

# Executive Compensation Changes Under Tax Reform – An Update for Plan Sponsors

Article By:

Christine M. Kong

Erik D. Vogt

---

On December 22, 2017, President Trump signed into law H.R. 1, a congressional revenue act originally introduced in Congress as the Tax Cuts and Jobs Act (the “Act”). The Act makes changes to the executive compensation and equity compensation programs of for-profit employers. It also amends certain executive compensation rules applicable to tax-exempt employers. The changes generally apply to taxable years beginning after December 31, 2017.

The Act also makes changes to the tax rules applicable to qualified plans and to fringe benefits. [Read our recent alert summarizing those changes.](#)

## Executive Compensation of For-Profit Employers

### The \$1 Million Deduction Limit Under Section 162(m) of the Code

#### 1. Are there changes to the exemptions to the \$1 million deduction limit under Section 162(m) of the Internal Revenue Code (the “Code”)?

Section 162(m) of the Code prohibits a public company from deducting compensation paid to a “covered employee” in excess of \$1 million per year. Prior to the Act, the \$1 million deduction limit did not apply to performance-based compensation or to remuneration payable on a commission basis. As anticipated under the House and Senate versions of tax reform, the Act repeals the performance-based compensation exception and the exception for remuneration payable on a commission basis.

#### 2. Are there changes to the individuals who are subject to Section 162(m)?

Prior to the Act, the principal financial officer (*i.e.*, the CFO) of a public company was not considered a “covered employee” for purposes of the \$1 million deduction limit of Section 162(m) of the Code. As anticipated under the House and the Senate versions of tax reform, the Act applies the \$1 million deduction limit to a company's principal financial officer and to any employee who was a covered employee in any preceding tax year beginning after December 31, 2016.

#### 3. How about the entities that are subject to Section 162(m)?

---

The Act expands application of the \$1 million deduction to include companies that are required to file reports with the SEC under Section 15(d) of the Securities Exchange Act, such as a company that issues debt securities to the public.

#### **4. When do these changes take effect?**

The above changes generally apply to taxable years beginning after December 31, 2017. However, a transition rule in the Act provides that the Section 162(m) changes “shall not apply to remuneration which is provided pursuant to a written binding contract which was in effect on November 2, 2017, and which was not modified in any material respect on or after such date.” In other words, certain arrangements are grandfathered under the transition rule.

**Drinker Biddle Comment:** While the transition rule may seem straightforward, employers should exercise caution before modifying existing contracts if they wish to preserve the grandfathered status of those arrangements.

### **Equity Compensation**

#### **1. Are there any changes to the rules allowing for the deferral of equity compensation?**

Yes, the Act adds a new Section 83(i) to the Code to provide a deferral feature for certain equity awards. Under Section 83(i), “qualified employees” who are granted stock options or restricted stock units (RSU) and who later receive stock upon exercise of the option or upon settlement of the RSU (“qualified stock”) may elect to defer the recognition of income for up to five years if the corporation’s stock is not publicly traded, if the corporation has a written plan under which not less than 80 percent of all U.S. employees are granted options or RSUs with the same rights and privileges to receive qualified stock, and if certain other requirements are met.

**Drinker Biddle Comment:** In other words, if qualified stock is transferred to a qualified employee and the employee timely makes a Section 83(i) election, the employee recognizes income with respect to that stock in the tax year that includes the five-year anniversary of the date the employee’s rights in the stock vest, subject to earlier inclusion if certain events occur. The amount of the income to be recognized is determined under Section 83(a) of the Code (i.e., the value of the stock upon exercise of the option or upon the vesting and settlement of the RSU).

#### **2. Who is a “qualified employee” under Section 83(i)?**

A “qualified employee” under Section 83(i) is generally defined as any employee of a corporation *other than* an individual (i) who is a 1 percent owner of the corporation at any time during the current calendar year or during the preceding 10 calendar years; (ii) who is or has been the CEO or the CFO of the corporation or an individual acting in that capacity (or a member of the CEO or the CFO’s family); or (iii) who is one of the four highest compensated officers of the corporation for the current tax year or any of the 10 preceding tax years.

#### **3. Is a Section 83(i) deferral arrangement subject to Section 409A?**

A Section 83(i) deferral arrangement is not considered nonqualified deferred compensation under Section 409A of the Code solely because of the employee’s Section 83(i) deferral election or the employee’s ability to make such an election. This exception from treatment as a nonqualified deferred compensation arrangement under Section 409A applies solely with respect to an employee

---

who may receive qualified stock.

#### **4. Does a Section 83(i) deferral election impact FICA and FUTA taxes?**

An election under Section 83(i) applies only for income tax purposes. The election has no effect on the application of Social Security and Medicare taxes under FICA and unemployment taxes under the Federal Unemployment Tax Act.

#### **5. What is the effective date of Section 83(i)?**

The Section 83(i) changes apply to RSUs settled and to stock attributable to options exercised after December 31, 2017.

#### **6. Are there any changes to the excise tax on equity compensation held by insiders of an expatriated corporation?**

Prior to the Act, Section 4985 of the Code imposed a 15 percent excise tax on certain stock compensation held directly or indirectly by a disqualified person with respect to an expatriated corporation. For purposes of this tax, a "disqualified person" is any individual who is an officer, a director or a 10 percent-or-greater owner of the corporation at any time during the 12-month period beginning on the date that is six months prior to the expatriation date. The Act increases this excise tax to 20 percent. This change applies to corporations that first become expatriated corporations after December 22, 2017.

### **Executive Compensation of Tax-Exempt Employers**

#### **New Excise Tax on Executive Compensation**

##### **1. Is there a new excise tax on executive compensation paid by a tax-exempt employer?**

The Act provides for a 21 percent excise tax on certain executive compensation paid by an entity that is exempt from tax under Section 501(a) of the Code.

The excise tax equals 21 percent of the sum of (i) the compensation paid by the entity to any covered employee in excess of \$1 million (other than the "excess parachute payment" described in (ii)), plus (ii) the amount of any "excess parachute payment" paid by the entity to any covered employee. This tax is imposed on the employer.

##### **2. Who is a "covered employee" for purposes of the new excise tax?**

A "covered employee" for purposes of the new excise tax includes an employee who was among the organization's five highest compensated employees in the current taxable year or who was a covered employee for any preceding taxable year beginning after December 31, 2016.

##### **3. What is an "excess parachute payment" for purposes of the new excise tax?**

The Act defines an "excess parachute payment" as an amount equal to the excess of any "parachute payment" over the employee's "base amount" (the employee's average annualized compensation from the employer over the five calendar years preceding his or her separation from service). An amount would be a parachute payment if it is contingent on the employee's separation from

---

employment and the present value of the compensation equals or exceeds three times the employee's base amount.

#### **4. What compensation is taken into account for purposes of the new excise tax?**

For purposes of this tax, "compensation" means an employee's wages for federal income tax purposes under Section 3401(a) of the Code, including amounts required to be included in gross income under Section 457(f) of the Code, but excluding designated Roth contributions and 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.

#### **5. When do these changes take effect?**

The new excise tax provisions apply to taxable years beginning after December 31, 2017.

**Drinker Biddle Comment:** The tax-exempt employer executive compensation excise tax provisions are substantially similar to the Senate and House versions of the bill; however, the Act increases the amount of the excise tax to 21 percent and creates an exception for remuneration paid for medical services.

### **Intermediate Sanction Changes Not Adopted**

#### **1. Were there any changes to the intermediate sanction rules?**

No, the Act does not make any changes to the intermediate sanction rules. The Senate version of the bill had proposed a number of changes to these rules, including:

- Imposing a 10 percent excise tax on tax-exempt organizations in the event of an excess benefit transaction unless certain requirements are met.
- Eliminating the rebuttable presumption of reasonableness.
- Expanding the definition of "disqualified person" to include certain athletic coaches (and their family members) and additional types of investment advisors.
- Extending the intermediate sanction rules to cover tax-exempt organizations described in Section 501(c)(5) of the Code (labor, agricultural or horticultural organizations) and Section 501(c)(6) of the Code (business leagues, chambers of commerce, etc.).
- An organization manager's reliance on the written opinion of a professional advisor with respect to a transaction would not, by itself, preclude the manager from being treated as knowingly participating in the transaction.

As noted above, the Act does *not* include the above changes that had been proposed in the Senate version of the bill.

### **Governmental 457(b) Changes Not Adopted**

#### **1. Were there any changes to the deferral limits for governmental 457(b) plans?**

No, the Act does not change the annual deferral limits for contributions to governmental 457(b) plans. This limit is \$18,500 for 2018. A separate \$18,500 annual deferral limit applies for 2018 to employee contributions to a 403(b) plan or to a 401(k) plan (this limit is \$24,500 if the employee is age 50 or older in 2018).

**Drinker Biddle Comment:** The Senate version of the bill would have changed these limits by imposing *one* limit on an employee's deferrals to a governmental 457(b) plan, a 403(b) plan, and a 401(k) plan.

**2. Were there changes to the rules for special catch-up contributions to governmental 457(b) plans?**

No, the Act does not change rules allowing for special catch-up contributions to governmental 457(b) plans. Special catch-up contributions may continue to be made to governmental 457(b) plans in the last three taxable years ending before an employee reaches normal retirement age under the plan.

© 2025 Faegre Drinker Biddle & Reath LLP. All Rights Reserved.

---

National Law Review, Volume VIII, Number 12

Source URL: <https://natlawreview.com/article/executive-compensation-changes-under-tax-reform-update-plan-sponsors>