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EXECUTIVE COMPENSATION ALERT

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EXPERTS AT ALI-CLE PROGRAM FORECAST THE FUTURE OF CODE SEC. 162(m) PLANNING

The Tax Cuts and Jobs Act (TCJA) added major limitations on the deductibility of compensation paid to top executives of companies with publicly-traded securities. The $1 million limit in Code Sec. 162(m) on the deduction of compensation paid to covered employees has been "dramatically revised," remarked Joseph M. Yaffe, Esq. of Skadden, Arps, Slate, Meagher & Flom LLP in Palo Alto, CA.

Mr. Yaffe teamed with Daniel L. Hogans, Esq. of Morgan, Lewis & Bockius LLP in Washington, D.C. to speak about the changes—and what to do about them. Appropriately called "The Latest Reincarnation (or Demise) of Section 162(m) Planning," their session was part of an ALI-CLE program held in New York City on June 14-15. The program, "Executive Compensation 2018: Strategy, Design, and Implementation," attracted compensation professionals from around the country.

The TCJA eliminated the exception for performance-based compensation, noted Mr. Yaffe. This change turns Code Sec. 162(m) into a "hard" $1 million annual deduction limit for compensation paid to covered employees. And it's expected to have a significant impact on compensation decisions going forward, such as by reducing the attractiveness of stock options.

Pre-TCJA law exempted performance-based compensation from the $1 million limit. Stock options satisfied the performance-goal requirement if: (1) the grant was made by the compensation committee; (2) the plan stated the maximum number of shares for which options could be granted to an individual employee; and (3) the employee's compensation was based solely on an increase in the stock's value after the date of grant.

Last chance for fiscal-year companies. The TCJA provision eliminating the performance-based exception is effective for tax years beginning after Dec. 31, 2017. For calendar-year corporations, this change has already taken effect. For fiscal-year corporations, the pre-TCJA rules continue to apply for the tax year ending in 2018.

This provides an opportunity for fiscal-year corporations to nail down a deduction for performance-based compensation one last time. Whether compensation is deductible in fiscal year 2018, and so is subject to the pre-TCJA rules, will depend on the all-events test and on Code Sec. 404 which governs the employer's deduction for deferred compensation. Under those rules, compensation paid more than 2½ months after the close of the employer's tax year is presumed to be deferred.

Mr. Yaffe suggested that fiscal-year corporations set aside amounts to pay performance-based compensation during the 2018 fiscal year. The certification that the performance goals were met can take place after year-end.

A safer course would be to certify and pay the compensation during the 2018 fiscal year. Some plans may allow this, where it can be

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ascertained before year-end that the performance goals have been met. But this approach might not be realistic, because events occurring near the end of the year may cause the performance goals not to be met.

Binding contracts are grandfathered. The TCJA includes a grandfather rule that applies to amounts covered by a written binding contract that was in place on Nov. 2, 2017, and that hasn't been materially modified. But this rule won't turn compensation that isn't performance-based into performance-based compensation, Mr. Hogans pointed out. Because salary and time-vested restricted stock units (RSUs) aren't performance-based, they aren't covered by the grandfather rule. On the other hand, stock options that qualify as performance-based should be covered by the grandfather rule unless they are materially modified.

Determining whether compensation is subject to a written binding contract may turn on state contract law. For example, observed Mr. Yaffe, California takes an expansive view of the employee's rights under a contract. But many annual plans aren't contracts at all; they merely set forth the terms under which the plan operates, and grant no rights to individual employees.

The statute and committee report leave it unclear whether the presence of negative discretion—the company's right to pay less than the prescribed amount of performance-based compensation—would make the contract non-binding and disqualify the plan from using the grandfather rule. Annual plans usually provide for negative discretion, Mr. Hogans noted, but long-term plans generally don't. In addition, the company's unrestricted authority to amend a plan may place the plan outside the scope of the grandfather rule.

More executives are covered by limit. The TCJA also increased the number of executives who are covered employees subject to the $1 million limit. Under pre-TCJA law, as interpreted by the IRS in Notice 2007-49, a company had only four covered employees in each tax year, the principal executive officer (PEO) and the three highest paid officers other than the PEO and the principal financial officer (PFO). In other words, the PFO was never a covered employee under pre-TCJA law.

In contrast, the TCJA defines "covered employee" to include the PEO, the PFO, and the three other highest paid officers. In addition, a look-back rule provides that an individual who was a covered employee of a corporation for a tax year beginning after Dec. 31, 2016, remains a covered employee for all future years, including years during which the individual is no longer employed by the corporation and years after the individual's death.

This new definition turns the covered employees into an ever-expanding group, especially for executives at the bottom of the highest-paid group, who may join the group for one year and thereafter forever remain covered employees of the corporation.

Summing up. Overall, said Mr. Yaffe, companies aren't too flummoxed by the TCJA changes to Code Sec. 162(m). This is because the costs of the change are offset by the reduction in corporate tax rates, which were 15%, 25%, and 34%, to a flat 21% rate.

But Mr. Hogans added that while the biggest companies regard large amounts of nondeductible executive compensation as a fact of life, middle-market companies may seek to use planning to avoid the limitation. This can be done by using deferred compensation plans and supplemental executive retirement plans (SERPs) so that the $1 million limit isn't exceeded in any year.

PRACTICE ALERT: NEW DEFERRAL ELECTION FOR EMPLOYEES RECEIVING STOCK-BASED COMPENSATION FROM PRIVATELY HELD CORPORATIONS

Many businesses use equity-based compensation plans to reward and retain employees. The most common forms of stock-based compensation are restricted stock, incentive stock options (ISOs), and nonqualified stock options (NQSOs). In a nutshell, restricted stock is taxable when the employee's right to the stock is transferable or is not subject to a substantial risk of forfeiture, whichever occurs earlier (unless a Code Sec. 83(b) election is made to include in income for the tax year of the transfer the excess of the FMV of the property over the amount paid for it). ISOs are generally taxable when the underlying shares are sold (subject to an Alternative Minimum Tax (AMT) adjustment), and NQSOs generally are taxable when exercised.

If the employer's stock is publicly traded, an employee can sell some of the stock to provide funds to cover that tax liability, but that doesn't work with a closely held startup that restricts the transferability of its stock, or whose stock isn't listed yet on any exchange. In the case of stock options, the inability to pay the tax liability that would result from the stock received on exercise of the option may mean employees let options lapse, thus losing compensation they have already earned.

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New, targeted relief. Code Sec. 83(i) was added to the Code by the Tax Cuts and Jobs Act (TCJA; P.L. 115-97, 12/22/2017). According to the House Ways Committee Report on the TCJA (House Report 115-409; "the TCJA Committee Report"), the new-for-2018 Code Sec. 83(i) election addresses this problem by giving employees the opportunity to elect to defer recognition of income attributable to stock received on exercise of an option (or settlement of a restricted stock unit (RSU)) until an opportunity to sell some of the stock arises, but in no case longer than five years from the date that the employee's right to the stock becomes substantially vested. The Code Sec. 83(i) election applies with respect to stock attributable to options exercised or RSUs settled after Dec. 31, 2017.

Transfers that qualify for the election. The Code Sec. 83(i) election may be made only with respect to a transfer of "qualified stock," which is stock received in connection with the exercise of an option, or in settlement of a restricted stock unit (RSU), to a qualified employee for the performance of services for an eligible corporation. According to the TCJA Committee Report, an RSU is an arrangement under which an employee has the right to receive at a specified time in the future an amount determined by reference to the value of one or more shares of employer stock. An employee's right to receive the future amount may be subject to a condition, such as remaining employed for a fixed number of years, or meeting performance goals. The TCJA Committee Report also says that RSUs are nonqualified deferred compensation (NQDC) and therefore subject to the rules that apply to NQDC.

In 2007, in anticipation of comScore's public offering, Mr. Powers' stock options were subject to a 1:5 reverse split, which resulted in his holding options to acquire 20,000 shares of comScore stock for $1.25 per share.

To be qualified stock, the stock must be from the corporation that's the employer of the qualified employee, and the employee must have received the option or RSU in connection with the performance of services. (Code Sec. 83(i)(2)(A)) However, stock isn't qualified if the employee has the right to either sell it back to the employer or receive cash in lieu of stock immediately upon vesting. (Code Sec. 83(i)(2)(B))

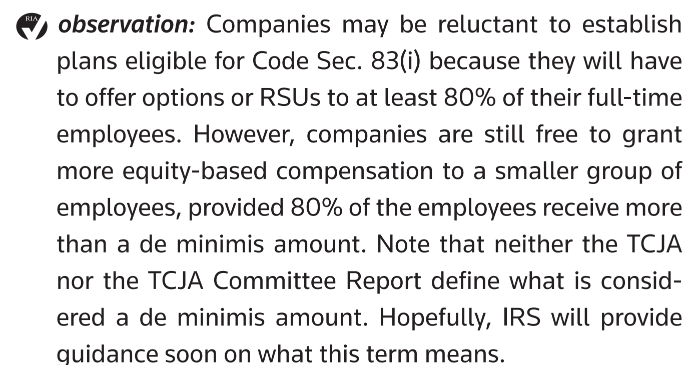
A stock option eligible for the Code Sec. 83(i) election can be an ISO, an Employer Stock Purchase Plan (ESPP), or an NQSO. If the election is made, the option is treated as a disqualifying distribution and the provisions of Code Sec. 422 and Code Sec. 423, which would normally apply to ISOs or ESPP options, don't apply when the options are exercised. Instead, the rules applicable to NQSOs under Code Sec. 83 apply. (Code Sec. 422(b), Code Sec. 423(d), TCJA Committee Report)

Who is a qualified employee? A qualified employee, i.e., one eligible to make the Code Sec. 83(i) election, is generally any employee other than the following (Code Sec. 83(i)(3)(B)):

1. An individual who owns (either directly or constructively) more than 1% of the outstanding stock or total combined voting power of the corporation (a 1% owner). This includes any individual who was a 1% owner at any time during the last 10 years.
2. Anyone who has ever been the company's CEO or CFO (including family members described in Code Sec. 318(a)(1)).
3. The four highest compensated officers for the current year or any of the prior 10 years. This is determined based on the shareholder disclosure rules for compensation under the Securities Exchange Act of 1934.

What is an eligible corporation? To be eligible for the Code Sec. 83(i) election, the option or RSU must have been granted by a corporation during a calendar year in which it was an eligible corporation. (Code Sec. 83(i)(2)(A)(ii)(II)) This is a corporation whose shares (including any predecessor's shares) are not tradable on an established securities market (i.e., a privately held company); and that has a written plan under which at least 80% of full-time employees are granted stock options or RSUs. (Code Sec. 83(i)(2)(C))

The written plan must grant employees options or RSUs with the same rights and privileges to receive qualified stock. However, employees may receive varying amounts of options or RSUs as long as they get the same type of award and more than a de minimis amount. (See Code Sec. 83(i)(2)(C)(ii).) For purposes of the 80% rule, part-time employees (i.e., those who usually work less than 30 hours per week) and individuals excluded from the definition of qualified employee aren't counted.



observation: Companies may be reluctant to establish plans eligible for Code Sec. 83(i) because they will have to offer options or RSUs to at least 80% of their full-time employees. However, companies are still free to grant more equity-based compensation to a smaller group of employees, provided 80% of the employees receive more than a de minimis amount. Note that neither the TCJA nor the TCJA Committee Report define what is considered a de minimis amount. Hopefully, IRS will provide guidance soon on what this term means.

Making the election. An employee must make the Code Sec. 83(i) election to defer income no later than 30 days after the earlier of the date the employee's rights in the stock are transferable or aren't subject to a substantial risk of forfeiture. (Code Sec. 83(i)(4)(A)) According to the TCJA Committee Report, the determination of when the stock is transferable or not subject to a substantial risk of forfeiture should be made using rules similar to those established by Code Sec. 83(c) and its related regs. IRS has yet to issue guidance on the Code Sec. 83(i) election mechanics.

Limitations. A Code Sec. 83(i) election can't be made with respect to any qualified stock if (1) the qualified employee

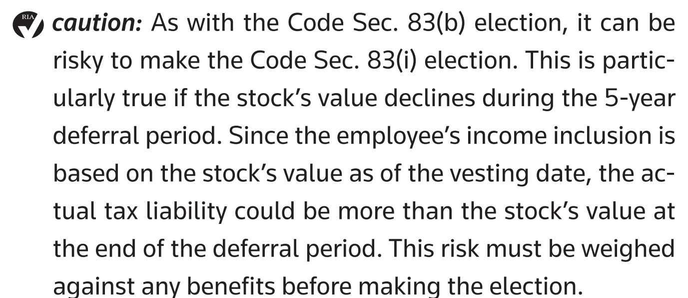
made a Code Sec. 83(b) election with respect to the same stock, or (2) any stock of the corporation that issued the qualified stock is readily tradable on an established securities market at any time before the election is made. (Code Sec. 83(i)(4)(B)) Additionally, if the corporation repurchased any stock in the preceding calendar year, a Code Sec. 83(i) election may not be available unless at least 25% of the total dollar amount of the stock repurchased is stock for which a Code Sec. 83(i) election is in effect, and the determination of the individuals from whom deferral stock is purchased is made on a reasonable basis. (Code Sec. 83(i)(4)(B)(iii)

Tax consequences of the election. An employee that makes a Code Sec. 83(i) election may defer income from an option, or an RSU, for a maximum of five years from the vesting date. However, the income must be recognized earlier upon the occurrence of any of the following events. (Code Sec. 83(i)(1)(B)):

1. The qualified stock becomes transferable (including to the employer).
2. The employee becomes an excluded employee (i.e., no longer qualified under Code Sec. 83(i)(3)(A)).
3. Stock of the corporation becomes readily tradable on an established securities market.
4. The employee revokes the Code Sec. 83(i) election.

In general, the amount includible in income for the exercise of a stock option is the excess of the stock's FMV at the time of exercise over the exercise price. For an RSU, the amount includible in income is the stock's FMV at the time of exercise less the amount, if any, that the employee pays for the stock. The includible amount is determined when the Code Sec. 83(i) election is made, based on the value of the stock when the stock option was exercised or the RSU was settled, even though the income inclusion occurs in a later year. The employer can take an income tax deduction for the amount of income reported to the employee in box 1 of Form W-2 on its federal income tax return for the tax year that includes the end of the employee's tax year in which the income is recognized. (TCJA Committee Report)

Under Code Sec. 83(i)(1), the Code Sec. 83(i) election to defer income from qualified stock applies only for income tax purposes. Thus, the election has no effect on the application of social security and Medicare taxes under FICA and unemployment taxes under the Federal Unemployment Tax Act (FUTA). (TCJA Committee Report) Thus, for FICA and FUTA purposes, the income isn't deferred. Employers can withhold the FICA from other wages of the employee, have the employee remit the amount of the withholding to the employer from his or her own funds, or pay the FICA for the employee. This third alternative results in additional compensation to the employee.



caution: As with the Code Sec. 83(b) election, it can be risky to make the Code Sec. 83(i) election. This is particularly true if the stock's value declines during the 5-year deferral period. Since the employee's income inclusion is based on the stock's value as of the vesting date, the actual tax liability could be more than the stock's value at the end of the deferral period. This risk must be weighed against any benefits before making the election.

Notice and reporting requirements. An employer that transfers qualified stock to a qualified employee must provide a notice to the employee when the stock is transferred (or a reasonable time before) that contains the following information: (Code Sec. 83(i)(6))

. . . Certification that the stock is qualified stock.

. . . That the employee may elect to defer income by making a Code Sec. 83(i) election.

. . . That if a Code Sec. 83(i) election is made, the income recognized at the end of the deferral period will be based on the stock's value on the earlier of when the stock first became transferable or not subject to a substantial risk of forfeiture (even if the stock declines in value during the deferral period).

. . . That the income, when recognized by the employee for income tax purposes, will be subject to federal income tax withholding at the maximum rate in effect for individuals (37% for 2018).

. . . That the employee must agree to ensure the withholding requirements are met.

An employer failing to provide the required notice is subject to a penalty of $100 for each failure, up to a maximum of $50,000 for any calendar year (Code Sec. 6652(p)). No penalty will be assessed if the failure is due to reasonable cause and not willful neglect.

In addition to providing notice to employees, employers must report the following on each employee's Form W-2:

1. The amount includible in gross income under Code Sec. 83(i)(1)(A) with respect to a Code Sec. 83(i) election for both the year of deferral and the year the income is required to be included in income by the employee (Code Sec. 6051(a)(16)).
2. The aggregate amount of income that's being deferred under Code Sec. 83(i) elections, determined as of the close of the calendar year (Code Sec. 6051(a)(17)).

Wrapping it up. The new Code Sec. 83(i) election will help employees of private companies receiving stock-based compensation, but IRS will have to provide guidance for taxpayers, employers and practitioners to fully understand and properly apply the election.

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