



Tax Bulletin 3: TCJA Impact on Executive Compensation and Employee Benefits

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The Tax Cuts and Jobs Act of 2017 (the “TCJA”) became law on December 22, 2017. This bulletin provides a summary and analysis of the key employee benefits and executive compensation provisions of the TCJA and the potential impacts for employees and businesses.

1. Additional Restriction on Deductibility of Performance-Based Compensation in Excess of \$1 Million

Previous Rule:

An employer general could deduct reasonable compensation for personal services as an ordinary and necessary business expense. Under prior law, Section 162(m) of the Internal Revenue Code limited the ability of a public company to deduct any compensation in excess of \$1 million paid to its “covered employees” (i.e. its Chief Executive Officer and its next three highest compensated officers, but specifically excluding its Chief Financial Officer). However, the previous law provided an exception for “performance-based compensation,” all of which would be deductible even in excess of the \$1 million threshold.

New Rules:

- The TCJA eliminates the exceptions for commissions and “performance-based compensation”. However, the TCJA provides a transition rule that grandfathers compensation paid pursuant to a plan if the right to participate in the plan is part of a written building contract in effect on November 2, 2017. This exception ceases to apply to any amount paid after there has been a material modification to the terms of the contract. A contract renewed after November 2, 2017 is treated as a new contract entered into on the date of renewal.
- The “covered employees” now include both the principal executive officer and the principal financial officer. Further, an individual is a covered employee if the individual holds one of these positions at any time during the taxable year. Also defined as a covered employee are the three (rather than four) most highly compensated officers for the taxable year. In addition, if an individual is a covered employee with respect to a corporation for a taxable year beginning after 2016, the

individual remains a covered employee for all future years. Thus, an individual remains a covered employee with respect to compensation otherwise deductible for subsequent years, including for years during which the individual is no longer employed by the corporation and years after the individual has died. Compensation remains subject to the deduction limit even if it is includible in the income of, or paid to, another individual, such as compensation paid to a beneficiary after the employee's death, or to a former spouse pursuant to a domestic relations order.

- The TCJA expands the definition of "public company" to include foreign private issuers, as well as private companies that have registered debt offerings and must report under Section 15(d) of the Securities Exchange Act.

2. Non-Profit Organizations – New Excise Tax on Excess Compensation

Previous Rule:

Tax-exempt organizations were generally not subject to any limits on executive compensation other than private inurement rules and sanctions for excessive compensation.

New Rule:

The TCJA adds a new Section 4960 to the Internal Revenue Code that imposes a 21% excise tax on certain tax-exempt organizations that pays compensation to any "covered employee" (i.e. one of its top 5 employees) that is either (a) in excess of \$1 million or (b) an excess parachute payment.

3. Private Company Options and RSUs – New 5-Year Tax Deferral Regime

Previous Rule:

Pursuant to Section 83 of the Internal Revenue Code, the value of property transferred in connection with the performance of services becomes taxable income to the employee at such time when the property is no longer subject to a substantial risk of forfeiture. As a result, recipients of private company stock options and restricted stock units could have phantom taxable income when a stock option is exercised or a restricted stock unit is settled.

New Rule:

The TCJA adds new subsection (l) to Section 83, which allows certain non-executive recipients of private company stock options or restricted stock units to defer the recognition of income for up to five years from the exercise date of an option or the vesting date of a restricted stock unit.

4. Fringe Benefits – Meals and Entertainment

Previous Rule:

Taxpayers were able to deduct 50% of expenses for (a) entertainment activities that directly relate to or are associated with substantial and bona fide business discussions and (b) meals (and in some cases, 100% for meals).

New Rules:

- Repeals the 50% deduction for entertainment activities, rendering such expenses non-deductible.
- The 50% deduction for meals is only allowable where the expenses are associated with operating the business

- There are some narrow exceptions to the general rule. For example, meals provided to guests — even business guests — would qualify as a deduction despite the passage of the TCJA, as long as they are furnished on the business premises, and so long as the costs incurred (as a whole) are primarily for employees. There is no need to segregate expenses for food and beverages provided to guests. There is also an exception that allows deductions for business meals directly related to business meetings of the taxpayer’s employees, stockholders, agents or directors. Whether and to what extent business marketing meetings with clients is uncertain.

5. Roth IRA Deductions

Recipients of inherited traditional and Roth IRAs historically have been able to claim a miscellaneous itemized deduction under IRC 691(c) for the estate tax paid allocable to the income reported on that year’s return. With the doubling of the estate tax exemption, fewer IRAs will trigger an estate tax, so the deduction will benefit far fewer beneficiaries.

6. Roth IRA Conversions

Previous Rule:

Many clients took advantage of the loosened rules permitting conversion of the traditional IRAs to Roth IRAs, relying in part on the ability to recharacterize under IRC section 408A(d)(6) by filing of a tax return for the conversion year to transfer the Roth back to a traditional IRA. Such a conversion would be used in cases in which asset values declined, so income tax would not be paid on the prior higher value.

New Rule:

IRC section 408A(d)(6) recharacterizations have been eliminated. However, Treasury has agreed that recharacterizations in 2018 of 2017 conversions can be made.

7. Affordable Care Act

Previous Rule:

Individuals who were not covered under a health care plan providing minimum essential coverage were subject to an annual penalty under the Affordable Care Act.

New Rule:

The penalty for failure to have coverage was reduced to \$0, thus essentially repealing the Individual Mandate.

