



Tracking Tax Reform: The Executive Compensation and Employee Benefit Provisions of The Tax Bill

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On December 20, 2017, the House of Representatives and the Senate voted to enact the tax reform bill, which has been renamed "To provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018" (the "Tax Act"). President Trump signed the bill on December 22, 2017.

Below is a brief summary of the material provisions of the Tax Act impacting executive compensation and employee benefits. Generally, the effective dates for these provisions are for compensation attributable to services performed, or tax years beginning, after 2017.

Elimination of Performance-Based Compensation Exception to Excessive Employee Remuneration

Code Section 162(m) limits tax deductions for payments in excess of \$1 million to certain top executives (the "covered employees") of publicly traded corporations. The Tax Act eliminates two key exceptions to the \$1 million deduction limitation and expands the group of executives who are classified as covered employees.

- The current exception for commissions and performance-based compensation paid to covered employees is eliminated.
- The definition of "covered employee" is expanded to include the CFO. A covered employee will include the CEO, CFO and three other highest paid employees.
- The definition of "covered employee" will also include any person who was a covered employee for any prior taxable year beginning after December 31, 2016. Thus, once an executive is classified as a covered employee, the deduction limitation will continue to apply to that individual during any period the corporation pays remuneration to such person (or to any of his or her beneficiaries). This will significantly expand the number of impacted individuals and will cause the deduction limit to apply to payments to former employees. This will also cause severance payments and other post-employment payments to be subject to the \$1 million deduction limitation.
- The definition of a "publicly held corporation" subject to Section 162(m) is expanded to include issuers of securities required to file reports under Section 15(d) of the Exchange Act (e.g., corporations with registered debt securities) and foreign companies whose stock is effectively traded through the American Depository Receipt System.

The Tax Act includes a transition rule that would grandfather remuneration that 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 after such date.

Excise Tax on Excess Tax-Exempt Organization Executive Compensation

A tax-exempt organization will be subject to a 21% excise tax (the corporate tax rate) on the sum of (i) remuneration paid to a covered employee in excess of \$1 million and (ii) an excess parachute payment paid to a covered employee.

- A covered employee includes an employee and former employee who (i) is one of the five (5) highest compensated employees of the organization for the taxable year, or (ii) was a covered employee for any preceding taxable year beginning after December 31, 2016.
- Remuneration includes all W-2 wages, other than designated Roth contributions, paid by the tax-exempt organization or any related organization.

- Any amounts taxable under Code Section 457(f) are included as part of remuneration and remuneration will be treated as paid when there is no substantial risk of forfeiture of the rights to such remuneration.
- Remuneration does not include remuneration paid to a licensed medical professional (including a veterinarian) for the performance of medical or veterinary services.
- A payment is an “excess parachute payment” if the total present value of all parachute payments exceeds three times the covered employee’s base amount. If the 3-times threshold is exceeded, the excess parachute payment subject to the excise tax equals the amount of the parachute payments less the base amount. This is similar to the Code Section 280G tax penalties with respect to change in control excess parachute payments paid to employees of for-profit corporations.
 - A payment is a parachute payment if it is contingent on the covered employee’s separation from employment.
 - A parachute payment does not include any payments made under qualified retirement plans, Code Section 403(b) or 457(b) annuity plans but may include payments under Code Section 457(f) plans.
 - A parachute payment does not include payment to a licensed medical professional (including a veterinarian) for the performance of medical or veterinary services.
 - The “base amount” is a covered employee’s average W-2 compensation over the five years preceding the separation from employment.
 - If a covered employee receives compensation from multiple related entities, then those payments will be aggregated for this purpose and the excise tax will be paid on a pro rata basis by each of the entities.

Deferred Taxation on Qualified Equity Grants

The Tax Act amends Code Section 83 by adding a new Section 83(i) under which “qualified employees” of privately held corporations can elect to defer, for up to five years, the income tax (but not employment taxes) on receipt of stock in connection with the exercise of stock options or the settlement of restricted stock unit (RSU) awards if certain conditions are satisfied.

- Qualified employees include employees other than an employee who (i) is or was in the preceding 10 years a 1% owner of the corporation, (ii) is or has been at any time the CEO or CFO (including any of their family members), or (iii) is one of the four highest compensated officers of the corporation for the current or any preceding 10 years.
- The corporation must grant the options and RSUs under a written plan to at least 80% of its non-part-time employees.
- The employer is required to give notice to qualified employees to their right to defer and the employee has 30 days to elect to defer income taxation.
- At the end of the deferral period, the amount of the income tax will be based on the value of the stock at the time of the option exercise or RSU settlement (even if the value of the stock decreases during the deferral period).
- This provision applies only to corporations and not to limited liability companies taxed as partnerships.
- The Code Section 83(i) election is available with respect to incentive stock options (ISOs) and options granted under an employee stock purchase plan (ESPP); however any election under Code Section 83(i) will cause the existing rules relating to those qualified stock options to end.

Retirement and Fringe Benefits

The Tax Act does not contain many of the provisions affecting retirement plans that were in the House bill, and retains the tax-favored adoption assistance programs, educational assistance programs and dependent care assistance programs.

Rollover Rules on Plan Loans

The Tax Act extends the time by which an employee whose plan terminates or who separates from service while a plan loan is outstanding can rollover the unpaid loan balance to avoid that amount being treated as a taxable distribution. In this situation, if the employee takes a distribution of the account balance, the amount of the outstanding plan loan is “offset” against the account balance and considered a taxable distribution. Starting in 2018, the employee will have until the due date for filing the employee’s tax return for the year of the distribution “offset” (rather than 60 days) to transfer an amount equal to the unpaid loan balance to an IRA or employer retirement plan to avoid that amount being taxed as a distribution.

Fringe Benefits

- **Qualified Moving Expenses.** The Tax Act eliminates the exclusion from the employee’s income of reimbursements of qualified moving expenses. This change will have a material impact on employers, since any reimbursement of moving expenses will now be taxable to the employee.
- **Employee Achievement Awards.** The Tax Act eliminates the exclusion from income for many forms of employee achievement awards by redefining the term “tangible personal property”. Starting in 2018, cash, cash equivalents, gift cards, gift coupons or

gift certificates (other than arrangements conferring only the right to select and receive pre-approved items), vacations, meals, lodging, theater and sporting event tickets, stock, bonds and other securities will not qualify as “tangible personal property” eligible for special tax treatment.

- **Entertainment and Meal Expenses.** The Tax Act eliminates an employer’s ability to take a deduction for entertainment, amusement or recreation activities, but retains the deduction (subject to the 50% limitation) for business meal expenses.

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