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The New Tax Law: Key Employee Benefits and Executive Compensation Changes

By Andrew E. Graw, Esq., and Darren Goodman, Esq.[*]

On December 22, 2017, President Trump signed the final version of the 2017 tax act (informally known as the Tax Cuts and Jobs Act) into law.[1] The act makes substantial changes to the taxation of corporations, pass-through entities, and individuals.

Although the more sweeping changes to employee benefits and executive compensation proposed in early drafts of the 2017 tax act — namely, repeal of §409A and its replacement with §409B — were dropped, there are many compensation and benefits changes in the act that will impact employers and executives.[2] Some of those changes are discussed below.

COMPENSATION DEDUCTIONS FOR PUBLICLY HELD CORPORATIONS — §162(m)

For publicly held corporations, perhaps the most consequential compensation-related changes relate to §162(m). Before the 2017 tax act, publicly held corporations subject to §162(m) could deduct reasonable compensation in excess of $1 million per year paid to any ''covered employee'' to the extent that the compensation was ''performance-based compensation'' or payable on a commission basis.[3] Covered employees included, in general, the company's principal executive officer or an individual acting in such a capacity as of the close of the taxable year, and any employee whose total compensation for the taxable year is required to be reported to shareholders under the Securities Exchange Act of 1934, as amended (the ''Exchange Act''), by reason of such employee being among the three highest compensated officers for the taxable year (other than the principal executive officer or the principal financial officer).[4]

The 2017 tax act alters this framework by:

- eliminating the exceptions for performance-based compensation and compensation paid on a commission basis;[5]
- revising the definition of ''covered employee'' to mean (i) any employee who is a company's principal executive officer or principal financial officer at any time during the taxable year, or an individual acting in such a capacity, (ii) the three highest compensated officers for the taxable year (other than the principal executive officer or the principal financial officer, or an individual acting in such a capacity) whose total compensation for the taxable year is required to be reported to shareholders under the Exchange Act, and (iii) any employee who was a covered employee for a taxable year beginning after December 31, 2016 (in other words, once an individual is a covered employee, he or she will always be a covered employee, even following retirement or other termination of employment);[6] and
- expanding the definition of ''publicly held corporation'' to cover corporations that are required to

[*] Andrew E. Graw is a partner at Lowenstein Sandler LLP, and Chair of the firm's Employee Benefits & Executive Compensation group. Darren Goodman is counsel in Lowenstein Sandler's Employee Benefits & Executive Compensation group. Mr. Graw and Mr. Goodman advise employers and executives on a full range of employee benefit and executive compensation matters, including deferred compensation arrangements, equity compensation programs, and a variety of other employee benefit plans.

[1] Pub. L. No. 115-97.

[2] All section references are to the Internal Revenue Code of 1986, as amended (the ''Code'') and the regulations thereunder, unless otherwise specified.

[3] *See* former §162(m)(4)(B), §162(m)(4)(C), prior to amendment by §13601(a)(1) of the 2017 tax act.

[4] Notice 2007-49.

[5] §13601(a)(1) of the 2017 tax act.

[6] §13601(b) of the 2017 tax act.

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file reports under §15(d) of the Exchange Act (e.g., companies with public securities or debt that are not listed on an exchange).[7]

The changes are effective for taxable years beginning after December 31, 2017 (e.g., January 1, 2018, for calendar year taxpayers).[8] Notably, the amendments made by the 2017 tax act will not apply to remuneration that is provided pursuant to a written binding contract that was in effect on November 2, 2017, unless such contract is modified in any material respect on or after that date.[9]

Elimination of the exceptions for performance-based compensation and compensation paid on a commission basis means that §162(m) will effectively become a ''hard'' $1 million limit on the amount of compensation a publicly held corporation may deduct with respect to each covered employee in a taxable year, subject to the grandfathering provision for written binding contracts in effect on November 2, 2017.

Unfortunately, the scope of the grandfathering provision is uncertain. The Joint Explanatory Statement of the House and Senate Conference Committee (the ''Conference Report'') that accompanied the 2017 tax act makes clear that the mere fact a plan was in existence on November 2, 2017, is not alone sufficient to qualify for grandfathering.[10] The Conference Report also states that a ''contract that is terminable or cancelable unconditionally at will by either party to the contract without the consent of the other, or by both parties to the contract, is treated as a new contract entered into on the date any such termination or cancellation, if made, would be effective.''[11] Accordingly, terms that reserve to a company the right to unilaterally discontinue the arrangement without liability would seem ineligible for grandfathering.

In addition, caution is advised for companies that maintain an ''umbrella plan'' allowing for the exercise of negative discretion, in case such discretion causes the plan not to meet the ''written binding contract'' requirement of the 2017 tax act's grandfathering rule.

Treasury regulations issued in relation to a transition rule following §162(m)'s initial enactment in 1993 may provide some guidance in this regard. That transition rule grandfathered remuneration payable ''under a written binding contract which was in effect on February 17, 1993, and which was not modified thereafter in any material respect before such remuneration is paid.''[12] Those Treasury regulations provided that a ''written binding contract'' would not exist ''unless, under applicable state law, the corporation is obligated to pay the compensation if the employee performs services.''[13] If the same principle applies to the grandfathering provision of the 2017 tax act, employers would consider applicable state contract law in determining whether a plan that contains negative discretion will be considered a ''written binding contract.''

Hopefully, the IRS will issue timely guidance on the scope of the grandfathering exception. In the interim, plan terms and any proposed change to remuneration payable to a covered employee should be carefully reviewed to determine whether they may cause the loss of grandfathered status.

Going forward, public companies should consider reviewing their equity and bonus compensation arrangements with an eye to modifying or eliminating some of the structures established in order to qualify for the §162(m) performance-based compensation exception. More broadly, apart from meeting the grandfathering exception, companies no longer have an incentive to design and administer their performance compensation arrangements so as to qualify for the §162(m) performance-based compensation exception.

Without the need to satisfy the performance-based compensation exception to §162(m), companies are free to determine performance compensation based on subjective as well as objective factors (subject to non-tax law requirements, of course, such as the terms of any existing plan). They can, subject to existing constraints in plan documents and shareholder relations concerns, freely exercise discretion in determining the amounts and terms of performance-based compensation, and can set performance goals later in the year than §162(m) permitted. Shareholder approval of performance-based compensation arrangements will no longer be required (at least from a §162(m) perspective).

Under §162(m), compensation attributable to stock options and stock appreciation rights was deemed to be performance-based compensation if, among other things, the options or rights were granted under a plan that stated the maximum number of shares with respect to which options and stock appreciation rights may be granted during a specified period to any indi-

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[7] §13601(c) of the 2017 tax act.

[8] §13601(e)(1) of the 2017 tax act.

[9] §13601(e)(2) of the 2017 tax act.

[10] 115th Cong., Joint Explanatory Statement of the Committee of the Conference on H.R. 1, the Tax Cuts and Jobs Act, at 345 (Dec. 15, 2017).

[11] *Id.* A contract will not be treated as terminable or cancelable at will if it can only be terminated or cancelled by terminating the employment relationship. *Id.* at 345–46.

[12] §162(m)(4)(B), as redesignated by §13601(a)(1) of the 2017 tax act.

[13] Reg. §1.162-27(h)(1).

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vidual employee.[14] Following the 2017 tax act, such a limitation is no longer necessary (though such a limit may be desirable from a shareholder relations perspective). Accordingly, companies could consider removing such limitations from existing equity plans and omitting such limitations from new plans (taking into account the shareholder relations aspects of such changes).

It remains to be seen how corporate governance proponents respond to the changes to §162(m), and whether such organizations encourage companies to maintain some or all of the §162(m) performance-based compensation structures.

TAXATION OF STOCK OPTIONS AND RESTRICTED STOCK UNITS — QUALIFIED EQUITY GRANTS

The 2017 tax act amends §83 to provide a new opportunity for employees to elect to defer income tax (but not payroll tax) with respect to stock received in connection with an option exercise or in settlement of a restricted stock unit (RSU).[15]

In general, stock options and RSUs are taxed as follows:

- non-qualified stock options (NSOs) are taxable as ordinary income upon exercise (assuming the NSOs do not have a readily ascertainable fair market value at the time of grant);[16]
- incentive stock options (ISOs) within the meaning of §422 are not taxable on exercise, but any gain on ISOs at exercise is included as a preference item for purposes of the alternative minimum tax;[17]
- shares issued pursuant to an option exercised under a §423 employee stock purchase plan (ESPP) are taxed when the shares are sold or otherwise disposed of, with the exact tax treatment dependent on whether the shares were offered at a discount and the length of time the shares were held prior to the disposition;[18] and
- RSUs are taxed when the shares underlying the RSUs are issued (or cash settled), based on the fair market value of the shares (or the amount of the cash settlement).

Section 13603 of the 2017 tax act adds a new §83(i) addressing ''qualified equity grants.'' If ''qualified stock'' is transferred to a ''qualified employee'' who makes an election with respect to such stock, income tax can be deferred for up to five years from when the employee's rights in the stock become transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier (subject to earlier taxation on the occurrence of other events set forth in the act).[19] In general, (i) a ''qualified employee'' includes non-executive employees,[20] and (ii) ''qualified stock'' includes stock received on exercise of a stock option or settlement of an RSU that was granted in connection with the performance of services as an employee and during a calendar year in which the corporation was an ''eligible corporation.''[21]

A number of restrictions must be satisfied for a qualified employee to make such a deferral election. To be eligible to make such a deferral election, the act requires, among other things, that the corporation have a written plan under which (1) not less than 80% of all U.S. employees are granted either stock options or RSUs in the calendar year, and (2) these employees have the ''same rights and privileges'' to receive qualified stock.[22]

The new deferral opportunity may yield benefits for employees of closely held businesses and startups, but it remains to be seen whether the restrictions companies must adopt to offer these opportunities — in particular, the 80% participation requirement — will hinder widespread application.

Significantly, the 2017 tax act itself contains a deterrent from offering the deferral opportunity. Holders

[14] Reg. §1.162-27(e)(2)(vi)(A).

[15] §13603 of the 2017 tax act.

[16] Reg. §1.83-7(a).

[17] §421(a)(1), §56(b)(3).

[18] §423.

[19] §83(i)(1). The election must be made no later than 30 days after the first date the employee's rights in the stock are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier. §83(i)(4)(A). Interestingly, the employee can revoke the election ''at such time and in such manner as the Secretary provides'' and trigger earlier taxation. §83(i)(1)(B)(v). Presumably, an employee would revoke the election at the time most advantageous to him or her. It remains to be seen what guidance the IRS provides with respect to revocation of such elections.

[20] §83(i)(3). Specifically, ''qualified employee'' means any individual who is not an ''excluded employee,'' and agrees in the deferral election to meet such requirements as are determined by the Secretary to be necessary to ensure that the corporation's withholding requirements are met. §83(i)(3)(A). ''Excluded employee'' means any individual (i) who is a ''1% owner'' during the calendar year or was such an owner at any time during the 10 preceding calendar years, (ii) who is or has been at any prior time (A) the chief executive officer or an individual acting in such a capacity, (B) the chief financial officer or an individual acting in such a capacity, (iii) any individual who bears a relationship described in §318(a)(1) (i.e., a spouse, child, grandchild, or parent) to any individual described in (ii), or (iv) who is one of the 4 highest compensated officers of such corporation for the taxable year, or was one of the 4 highest compensated officers of such corporation for any of the 10 preceding taxable years. §83(i)(3)(B).

[21] §83(i)(2).

[22] §83(i)(2)(C)(i)(II).

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of qualified stock must be notified that they may be eligible to elect to defer income.[23] If that notice is not provided, the person failing to provide the notice could be liable for a penalty of $100 for each failure, up to a maximum of $50,000 per calendar year.[24]

TAX-EXEMPT ORGANIZATIONS — EXCISE TAX ON EXCESS EXECUTIVE COMPENSATION

As described above, §162(m) limits a publicly held corporation from deducting more than $1 million per year for compensation paid to certain covered employees. Before the 2017 tax act, there was no analogous provision under the Code for tax-exempt organizations.

The 2017 tax act changes that. Section 13602 of the act, provides that, for taxable years beginning after December 31, 2017, an applicable tax-exempt organization will be liable for an excise tax equal to 21% (the act's new corporate income tax rate) on (1) any remuneration in excess of $1 million paid to a ''covered employee'' for a taxable year (other than any ''excess parachute payment''), plus (2) any excess parachute payment paid to a covered employee.[25] ''Remuneration'' for these purposes does not include ''the portion of any remuneration paid to a licensed medical professional (including a veterinarian) which is for the performance of medical or veterinary services by such professional.''[26] The 2017 tax act did not contain a grandfathering provision with respect to this excise tax, so it appears that the new excise tax applies to payments pursuant to pre-existing contracts.

A ''covered employee'' for this purpose includes the five highest compensated employees of the organization for the taxable year, or any employee who was a covered employee of the organization (or any predecessor) for any preceding taxable year beginning after December 31, 2016.[27]

The $1 million and excess parachute amount thresholds are likely high enough that most nonprofits need not worry about triggering them. However, nonprofits with covered employees whose remuneration may be high enough to trigger an excise tax should review their compensation practices and executive employment agreements to determine the potential impact of the new excise tax. Organizations may want to consider restructuring compensation programs, though changes to existing agreements will likely require the executives' consent.

PROFITS INTERESTS — LONG-TERM CAPITAL GAIN HOLDING PERIOD

Partnerships, limited liability companies, and other ''pass-through'' entities often compensate key management personnel with ''profits interests.'' Profits interests are equity interests that afford the recipient the opportunity to participate in the growth in the value of the business — much like a stock option or stock appreciation right (but usually without a purchase price).

Before the act, gains on the sale or disposition of profits interests were taxed as long-term capital gains (subject to preferential tax rates) if the interests were held for at least one year.[28] However, effective for tax years beginning after December 31, 2017, capital gains recognized in respect of an ''applicable partnership interest'' are treated as long-term capital gains only to the extent the partnership assets producing the gains are held for more than three years.[29] There is no grandfathering provision for applicable partnership interests outstanding prior to the effectiveness of this change.

An ''applicable partnership interest'' is, in general, a partnership interest received by a taxpayer in connection with the taxpayer's (or a related person's) performance of substantial services in the trade or business of raising or returning capital and either (i) investing in, or disposing of, securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivatives with respect to any of the foregoing, and an interest in a partnership to the

[23] §83(i)(6). The notice must be provided at the time that (or a reasonable period before) amounts attributable to the qualified stock would (but for a deferral election) first be includible in the holder's gross income. *Id.*

[24] §6652(p).

[25] §13602(a), 13602(c) of the 2017 tax act. The excise tax on ''excess parachute payments'' incorporates concepts familiar to practitioners from §280G, with some modifications. Specifically, a ''parachute payment'' with respect to an applicable tax-exempt organization occurs if payments in the nature of compensation to (or for the benefit of) a covered employee that are contingent on a separation from employment have an aggregate present value that equals or exceeds three times the employee's ''base amount,'' and an ''excess parachute payment'' means ''an amount equal to the excess of any parachute payment over the portion of the base amount allocated to such payment.'' §13602(a) of the 2017 tax act. ''Base amount'' is determined under rules ''similar to'' to the rules of §280G(b)(3) (which, in general, requires that base amount be determined using an individual's average annual taxable compensation from the employer over the prior five-year period). *Id.*; Reg. §1.280G-1, Q&A 34-36.

[26] §13602(a) of the 2017 tax act.

[27] *Id.*

[28] §1222(3).

[29] §13309(a)(2) of the 2017 tax act.

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extent of the partnership's proportionate interest in any of the foregoing, or (ii) developing such assets.[30]

The new provisions clearly were intended to apply to profits interests (as well as carried interests) granted in respect of a portfolio or asset management business. However, until the IRS issues regulations, it is too early to assess the scope of the new holding period rules.

Pass-through entities, particularly hedge funds, private equity funds, and asset management firms, should consult with their tax advisers when considering awarding profits interests to key personnel.

MOVING EXPENSE REIMBURSEMENTS AND OTHER DEDUCTIONS

Employers should be aware that the 2017 tax act suspends or limits a series of other deductions and exclusions from income for common employee-related payments.

First, the act suspends (i) an exclusion from income for reimbursement of qualified moving expenses, and (ii) an above-the-line deduction individuals may take for such expenses, in each case effective for taxable years beginning after December 31, 2017.[31] Employers should re-examine moving expense reimbursement policies and consider whether to continue offering moving expense reimbursements. Although no longer excludible from income, moving expense reimbursement will likely remain a valuable tool for recruiting new employees who would be required to relocate. Some employers may consider grossing-up moving expenses to attract qualified talent.

Next, in certain circumstances, companies could previously deduct expenses for entertainment, amusement, or recreation activities,[32] qualified transportation fringes (including qualified parking, transit passes, vanpool benefits, and qualified bicycle commuting reimbursements), and employer-provided meals.[33]

The 2017 tax act removes deductions for entertainment, amusement, or recreation activities,[34] as well as the deduction for providing qualified transportation fringes[35] and, except as necessary for ensuring the safety of an employee, any expense incurred for providing transportation, or any payment or reimbursement, for travel between an employee's place of residence and place of employment.[36] The deduction for employer-provided meals is generally retained until December 31, 2025;[37] thereafter, expenses for the operation of an on-premises eating facility and meals furnished for the convenience of the employer generally are not deductible.[38]

Removal or limitation of these deductions will increase the cost to employers of providing these benefits. Employers should review entertainment policies and transportation fringe benefit arrangements to determine whether to continue to offer these benefits, or whether the 2017 tax act's changes merit reduction or elimination of these benefits.

CONCLUSION

For many companies, the loss of favored deductions, such as the deduction for performance-based compensation, will be offset by the new, reduced corporate tax rate. However, businesses and tax-exempt organizations of all shapes and sizes should examine the impact of the 2017 tax act on their employee benefits and executive compensation plans, practices, and arrangements to determine whether to make changes.

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[30] §13309(a)(2) of the 2017 tax act.

[31] §11048, §11049 of the 2017 tax act. The act does, however, retain an exclusion for reimbursements to, and deductions taken by, members of the armed forces on active duty who move pursuant to a military order and incident to a permanent change of station. §11048(a), 11049(a) of the 2017 tax act.

[32] *See* former §274(a)(1), prior to amendment by §13304(a)(1)(A) of the 2017 tax act.

[33] *See* former §274(n)(1), prior to amendment by §13304(a)(2)(D) of the 2017 tax act.

[34] §274(a)(1), as amended by §13304(a)(1)(A) of the 2017 tax act.

[35] §274(a)(4), as amended by §13304(c)(1)(B) of the 2017 tax act.

[36] §274(l)(1), as amended by §13304(c)(2) of the 2017 tax act.

[37] §274(n)(1).

[38] §274(o), as amended by §13304(d) of the 2017 tax act.

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