This is the second in a series of articles by which the Spencer Fane LLP Employee Benefits Practice Team will explain key changes made in the employee benefits area by the Tax Cuts and Jobs Act (Public Law 115-97), which was signed into law on December 22, 2017. In addition to establishing new rules for transportation fringe benefits (see our first article in this series), the Act makes a number of changes that may affect how employers structure their executive compensation programs. This article describes the Act’s impact on for-profit employers, and outlines options that those employers should consider for their compensation arrangements.

KEY CHANGES

New Ability to Defer Income from Stock Option Exercise or RSU Settlement

Under current law, upon exercise of a nonqualified stock option (i.e., an option that does not qualify for the special tax rules applicable to “incentive stock options”) an employee recognizes ordinary compensation income equal to the value of the stock received over the option price paid. Also under current law, the value of restricted stock units (RSUs) granted to an employee is taxable as ordinary compensation income when such RSUs vest.

The Act adds a new Code Section 83(i), which permits a “qualified employee” to elect to defer income tax on amounts attributable to the “qualified stock” of an “eligible employer” received upon exercise of a stock option or RSU settlement.

Only privately held companies that grant stock options or RSUs to at least 80% of their U.S. employees will be eligible to offer such an election.

A “qualified employee” is any employee other than (i) one who is, or was within the previous ten years, a one percent owner of the company; (ii) one who, at any time, has been the company’s CEO or CFO, or acted in such capacity; (iii) a spouse, child, grandchild, or parent of any individual listed in the first two categories; or (iv) one of the four highest-compensated officers of the company for the taxable year or for any of the prior 10 years.

“Qualified stock” is stock received in connection with the exercise of a stock option or in settlement of an RSU. Stock is not “qualified stock” if the employee can sell the stock to the company or receive cash in lieu of the stock when the employee’s right to the stock vests.

If a qualified employee makes an election under Section 83(i), the excess of the fair market value of the stock on the date it is transferred to the employee over the price paid by the employee will not be taxed until (i) the date the stock first becomes transferable, including to the employer; (ii) the date the employee becomes an “excluded employee”; (iii) the date the stock first becomes readily tradable on an established exchange; (iv) five years after the date the equity grant vests or becomes transferable, whichever is earlier; or (v) the date the employee revokes his or her election. Note that although income tax is deferred, payroll taxes are not. A deferral of tax under Section 83(i) is not to be treated as deferred compensation for purposes of Code section 409A.

When the employee makes a Section 83(i) election, the stock begins its holding period for long-term capital gain treatment. Only the value on the date of vesting will be treated as ordinary compensation income. This value will be treated as ordinary income and subject to tax even if the stock later declines in value during the deferral period.
A corporation that transfers qualified stock to a qualified employee must provide a notice to the employee at the time the amount would first be included in the employee’s income if no Section 83(i) election were made. The employee must choose whether to make the election within 30 days of the vesting date by sending an election to the IRS, with a copy to the employer.

These new rules apply to options exercised, or RSUs settled, after December 31, 2017.

**Expansion of Deduction Limit for Executive Compensation Exceeding $1 Million**

Prior law imposed a $1 million limitation on the amount a publicly traded company may deduct for compensation paid to an individual deemed to be a “covered employee” on the last day of the tax year. For these purposes, a covered employee was defined to be the CEO or others among the four highest-paid officers for the taxable year. Excepted from this limitation was compensation paid on a commission basis or that was payable solely on account of the attainment of performance goals under specified circumstances.

The Act expands the type of employers that are subject to the limitation, the individuals who will be considered “covered employees,” and the types of remuneration that will be applied against the cap. As a result, prior strategies that were used to avoid the deduction limit may no longer work.

In addition to companies whose stock is publicly traded, the deduction limitation will now apply to companies with any stock or debt which is publicly traded, including foreign companies whose stock is effectively traded through the American Depositary Receipt System or which are otherwise treated as Reporting Companies under Section 15(d) of the Securities Exchange Act.

The Act repeals the commission- and performance-based exceptions to the $1 million deduction limitation. Thus, performance-based stock options, stock appreciation rights, and other amounts payable under objective, performance-based criteria will now be included in the calculation of the remuneration subject to the deduction limit.

The Act revises the list of “covered employees” to include the CEO, CFO, and the three highest-paid officers during the year. Further, the definition of “covered employee” will now include, for all future years, anyone who in 2017 or in any year thereafter is treated as a covered employee — even with respect to compensation the individual receives in a year after he or she ceases to be the CEO, CFO, or one of the top-paid officers. Covered compensation now also includes amounts paid to the covered employee or his or her beneficiaries. Thus, severance payments, consulting and director’s fees, and deferred compensation amounts paid following termination of employment (including amounts paid to a spouse or other beneficiary) will now fall within the scope of the dollar cap.

The Act grants limited transition relief for compensation arrangements that were in effect on November 2, 2017, and which are not materially modified thereafter.

**OPTIONS FOR EMPLOYERS**

Employers should evaluate whether any of their current executive compensation practices are affected by the Act. Programs that were in place on November 2, 2017, and which therefore may be entitled to grandfathered treatment, cannot be “materially” modified without losing that protection and becoming subject to the new rules. Until the IRS issues guidance concerning what constitutes a “material” change, employers should approach such changes cautiously. For instance, extending an option’s exercise period, or altering the parameters of an incentive award, might be considered material changes.

Privately held employers that use stock options or RSUs as a component of their compensation package for rank and file employees should evaluate whether to offer employees the opportunity to defer income tax inclusion under the new Code Section 83(i) election rules. Employers that do not currently use options or RSUs as a compensation tool now have an additional reason to consider doing so.

Public employers that planned around the Section 162(m) deduction limit by characterizing compensation as performance-based, or by deferring the payment of compensation until after the executive terminates employment, should reevaluate those strategies, as they may no longer be effective for compensation earned after 2017. Such employers should review their nonqualified deferred compensation documents and consider amending them, to the extent permitted under Code Section 409A. Employers should coordinate with their record keepers in order to identify deferred compensation and SERP benefits that were earned as of November 2, 2017, and track those
amounts so that they are treated under the pre-Act rules.

The Spencer Fane Employee Benefits Team is available to help employers evaluate these new rules.

View the other articles in the Tax Cuts and Jobs Act series here.

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