GOP Tax Reform: Impact on Executive Compensation and Employee Benefit Plans

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The tax reform act, formerly known as the Tax Cuts and Jobs Act (the “Act”), was approved by House and Senate Republicans and is ready to be signed into law by President Donald Trump. President Trump is expected to sign the legislation no later than January 3. The Act drops the corporate tax rate from 35% to 21%, alters individual standard and itemized deductions, and repeals the individual mandate of the Affordable Care Act. The Act also has a significant effect on executive compensation and health and welfare benefits, as described below. Williams Mullen’s Tax Section will publish a summary of the Act.

Compensation

Compensation Deductions Under 162(m): Repeal of Performance-Based Compensation and Commission Exceptions to $1 Million Deduction

Publicly-traded corporations may not deduct more than $1 million in compensation paid to certain executives under section 162(m) of the Internal Revenue Code (“Code”). Significant exceptions to this limit are repealed by the Act. The performance-based compensation exception to the $1 million cap, and the commission pay exception, are no longer available for taxable years beginning after December 31, 2017.

Amounts paid pursuant to a binding written contract, in effect on November 2, 2017, can retain the historic exempted status if the contract is not materially modified on or after that date. This “grandfathering” rule is fairly easily applied for compensation plans or agreements that are not subject to negative discretion (*i.e.*, the discretion to reduce amounts otherwise payable under the compensation formula for a particular award). Most Code section 162(m) plans do contain this discretion, however. This common plan term is not expressly addressed in the legislation, but it seems reasonable that such a provision would not in itself disqualify an outstanding award from the binding written contract exception. The reasoning would simply be that, on November 2, 2017, the provision appeared in the plan or agreement governing the award, and must be implemented in the manner set forth in the arrangement on that date. Of course, further guidance on this point may be forthcoming and could differ from this analysis.

The new law also expands the group of corporations covered by the Code section 162(m) limit, and expands the group of covered executives. Historically, covered corporations were those required to register their securities under section 12 of the Securities Exchange Act of 1934, as amended (the

“Exchange Act”). Under the new law, corporations required to file reports under section 15(d) of the Exchange Act are also covered. The group of affected executives is likewise expanded. Under the Act, this group consists of the principal executive officer, principal financial officer, and each of the next three most highly compensated officers of the employer (or any predecessor entity) for any year beginning after December 31, 2016. Once an individual becomes subject to the compensation limit, he or she remains subject to the limit for all future years.

Excise Tax on Tax-Exempt and Governmental Employers for Payments of Excessive Executive Compensation

A new 21% excise tax applies to compensation in excess of $1 million paid to certain employees, and to excessive severance pay. The tax is imposed on the employer. Entities subject to the excise tax are employers exempt under Code section 501(a), state or local governmental entities, farmers’ cooperatives, and Code section 527 political organizations. The excise tax applies for taxable years of a tax-exempt entity beginning after December 31, 2017.

Employees whose pay is covered by the new law are the five most highly-compensated employees of the employer for any tax year beginning after December 31, 2016. Once an individual falls into this group, he or she retains that status for all future years.

Compensation considered includes payments from a related person or governmental entity. An important exemption applies to payments to a doctor, nurse, or veterinarian to the extent the payments are for the performance of medical or veterinary services by the individual. Generally, deferred compensation is considered paid when vested for purposes of this excise tax.

Severance pay is subject to a 21% excise tax under a structure that mirrors the golden parachute rules. The excise tax is triggered by severance that equals or exceeds three times average compensation for the five-year period ending before the year of the executive’s severance from service. Once triggered, the excise tax applies to compensation in excess of one times average compensation. Payments under a qualified plan, a tax-deferred annuity, or an eligible deferred compensation plan of a state or local governmental employer are excluded in calculating severance compensation, as are payments for the performance of medical or veterinary services.

The excise tax can apply to severance pay even if it does not exceed $1 million. The excise tax, however, will not be applied twice to the same amount of pay for individuals who receive both severance pay and compensation over $1 million in a taxable year.

Elective Deferral of Income Recognition for Certain Private Company Stock Options and RSUs

Under the new law, privately-held companies that make grants of restricted stock units (“RSUs”) or stock options must notify employees of the right to defer recognition of income on those awards. Employees *other than* certain officers, owners, and highly compensated employees may elect, within 30 days of exercise of an option, or settlement of an RSU, to defer income recognition for up to five years. Income must be taken into account sooner if the stock becomes transferable (including to the company), the company undergoes an IPO, or the individual becomes an excluded employee. The new law affects exercises and settlements after December 31, 2017. Penalties apply if an employer fails to provide the election notice.

The new election applies only if the equity is granted pursuant to a broad-based written program under which at least 80% of employees receive grants. Employers must notify employees of this right and of general tax consequences at or within a reasonable period of time before the stock would otherwise be taxable (at exercise, settlement, or vesting, if later). Finally, this right is available for ISOs and stock acquired under a Code section 423 employee stock purchase plan, but use of the deferral election negates special tax treatment. Essentially, the option would be taxable as a nonqualified option.

Fringe Benefits

Suspension of exclusion for qualified bicycle commuting reimbursement

Before the Act, qualified employer reimbursements of up to $20 per month for the cost of purchasing and maintaining a bicycle used for commuting to and from an employee's place of employment were excludible from the employee's gross income. The Act removes the commuter bicycle exclusion for taxable years beginning after December 31, 2017, and before January 1, 2026.

Repeal of exclusion for qualified moving expense reimbursements

Employer-provided moving expense reimbursements historically have been excludible from an employee's gross income if the expenses would be deductible moving expenses if directly paid or incurred by the employee. The Act provides that the exclusion will no longer apply for taxable years beginning after December 31, 2017, and before January 1, 2026, except with respect to members of the Armed Forces.

Individual Retirement Accounts

Repeal of rule allowing recharacterization of IRA contributions

Prior to the new law, taxpayers could recharacterize contributions to one type of IRA (traditional or Roth) as a contribution to the other type of IRA. The Act provides that the recharacterization rule may not be used to unwind a conversion from a traditional IRA to a Roth IRA effective for taxable years beginning after December 31, 2017.

Defined Contribution Retirement Plans

Rollovers of plan loan offset amounts

Historically, the period of time that a plan loan offset amount may be contributed to an eligible retirement plan as a tax-free rollover has been 60 days from the date of the offset. The Act provides that, for plan loan offset amounts resulting from a plan termination or a participant's severance from employment, the rollover deadline is the due date for filing the Federal income tax return for the taxable year in which the loan offset occurs, effective for taxable years occurring after December 31, 2017.

Health Care

Elimination of the Affordable Care Act Individual Mandate

Under the Affordable Care Act, individuals must have minimum essential (health) coverage or pay an "individual responsibility payment." The annual tax amount for 2017 and 2018 is $695. The individual responsibility payment is reduced to $0 effective for months beginning after December 31, 2018.

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