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What Employers Need to Know About the Tax Cuts and Jobs Act

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TAX REFORM CHANGES TO SECTION 162(m)

Section 162(m) – Prior Law

- Generally, compensation paid to "covered employees" greater then $1 million is not deductible
  - Exception for performance- and commission- based compensation
- **Covered Employers** – Common stock required to be registered, or required to file reports, under the Securities and Exchange Act of 1934
- **Covered Employee** – CEO and three other most highly compensated executive officers
  - CFO not included by title
  - Determined annually based on title and/or compensation at the end of each fiscal year

Section 162(m) – Tax Cuts and Jobs Act

- Eliminates performance- and commission-based compensation exception
- **Covered Employer --** Now includes private companies that issue publicly traded securities (e.g. debt or ADRs) and that must file '34 Act reports
- **Covered Employee –**
  - CEO or CFO any time during the fiscal year
  - Compensation is (would be) required to be reported in the CD&A
  - Once a covered employee, always a covered employee!
    - Covers post-termination payments
    - Even payments to beneficiaries
    - Begins with 2017 fiscal year – Use 2017 rules?

Grandfathered Agreements

- "Written binding contracts" in effect by 11/02/17 are grandfathered from the TCJA changes
  - Lose grandfathered status if materially modified
  - Need guidance on "materially modified" and "written binding contract"
- TCJA uses same statutory language as used for grandfathered status from 162(m) changes in 1993
  - Reg. § 1.162-27(h)(1)(iii) definition (1993)
    - Material modification means the contract is "amended to increase the amount of compensation payable to the employee"

Grandfathered Status

- Modifications previously ruled not to be a material under § 162(m) 1993 regulations
  - Transfer of options for estate planning purposes
  - Changes to options for corporate transaction
  - permitting beneficiary designations for stock options
  - accelerating vesting of stock options
- New compensation structures since 1993
  - § 1.162-27(h)(1)(i) (1993) "under applicable state law … obligated to pay the compensation if the employee performs services".
  - 409A regulations – legally binding right

Grandfathered Status

- Negative discretion
  - Some performance-based compensation would include a maximum amount payable with negative discretion to reduce if goals were not achieved
    - No IRS guidance on negative discretion
  - Effect on requirement for written binding contract
  - Generally no "legally binding right" to discretionary compensation under 409A regulations
    - Only required payments are part of a written binding contract
    - If some amount must be paid, all payments under arrangement are pursuant to a written binding contract
- Proceed with caution

Grandfathered Status

- Rules relating to what agreements are grandfathered is on the IRS's priority list. Some have said that the guidance will be out by June
- Examples
  - Performance-based equity compensation
  - Employment agreements
  - Nonqualified deferred compensation plans
    - Elective account balance (irrevocable elections, evergreen)
    - Non-elective employer contributions
    - Defined benefit plans (salary increases)
- Speculation until IRS guidance

Grandfathered Status -- Due Diligence

- Analyze compensation arrangements of current covered employee
  - Written binding contract
    - 1993 law regulations
    - 409A regulations
  - Elections – required, permitted, evergreen
  - Discretion/negative discretion
  - Renewals – automatic
  - Compensation increases
- Do state tax laws conform?

Grandfathered Status -- Maintain 162(m) Requirements

- For potentially grandfathered agreements, corporations should continue to comply with the 162(m) requirements to maintain potential deduction:
  - Objective performance goals
  - 90-day time period
  - Certification
  - Compensation committee make up (outside directors)
  - 5-year shareholder approval of range of performance standards
  - Plan/agreement requirements(transition provisions?)

New Compensation Arrangements

- Less incentive for base salaries to not exceed $1,000,000
- More flexibility/discretion establishing performance standards
  - No need for negative discretion
  - Easier to take into account individual performance
  - No pre-determination requirement
  - No shareholder approval of performance standards
- No certification required
- Remove plans provisions relating to 162(m)
  - Consider transition rules for new arrangements

New Compensation Arrangements

- Best practices
  - Shareholder views
    - Shareholder friendly provisions
    - Say-on-pay votes
  - Institutional shareholder requirement
    - pay for performance
  - CD&A disclosures
    - Compensation committee report

Minimization of Nondeductible Compensation

- ***Changes to 162(m) do not change the tax treatment of the compensation for the executive***
- Non-deductibility not as big an issue with reduced 21% corporate tax rate
- Will executives restructure current non-grandfathered agreements?
- Board of directors will need to balance recruitment and retention with loss of deduction
  - Cost of doing business?

Minimization of Nondeductible Compensation

- Maximize contributions to 401(a) retirement plans
  - Defined benefit plans (QSERPs)
- Non-qualified deferred compensation
  - Mandatory deferrals
- Incentive stock options
- Extended post-termination exercise periods
- Life insurance benefits
- A payment may be delayed if reasonably anticipate that deduction denied under section 162(m)
  - > Need a provision in the plan or agreement?

Section 162(m) – Compensation Committees

- Not required to have "outside directors"
  - Stock exchange independence requirements for compensation committee members
    - Former officers can be independent under listing standards
  - Section 16 requirements
  - State law requirements
- Review charter for requirements to comply with 162(m)
  - But certification by outside directors needed under transition rule
  - Consider changes to compensation committee charter

TAX PENALTIES ON EXCESS COMPENSATION PAID BY TAX-EXEMPT ORGANIZATIONS

New Section 4960 Tax Penalties on Excess Compensation

- Penalty under section 4690 of the Internal Revenue Code (the "Code") —
  - "Applicable tax-exempt organization" pays the excise tax penalty
  - Tied to corporate tax rate, which is currently 21%
  - Applies to remuneration paid to "covered employees":
    - In excess of $1,000,000, or
    - Which are "excess parachute payments"
  - ***Does not change the covered employee's tax treatment for the compensation***

Applicable Tax-Exempt Organization

- Any organization that is exempt from taxation under:
  - Code section 501(a)
    - Covers all entities exempt from tax under 501(b) and (c), including 501(c)(3) organizations
  - Code section 115(1)
    - This covers all entities that exercise essential governmental functions and its income accrues to the state
    - Does not cover actual state government or its political subdivisions
  - Code section 521(b)(1) farmers cooperative org
  - Code section 527(e)(1) political organization

Applicable Tax-Exempt Organization

- No limitation based on controlled group principles or Code Section 414 "single" employer concept
  - Unless IRS gives limiting guidance, penalty appears to apply at the organization level and not the entire group level
  - Many statutes do not have controlled group or single employer principles, but they are added by regulation
- How many CEOs does your organization have?

Related Organization

- A person or governmental entity related to an applicable tax-exempt organization during a taxable year which—
  - controls, or is controlled by, the organization;
  - is controlled by one or more persons which control the organization;
  - is a supported organization (as defined in section 509(f)(3));
  - is a supporting organization described in section 509(a)(3); or
  - Certain VEBAs

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Multiple Payors of Excess Compensation

- All remuneration from related organizations included in calculating the penalty
- If remuneration from more than one "employer" is taken into account in calculating the penalty — then each employer pays pro-rata share of penalty
  - It does not say that each related organization pays a pro-rata share of the excise tax
  - Excise tax is paid at employer level

Covered Employee

- Five highest paid employees of the organization
  - Not necessarily top five on Form 990 because 990 reports income that is not 3401(a) wages
  - Not wages on covered employee's Form W-2
  - Must look at 3401(a) wages paid during organizations fiscal year
- Once a covered employee, always of covered employee
  - Beginning in taxable year that begins after December 31, 2016
  - For compensation from that tax-exempt organization

Remuneration

- Code Section 3401 wages (basically W-2 wages)
  - Benefits from tax-qualified plans are excluded
  - Non-taxable fringe benefits excluded
  - Roth contributions are excluded
- Treated as paid when no longer subject to a substantial risk of forfeiture (i.e., vested)
- Excludes any remuneration paid to a licensed medical professional (including a veterinarian) which is for the performance of medical or veterinary services by such professional

Welcome to the World of Excess Parachute Payments

- "Parachute payment" means any payment in the nature of compensation to (or for the benefit of) a covered employee if:
- The payment is contingent on the covered employee's separation from employment with the employer, and
- The parachute payment is equal to or in excess of 3x the employee's "base amount"
  - Unlike Code section 280G —
    - No change of control needed
    - No reasonable compensation exception

Base Amount

- Base amount is the same as under Code section 280G(b)(3)—
  - Annualized includible compensation for base period.
  - In other words, the covered employee’s average annual compensation for the past five years with the applicable tax-exempt organization (or if less than five years, the lesser period

Exceptions

- The following payments will not be treated as parachute payments—
  - Payments from tax-qualified plans;
  - Benefits paid from a 403(b) or 457(b) plan;
  - Payments for medical or veterinary services by such professional; or
  - Payments to a non-highly-compensated employee (Code section 414(q))

Excess Parachute Payments

- The penalty is calculated based on the amount by which the excess parachute payment exceeds the base amount
- Summary: If the covered employee is paid severance in excess of three times her or his average compensation for the past five years, then the amount paid in excess of that average compensation is subject to a 21% penalty, payable by the applicable tax-exempt organization

Excess Parachute Payments

- No reasonable compensation exclusion
  - Most tax-exempt organizations do obtain a reasonableness opinion regarding the amount of the compensation
- No change in control needed
- Should a ***clawback***, or some other 4960 provision, be put into employment agreements, similar to for-profit companies?

Minimizing Excess Compensation Penalties

- Maximize Tax-Qualified Retirement Benefits
  - Defined benefit plans
  - Defined contribution plans
    - profit sharing contributions
    - Roth *contributions*
  - QSERP
  - 403(b) — Mandatory Deferrals and Employer Contributions
  - 457(b) Plan (governmental)

Minimizing Excess Compensation Penalties

- 457(f) plan -- deferred income inclusion until vested (substantial risk of forfeiture)
  - Defer income to retirement
  - Non-compete post-termination/retirement deferral period
  - Rolling vesting to extend pre-retirement vesting
  - Short-term deferral exception
  - Requires modeling
- 457(b) non-governmental plan
  - Possible to elect time and form at termination

New Plan Designs for 457(f) Plans Can Help Recruiting and Retention

✦ Non-Compete As A Substantial Risk of Forfeiture/Post-Termination Deferrals

> The proposed regulations provide that a post-termination non-compete provision can create a post-termination of employment substantial risk of forfeiture

> Hospitals have an interest in their executive not competing with the hospital for talent and fundraising

- Retirements for non-compete vesting period

> Preempts California restrictions on non-competes because it is an ERISA plan

New Plan Designs for 457(f) Plans Can Help Recruiting and Retention

✦ Rolling Vesting

> Requirements

- Enter into written agreement 90 days before current vesting period
- Extend vesting for minimum of two years
- Employer must increase account balance subject to extended vesting by no less than 25.01% of present value of benefit on the original vesting date

New Plan Designs for 457(f) Plans Can Help Recruiting and Retention

- Addition of Short-Term Deferral Rules to 457(f) regulations
- Permits payment by 15th day of the third month of the taxable year (calendar or fiscal) following the taxable year in which the benefit vested
- Executive cannot elect payment date
- Employer has discretion to elect payment date

OTHER EMPLOYEE BENEFIT CHANGES

Nondeductible Entertainment Expenses

- The Act eliminated the business deduction under Code section 274(a) for activities that are generally considered to be entertainment, amusement, or recreation expenses, and for facilities used to carry on these activities, in connection with conducting the employer's trade or business
  - Previously, 50% deduction for entertainment expenses
  - This does not affect deduction for social or recreation expenses paid for employee events
  - Employers may still deduct food or beverages provided to employees as part of carrying on the employer's trade or business, such as travel expenses.

Deductions for Food and Beverages

- Providing food and beverages to clients is entertainment and generally not deductible.
- Providing food and beverages to employees:
  - As social or recreational activities (i.e., Christmas party) is fully deductible.
  - Travel costs to carry on employer's trade or business are not entertainment. Providing food and beverages to employees as travel costs is 50% deductible.
  - Food provided as part of business meetings of employees, shareholders, *agents* or directors is 50% deductible. This includes off premise food or beverage to employees.
  - Food and beverages provided to employees on the employer's premise is 50% deductible

Limits and Phase-Out on Deduction for Employer-Operated Eating Facilities

- Previously, an employer could deduct the cost of food and beverages provided to employees at an employer-operated eating facility if the food and beverages are provided for the convenience of the employer.
- The qualifying employer-provided meals continue to be excluded from the employees' taxable income.
- The Act amends Code Section 274(n) to reduce the employer deduction to 50% beginning in 2018 and to completely eliminate the deduction beginning in 2026.

Unrelated Business Income Tax

- Tax exempt organizations must pay UBIT (flat rate of 21%) for amounts earned that are not related to the purpose of the tax-exempt status
- Nondeductible entertainment expenses paid by a tax-exempt organization are subject to UBIT
  - i.e., tickets to sporting events or theaters, amusement activities, and recreational activities.
  - UBIT is also increased for all club dues paid by the organization.
- Costs for recreational and social activities for employees continue to be deductible (so no UBIT)

Qualifying Transportation Fringe Benefits

- Qualified transportation fringe benefits under Code section 132(a)(5) are still excludable from employee income
- Employers are no longer entitled to deductions for the costs of qualifying transportation fringe benefits
  - Commuter highway vehicle
  - Transit pass
  - Qualified parking
  - Qualified bicycle commuting reimbursement
- Employee pre-tax purchases are also considered a non-deductible employer provided benefit – Publication 15B

Qualified Bicycle Commuting Reimbursement Fringe Benefit

- The Act amends Code section 132(f) to suspend the employee income exclusion for qualified bicycle commuting reimbursements for the 2018 through 2025 tax years.

Certain Fringe Benefits Subject to UBIT

- Tax-exempt organizations will generate UBIT on the value of providing the following fringe benefits tax-free:
  - Payment of qualified transportation fringe benefits
  - Costs associated with any parking facility used to provide employee parking
  - Costs associated with any on-premises athletic facility
- Providing taxable benefits is not subject to UBIT
- Permitting employees to pay pre-tax for qualified transportation and parking is still subject to UBIT

Employee Achievement Awards

- Employee achievement and safety awards are not included in employee income and are deductible by employer if the conditions under Code section 274(j) are met
- The award must constitute a transfer of tangible personal property, instead of cash or cash equivalents
  - Amends Code section 274(j)(3)(A) to specifically define what is not treated as tangible personal property

Employee Achievement Awards

- Items not treated as tangible property:
  - cash,
  - cash equivalents,
  - gift cards, gift coupons, and gift certificates
    - other than arrangements conferring only the right to select and receive tangible personal property from a limited array of such items pre-selected or pre-approved by the employer
  - vacations, meals, lodging,
  - tickets for theater or sporting events,
  - stocks, bonds, other securities,
  - other similar items.

Qualified Moving Expense Reimbursement

- Moving expenses paid or reimbursed by an employer in connection to an employee beginning employment in a new principal place of work have been excluded from the employee's income as "qualified moving expense reimbursements" under Code section 132(a)(6)
- Income exclusion, and employer deduction, suspended from 2018 until 2025
- Exception for certain moving costs for members of the United States Armed Forces

Length of Service Award Plans

- Tax-exempt organizations can provide a length of service award to bona fide volunteers
- The maximum aggregate amount that can be given in any given year of service was increased from $3,000 to $6,000.
- The new limit will be increased annually by a cost-of-living adjustment in minimum increments of $500.

Employer Credit for Paid Family and Medical Leave

- Certain employers may now receive a tax credit for offering paid family and medical leave. The credit will be a part of the general business credit under Code section 38, and can be used to lower an employer's taxable income (subject to limitations) and any applicable alternative minimum tax
- The credit is a temporary addition to the tax code and will not apply to wages provided after December 31, 2019.

Employer Credit for Paid Family and Medical Leave

- An "eligible employer" is any employer that has a written policy in place that provides:
  - At least two weeks of paid family and medical leave per year for all qualifying employees who are not considered part-time (less than 30 hours per week)
  - For qualified part-time employees, an amount of paid family and medical leave that is proportionally equal to the amount for full-time employees described above.
  - A rate of payment for paid family and medical leave which is at least 50% of the normal pay rate for the applicable employee

Employer Credit for Paid Family and Medical Leave

- A "qualified employee" is an employee who has been employed by the employer for one or more years and whose salary in the preceding year did not exceed 60% of that of a highly compensated employee, as described in Code section 414(q)(1)(B)(i).

Qualifying Family and Medical Leave

- The birth of a child and to care for the child.
- Placement of a child with the employee for adoption or foster care.
- To care for a spouse, child, or parent with a serious health condition.
- The employee has a serious health condition that makes him/her unable to perform.
- Any qualifying exigency, as defined by the Secretary of Labor, related to a spouse, child, or parent of the employee being on covered active duty.

Qualifying Medical and Family Leave

- If the paid leave is processed as vacation time, personal leave, or sick leave, then it will not be considered paid family and medical leave, and amounts paid under state or local law are not taken into consideration.

Amount of Employer Credit

- The amount of the credit will be calculated based on a percentage of the wages paid to employees for paid family and medical leave
- The calculation begins at 12.5% of the wages paid to employees for paid family and medical leave, and increases in increments of .25% (not to exceed 25% total) for every percentage point by which the rate of pay for paid family and medical leave exceeds 50% of normal wages for the employee

Example

- Employer pays employee $1,000 in paid family and medical leave. If $1,000 is 50% of the normal rate of pay for the employee, then the employer may take a tax credit of $125 for this employee ($1,000 x 12.5% = $125). However, if $1,000 is 100% of the normal rate of pay for the employee, then the employer may take a tax credit of $250 ($1,000 x 25% = $250)

Amount of Employer Credit

- The credit for a given employee may not exceed the normal hourly wage of the employee (if the employee is not paid hourly, his/her salary will be prorated to an hourly wage) multiplied by the amount of hours taken for paid family and medical leave
- Additionally, the amount of paid family and medical leave used to determine the tax credit for a given employee may not exceed twelve (12) weeks

Repeal of Individual Mandate

- Effective January 1, 2019, individuals are not subject to tax penalties if they fail to maintain minimum essential coverage
- Employees may choose to go uninsured without facing individual mandate penalty
- Possible impact is that a number of young, healthy Americans will drop health coverage and this may cause the individual market to become unstable to too expensive
- Outcome of repeal is unclear

CODE SECTION 83(I) OF THE INTERNAL REVENUE CODE (“CODE”)

Code Section 83 Review

- Under Code section 83(a), property transferred to a service provider that is non-transferrable and subject to a substantial risk of forfeiture ("vesting") is not treated as actually transferred until it becomes vested. The service provider is taxed on the value of the property upon vesting, not when initially transferred
- Under Code Section 83(b), a service provider can elect to be taxed on the FMV of the property at the time of the initial transfer

Code Section 83 Review

- Section 83(b) elections
  - Election must be made within 30 days of the initial transfer
  - An 83(b) election is irrevocable
  - Property is treated as owned by the service provider and the holding period for long-term capital gains is triggered
    - For private equities, the downside of an 83(b) election is that the service provider must come up with the exercise price (if an option) and pay the taxes even though the stock is currently non-transferrable or marketable
      - Cannot sell the stock to recoup exercise price or taxes paid
    - No deduction for losses (deduction for any amount paid)

Code Section 83(i)

- A Section 83(i) election may be made:
  - By a "qualified employee"
  - Of an "eligible corporation"
  - With respect to "qualified stock"
  - Transferred pursuant to a qualified equity grant (QEG)
- Can be made at the time a QEG vests
- Effects of an 83(i) election:
  - (1) Deferral of income tax for up to five years, and
  - (2) Holding period begins for long-term capital gain treatment

Qualified Employee

- A "qualified employee" is any employee that is not one of the "excluded employees" listed below:
  - One-percent owner at any time during the calendar year or during the ten preceding calendar years;
  - Chief executive officer or chief financial officer, or an individual acting in either capacity (current or former);
  - Spouse, child, grandchild or parent of any individual listed in the two categories above; or
  - One of the four highest compensated officers of the company for the taxable year or for any of the ten preceding taxable years
- Independent contractor are not eligible
- Code section 83(i) does not provide for any classes of employees that can be excluded from participating in the plan (such as the classes under Code section 423 for an ESPP)
  - Employer discretion as long as 80%

Eligible Corporation

- An "eligible corporation" is
  - a privately held company (i.e., no stock is traded on an established securities market),
  - that has a written plan that provides stock options or restricted stock units (RSUs), to acquire "qualified stock,"
  - to at least 80% of its employees in the United States,
  - with the same rights and privileges under the plan as required under Code section 423(b)(5) for qualified employee stock purchase plans.
- Employees will not be treated as having disparate rights and privileges under a qualified equity grant plan solely because:
  - the number of shares of qualified stock granted to all employees is not the same, as long as the amount granted to any eligible employees is not de minimis, or
  - the rights and privileges with respect to the exercise of an option are not the same as the rights and privileges for the settlement of a RSU
- Parents and subsidiaries

Qualified Stock

- Code Section 83(i) defines qualified stock as:
  - Stock of an eligible corporation that is received in connection with the exercise of a stock option or RSU
  - The stock option or RSU must be granted by the employer in connection with the employee's performance of services while the corporation was an eligible corporation
- Stock is not qualified stock if:
  - The employee can sell the stock to the corporation or receive cash in lieu of the stock
- Restricted stock and stock appreciation rights do not qualified as qualified equity grants

83(i) Deferral Period

- The FMV of the "deferral stock" on the date of vesting will not be taxed until the earlier of:
  - The first date "deferral stock" become transferable,
  - The date the qualified employee becomes an excluded employee,
  - The first date the corporation's stock becomes tradable on an established securities market,
  - Five years after the first date the <u>qualified equity grant</u> vests or becomes transferable, or
  - The date employee validly revokes the 83(i) election.

Section 83(i) Elections

- Election made at time of vesting
- Defers income taxes during the deferral period
  - For stock options still need to come up with exercise price out of pocket
  - Still need to pay FICA taxes (Employer withholding obligation)
- Begins long-term capital gain holding period
  - Even though taxes have not been paid
- Can revoke an 83(i) election
- Deferred income taxes calculated base on value of the deferral stock on date of transfer (less any amount paid)
  - How is that value determined?
- If the value of the deferral stock drops, still must pay taxes based on stock's "value" at time of 83(i) election

83(i) Election not Available when:

- The employee has made a prior 83(b) election with respect to the qualified stock
- Not available if the company has repurchased any of its "deferral stock" in the year before the date the employee's rights are transferable or vested, unless at least 25% of the total dollar amount of the repurchase is "deferral stock", and the company acts reasonably in its determination of which employee to purchase the stock from

Notice Requirements for Company

- Notice to Employee must be given at the time (or a reasonable period before) the amount would be first included in gross income under Section 83 (disregarding the 83(i) election)
- The Notice must:
  - Certify the stock is qualified stock
  - Notify the employee he or she may chose to defer under 83(i)
  - Notify the employee when income recognition is determined
  - Notify the employee of FICA withholding responsibilities
- The IRS may asses a fine of $100 for each notification failure, up to a maximum of $50,000 per year

Practical Considerations

- Employee 83(i) elections
  - Risk Evaluation
    - Will there be a liquidity event before the end of the deferral period?
    - Will the employee have enough money at the end of the deferral period to pay the taxes if there is no liquidity event?
    - Will the employee have current income or savings to pay the current FICA taxes?
  - Design issues:
    - Frequent vesting could make 83(i) elections impractical
    - Does termination of employment affect 83(i) elections

Practical Considerations

- Employer issues
  - Establishing and maintaining the group of 80%
  - Tax withholding obligations
  - Potential penalties for failure to provide compliant notices
  - Must report on tax return any purchases of deferral stock
  - Ambiguities and Lack of IRS guidance
    - Can rely on good faith compliance until IRS issues additional guidance

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