ALERT

Five Things Employers Should Know About Tax Reform

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With the enactment of the Tax Cuts and Jobs Act comes sweeping changes to executive and equity compensation and employee benefits.

by Pillsbury's Executive Compensation & Benefits Team

TAKEAWAYS

- Employers should evaluate whether they will be subject to the $1 million tax deductibility limit on compensation under Section 162(m) and the impact the elimination of the performance-based compensation exception will have on incentive compensation.
- Employers should evaluate whether to revise equity incentive award strategies to take advantage of new tax reduction and tax planning opportunities aimed at non-senior executives.
- Employers should review whether changes to the tax treatment of parking and commuter fringe benefits and employer-paid or reimbursed moving expenses will impact their approach to, and the cost of, providing these benefits.

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After an intensive legislative process, tax reform is here to stay. The Tax Cuts and Jobs Act, entitled the "Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018" (the "Act") has passed. While employers are breathing a sigh of relief because some of the more far-reaching amendments initially proposed by the House and the Senate were ultimately not adopted as part of the Act, employers should prepare for changes to their compensation and benefit arrangements that are now law.

Legislative Process

On December 15, 2017, the Conference Committee released its final legislative text of the Act. Just five days later, on December 20, 2017, the Act was passed by both the Senate and the House, and President Donald Trump signed the Act into law on December 22, 2017. The majority of the Act is effective as of January 1, 2018.

Top Five Tax Reform Changes

While the Act will alter the tax treatment of executive and equity compensation and employee benefits in a number of ways, employers should be particularly aware of the following five significant changes to current law:

1. Code Section 162(m) and Elimination of Performance-Based Compensation Exception

Overview

Section 162(m) of the Internal Revenue Code (the "Code") caps a public company's federal income tax deduction for compensation paid to any "covered employee" at $1 million in any taxable year, subject to exceptions for commissions and qualified performance-based compensation (including stock options and stock appreciation rights). (For a detailed summary of Section 162(m) prior to the Act, see our alert "Tax Reform: The Shifting Landscape of Executive and Equity Compensation.") The Act amended Code Section 162(m) by:

- Eliminating the exceptions for commissions and performance-based compensation.
- Expanding the scope of a company's covered employees to include its CFO and any person who is a "covered employee" on or after January 1, 2017, for as long as that person (or his or her beneficiary) receives compensation even if the person no longer serves as an officer of the company.
- Expanding the scope of covered employers to include all foreign corporations traded through American Depositary Receipts (ADRs), companies with publicly registered debt and large private C or S corporations that are not publicly traded.

Transition Rule

The Act contains a transition rule which provides that the above changes do not apply to compensation under a written contract that was in effect on November 2, 2017, and that was not materially modified after such date. The Joint Explanatory Statement released by the Conference Committee together with the Act contains a number of gaps in its discussion of the transition rule. For example, it provides that, in order to be eligible for the rule, "amounts payable under the plan [must not be] subject to discretion." This requirement is troubling because many incentive plans allow the compensation committee to make discretionary adjustments to the amount of compensation. Therefore, while employers should evaluate whether their existing arrangements would be eligible for the transition rule—thereby allowing the arrangements to be covered by the performance-based compensation exception—they should do so recognizing that the extent of the transition rule needs guidance from the Treasury and the Internal Revenue Service.

Incentive Compensation Design and Disclosure Changes

The elimination of the performance-based exception means that companies will have more flexibility in the design of their incentive compensation arrangements because they will not be bound by the prescriptive requirements of Section 162(m) (e.g., pre-established performance objectives approved by shareholders).

Specifically, companies will have flexibility (a) to use any performance metrics that the compensation committee deems appropriate, including subjective performance metrics, and will not be limited to shareholder-approved performance metrics (however, SEC-reporting companies will need to ensure that such changes are aligned with the proxy advisory firms' pay-for-performance models); (b) to increase or decrease the amount of incentive compensation granted to executives (before the Act, a compensation committee had only negative discretion to reduce the amount of incentive compensation); (c) to adjust incentive compensation to take into account extraordinary events affecting the company's financials; (d) in the type of equity compensation granted because stock options and stock appreciation rights will no longer be favored under Section 162(m); and (e) to grant equity and cash incentive compensation without being subject to the annual individual limits in equity and cash incentive plans. In order to take advantage of this increased flexibility, companies will need to amend their incentive compensation plans, which may require shareholder approval. Such changes may also require SEC-reporting companies to revise their public disclosure.

Further, the elimination of the performance-based compensation exception will impact SEC-reporting companies' Section 162(m) disclosure in the Compensation Discussion & Analysis (CD&A) sections of their proxy statements.[1]

[1] Item 402(b)(2)(xii) of Regulation S-K provides that, while the material information to be disclosed under the CD&A will vary depending on the facts and circumstances, examples of such information may include the "impact of the accounting and tax treatments of the particular form of compensation."

Specifically, companies will need to update their disclosure to reflect the above changes to Section 162(m). In addition, companies could consider including more robust narrative and/or tabular disclosure in their CD&As that describes the amount of the non-deductible compensation under Section 162(m), the company's rationale for paying such compensation and the fiscal impact to the company of the lost tax deduction. Whether or not a company decides to include such additional disclosure in its CD&A will depend on the particular facts and circumstances.

2. Equity Award Tax Benefits – Tax Deferral for Private Company Awards Under New Section 83(i) and Broader Tax Reduction by ISOs Under Adjusted AMT Limits

Overview

The general rules for taxation of employee equity incentive awards remain substantially intact after the Act. As is further described in our alert "Tax Reform: The Shifting Landscape of Executive and Equity Compensation," these general rules provide for non-qualified stock options (NSOs) to be taxed when exercised, RSUs to be taxed when settled and incentive stock options (ISOs) to be taxed when the shares acquired by exercise are sold (subject to potential Alternative Minimum Tax (AMT) on the ISO exercise). The Act tweaks these general rules in two ways:

- Non-executives at privately held companies that implement broad-based employee equity award programs may defer taxation on stock received on exercise of NSOs and settlement of RSUs for up to five years.
- Fewer employees will be subject to the AMT and correspondingly more employees may avoid taxation on the exercise of ISOs until the underlying shares are sold.

New Section 83(i) Tax Deferral Elections

Privately held companies committed to a culture of employee ownership may wish to structure their NSO and/or RSU equity award programs to permit employees to take advantage of a brand new opportunity to defer taxation on such awards. A concern of equity award recipients at private companies is the obligation to pay taxes on the shares received upon NSO exercise or RSU settlement at a time when the employee has no ability to liquidate such shares to cover that cost. This concern has been exacerbated in the past decade as emerging growth companies take ever longer to make their shares available for trading via initial public offering.

To address this mismatch between timing of taxation and timing of liquidity, the Act provides an opportunity, under new Section 83(i) of the Code, to elect to defer taxation on private company NSOs exercised and RSUs settled in 2018 or later. Excluded from this deferral opportunity are certain ineligible executives, including the CEO, CFO, top four compensated officers and 1% owners. The deferral will cease to be effective, and the employee will be subject to taxation on the then-fair market value of the shares (less option exercise price if acquired by NSO exercise), upon the earliest to occur of: (a) the shares becoming transferable (including repurchase by the employer); (b) the shares becoming publicly traded; (c) the employee becoming an ineligible executive (see description above); (d) the employee revoking the election; and (e) the fifth anniversary of the NSO exercise or RSU settlement.

The Section 83(i) election opportunity will appeal to employees (other than ineligible executives), but may be unattractive to employers given the eligibility conditions. Most significantly, the employer must make the relevant class of award, NSO or RSU, available to at least 80% of its U.S. employees on equivalent terms (based on the ratio between employee's award value and annual compensation). Eligibility for the deferral opportunity is also contingent on the employer having not made significant, recent stock repurchases, unless such stock repurchases also included employee-holders. In addition to these eligibility strictures, the employer must actively solicit elections from eligible employees at or before the time of NSO exercise or RSU settlement, or be subject to federal tax penalties of up to $50,000 per year for failure to do so.

Expanded AMT Exemptions Reinvigorate ISO Tax Benefit

Companies may wish to structure more option grants as ISOs given that more employees will be able to fully benefit from the ISO tax advantages due to the decreased scope of the AMT. Employer usage of ISOs (as compared to NSOs) has fallen in the past decade, in part because many employers determined that ISO tax benefits were not being fully obtained by employees for three reasons: (a) employees becoming subject to AMT; (b) employees selling shares from ISO exercise prior to the first anniversary of the exercise and/or the second anniversary of the grant (collectively referred to as the ISO holding periods); and (c) employees' (especially executives) inability to qualify a meaningful proportion of their grants under the $100,000 per year limit on ISO grant value. Employers also favor NSOs due to the federal income tax deduction available for the value of NSO exercises.

The Act addresses only one of the limiting factors on ISO usage—the number of employees subject to AMT. Currently, it is common for households with more than $200,000 in annual taxable income to be subject to AMT (at a rate of 26% – 28%) on the "spread" value of any ISO exercise. These employees are unable to fully benefit from the non-AMT rules providing for ISOs to be taxed at time of sale at the capital gain tax rates (subject to satisfaction of the holding period requirements mentioned above). In tax years 2018 through 2025, the Act increases (approximately 27%) the amount of income exempt from AMT and increases (approximately 500%, depending on filing status) the threshold at which this AMT exemption phases out. As a result, far fewer households will be subject to AMT.

In light of the AMT changes, employers may wish to increase ISO usage. Especially for public reporting companies whose employees can quickly and easily sell shares after an ISO exercise, it would be important to pair any reintroduction of ISO grants with a fulsome employee communications plan describing the ISO holding period requirements.

3. 401(k) Plan Loans – Extension of the Loan Rollover Period

Overview

Certain employer-sponsored retirement plans, including 401(k) plans, may provide loans to participants provided certain requirements are satisfied, including that the terms of the plan loan provide for a repayment period of not more than five years (except for a loan to purchase a home). If a participant fails to make payments on the loan balance before the loan is repaid, the outstanding loan balance is treated as a taxable "deemed distribution" to the participant. A 401(k) plan may provide that if a participant terminates employment and has a plan loan outstanding, the participant's obligation to repay a loan is accelerated. If the loan is not repaid, the loan is cancelled and the amount in the employee's account balance is offset by the amount of the unpaid loan balance, referred to as a "loan offset." The loan offset amount is eligible for tax-free rollover to another eligible retirement plan, including an individual retirement account (IRA), within 60 days of an employee's termination from employment. If an employee does not roll over the loan offset amount, that amount is treated as a taxable deemed distribution.

Extension of the Rollover Period

The Act amended Code Section 402(c) by extending the period to make a tax-free rollover to another eligible retirement plan, including an IRA, to the participant's due date for filing a federal tax return, including extensions. Plan participants may take advantage of the extended rollover period independently—Employers do not need to amend their plans to provide this opportunity to participants. The extended rollover period is effective for tax years beginning after 2017.

4. Qualified Transportation Fringe Benefits – Elimination of Employer Deduction

Overview

Certain employer-provided fringe benefits, including qualified transportation fringes, are deductible by the employer and excluded from an employee's gross income. "Qualified transportation fringes" include qualified parking (parking on or near the employer's business premises or on or near a location from which the employee commutes to work by public transit), transit passes, vanpool benefits, and qualified bicycle commuting reimbursements. Qualified transportation fringes offered through a cafeteria plan allow employees to pay for these benefits on a pre-tax basis and permit the employer to deduct the amount employees pay with pre-tax money for these benefits.

Elimination of Employer Deduction for Transportation Benefits

The Act amends Code Section 274 to disallow an employer's deduction for expenses associated with providing any qualified transportation fringe or commuter benefits to employees, except as necessary for ensuring the safety of an employee. The Act does not modify the tax treatment for employees who receive employer-provided qualified transportation fringes.

San Francisco, New York, and Washington, DC, each require that certain employers provide employees with the opportunity to purchase commuter benefits, including transit passes, on a pre-tax basis. The Act does not change these local laws. As such, employers who employ employees in San Francisco, New York, and Washington, DC, should prepare for the additional cost of compliance with local laws. All employers may wish to reevaluate their strategy for providing qualified transportation fringes, including the cost to the employer, the value provided to employees, and, if a cutback of these benefits is considered, the impact eliminating the benefits may have on employee morale and retention. The elimination of the employer deduction for qualified transportation fringes is effective for amounts paid or incurred beginning after 2017 and before 2026. (This provision sunsets on December 31, 2025.)

5. Qualified Moving Expense Reimbursements – Elimination of Employee Income Exclusion and Deduction

Overview

Under current law, employer-paid or reimbursed qualified moving expenses are excludible from an employee's gross income and employers deduct qualified moving expenses paid to employees. A "qualified moving expense" is any amount received (directly or indirectly) from an employer as payment for, or reimbursement of, expenses which would be deductible as moving expenses under Code Section 217 if directly paid or incurred by the employee.

Elimination of Employee Income Exclusion and Deduction

The Act eliminates the individual deduction for qualified moving expenses paid by the employee. The Act also repeals an employee's income exclusion for employer-provided moving expense payments and reimbursements. Accordingly, employer-paid or reimbursed moving expenses that were previously excludable from an employee's gross income will be subject to income taxes and employment taxes, including FICA taxes. Employers may still take a deduction. Employers should review whether changes to the tax treatment of employer-paid or reimbursed moving expenses impacts their approach to, and costs of, providing these benefits to employees. Absent a gross up, the inclusion of these benefits in an employee's income makes these benefits less valuable to the employee. Some employers may wish to reduce the administrative burden of providing these benefits and instead pay employees an additional taxable amount to compensate them for moving expenses.

The elimination of the individual income exclusion for employer-provided qualified moving expense payments reimbursements and the individual deduction for moving expenses is effective for amounts paid or incurred beginning after 2017 and before 2026. (This provision sunsets on December 31, 2025.)

Practical Considerations

Employers can begin to prepare for the changes to take place in 2018 by taking the following steps:

- Consider whether any design changes to your incentive compensation are appropriate.
- Review your current proxy disclosure and, starting with the 2018 proxy statement, amend it to reflect the changes made to Code Section 162(m).

- Keep track of vesting dates regarding the Act's new Section 83(i) rules for stock options and RSUs. Qualifying employers are required to notify employees of deferral election opportunity on or prior to vesting date.
- If you have employees in cities and states that require employers to provide some form of commuter benefits, you may be required to continue to facilitate transportation fringe benefits; consider the potential additional cost of compliance.
- Consider paying qualified moving expense amounts or reimbursements directly to employees as a bonus or other direct compensation.
- Contact the Executive Compensation team at Pillsbury for guidance on how to comply with the new tax law and take advantage of new planning opportunities.

For a summary of changes contemplated by the Act that relate to the taxation of employee benefits and executive and equity compensation, see our alerts "A Moving Target: Tax-Qualified Plans and Other Employee Benefits," and "Tax Reform: The Shifting Landscape of Executive and Equity Compensation," respectively.