

Compensation & Benefits Tax Reform: Eliminating the Performance-Based Exception to Section 162(m) and Other Changes Regarding Compensation

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Tax Rate Changes Affect on Compensation

1. Individual Rates – 10%, 12%, 22%, 35%, and 37%
 - Supplemental Rates: Notice 1036 – 22% up to \$1M, 37% over \$1M
2. No AMT Repeal
 - 2018 AMT exemptions rises to \$70,300 from (\$54,300) for singles, and \$109,400 (from \$84,500) for married/joint filers
 - 2018 AMT phase-out: \$500,000 for individuals (from \$120,700) and \$1,000,000 (from \$160,900) for married couples
 - Less likely ISOs will trigger AMT
3. No Change in Capital Gains Rate (15% and 20%)
 - 15% threshold (\$77,200 for joint filers, \$38,600 for single)
 - 15% to 20% threshold (\$475,000 joint filers, \$425,800 single)
4. Excise tax on stock compensation – Inversions Section 4985
 - Increased from 15% to 20%
5. Miscellaneous Itemized Deduction Repeal
 - Affects clawback repayments
 - No 162 or 165 deduction
6. Changes Not Enacted
 - No 409A repeal
 - No FIFO cost basis rule

Fringe Benefit and Retirement Plan Changes & Impact

- Qualified Equity Grants – New IRC § 83(i) deferral election for options/RSUs
 - Deferral of income recognition for up to 5 years (or if earlier, on certain events including becoming transferable or IPO)
 - Deferral unavailable once employee becomes excluded (CEO or CFO and related individuals, 1% owner or top-4 highest paid officer (based on SEC disclosure rules if they had applied) in year or any prior 10 years)
 - Limited to eligible companies - stock not readily tradeable, written plan covers 80% of full-time employees who are granted options or RSUs
 - Amount included is still based on FMV at time of exercise-policy goal not valuation-based but about limiting need to liquidate holdings
 - Deferral election within 30 days after rights to shares are transferrable or vested
 - Deferral does not apply to Medicare, social security, taxes
 - Turns ISO into NQSO; does not apply to “early exercises”

Section 162(m) Summary

- Expands companies covered
- Expands officers covered
 - Covered employees FOREVER retain status
- Repeals performance pay & commission exceptions
- Transition relief applies to existing “written binding contracts” that are not “materially modified” – scope unclear

Expands Companies Covered

- All ADR traded companies
- Companies with publicly-traded debt
- SEC 15(d) reporting
- How are covered employees determined?
 - Example – ADR traded foreign parent

Expansion of “Covered Employee”

- CFO added back to list
- Covers individuals who are CEO or CFO (or acting as such) at any point during the year (not just last day)
- Covered employees (starting in 2017) FOREVER retain status
 - Even after termination of employment
 - Perhaps even after company is acquired (reference to “predecessor” of taxpayer is not defined)
 - Captures pay that previously avoided the reach of Section 162(m)
 - Deferred compensation
 - Death benefits
 - Golden Parachutes

Transition Relief

- **Written binding contracts** as of 11/2/2017
- That are not modified in **material respects**
- Contract law issues
 - Unilateral contracts versus bilateral contract
 - Employers retained powers – negative discretion, plan amendment and termination, at will employment
 - Committee report example – raises questions
- Significant issues
 - Outstanding grants
 - Nonqualified deferred compensation
 - Golden parachutes
- 1993 transition rules
 - Covers unilateral contracts (Treas. Reg. § 1.162-27(h)(1), CCA 199926030)
 - At will employment does not negate transition
 - Extent of future accrual protection unclear (CCA 199926030)

Repeals Performance Pay Exceptions

- Companies can move to non-performance based incentives, exercise discretion to increase payout
- Companies free of the Section 162(m) compensation committee requirements
- May not need shareholder re-approvals
- Committee certification requirement eliminated – gives more flexibility as to timing of payments

Planning Opportunities

- Installment payments favored: company may want to change payment to installments or encourage election of installments for future accruals
- Company may want stock option exercises spaced out
- Consulting arrangements
- Qualified plan benefits exemption – QSERP
- Non-taxable benefits (e.g., retiree medical exempt)
- Incorporated employee, partnership employs executive

Leveling the Playing Field...?

- 21% excise tax on
 - Remuneration paid in excess of \$1M, plus
 - Excess parachute paymentby an “applicable exempt organization” to a “covered employee”
- Paid when no SRF (457(f)(3)(B))
- Tax paid pro-rata if more than one payment source
- No change to intermediate sanctions

Covered Employee

- “Covered employee” is employee (including former employee) that
 - is one of the 5 highest compensated employees for the taxable year
 - was a covered employee for any preceding taxable year beginning after December 31, 2016
- Predecessor organization

Remuneration

- Includes
 - Wages as defined for income tax withholding under 3401(a)
 - Other amounts required to be included in income under 457(f)
- But excludes
 - Designated Roth contributions defined in 402A(c)
 - Remuneration paid to a licensed medical professional (including veterinarian) that is for the performance of medical or veterinary services by that professional
 - Remuneration not deductible under section 162(m)

Source of Remuneration

- Applicable exempt organization
- Related person or governmental entity
 - Controls, or is controlled by, the organization
 - Is controlled by one or more persons that control the organization,
 - Either a supported or supporting organization during the taxable year with respect to the organization (see 409(a)(3) and 509(f)(3)), or
 - Establishes, maintains, or makes contributions to a VEBA

Excess Parachute Payment

- Excess of the present value of payments that are contingent on separation from service over 3 times the base amount
- Excluded payments:
 - To or from a qualified plan
 - To or from a 403(b) annuity contract or 457(b) plan
 - To a licensed medical professional (veterinarian) to the extent the payment is for the performance of medical or veterinary services by the professional, or
 - To a non-HCE (section 414(q))

Some Potential Responses

- Limit compensation or pay the tax
- “Shift” compensation to unrelated persons
 - Range from independent contracting relationship to guarantee in employment agreement
 - But see regulatory authority
- Insurance, annuities, deferred compensation