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What the Tax Cuts and Jobs Act Means for Executive Compensation

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The Tax Cuts and Jobs Act has been passed by both the House and the Senate and signed into law by President Trump. Although the final bill did not include a repeal of Code Section 409A, the complex regulatory scheme governing the taxation of deferred compensation, it may still have a significant impact on the current compensation practices of public and tax-exempt employers. On perhaps a more positive note the Act does provide a new opportunity to defer taxation of private company compensatory options and restricted stock unit awards.

Qualified Performance-Based Compensation. Section 162(m) limits to $1 million the annual deductions that public companies may take on compensation paid to each of the chief executive officer and the next three highest paid executive officers (excluding the CFO). However, current law contains significant exemptions, including for compensation that is performance-based or paid after termination of employment. These exemptions have driven the design of executive compensation awards for years. The Act, which is effective for taxable years beginning after December 31, 2017, makes sweeping changes to Code Section 162(m). These changes will likely result in a dramatic shift in how executive compensation awards are designed in the future.

Specifically, the Act:

- Eliminates the exception for commissions and performance-based compensation;
- Expands the scope of executives covered by the $1m limitation to include the CFO;
- Includes a “once covered always covered” rule. Once an employee is covered by Section 162(m), he or she will remain covered and subject to the $1m limitation on deductibility for all future years (even after death, with respect to compensation payable to his or her estate or beneficiaries); and
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- Expands the companies subject to Section 162(m) to include corporations with publicly traded debt and foreign companies publicly traded through American depositary receipts (ADRs).

- The Act contains a transitional rule, but, given the current design of most executive compensation plans and awards, it may prove to be not very useful. Under the transitional rule, compensation paid under a binding written agreement in effect on November 2, 2017, and which is not materially modified remains subject to the current rules meaning it is still eligible for the performance-based exception. Since most executive plans and awards contain provisions that grant the compensation committee the discretion to reduce the amount of an award or to modify or terminate the plan or award, these provisions will likely disqualify the plan and/or award from the transition rule. Many questions remain regarding the scope of the transition rule and we expect future IRS guidance will further clarify its application.

Compensation Paid by Tax-Exempt Employers. Under current law, compensation paid to executives of tax-exempt organizations is not subject to any specific dollar limitation. In an effort to put tax-exempt organizations on par with for-profit entities, the Act includes a new Code Section 4960. Under Section 4960, a tax-exempt organization, generally any organization exempt from tax under Code Section 501(a), such as a Code Section 501(c)(3) organization, as well as certain other types of tax-exempt entities, will now be subject to a 21% excise tax on compensation paid in a taxable year to any of its five most highly paid employees (defined as “covered employees”). Covered employees also include any person who was a covered employee in any preceding year beginning after December 31, 2016.

Specifically, under the Act, the excise tax will be imposed on:

- Annual compensation paid to a covered employee in excess of $1m; and

- Compensation paid to a covered employee which is contingent upon separation from employment if the value of the compensation exceeds three times the employee’s average compensation in the preceding five taxable years. The Act refers to these payments as “parachute payments.” Parachute payments do not need to be in excess of $1 million to be subject to the excise tax. Benefits payable from a tax-qualified retirement plan, a Code Section 403(b) plan or a Code Section 457(b) plan are not treated as parachute payments.

Compensation for this purpose includes all amounts treated as wages for Federal income tax withholding purposes but does not include designated Roth contributions. Any amounts vesting (and taxable) under Code Section 457(f) are included as compensation and are treated as paid for purposes of the excise tax when there is no longer a substantial risk of forfeiture.

Unlike the House and Senate bills, the Act contains several important exemptions. The excise tax does not apply to compensation paid for medical services provided by doctors, nurses, and veterinarians. In addition, any compensation paid to a non-highly compensated employee is not considered a parachute payment.

New Code Section 4960 will be effective for taxable years beginning after December 31, 2017.

Qualified Equity Grants for Private Companies. The Act permits eligible private companies to offer certain employees the opportunity to defer income tax inclusion on restricted stock units (RSUs) and stock options under new Code Section 83(i). To be eligible, a private company must have a written plan in place under which at least 80% of all full-time, U.S.-based employees are granted compensatory stock options or RSUs that have the same rights and privileges (determined under the rules for Employee Stock Purchase Plans in Code Section 423). Employees may receive different amounts of stock, but each participant must get more than a de minimis amount and employees must be granted compensatory stock options or RSUs; they cannot be granted a combination of the two forms of equity grants.

New Code Section 83(i) will generally permit qualified employees to make an affirmative election within 30 days of the date of exercise of an option (or settlement of an RSU) to defer the income that he or she would otherwise have been required to include for the year in which he or she receives the underlying stock (or, if later, the first year for which the stock ceases to be “substantially nonvested”). A qualified employee does not include a current or former CEO or CFO, a 1% owner or one of the top four highest-paid employees for any of the 10 preceding taxable years. Once this election is made, income taxes will be due upon the earliest of the following:

- The date the stock is transferable, including to the employer.
- The date the employee is no longer a qualified employee.
- The first date any stock of the employer becomes publicly traded.
- The date five years after the date the qualified employee’s right to the stock ceases to be “substantially nonvested”.
- The date on which the employee revokes a deferral election.

The deferral election is not available if, in the preceding calendar year, the company purchased any of its outstanding stock, unless at least 25% of the stock purchased was stock with respect to which an inclusion deferral election was in effect, and the determination of which stock is purchased is done on a reasonable basis.

The Act imposes specific income tax withholding and reporting requirements and employee notice requirements and provides that equity grants will not be treated as deferred compensation for purposes of Code Section 409A solely because of the deferral election permitted by Code Section 83(i).

New Code Section 83(i) is generally applicable to compensatory options exercised and RSUs settled after December 31, 2017.

Time will tell whether this new form of equity grant will catch on. It may not be attractive to many private companies due to the requirement that the plan cover a broad base of employees and due to the administrative burdens related to administering such a plan.

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