services as an employee during a calendar year in which the corporation:
  - Did not have readily tradable stock on an established market for any preceding year –and–
  - Had a written plan under which at least 80% of all of the company's employees in the U.S. were granted stock options or RSUs with the same rights and privileges to receive qualified stock
- The employee does not have a right to sell the stock to the corporation at the time of the option exercise or RSU vesting.

I.R.C. § 83(i)(2).

Whether the granted options or RSUs have the same rights and privileges is determined by reference to the qualified employee stock purchase plan (ESPP) rules under I.R.C. § 423(b)(5). Although the company must have a broad-based plan in place, these rules do not require the company to grant an equal number of shares to all employees., although the number of shares available to each employee must be more than a de minimis amount.

Eligible Employees

The employees eligible to make the new section 83(i) election are those who are customarily employed for at least 30 hours per week, excluding any individual who:

- Is a 1% owner or was at any time during the 10 preceding calendar years
- Is or has been at any time the CEO or CFO of the corporation (or a spouse, child, grandchild, or parent of such an individual) –or–
- Is one of the four highest compensated officers of the corporation for the taxable year in which the option is exercised or RSU vests, or any of the 10 preceding taxable years

The Time for Making a Section 83(i) Election

Analogous to the making of a section 83(b) election, the new section 83(i) election must be made no later than thirty 30 days after the option exercise or RSU vesting date (or an earlier date upon which the award becomes taxable because the employee's rights in the stock become transferable). The section 83(i) election is made in a form and manner similar to a section 83(b) election.

Limitations and Restrictions

It should be noted that, although the rights granted under new IRC Section 83(i) are available for grants of incentive stock options under I.R.C. § 422 and stock issued pursuant to a qualified ESPP under I.R.C. § 423, an employee's section 83(i) election will negate the preferential tax treatment otherwise afforded such options or stock.

Finally, the new deferral election is generally not available if any stock of the issuing corporation is readily tradable on an established securities market at any time before the election is made. The deferral election is also not available if the issuing corporation bought back any outstanding stock in the preceding calendar year, unless not less than 25% of the total amount the company bought back is stock for which a section 83(i) deferral election is in effect and the buyback's eligibility criteria are made on a reasonable (nondiscretionary) basis.

Reporting and Notice Requirements

The new rule imposes several reporting and notice requirements on applicable issuing corporations. First, if a corporation has stock outstanding on January 1 of any calendar year for which a section 83(i) election is in effect (referred to as deferral stock) and the company purchases any of its outstanding stock during that year, it is required to report on its return for that year the total dollar amount of its outstanding stock so purchased, along with any other information that may be required in future regulations.

Second, any corporation that transfers qualified stock to a qualified employee is required to take the following actions at the time the employee becomes eligible to make a section 83(i) election:

- Certify to the employee that such stock is qualified stock –and–
- Notify the employee that he or she may be eligible to defer income by making a section 83(i) election, and about the consequences for making such an election

The notice requirement applies to stock attributable to options exercised or RSUs settled after December 31, 2017. Penalties apply if an employer fails to provide the required notice: $100 for each failure to provide timely notice, up to $50,000 for any calendar year.

The Good and the Bad of Qualified Equity Grants

In addition to lessening the tax burden imposed on recipients of private company stock, the 2016 Empowering Employees Through Stock Ownership Act was designed to create incentives for private companies to broaden the base of employee-shareholders. Whether new I.R.C. § 83(i) will accomplish that goal is not at all clear. For private tech corporation, particularly, and other startup corporations that seek to use equity-linked compensation to attract and retain talent while minimizing cash compensation prior to a liquidity event such as a sale, merger, or IPO, qualified equity grants represent a powerful new talent acquisition and retention tool.

For the vast majority of privately owned corporations, however, the value of a section 83(i) election may be more limited. First, the requirement to offer options or RSUs with the same rights and privileges to at least 80% of all U.S. employees may result in too great a broadening of the shareholder base from the perspective of many legacy shareholders, especially in closely held and family-controlled corporations.

Second, with the exception of private corporations with a short liquidity event timeline, the section 83(i) election merely delays the inevitable income tax consequence, with no impact on the time for payment of employment taxes. Although there is a time value of money benefit associated with the deferral period, it remains inevitable for employees of private corporations having longer-term horizons that, at some point, they will have to go out of pocket to pay both the income and employment taxes associated with the exercised options or vested RSUs.

Excise Tax on Excessive Compensation Paid by Exempt Organizations

The Tax Act imposes a new cost on excessive executive compensation and severance benefits paid by tax-exempt organizations (EOs) for taxable years beginning after December 31, 2017. First, EOs are subject to a 21% (the corporate rate) excise tax on any remuneration paid to "covered employees" in excess of $1 million. The term "covered employee" for this purpose means any employee (including any former employee) of an EO if the employee is one of the five highest compensated employees of the organization for the taxable year, or was a covered employee of the EO for any preceding taxable year beginning after December 31, 2016. (An exception is provided for remuneration paid to a licensed medical professional (including a veterinarian) which is for the performance of medical or veterinary services by that professional.)

Second, EOs are also now subject to a "golden parachute" regime similar to I.R.C. §§ 280G and 4999, but irrespective of any organizational change in control. The Tax Act imposes a 21% excise tax on "excess" severance payments to highly compensated covered employees (using the I.R.C. § 414(q) threshold ($120,000 for 2018)). The tax applies to payments that are conditioned upon a separation from service that exceed the individual's average compensation over the preceding five years (the base amount), but only if the total amount of such severance payments exceeds three times the covered employee's base amount. I.R.C. § 4960 (added pursuant to). Pub. L. No. 115-97, § 13602

For more information, see Executive Compensation Arrangements for Tax-Exempt Organizations.

Other Tax Act Effects on Employee Benefits

The Tax Act changed some of the rules governing less high-profile matters as well, including the following:

- **Retirement plans.** Qualified plans are another area that escaped dramatic changes in some legislative proposals, such as dramatic reduction of pre-tax deferrals. The main change affecting retirement plans is to provide relief to participants who have an outstanding plan loan at the time of a distribution arising due to a termination of employment. In this situation, plans typically reduce the participant's plan benefit by the amount owed under the loan. That offset amount is a taxable distribution (and subject to an early withdrawal penalty for younger participants) unless the individual makes a rollover to another eligible plan or IRA (out of pocket for the remaining loan balance). The Tax Act extends the time for rolling over the offset amount from the usual 60 days to the due date (with extensions) for filing the participant's tax return for the distribution year. Pub. L. No. 115-97, § 13613.

- **Fringe benefits.** The income exclusion for employer-paid qualified moving expense reimbursements under I.R.C. § 132(g) has been suspended through 2025 for reimbursements received after December 31, 2017. As a result, employees who are reimbursed for moving expenses will now have to report such reimbursements as income subject to both income and employment tax, at least through 2025. Pub. L. No. 115-97, § 11048. Similarly, the Tax Act suspends through 2025 the income exclusion transportation fringe benefit for reimbursement of up to $20 per month for qualified bicycle commuting previously permitted under the I.R.C. § 132(f). Pub. L. No. 115-97, § 11047.

- **Deductions for employee benefits.** Certain employer deductions for employee benefit expenses have been cut or reduced:

    - Expenses incurred to provide a qualified moving expense reimbursement and any qualified transportation fringe benefit (not just bicycle commuting reimbursements) are no longer deductible, unless paid to ensure the safety of an employee. In addition, there is a reduction to 50% for the deduction allowable for on-premises employee eating facilities eligible as an excludible fringe benefit under I.R.C. § 132(e). Also, beginning in 2026, the deduction available for providing employee meals for the employer's convenience (eligible for income exclusion under I.R.C. § 119(a)) will also be eliminated. Pub. L. No. 115-97, § 13304.

    - The rules for employee achievement award deductions under I.R.C. § 274(j) are now restricted to awards consisting of tangible personal property, excluding cash, gift certificates and other cash equivalents, vacations, meals, and tickets or vouchers for services and events. Pub. L. No. 115-97, § 13310.

- **Volunteer award program limits.** The Tax Act increased the annual amount that may be contributed to a length-of-service award program for bona fide firefighting and emergency responder volunteers under I.R.C. § 457(e)(11) to $6,000 (up from $3,000), subject to adjustment for inflation. Pub. L. No. 115-97, § 13612.

- **Affordable Care Act.** In a larger development, only tangentially related to employee benefits, the Tax Act essentially eliminates, as of 2019, the Patient Protection and Affordable Care Act's individual mandate, which penalizes individuals who do not obtain qualifying health insurance coverage, either through an ACA exchange or otherwise. This could lead to fewer insurers offering individual coverage on the ACA exchanges, leaving employers back in the position of being the sole source of affordable health insurance options for their employees. On the other hand, it may be less likely that an applicable large employer that fails to offer qualifying coverage will incur an employer shared responsibility penalty if fewer of its employees opt for exchange coverage. Pub. L. No. 115-97, § 11081.

The Dog that Didn't Bark: Nonqualified Deferred Compensation Unchanged

As originally proposed in the initial House bill and the Senate Conference Committee markup, I.R.C. § 409A (and I.R.C. §§ 457A, and 457(f)) would have been repealed, and NQDC would have been made taxable to employees and other service providers when vested, (i.e., when no longer subject to a substantial risk of forfeiture). Moreover, "substantial risk of forfeiture" was narrowly defined to cover only payments conditioned on the future performance of substantial services. Notwithstanding the complexity of Section 409A and the substantial penalties for noncompliance, under current tax law those rules permit a wide variety of compensation arrangements to defer taxation on vested amounts until payment is actually or constructively made. The proposals went further yet, and would have defined NQDC to include nonqualified stock options and stock appreciation rights. As a result, the tax deferral for NQDC, including elective deferrals, supplemental executive retirement plans, stock appreciation rights, nonqualified stock options, and other arrangements would have essentially been eliminated under the now rejected proposals. This would have been a hugely disruptive change resulting in a massive reassessment of existing and future compensation arrangements across public and private companies of all sizes.