
On December 22, 2017, President Trump signed into law a comprehensive tax reform bill, H.R. 1, which was originally known as the Tax Cuts and Jobs Act. While the headlines in the popular press focus on the major changes affecting businesses and individuals, H.R. 1 also impacts many of the Internal Revenue Code (the “Code”) provisions regarding executive compensation. These changes may affect the compensation practices of a variety of employers, from publicly held and private corporations to tax-exempt organizations. Below, we describe key executive compensation changes in the bill, and we outline next steps that employers should consider.

1. Expansion of the $1 Million Deduction Limit under Code Section 162(m)

- Prior Law – Code Section 162(m) restricts a publicly held corporation’s ability to take an income tax deduction for compensation paid to its “covered employees” in excess of $1 million. A corporation’s “covered employees” generally consisted of its CEO, and its three most highly compensated officers other than the CEO and CFO whose compensation is required to be reported to shareholders. An individual was generally considered a covered employee only if he or she was employed in the covered position on the last day of the tax year for which the deduction applied. Also, amounts paid to a beneficiary of a covered employee were not subject to the $1 million deduction limit.

- Compensation payable solely on account of attainment of objective performance goals was not subject to the $1 million deduction limit, so long as a compensation committee comprised solely of outside directors determined the goals and certified that the goals were satisfied, and the material terms of the compensation were disclosed to and approved by the corporation’s shareholders prior to payment. Accordingly, publicly held corporations commonly designed their incentive programs for top executives such that some or all such performance-based compensation was exempt from the $1 million deduction limit.

- What Changed – The definition of “covered employee” now includes the employer’s CEO, its CFO, and the three most highly compensated officers (other than the CEO and CFO) whose compensation is required to be reported to shareholders. In addition, if an individual is considered a covered employee at any time during a tax year commencing after 2016, he or she will remain a covered employee permanently. Thus, all future payments to such individuals would be subject to the $1,000,000 deduction limit – even if the individual had ceased being
an officer or had terminated employment at the time of payment. Further, payments to the officer’s beneficiary remain subject to the $1,000,000 deductibility limit each year.

The performance-based compensation and commission-based compensation exceptions are eliminated. As a result, generally all incentive compensation and commission-based compensation paid to covered employees with respect to the 2018 tax year and subsequent tax years will be subject to the $1 million deduction limit (unless it is eligible for the “grandfather” rule discussed below).

Code Section 162(m) now applies to any corporation that is an issuer under Section 3 of the Securities Exchange Act of 1934 that is required to register its securities under Section 12 of that Act or is required to file reports under section 15(d) of that Act. This means that both listed corporations and certain unlisted corporations that register debt or equity securities with the Securities and Exchange Commission, including foreign companies publicly traded through ADRs, are now subject to the Code Section 162(m) limitations.

- **When** – Generally, the changes are applicable for tax years beginning after December 31, 2017. However, H.R. 1 provides a “grandfather” rule with respect to compensation provided under a written binding contract which was in effect on November 2, 2017, and which is not materially modified on or after such date. Such compensation would be subject to the Code Section 162(m) rules prior to the enactment of the Act (including the performance-based compensation exception).

While the IRS is expected to provide detailed guidance on the requirements for the grandfather rule, we expect the rule to apply to amounts covered by a plan or agreement where there is an outstanding award and the amount of compensation is objectively determinable and not subject to unilateral change or reduction. Further, no material changes can be made to applicable terms for such amounts after November 2, 2017. Thus, we expect that in order for a benefit to meet the grandfather rule: a covered employee must have had a right to such benefit under a plan or agreement on November 2, 2017; the employer cannot have the right to unilaterally reduce or terminate the covered employee’s right to such benefit (e.g., by exercise of discretion or discretionary amendment); and no material changes are made with respect to such benefit after November 2, 2017.

### Next Steps:

- **Existing Plans and Awards**
  - **Incentive Programs** – Incentive programs in process on November 2, 2017 that were considered performance-based compensation may satisfy the grandfather rule, and be able to still use the performance-based compensation exception to avoid the Section 162(m) deduction limit. However, incentive plans that allow the company to exercise negative discretion (e.g., set a high target bonus and allow the compensation committee to use discretion to scale back the payment) or unilaterally terminate or reduce the award may not satisfy the grandfather rule.
  - **Options** – Outstanding fair market value-based options as of November 2, 2017 may also satisfy the grandfather rule if exercised during their remaining exercise period. Pending guidance from the IRS, we are concerned that extensions of the exercise period, if such extension period was not embedded in the option as of November 2, 2017, may be a material modification that causes the option to subsequently fail the grandfather rule. Compensation from the exercise of options granted after November 2, 2017 by covered employees would be subject to the Section 162(m) deduction limits if the grandfather rule does not apply.
**Next Steps (Continued):**

- **Deferred Compensation and SERPs** – Many employers have planned around the 162(m) deduction limit by having non-performance based compensation paid after the employee ceases to be a covered employee (e.g., after termination of employment). As a result of the changes in H.R. 1, that strategy is not as effective for compensation earned after 2017, since the deduction limit applies to all future years. Amounts can be deferred to future years where deduction “headroom” exists, but the strategy may be of limited effectiveness for large amounts and could also be significantly impacted by the effects of long-term earnings credit, which could increase nondeductible amounts in future years. Thus, affected employers should review their plan documents for provisions requiring deferral of amounts subject to Code Section 162(m), and consider amending these documents to the extent permissible under Code Section 409A and the related regulations. In addition, in order to avoid the loss of the tax deduction on existing deferred compensation and SERP benefits payable to covered employees (present and future), employers should work with their record keepers to identify the deferred compensation and SERP benefits as of November 2, 2017 for all participants, and track these amounts as subject to the grandfather rule. Other rights to future benefits under the deferred compensation or SERP programs should be carefully reviewed to determine if they too can fall within the protective umbrella of the written binding contract exception.

Pending further guidance from the IRS, discretionary changes in payment timing for amounts otherwise expected to be subject to the grandfather rule should be approached with caution, as such changes could be treated as material modifications. Also, if the employer has historically delayed payments as necessary to avoid the loss of the deduction under Section 162(m), the changes made by H.R. 1 will impact how such a delay may need to be administered.

- **New Plans and Awards**
  - Because many publicly held corporations have integrated the performance-based compensation rules into their compensation committee charters and plan documents, these documents should be reviewed to consider whether any changes are desirable for future awards. Further, although H.R. 1 obviates the need for publicly held corporations to comply with the performance-based compensation rules, the process of establishing performance-based compensation programs in conformity with the prior rules has become a widely accepted exercise. It therefore remains to be seen whether shareholders (or shareholder advisory firms) will approve of major changes to the process merely because Code Section 162(m) no longer requires it.
2. New Excise Taxes for Excessive Compensation at Tax-Exempt Employers

- **Prior Law** – The $1 million deduction limit under Code Section 162(m) does not apply to tax-exempt organizations. Similarly, tax-exempt organizations are not subject to the Code Section 280G deductibility limit on excess parachute payments made to top executives in connection with a change in control. Tax-exempt organizations were not subject to any excise taxes on these amounts.

- **What Changed** – New Code Section 4960 imposes a 21% (i.e., the new corporate income tax rate) excise tax on compensation paid by a tax-exempt organization (or by any related person or government entity) to a “covered employee” in excess of $1 million for a tax year. A “covered employee” includes any of the five highest compensated employees (including former employees) of the organization for the tax year, as well as any individual who was a covered employee in any preceding tax year beginning after December 31, 2016. Compensation for these purposes includes wages as defined for income tax withholding purposes, except that compensation does not include designated Roth contributions to an employer’s qualified defined contribution plan. In addition, compensation generally includes amounts includible in income under a Code Section 457(f) deferred compensation plan, and such amounts are treated as paid when there is no substantial risk of forfeiture as defined in Code section 457(f)(3)(B). Thus, the excise tax will apply to vested amounts under a Code section 457(f) plan even if those amounts have not yet been paid. Compensation does not include amounts paid to licensed medical or veterinary professionals for the performance of medical or veterinary services.

Code Section 4960 also imposes a 21% excise tax on “excess parachute payments” paid by an applicable tax-exempt organization to a covered employee. An excess parachute payment is generally an amount contingent on the employee’s separation from service with the organization which exceeds three times the employee’s “base amount.” The employee’s base amount is generally his or her average annual compensation over the previous five tax years, determined in accordance with Code Section 280G. Amounts paid under qualified retirement plans, 403(b) and 457(b) plans and amounts paid to licensed medical or veterinary professionals for the performance of medical or veterinary services, or amounts paid to individuals who are not considered “highly compensated employees” under Code Section 414(q) (generally relating to qualified retirement plans), are not taken into account for purposes of calculating an individual’s excess parachute payment.

- **When** – Code Section 4960 applies with respect to tax years beginning after December 31, 2017. There is no grandfather rule for existing arrangements, but it appears that deferred compensation amounts under a Code section 457(f) plan that were vested and included in income before 2018 would not be subject to the excise tax when paid. As noted above, an individual who is a covered employee for the tax year beginning after December 31, 2016 will be a covered employee in subsequent tax years.

- **Affected Entities** – The excise tax imposed by Code Section 4960 applies to “applicable tax-exempt organizations,” defined as organizations exempt from tax under Code Section 501(a), a farmers’ cooperative organization under Code Section 521(b)(1), a governmental entity with excludable income under Code Section 115(1), or a political organization under Code Section 527(e)(1). Remuneration includes payments to a covered employee by any related person or government entity that controls or is controlled by the tax-exempt organization, is controlled by one or more persons that control the tax-exempt organization, or is a supported or supporting organization to the tax-exempt organization during the taxable year. To the extent a covered employee receives compensation from more than one employer, each employer is liable for its proportionate share of the excise tax.
3. Qualified Equity Grants

- **Prior Law** – Generally, if an employer transfers employer stock to an employee as compensation, the employee must recognize income in the tax year in which the employee’s right to the stock is transferable or is not subject to a substantial risk of forfeiture (i.e., “vested”). While employees of publicly held corporations can sell shares to generate cash to pay income taxes when their stock awards vest, the options for employees of private companies are more limited. In addition, compensation (including restricted stock unit (RSU) awards) paid under a nonqualified deferred compensation plan is subject to the requirements of Code section 409A, unless an exemption applies.

- **What Changed** – A new Section 83(i) is added to the Code, which allows private companies to offer rank and file employees the opportunity to defer income tax inclusion on compensatory stock options or RSUs for up to five years, provided certain requirements are met.

Qualified stock includes stock received in connection with the exercise of options or settlement of RSUs, and provided for an employee’s performance of services during a calendar year in which the corporation was an eligible corporation. A company is generally an “eligible corporation” if it is privately held and has a written plan under which at least 80% of all employees providing services to the company in the U.S. are granted “qualified stock.”

Stock would not be considered “qualified stock” if the shares can be liquidated by permitting the employee to transfer the stock back to the corporation for cash once it is transferable or becomes vested.

This special deferral rule is not available to 1% owners, current or former CEOs and CFOs (including their family members), or certain highly compensated officers.

Deferrals made in accordance with Code Section 83(i) are not subject to Code Section 409A.

- **When** – Generally, the new law is applicable to tax years beginning after 2017. The IRS is instructed to issue reasonable good faith compliance transition rules.
Next Steps:

- Private corporations should consider whether qualified equity grants are a desirable compensation tool for their respective businesses.

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Please contact any of the attorneys listed here or your regular Groom Law Group attorney for further information or to discuss next steps.