BENEFITS AND COMPENSATION: IMPLICATIONS OF TAX REFORM ON EXECUTIVE COMPENSATION, FRINGE BENEFITS, AND MISCONDUCT SETTLEMENTS

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Agenda

1. Section 162(m) changes and grandfather provisions
2. New questions and unexpected consequences
3. Fringe benefits and bonus accruals
4. Equity issues for private companies: stock options, RSUs, and profits interests
5. Tax reform implications for sexual harassment settlements and fine and penalty payments to the government

SECTION 1

SECTION 162(M) CHANGES AND GRANDFATHER PROVISIONS

Section 162(m) – Before Tax Reform

- A publicly held corporation may not deduct compensation paid to a "covered employee" to the extent such compensation exceeds $1 million in a single tax year.
  - This general rule remains in effect under the new law.
- A covered employee is any individual who, on the last day of the taxable year, was (a) the CEO or (b) one of the three highest-paid officers (other than the CFO) whose compensation was required to be disclosed to shareholders.
- Common strategies for avoiding the Section 162(m) limit:
  - Utilize the qualified performance-based pay exception
  - Defer payments until termination of employment
  - Cease being a covered officer prior to year end

Section 162(m) – What has Changed?

- The qualified performance-based pay exception has been eliminated, effective for the 2018 tax year
  - $1 million deduction limit now applies to performance bonuses, stock options, equity, etc.
- CFO is a covered employee
- Once a covered employee, always a covered employee
  - Applies to anyone who is a covered employee any time on or after 1/1/17
  - Applies to payments made following the covered employee's termination of employment or death
- The deduction limit applies to foreign companies publicly traded through American depositary receipts (ADRs) and companies that have publicly traded debt, even if they have no publicly traded stock
- Tax-exempt companies will be subject to Section 162(m) through a 20% excise tax

Section 162(m) – Grandfather Rule

- The transition rule leaves the prior qualified performance-based pay exception in effect for compensation that meets the following requirements:
  - Paid pursuant to a "written binding contract"
  - That was in effect on November 2, 2017
  - And is not materially modified thereafter
- Applies to payments made after 2017 if the requirements set forth above are satisfied
- State law generally determines whether there is a "written binding contract" for these purposes
  - Standard is generally whether the employee has a "legally binding right" to the compensation
    - Discretion to reduce or eliminate, a common feature of Section 162(m) awards, could be problematic depending on the facts and circumstances (e.g., terms of the plan and award, past history, state law)

Section 162(m) – Next Steps

- Analyze whether the transition rule applies
  - Review terms of employment agreements, plan documents, and outstanding awards
  - Pay particular attention to the retention of negative discretion
  - Consider amending plan provisions to avoid unintended consequences
- No need to be bound by the strict requirements of the qualified performance-pay exception when designing future awards
  - Maintain flexibility to establish goals more than 90 days into the performance period
  - Retain discretion to adjust payouts upward or downward based on actual performance
  - Ensure that the exception is not limited to payout of performance-based compensation on termination of employment without cause
- ISS/Glass Lewis and shareholders will likely still seek pay-for-performance models
- Consider longer vesting schedules for extending timing of payouts to within $1 million/year Section 162(m) annual thresholds

SECTION 2

NEW QUESTIONS AND UNEXPECTED CONSEQUENCES

Section 409A: Losses

- New Code Section 67(g) suspends miscellaneous itemized deductions, effective 2018 through 2025, including Section 165(c)(1) deduction for losses incurred in the trade or business of being an employee
- **<u>Example</u>** (from Proposed Treasury Regulations Section 1.409A-4(a)(ii), Example 3)
  - Participant's account balance plan of $250,000 is taxable under Section 409A in 2018
  - Account balance = $80,000 in 2019 (because of investment losses)
  - Entire $80,000 account balance is distributed in 2019
- Pre-2018 law and proposed regulations:
  - $80,000 distribution offset for tax purposes by $250,000 taxed in 2018
  - Loss deduction in 2019 of $170,000 (=$250,000 taxed under Section 409A minus $80,000)
- New law
  - No loss deduction under Section 165(c)(1)
  - Deduction is only "suspended": Is carryback to 2017 available? Carryforward?
  - Section 1341 "claim of right" deduction is not suspended, and apparently remains available even though it applies only to amounts "otherwise deductible"
  - But IRS thinks that Section 1341 does not apply for write-offs of deferred compensation merely because it was previously taxed under Section 409A

Section 409A: Permitted Deferrals for Pay Subject to Section 162(m)

- Section 409A regulations let employers delay payment without triggering the subsequent-deferral 12-month/5-year rule if the payment would not be deductible under Section 162(m)
- A delay is permitted until EITHER (i) the first year in which Section 162(m) does not apply OR (ii) the year of separation (or 2½ months after separation)
- Employer must:
  - Apply the rule on a "reasonably consistent basis" to all similarly situated employees;
  - Treat all Section 162(m)—covered compensation of any one employee the same; and
  - Not give an employee a deferral election
- Planning opportunities under the new Section 162(m) rule
  - Can apply at any time (subject to the consistency rule)
  - Rule permitting delay until the year of separation is unaffected
  - What about a permitted delay until Section 162(m) no longer applies: Can an employer limit post-severance payments to $1 million/year?

Clawbacks

- An employee’s bonus might be recouped by his/her employer in a later year because of, e.g., an accounting restatement resulting from material noncompliance with reporting rules; a violation of a noncompete covenant; or a violation of company policy
- Pre-2018 and new tax law: an employee may not amend a prior year’s tax return to reverse the tax on payment merely because the payment was reversed
- Pre-2018 tax law: an employee subject to a clawback could:
  - Deduct the repayment as a miscellaneous itemized deduction under Section 165(c)(1) or Section 162, subject to an alternative minimum tax (AMT) and 2% floor; OR
  - Try to deduct the repayment as a “claim of right” deduction under Section 1341, which is not subject to the AMT or 2% floor; OR
  - Try to persuade his/her employer that the compensation repaid in one year should be offset against other compensation payable in that year for all tax reporting and withholding purposes, under case law

Clawbacks (cont.)

NEW LAW:

- An employee may not deduct a clawback under Section 165(c)(1) or 162
- An employee may still try to deduct a clawback under Section 1341
  - Section 1341 is still available for amounts "otherwise deductible"
  - Problem: IRS hates Section 1341
- The employer may still try to take the position that a clawback offsets other compensation for tax withholding and reporting purposes
  - Problem: While some case law supports, IRS likely does not agree
- The employer may reimburse its employee for a clawback on a nontaxable basis
  - Excludable working condition fringe if the employee could deduct under Section 162. An employee's deduction under Section 162 is not repealed – just suspended until 2026!
  - For example, a new employer might reimburse for a noncompete clawback

Equity Compensation: Withholding

- An employer that withholds shares on equity awards to settle withholding tax liability will trigger variable (liability) accounting unless the withholding is capped at the maximum statutory rate
- Pre-2018 tax law: maximum statutory rate on supplemental wage payments = 39.6%
- New law: = 37.0%
- Open question: Is variable accounting triggered if 39.6% withholding is continued?

SECTION 3

FRINGE BENEFITS AND BONUS ACCRUALS

Fringe Benefits

- Eliminates employer deductions for the following benefits:
  - Qualified transportation fringe benefits
    - Parking, transit passes, and van pooling
  - Business-related entertainment expenses
    - Eliminates the existing 50% deduction
  - Meals provided through company cafeterias, beginning in 2026

Fringe Benefits (cont.)

- Eliminates the exclusion for qualified moving expenses, from 2018 through 2025.
  - Also eliminates the deduction if the employee covers the expense, but employer reimbursements should be deductible when treated as compensation income to the employee.
- Eliminates the exclusion for qualified bicycle commuting expense reimbursements, from 2018 through 2025.
- Modifies the exclusion for employee achievement awards.
- Preserves the exclusions for qualified tuition or educational assistance, adoption assistance benefits, dependent care assistance, and contributions to Archer Medical Savings Accounts.
  - Earlier iterations of the bill targeted these exclusions.

SECTION 4

EQUITY ISSUES FOR PRIVATE COMPANIES: STOCK OPTIONS, RSUS, AND PROFITS INTERESTS

Deferred Tax on Private Company Options/RSUs

- New Section 83(i) allows nonexecutive and non-highly compensated employees of privately held companies to elect up to a five-year deferral of tax upon the exercise of nonqualified stock options or RSUs if the following conditions are met:
  - 80% of all full-time US employees are granted awards with the same rights
  - The amounts of the awards may vary by employee, so long as each employee receives more than a *de minimis* grant
  - The deferred tax election is not available to "excluded employees"
    - The CEO or CFO, any person who in the last 10 years was one of the four highest-paid officers of the company, or a 1% shareholder
- Even though the timing of the taxation is delayed, the amount includible in income is measured at the time of vesting or exercise
- Due to the many restrictions, it is unclear how widely these types of plans will be used

Recharacterization of Certain Profits Interest Gains

- A profits interest in a partnership is the right to receive future profits in the partnership
- IRS guidance indicates that the issuance of a profits interest is not a taxable event for the partnership or the partner
  - The partner then makes a Section 83(b) election, and any subsequent gain is taxed at long-term capital gains rates
- The new law provides for a three-year-holding-period requirement in order for long-term capital gain treatment to be applicable for profits interests

SECTION 5

TAX REFORM IMPLICATIONS FOR SEXUAL HARASSMENT SETTLEMENTS AND FINE & PENALTY PAYMENTS TO THE GOVERNMENT

Tax Reform Changed the Deduction Rules for Two Types of "Misconduct" Payments

1. Payments to settle claims related to sexual harassment and sexual abuse that are subject to a nondisclosure agreement (Internal Revenue Code Section 162(q))
2. Payments to settle claims brought by the government related to the violation or potential violation of any law (Internal Revenue Code Section 162(f))

Key Takeaways

- The new law prohibits a deduction for any settlement or payment related to sexual harassment or sexual abuse if such settlement or payment is subject to a nondisclosure agreement, and for attorney fees related to such settlement or payment.
- No deduction will be allowed unless a settlement agreement expressly identifies which portions of the payment are attributable to (a) restitution or remediation, or (b) coming into compliance. Settlement negotiations, therefore, must now address these new requirements in order for a taxpayer to be able to later deduct any part of a settlement payment. There should be support establishing the basis for amounts attributable to deductible restitution/compliance.
- Payments made to reimburse the government for investigation and prosecution costs are now *per se* nondeductible.
- Fine and penalty payments made to nongovernmental entities in connection with a qualified board or exchange now fall within the coverage of Section 162(f).

Key Takeaways

- Fine and penalty payments made to nongovernmental entities performing “essential government functions” will fall within the coverage of Section 162(f) once regulations are issued. It is unclear how expansive this may be.
- Otherwise, the substantive standards of prior Section 162(f) (i.e., the remedial vs. punitive test found in case law) remain in effect to determine the allowance of a deduction for a settlement payment, once the new procedural requirements are satisfied.
- The government party to a settlement is required to issue an information return to the taxpayer and to the IRS, stating the amount of the overall settlement and what portions of the overall settlement are attributable to deductible restitution and compliance costs.
- While the new law may appear to be a sword, taxpayers may be able to use it as a shield and push the government to engage meaningfully on the character of any payments being made.

QUESTIONS?

Biography

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Jonathan Zimmerman helps clients design and maintain all types of employee benefit plans and programs. His practice focuses on Internal Revenue Code and Employee Retirement Income Security Act (ERISA) compliance for retirement, health and welfare, and executive compensation plans. He has particular experience with Code Sections 409A, 162(m), and 280G, and with taxes and fees arising under the Affordable Care Act (ACA). Jonathan also devotes a large part of his practice to payroll, withholding, and fringe benefits matters. He works with clients of all sizes and routinely handles matters ranging from large transactions to day-to-day administrative questions.

Biography

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With experience gained as a trial lawyer in the Tax Division of the US Department of Justice (DOJ), Steven P. Johnson advises clients on tax controversies and litigation matters involving complex tax issues. Before joining Morgan Lewis and working for the DOJ, Steven served as a law clerk to Judge Tucker L. Melancon of the US District Court for the Western District of Louisiana. He holds a Masters in Tax Law (LL.M.) from Georgetown Law School.

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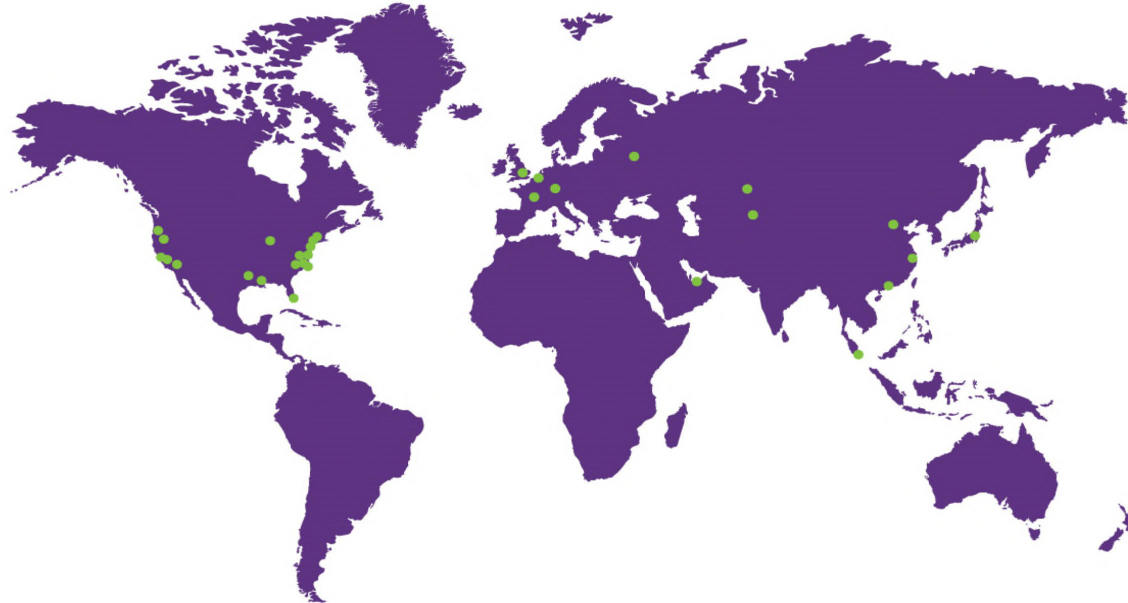

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