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Tax, Benefits, and Private Client

MARCH 2018 • NO.7

2017 New Tax Law: Executive Compensation Reform

*This client alert is part of a special series of the Tax Cuts and Jobs Act and related changes to the tax code, where Blank Rome's lawyers share their analysis of different provisions in the Act and how they may affect you and your business, along with specific action items. To see the full list of client alerts in this series, please click **here**.*

On December 20, 2017, Congress passed its comprehensive tax reform bill, the Tax Cuts and Jobs Act (the "Act"), which was signed into law by President Trump on December 22, 2017. The Bill represents one of the most extensive modifications to the U.S. tax code in recent history, significantly modifying U.S. taxation as it relates to executive compensation matters. Most provisions in the Bill took effect on January 1, 2018.

CHANGES TO INTERNAL REVENUE CODE SECTION 162(M)

The Act includes a provision that eliminates the "performance-based" exception to the one million dollar limit on compensation deductions, and makes certain other important related changes. Prior to 2018, compensation deductions for a publicly-traded employer for its top executives (other than the chief financial officer) was limited to one million dollars per executive, plus compensation that qualified as performance-based. Qualified performance-based pay generally included stock options and stock appreciation rights, restricted stock, restricted stock units, and cash incentive bonuses the vesting or payment of which was conditioned on the satisfaction of pre-approved objectively determinable performance conditions.

The Act:

- Repeals the exception for qualified performance-based compensation.
- Includes the chief financial officer (previously excluded from the one million dollar cap) as an executive subject to the deduction limitation.
- Expands the scope of employers subject to the deduction limitation to include issuers of publicly-traded debt instruments.
- Makes all payments to an individual serving as a covered executive at any time in 2017 or thereafter subject to the deduction limitation, including (i) compensation paid after the executive ceases to serve as an executive in the covered group, (ii) post-termination payments, and (iii) death benefits payable to the executive's beneficiaries.

The new rules are generally effective January 1, 2018. However, under a limited grandfathering rule, compensation payable pursuant to a binding written agreement in effect on November 2, 2017 and not materially modified after that date will not be subject to the new rules.

The new rules raise several planning issues for impacted employers.

For example, these employers may wish to review incentive plans to eliminate or revise baked-in rules that were intended to assure compliance with the qualified performance-based pay exception rules that no longer apply after 2017.

In addition, the grandfathering rules should be reviewed and taken into account. The Act provides for limited grandfathering relief that would otherwise preserve the deductibility of existing performance-based benefits that are subject to a binding legal right as of November 2, 2017. Any modification to a grandfathered agreement should be carefully considered to determine if it would be deemed a "material" modification causing it to lose its grandfathered status (e.g., extending the exercise period for an outstanding option).

EXCISE TAX ON TAX-EXEMPT ORGANIZATIONS

The Act also includes a provision that imposes an excise tax equal to the corporate tax rate—which is 21 percent under the Act—on certain compensation paid to employees of tax-exempt entities, including not only 501(c)(3) organizations, but also 501(c)(4) and 501(c)(6) organizations, as well as governmental employers and political organizations.

Under the Act, an employer subject to the new rules would be required to pay the excise tax with respect to compensation paid to any current or former employee who was in any year after 2016 one of its five most highly compensated employees for such year (referred to under the Act as "Covered Employees") in two separate instances:

- First, the excise tax is imposed on annual compensation paid to a Covered Employee in excess of one million dollars; and
- Second, if the value of compensation payable to a Covered Employee that is contingent on a termination of employment exceeds three times the Covered Employee's average annual compensation in the five preceding years, the amount of such compensation in excess of the Covered Employee's average annual compensation will be subject to the excise tax. The Act somewhat confusingly refers to compensation payable to a Covered Employee upon a termination of employment as a "parachute payment." In the case of for-profit businesses, under other provisions of the tax code that have been in place for a number of years, "parachute payments" are limited to compensation payable in connection with a change of control of the business.

Under the Act, parachute payments are defined as any "payment this is contingent on a [Covered Employee's] separation from employment from the employer," which means that parachute payments do not appear to be limited to severance payments. The Act does, however, provide that benefits payable from tax-qualified retirement plans (such as a 401(k) plan, a 403(b) plan, or a 457(b) eligible deferred compensation plan) are not parachute payments.

A potentially significant complexity is that the Act treats compensation as being paid when it vests. As an example, if a trade association executive who is a Covered Employee has a combined annual base salary and bonus of $750,000 and is granted a vested non-qualified deferred compensation benefit with a present value of $500,000, the executive would be treated as having been paid $1,250,000 and as a result, the trade association would owe a tax of 21 percent on $250,000.

One change that is helpful for tax-exempt hospitals is an exception from the excise tax for compensation payable to a Covered Employee who is a licensed medical professional for the performance of medical services. The exception does not apply to compensation paid to a licensed medical professional for services in any other capacity, such as for services as an officer.

Given the nature of this new excise tax, we expect that it may significantly impact universities. For example, the annual compensation of football and basketball coaches at universities across the country often exceed one million dollars.

These changes took effect on January 1, 2018. The Act does not provide for the grandfathering of existing agreements. In light of the Act's inclusion of compensation at the time of vesting, we anticipate some transition rules or clarification will be needed from the Internal Revenue Service for deferred compensation that has previously vested.

QUALIFIED EQUITY GRANTS

The Act added Section 81(i) to the Internal Revenue Code, which allows private companies to offer rank and file employees the opportunity to defer for up to five years the date when the value of non-qualified stock options or restricted stock units must be included in income and taxed.

This new provision applies to qualified stock—which includes stock of an eligible corporation received in connection with the exercise of options or the settlement of restricted stock units. In general, a company is an "eligible corporation" if it is privately held and has a written plan pursuant to which at least 80 percent of all U.S.-based employees receive awards. The deferral rule is not available to one percent of owners, current or former CEOs and CFOs (or their family members), or certain other highly compensated officers.

The IRS has been directed to issue reasonable good faith compliance transition rules so that interested employers can implement a plan prior to the issuance of final regulations.

Clients who would like more information about their specific circumstances should contact a member of Blank Rome's Tax, Benefits, and Private Client practice group.

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