Baker McKenzie.

Client Alert

Compensation | December 20, 2017

US Tax Reform: Tax Cuts and Jobs Act Expected to Come into Effect in 2018

As of December 20, 2017, both the House of Representatives and the Senate have voted to approve the final version of the Tax Cuts and Jobs Act, in substantially the form released by the Conference Committee on December 15th. The bill is expected to be presented to the President for signature before Christmas, making US tax reform a reality for 2018.

What's In? From a Compensation & Benefits perspective, among other things, the approved bill includes:

- Significant changes to Code Section 162(m);
- A new tax deferral regime for options and RSUs granted by private companies;
- Elimination of exclusion for fewer than expected employer-provided fringe benefits; and
- Increased disallowance of compensation-related deductions under Code Section 274

What's Out? Fortunately, the final bill does *not* include a Senate proposal to require the use of a first-in-first-out (FIFO) methodology when calculating capital gains on sale of shares, nor does it add back any of the changes to nonqualified deferred compensation that were proposed in the initial House version of the bill. Also, most of the changes proposed to qualified retirement plans have been eliminated.

Section 162(m) Expanded, Effective for Taxable Years Beginning After December 31, 2017, Subject to a Transition Rule

The final bill follows the Senate Mark and the House bill. In other words:

- The CEO, CFO, and top three other highest paid executive officers in a year are treated as covered employees subject to section 162(m) deduction disallowance on remuneration in excess of $1,000,000 in that year and all future years, including years following termination of employment, and regardless of whether the compensation is payable to the executive or on the executive's behalf.
- There is no longer an exception from section 162(m) for performance-based and commission compensation.
- The section 162(m) deduction disallowance has been expanded to all companies that file SEC reports, including companies issuing public debt or equity, non-U.S. issuers publicly traded through ADRs, and certain large private C and S corporations.

Transition Rule: The expanded section 162(m) provisions are generally applicable for taxable years beginning after December 31, 2017. However, the expanded provisions do not apply to remuneration provided pursuant to a written binding contract in effect on November 2, 2017 which is not modified in any material respect after that date.

Based on the Joint Explanatory Statement of the Conference Committee, this is intended to be a narrowly drawn transition rule. The fact that a plan of remuneration was in existence on November 2 is not by itself sufficient to qualify the plan as a binding written contract, unless (i) the executive had a written binding contractual right to participate under the plan, e.g., pursuant to a written employment agreement in effect on November 2, (ii) amounts payable under the plan are not subject to discretion, and (iii) the corporation does not have the right to amend materially the plan or terminate the plan (except on a prospective basis before

any services are performed with respect to the applicable period for which such compensation is to be paid).

The exception ceases to apply to amounts paid after there has been a material modification and does not apply to any contract entered into or renewed after November 2, 2017. A contract that is terminable at will by either or both parties (other than a contract that can only be terminated by terminating the employment relationship) is considered a new contract (for which the exception would not apply) on the date any such termination would be effective.

- **Practical Tip #1:** Although it is likely that most companies will continue to pay performance-based compensation due to the influence of shareholders and other stakeholders, there is no need to include 162(m)-type provisions (e.g., individual limits on the maximum compensation payable during the taxable year, prohibition on positive discretion, etc.) in executive compensation arrangements for taxable years after 2017. Consider whether such provisions can be deleted from existing executive compensation arrangements without shareholder approval.

- **Practical Tip #2:** There is no need to seek shareholder approval of performance-based compensation arrangements, nor to have such arrangements administered by a committee of independent directors, solely to qualify as "performance-based compensation" for section 162(m) purposes for taxable years after 2017.

- **Practical Tip #3:** Avoid amending any compensation arrangement that was in effect as of November 2, 2017, so as to preserve any available transition relief.

  - **Guidance Needed:** Guidance is needed to clarify that transition rule relief is available where the employer or a committee of independent directors has retained the right to reduce compensation payable under a binding written contract in effect on November 2, 2017 (so-called "negative discretion").

  - **Guidance Needed:** Guidance is needed to clarify that transition rule relief is available where a binding written contract in effect on November 2, 2017 does not expressly provide for its termination or cancellation.
  - Guidance Needed: Guidance is needed to clarify that awards under a written shareholder-approved annual cash incentive plan qualify for the transition rule even though there is no written contract between the executive and the company.

New Income Tax Deferral for Private Company Equity Awards

The final bill generally follows the Senate bill (which was generally the same as the House bill), with some minor modifications. The bill would allow eligible employees of private companies (companies whose stock is not publicly traded on an established securities market) to make an election to defer payment of income tax to the *earliest* of:

1. the stock becoming transferable (including to the company);
2. the stock of the company becoming publicly traded on an established securities market, such as upon an IPO;
3. five years after the vesting date;
4. the employee losing his or her status as an eligible employee; and
5. the employee revoking the deferral election.

The amount of income that would be required to be recognized under the deferral election would be based on the value of the stock at the time the employee's rights in such stock first became transferable or not subject to substantial risk of forfeiture, without regard to whether such value decreases (or increases) during the deferral period. The election, which will have similar procedural requirements to a Section 83(b) election, must be made no later than 30 days after the employee's right to the stock is substantially vested.

All full-time employees are eligible to make an election under the deferred tax rules, excluding an employee who:

1. first becomes in any taxable year or was at any time in the 10 preceding calendar years a 1% owner of the company;
2. is or has been the company's CEO or CFO;
3. is related to the CEO, CFO or former CEO or CFO;
4. first becomes in any taxable year or was at any time in the 10 preceding calendar years one of the company's four highest paid officers.

Among other requirements, to qualify for the deferred taxation, the equity awards must be offered on terms that provide the same rights and privileges (other than with respect to the number of underlying shares) to at least 80% of employees providing services in the US and the company must not have repurchased any of its outstanding stock in the preceding year, unless at least 25% of the dollar amount of the repurchased stock was stock issued to employees electing to defer taxation under the deferred tax rules. It is not clear how companies who have repurchased shares in 2017 will be able to satisfy this requirement in 2018 without specific transition relief.

The bill provides clarifications on the application of the legislation, including the following:

1. deferral elections for stock issuable pursuant to options under Code Section 423 ESPPs will be taxable as nonstatutory stock options for FICA purposes and will be subject to income taxation under the deferral rules; and
2. employees excluded from making a deferral election include individuals who first become a 1% owner or one of the 4 highest compensated officers in a taxable year even if the individual may not have met these requirements for the 10 preceding taxable years.

   The Joint Explanatory Statement of the Conference Committee makes it clear that the determination of when stock first becomes transferable or is no longer subject to a substantial risk will be limited to the circumstances described in Code section 83(c)(3) and the related treasury regulations, e.g., income inclusion cannot be delayed due to an IPO lock-up period.

- **Practical Tip:** Private companies granting options or RSUs over stock that qualifies for the new deferral election should consider providing employees with a communication, beyond the required notice mandated in the provision, that describes the tax implications of making a deferral election, including (i) income tax cannot be deferred beyond five years following the vesting date, even if there has not been an IPO of the company or other liquidity event by that time, (ii) tax deferrals with respect to shares issuable upon the exercise of Code section 422 "incentive stock options" or Code section 423 ESPPs will not be eligible for the favorable tax treatment otherwise available to such options, (iii) FICA will nonetheless be due upon exercise of options/vesting of restricted stock units (as is the case for any deferral under the new rules).

- **Guidance Needed:** The legislation is lacking clarity on whether the amount includible in income for a deferral made in connection with an option exercise would be calculated based on the option "spread" at exercise or at vesting. It would be more favorable to the employee (and would be consistent with the current taxation of options) if the amount of the includible income was determined based on the option spread at exercise, but the legislation suggests that the includible amount could be based on the option spread at vesting.

Elimination of Exclusion for Certain Employer-Provided Fringe Benefits

While the House bill would have done away with the exclusions for a number of popular employer-provided fringe benefits, the final bill has left most exclusions intact.

The following chart summarizes the status of these exclusions under the final bill:

Fringe Benefit	Treatment in House and Senate	Ultimate Treatment in Final Bill
Section 74 Employee Achievement Awards	House bill repealed section 74(c) exclusion from income for employee achievement awards; Senate bill limits excludable employee achievement awards to certain tangible property.	Follows the Senate Amendment limiting excludable employee achievement awards to certain tangible property.
Section 119	House bill contained various limits on lodging that could be provided on employer's premises on an excludable basis; the Senate bill had no such limitations.	Does not include the House limitations on employer-provided lodging.
Section 127 Education Assistance	House bill repealed exclusion; Senate bill had no provision.	Does not include House repeal of section 127.
Section 129 Dependent Care Assistance	House bill repealed dependent care exclusion effective in 2023; Senate bill had no provision.	Does not include the House sunset of the dependent care exclusion.
Section 132(a)(6) Moving Expense Reimbursements	House bill repeals exclusion for qualified moving expense reimbursements, except for the military; Senate bill is the same, but postpones the effective date until 2026.	Follows the Senate amendment postponing the effective date of the exclusion's repeal until 2026.
Section 132(f) Bicycle Commuting Benefit	House bill had no provision; Senate bill suspends exclusion for 2018-2025.	Includes Senate suspension.
Section 137 Adoption Assistances	House bill repealed the exclusion for adoption assistance; Senate bill contained no provision.	Does not include the House repeal of the adoption assistance exclusion.

Instead of doing away with exclusions, the final bill focuses more on disallowing deductions to the employer, as described below.

Expanded Deduction Disallowances Under Code Section 274

The final bill follows the Senate bill in terms of expanding the deduction disallowance under Section 274. What this means is that the Section 274 deduction disallowance applies to entertainment that is directly related to the conduct of a trade or business. Further, Section 274 is expanded to disallow a deduction for qualified transportation expenses (e.g., mass transit and parking benefits), and other employee commuting expenses unless needed to ensure the employee's safety.

The bill's treatment of meal expenses is quite complicated. First, effective for amounts incurred or paid after December 31, 2017, the exception from the 50% deduction disallowance for food and beverage that are excludable from income under section 132 as de minimis fringe benefits is repealed, so that such de minimis food and beverage expenses are subject to 50% disallowance. Second, food and beverage expenses, and expenses of operating an eating facility, are fully non-deductible under new section 274(o), beginning with such expenses paid or incurred after December 31, 2025.

Majority of Qualified Retirement Provisions Stripped From Bill

Both the House and Senate bill had contemplated making a number of changes to qualified retirement plans. While certain disaster relief and loan provisions remain in the final bill, the majority of these proposed changes were eliminated.

Please contact your Compensation attorney with any questions related to the tax legislation.

For more information on the broader implications of the tax legislation on your company, please see today's Baker McKenzie Tax Practice Group client alerts:

- *The Tax Cuts and Jobs Act: Congress Passes a Major Tax Bill for First Time in Thirty Years*
- *US Tax Reform - Provisions Impacting the Renewable Energy Industry*
- *US Tax Reform - Provisions Impacting Private Equity*

For More Information

Narendra Acharya
Chicago
+1 312 861 2840
narendra.acharya
@bakermckenzie.com

Anne Batter | Tax
Washington, D.C.
+1 202 835-6171
anne.batter
@bakermckenzie.com

Nicole Calabro
San Francisco
+1 415 576 3010
nicole.calabro
@bakermckenzie.com

Valerie Diamond
San Francisco
+1 415 576 3086
valerie.diamond
@bakermckenzie.com

Victor Flores
San Francisco
+1 415 591 3229
victor.flores
@bakermckenzie.com

Denise Glagau
San Francisco
+1 415 576 3067
denise.glagau
@bakermckenzie.com

Christopher Guldberg
Chicago
+1 312 861 6630
christopher.guldberg
@bakermckenzie.com

Sinead Kelly
San Francisco
+1 415 591 3241
sinead.kelly
@bakermckenzie.com

Barbara Klementz
San Francisco
+1 415 591 3211
barbara.klementz
@bakermckenzie.com

Maura Ann McBreen
Chicago
+1 312 861 6630
mauraann.mcbreen
@bakermckenzie.com

Lindsay Minnis
New York
+1 212 626 4930
lindsay.minnis
@bakermckenzie.com

Aimee Soodan
Chicago
+1 312 861 7515
aimee.soodan
@bakermckenzie.com

Brian Wydajewski
Chicago
+1 312 861 8286
brian.wydajewski
@bakermckenzie.com

Disclaimer - Baker & McKenzie International is a Swiss Verein with member law firms around the world. In accordance with the common terminology used in professional service organizations, reference to a "partner" means a person who is a partner, or equivalent, in such a law firm. Similarly, reference to an "office" means an office of any such law firm.