# Workshop C:
# Changes to Employee Benefits and Executive Compensation under the Tax Cuts and Jobs Act of 2017


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# Changes to Employee Benefits and Executive Compensation Made By the Tax Cuts and Jobs Act of 2017

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## Modification of the Limitation on Excessive Employee Compensation

### <u>Background</u>

Under tax law prior to the changes made by the Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97 (2017) (the "Act"), the general rule, under Internal Revenue Code ("Code") section 162(a)(1), is that a reasonable allowance for compensation paid or incurred by an employer for personal services actually rendered by an employee may be deducted by the employer as an ordinary and necessary expense in running a trade or business. Code section 162(m)(1) expressly limits this deduction for compensation paid in the case of a publicly held corporation. Under that Code section, in the case of a publicly held corporation, no deduction is allowed for applicable employee remuneration, paid or incurred with respect to a covered employee, to the extent that the amount of such remuneration for the taxable year exceeds $1,000,000.

A "publicly held corporation" is a corporation which issues any class of common equity securities required to be registered under section 12 of the Securities Exchange Act of 1934 ("Exchange Act"). Code section 162(m)(2).

The "covered employees" are:(1) the corporation's chief executive officer (or an individual acting in such capacity) as of the close of the taxable year; and (2) the employees whose compensation is required to be reported to shareholders under the Exchange Act because they are the four most highly compensated officers for the taxable year (other than the chief executive officer or individual treated as such). Code section 162(m)(3).

Under Code section 162(m)(4), the "applicable employee remuneration" is, with respect to any covered employee for any taxable year, the aggregate amount allowable as a deduction under Chapter 1 (NORMAL TAXES AND SURTAXES) of the Code for such taxable year (determined without regard to $1 million deduction cap) for remuneration for services performed by such employee (whether or not during the taxable year). Applicable employee remuneration includes all remuneration for services, whether paid in cash or in kind, and, so long as the individual is a covered employee during the tax year, whether the individual was a covered employee at the time the remuneration was earned. The $1 million deduction cap is reduced by excess parachute payments that are not deductible by the corporation under Code section 280G.

Certain types of compensation are not subject to, and are not taken into account, when applying, the $1 million deduction cap. Under Code section 162(m)(1) and (4), the excepted compensation includes:

(a) amounts that are paid only if one or more performance goals are met, and if certain outside director and shareholder approval requirements are satisfied, ("performance-based compensation");

(b) amounts that are paid on a commission basis;

(c) payments made to a tax-favored retirement plan (including salary reduction contributions);

(d) payments of deferred compensation, made upon or after termination of employment and in a taxable year after the individual has ceased to be a covered employee;

(e) amounts not included in taxable income (such as health benefits and certain other fringe benefits); and

(f) any remuneration payable under a written binding contract which was in effect on February 17, 1993, unless the contract is materially modified after that date.

## The Changes Made By The Act

The Act made several changes to the rules of Code section 162(m) and the $1 million deduction cap. The changes are effective for taxable years beginning after December 31, 2017. On August 21, 2018, the Internal Revenue Service (the "IRS") issued Notice 2018-68 (the "Notice") to provide initial guidance on the Act. The changes to the Code made by the Act, and, when applicable, the application of the changes pursuant to the Notice, are discussed below.

*Repeal of the Performance-Based and Commission Exception from Compensation*. The Act terminates the exceptions for amounts included in compensation for "performance-based compensation" and "commissions". That is, for taxable years beginning after 2017, for purposes of applying the $1 million deduction cap, compensation includes any cash or noncash payment for services rendered made in the form of performance-based compensation or a commission.

*Change to the Definition of "Covered Employee"*. Under the Act, a "covered employees" is an employee of the corporation who: (1) is the principal executive officer (the "PEO") (or an individual acting in such capacity) at any time during the taxable year; (2) is the principal financial officer (the “PFO”) (or an individual acting in such capacity) at any time during the taxable year; (3) is among the three highest compensated officers for the tax year (other than the PEO or the PFO) whose total compensation for the tax year must be reported to shareholders under the Exchange Act; or (4) was a covered employee of the taxpayer (or any predecessor) for any preceding taxable year beginning after December 31, 2016. See Code section 162(m)(3).

According to the Notice, an employee who serves as the PEO, the PFO or one of the three most highly paid officers will be a covered employee under the changed definition, whether or not serving in that capacity or employed at year end. The Notice also indicates that executive officers of a publicly held corporation can be covered employees, even if disclosure of their compensation is not required under US Securities and Exchange Commission (“SEC”) rules, including officers of a company that does not file a proxy statement. Accordingly, unlike under the pre-Act version of Code section 162(m), a company’s proxy statement will no longer serve as a definitive guide to who is a covered employee.

Further, the Notice points out the Act’s expansion of the definition of “covered employees” to cover any individual who was a covered employee after December 31, 2016. On this point, the Notice clarifies that covered employee determinations for years beginning prior to January 1, 2018 (including for calendar year 2017), should be made pursuant to Code section 162(m) as in effect prior to the Act.

According to the Notice, the Treasury Department and IRS are requesting comments on the application of the SEC executive compensation disclosure rules to determine the three most highly compensated executive officers for a taxable year that does not end on the same date as the last completed fiscal year. The Notice says that, until additional guidance is issued, to determine the three most highly compensated employees for these purposes, taxpayers should base their determination upon a reasonable good faith interpretation of the statute, taking into account the guidance provided under the Notice.

**Note**: It appears that the Act expanded the definition of covered employees, further broadening the reach of the deduction limitation.

*Change to the Definition of Publicly Held Corporation.* The Act expanded its definition of a publicly held corporation beyond corporations issuing common equity securities required to be registered under section 12 of the Exchange Act to corporations issuing other types of securities. Specifically under the Act, a "publicly held corporation" means any corporation which is an issuer (as defined in section 3 of the Exchange Act): (A) the securities of which are required to be registered under section 12 of the Exchange Act, or (B) that is required to file reports under section 15(d) of the Exchange Act. See Code section 162(m)(2).

*Addition to the Definition of Applicable Employee Remuneration*. The Act added a rule under which remuneration does not fail to be included in a covered employee's applicable employee remuneration, merely because it is includible in the income of, or paid to, a person other than the covered employee, including after the death of the covered employee. See Code section 162(m)(4)(F).

## Effect on Pre-Act Written Agreements

According to the Notice, the changes made by the Act to Code section 162(m) do **not** apply to any compensation paid under a "written binding contract" that is in effect on November 2, 2017 and is not "materially modified" after that date. The Notice states that remuneration is payable under a written binding contract that was in effect on November 2, 2017, only to the extent that the corporation is obligated under applicable law (for example, state contract law) to pay the remuneration under such contract if the employee performs services or satisfies the applicable vesting conditions. Any amount that exceeds what must be paid under applicable law will be subject to the new Code section 162(m) rules.

*Obligation to Pay Under Applicable Law.* It is unclear whether compensation would be treated as subject to an obligation to pay under applicable law, and thus be covered by the grandfather provision and not be subject to the changes made by the Act, when the contract, while in effect on November 2, 2017, is intended to comply with the performance-based compensation exemption under pre-Act law and permits (but does not require) the exercise of "negative discretion" (*i.e.*, discretion by a compensation committee to reduce payments otherwise payable due to meeting a performance goal). An example in the Notice suggests that this compensation would be subject to such an obligation to pay (and thus not be subject to the changes made by the Act) to the extent that a minimum payment is required to be made in any event.

*The Binding Requirement*. The Notice states that the Act's amendments to Code section 162(m) also apply to a written binding contract that is renewed after November 2, 2017. A written binding contract that is terminable or cancelable by the corporation without the employee's consent after November 2, 2017, is treated as renewed as of the date that any such termination or cancellation, if made, would be effective. Thus, for example, if the terms of a contract provide that it will be automatically renewed or extended as of a certain date unless either the corporation or the employee provides notice of termination of the contract at least 30 days before that date, the contract is treated as renewed as of the date that termination would be effective if that notice were given. Similarly, for example, if the terms of a contract provide that the contract will be terminated or canceled as of a certain date unless either the corporation or the employee elects to renew within 30 days of that date, the contract is treated as renewed by the corporation as of that date (unless the contract is renewed before that date, in which case, it is treated as renewed on that earlier date).

Alternatively, if the corporation will remain legally obligated by the terms of a contract beyond a certain date at the sole discretion of the employee, the contract will not be treated as renewed as of that date if the employee exercises the discretion to keep the corporation bound to the contract. A contract is not treated as terminable or cancelable if it can be terminated or canceled only by terminating the employment relationship of the employee. A contract is not treated as renewed if upon termination or cancelation of the contract the employment relationship continues but would no longer be covered by the contract. However, if the employment continues after such termination or cancellation, payments with respect to such employment are not made pursuant to the contract (and, therefore, are not grandfathered).

If a compensation plan or arrangement is binding, the amount that is required to be paid as of November 2, 2017, to an employee pursuant to the plan or arrangement will not be subject to the Act’s amendments to Code section 162(m) even though the employee was not eligible to participate in the plan or arrangement as of November 2, 2017. However, the Act’s amendments to Code section 162(m) will apply to such compensation plan or arrangement unless the employee was employed on November 2, 2017, by the corporation that maintained the plan or arrangement, or the employee had the right to participate in the plan or arrangement under a written binding contract as of that date.

Under an example in the Notice, it appears that amounts payable under stock options or SARs are subject to a written binding requirement if: (1) all approvals needed for the grant of the stock options and SARs were provided by November 2, 2017, and (2) no material changes are made to the stock options or SARs after that date. However, if the stock option or SAR is subject to obtaining approval by the board of directors or other persons at a date later than November 2, 2017, there is no written binding contract for these purposes.

Based on the Notice, it also appears that an amount that is earned under a written agreement during a taxable year ending before November 2, 2017, that will be paid at a later date, and that cannot be reduced retroactively by the employer, should be considered an amount payable under a written binding contract. However, if the amount is earned after 2017 under a written agreement in effect on November 2, 2017, is payable at a later date, but could be reduced by a unilateral employer amendment to the agreement, the amount should NOT be considered as an amount payable under a written binding contract.

Similarly, amounts paid under an employment agreement, which is in effect as of November 2, 2017, will generally be treated as payable under a written binding contact. However, if the employment agreement is renewed after November 2, 2017, due to action or the failure to act by the employer, amounts paid under the employment agreement will NOT be treated as payable under a written binding contact.

*Material Modifications*. The Notice says that the Act's amendments to Code section 162(m) will apply to any written binding contract that is materially modified after November 2, 2017. A material modification occurs when the contract is amended to increase the amount of compensation payable to the employee. If a written binding contract is materially modified, it is treated as a new contract entered into as of the date of the material modification. Thus, amounts received by an employee under the contract before a material modification are not affected, but amounts received subsequent to the material modification are treated as paid pursuant to a new contract, rather than as paid pursuant to a written binding contract in effect on November 2, 2017.

A modification of the contract that accelerates the payment of compensation is a material modification unless the amount of compensation paid is discounted to reasonably reflect the time value of money. If the contract is modified to defer the payment of compensation, any compensation paid or to be paid that is in excess of the amount that was originally payable to the employee under the contract will not be treated as resulting in a material modification if the additional amount is based on either a reasonable rate of interest or a predetermined actual investment (whether or not assets associated with the amount originally owed are actually invested therein) such that the amount payable by the employer at the later date will be based on the actual rate of return on the predetermined actual investment (including any decrease, as well as any increase, in the value of the investment).

The adoption of a supplemental contract or agreement that provides for increased compensation, or the payment of additional compensation, is a material modification of a written binding contract if the facts and circumstances demonstrate that the additional compensation is paid on the basis of substantially the same elements or conditions as the compensation that is otherwise paid pursuant to the written binding contract. However, a material modification of a written binding contract does not include a supplemental payment that is equal to or less than a reasonable cost-of-living increase over the payment made in the preceding year under that written binding contract. In addition, the failure, in whole or in part, to exercise negative discretion under a contract does not result in the material modification of that contract.

**Note**: The interpretation of the grandfather provision is the most troubling aspect of the Notice. This interpretation is very narrow and appears to restrict eligibility for grandfathering of compensation arrangements entered into prior to the Act.

## Effective Date

The Notice says that the Act's amendments to Code section 162(m) apply to taxable years beginning on or after January 1, 2018. The Treasury Department and the IRS anticipate that the guidance provided by the Notice will be incorporated in future regulations that, with respect to the issues addressed in the Notice, will apply to any taxable year ending on or after September 10, 2018. Any future guidance, including regulations, addressing the issues covered by the Notice in a manner that would broaden the definition of "covered employee", or restrict the application of the definition of "written binding contract, will apply prospectively only.

## Excise Tax on Excess Executive Compensation Paid By Tax-Exempt Organizations

### Background

Prior to the changes made by the Tax Cuts and Jobs Act of 2017 (again, the "Act"), the tax law did not impose any type of tax, or impose any statutory limitation, on the compensation paid to officers or other executives of tax-exempt organizations. The $1 million limit on deductions for compensation paid by publicly held companies under Code section 162(m) (discussed above) and the taxes imposed on golden parachute payments under Code section 280G do not usually apply to tax-exempt organizations.

The Act makes several changes to provisions covering tax-exempt entities, including imposing an excise tax on executive compensation that exceeds $1 million. Code section 4960 and Act § 13602(a). This new excise tax is discussed below. The new Code section is effective for taxable years beginning after December 31, 2017. Act § 13602(c). On December 31, 2018, the IRS issued Notice 2019-09 to provide guidance on the new excise tax.

### The Provisions of New Code Section 4960

*Imposition of the Excise Tax*. New Code section 4960 imposes an excise tax, at the current rate of 21%, on the sum of: (1) the remuneration paid, excluding any excess parachute payment, by an applicable tax-exempt organization for the taxable year with respect to employment of any covered employee in excess of $1,000,000, plus (2) any excess parachute payment paid by the organization to the covered employee for the taxable year. See Code section 4960(a).

The employer is liable for the payment of the excise tax. For purposes of calculating the excise tax, remuneration is treated as having been paid when there is no substantial risk of forfeiture (within the meaning of Code section 457(f)(3)(B)) of the rights to such remuneration. See Code section 4960(a) and (b).

*Definitions*.

Under Code section 4960(c)(1), an "applicable tax-exempt organization" or an "ATEO" is any organization which, for the taxable year:

(1) is exempt from taxation under Code section 501(a) -this would include-

--an organization exempt from tax under Code section 501(c)(3), such as a public university with an IRS determination letter affirming its tax-exempt status,

--a religious or apostolic organization exempt from tax under Code section 501(d),

--a trust forming part of a stock bonus, pension or profit-sharing plan under Code section 401(a), or

--a federal instrumentality exempt from tax under Code section 501(c)(1));

(2) is a farmers' cooperative organization described in Code section 521(b)(1);

(3) has income excluded from taxation under Code section 115(1); or

(4) is a political organization described in Code section 527(e)(1).

Under Code section 4960 (c)(2), a "covered employee" is any employee (including any former employee) of an applicable ATEO, if the employee: (a) is one of the 5 highest compensated employees of the ATEO for the taxable year, or (b) was a covered employee of the ATEO (or any predecessor) for any preceding taxable year beginning after December 31,

2016. As such, an individual who becomes a covered employee in any taxable year will retain that status for subsequent taxable years. There is no minimum dollar amount that must be reached for an employee to be classified as a covered employee.

Under Code section 4960(c)(3) and (6), the term "remuneration" means wages (as defined in Code section 3401(a)), including amounts required to be included in gross income under Code section 457(f). The term remuneration does not include:

(i) any designated Roth contribution (as defined in Code section 402A(c));

(ii) the portion of any remuneration paid to a licensed medical professional (including a veterinarian) for the performance of medical or veterinary services by the professional; or

(iii) any remuneration which is not deductible by reason of Code section 162(m) (the $1 million dollar limit on deductions for compensation discussed above).

The following definitions apply under Code section 4960(c)(5). The term "excess parachute payment" means an amount equal to the excess of any parachute payment over the portion of the base amount allocated to the payment. The term "parachute payment" means any payment in the nature of compensation to (or for the benefit of) a covered employee if: (1) the payment is contingent on the employee's separation from employment with the employer, and (2) the aggregate present value of the payments in the nature of compensation to (or for the benefit of) such individual, which are contingent on such separation, equals or exceeds an amount equal to 3 times the base amount. The following are not parachute payments:

--payments from qualified plans, annuity contracts described in Code section 403(b) or plans described in Code section 457(f);

-- payments to a licensed medical professional (including a veterinarian) to the extent that such payments are for the performance of medical or veterinary services by such professional, or

-- payments to an individual who is not a highly compensated employee as defined in Code section 414(q).

Rules similar to the rules of Code section 280G(b)(3) will apply for purposes of determining the "base amount".

*Remuneration from Related Organizations*. For purposes of applying the excise tax, the remuneration of a covered employee from an ATEO includes any remuneration paid with respect to employment of such employee by any related person or governmental entity. Code section 4960(c)(4)(A).

A person or governmental entity will be treated as a "related organization" of an ATEO, if such person or governmental entity:

(1) controls, or is controlled by, the ATEO;

(2) is controlled by one or more persons which control the ATEO;

(3) is a supported organization (as defined in Code section 509(f)(3)) during the taxable year with respect to the ATEO;

(4) is a supporting organization (described in Code section 509(a)(3)) during the taxable year with respect to the ATEO; or

(5) in the case of an organization which is a voluntary employees' beneficiary association described in Code section 501(c)(9) (a "VEBA"), the person that establishes, maintains, or makes contributions to the VEBA.

Code section 4960(c)(4)(B).

If remuneration from more than one employer is taken into account in determining the excise tax, each of the employers becomes liable for a proportional share of the excise tax, based on the amount of remuneration the particular employer paid to the employee at issue. Code section 4960(c)(4)(C).

## Guidance in Notice 2019-09 on New Code Section 4960

Notice 2019-09 (for purposes of this topic, the "Notice") provides the following guidance on Code section 4960.

*Remuneration Generally*. The Notice provides that, for purposes of computing the excise tax, any excess remuneration and excess parachute payment is determined based on the remuneration paid and excess parachute payment made in the calendar year ending with or within the employer's taxable year. This means that an ATEO will use the covered employees' calendar year taxable wages. This aligns with the Form W-2 reporting method currently used to report remuneration on Form 990, Return of Organization Exempt From Income Tax. However, because Code section 4960 modifies the definition of wages set forth in Code section 3401(a) and treats remuneration as paid only when there is no substantial risk of forfeiture, remuneration for the purposes of computing the excise tax may not be the same as the amount reported in Box 1 of the covered employees' Form W-2.

Additionally, any vested remuneration, including vested but unpaid earnings on deferred amounts, that is treated as paid before Code section 4960 is applicable (January 1, 2018, in the case of a calendar year employer) is not subject to the excise tax imposed under Code section 4960, although earnings after the effective date on those amounts are treated as remuneration paid for purposes of imposing the excise tax. According to the Notice, net earnings on previously paid remuneration is treated as paid at the close of the calendar year in which they accrue.

*Related Organization*. The Notice makes it clear that a taxable entity, nonstock organization or governmental entity can be a related organization. Also, a related organization can be an ATEO.

*Liability for Excise Tax.* The Notice says that the common-law employer, as generally determined for federal tax purposes, is liable for the excise tax imposed under Code section 4960. Such employer cannot avoid liability by using a third-party payor arrangement. A payment to the employer's employee from a third- party payor (including a payroll agent, common paymaster, statutory employer under Code section 3401(d)(1), or certified professional employer organization) or from an unrelated management company, is considered a payment to the employee from the common-law employer. Similarly, a payment to the employee from a related organization, including a related organization that is an ATEO, for services rendered to the common-law employer, is considered a payment to the employee from the common-law employer for purposes of calculating remuneration and determining liability for the excise tax.

According to the Notice, only an ATEO has covered employees, but a covered employee may also be an employee of a related organization. An ATEO calculates liability for the excise tax under Code section 4960 with respect to its covered employees by including remuneration paid by the ATEO and any related organization to the covered employees, and then allocating that excise tax liability among each of the employers. For purposes of the allocation, remuneration paid by a related organization to an ATEO's covered employees is treated as paid by the related organization, and forms the basis for allocating the excise tax liability to such related organization, if the payment is made for services rendered to the related organization. The ATEO remains liable for the portion of the excise tax attributable to amounts it pays, or is paid by the related organization, for services rendered to the ATEO. The Notice provides rules for allocating liability for the excise tax among the employers, with each employer being liable for its proportionate share of the excise tax.

Further, remuneration paid to a covered employee by another organization, which is not a related organization, with respect to the covered employee's employment by an ATEO is treated as remuneration paid by that ATEO for purposes of determining the amount of the excise tax under section 4960.

Under these rules the ATEO may also be liable for the excise tax under Code section 4960 as a related organization with respect to another ATEO that calculates the excise tax for its own covered employees. If an employer is liable for the excise tax under Code section 4960 as an ATEO and as a related organization for the same remuneration paid to a covered employee, the employer is not liable for the excise tax in both capacities; rather it is liable for the greater of the excise tax it would owe as an ATEO or the excise tax it would owe as a related organization with respect to that covered employee.

*Determining the Five Highest-Compensated Employees*. The Notice says that the determination of whether an employee is one of the five highest-compensated employees of an ATEO, for purposes of determining the ATEOs covered employees, is made on the basis of his or her remuneration for services performed as an employee of the ATEO, any remuneration paid by a related organization and any remuneration for services performed for the ATEO as an employee of a related or unrelated organization. The remuneration used for purposes of identifying the five highest-compensated employees is the remuneration paid to an employee during the calendar year ending with or within the ATEO's or related organization's taxable year. Remuneration paid for medical services (or veterinary services) is not taken into account for these purposes.

The Notice contains the following exception. It provides that an employee is not one of an ATEO's five highest-compensated employees for a taxable year if, during the calendar year ending with or within the taxable year, the ATEO paid less than 10 percent of the employee's total remuneration for services performed as an employee of the ATEO and all related organizations. However, if an employee would not be treated as one of the five highest-compensated employees of any ATEO in an ATEO's group of related organizations because no ATEO in the group paid at least 10 percent of the total remuneration paid by the group during the calendar year, then this exception does not apply to the ATEO that paid the employee the most remuneration during that year.

Whether an employee is one of the five highest-compensated employees is determined separately for each ATEO, and not for the entire group of related organizations; thus, each

ATEO has its five highest-compensated employees. As a result, in many cases, a group of related organizations will have more than five covered employees.

*Medical and Veterinary Services*. The statute excludes from remuneration the portion of any compensation that is paid for the performance of medical or veterinary services by a licensed medical professional. The Notice defines "licensed medical professional" as an individual who is licensed under state or local law to perform medical or veterinary services. Further, the Notice says that, in addition to those professionals listed, this definition generally includes dentists and nurse practitioners and may include other medical professionals depending on state or local law.

When a covered employee is compensated for both medical or veterinary services and other services, the employer must allocate remuneration paid to such employee between medical services and such other services. The Notice permits taxpayers to use any reasonable, good faith method to allocate remuneration between medical services and other services. For this purpose, the employer may rely on a reasonable allocation set forth in an employment agreement that explicitly allocates a portion of the remuneration as for medical or veterinary services or other services.

*Excess Remuneration*. The Notice indicates that, for each covered employee, excess remuneration is the excess for a taxable year of the remuneration that is paid to the employee (other than any excess parachute payment) by an ATEO, including remuneration paid by a related organization, over $1 million for the taxable year. The $1 million threshold is not adjusted for inflation.

The Notice says that "remuneration" is generally defined as wages under Code section 3401(a) (wages subject to federal income tax withholding), but excluding designated Roth contributions under Code section 402A(c) and including amounts required to be included in gross income under Code section 457(f). Also, any amounts excepted from section 3401(a) wages in that Section itself (Code section 3401(a)(1) to (23)) are not included in remuneration for these purposes. The Notice clarifies that remuneration includes a parachute payment that is not an excess parachute payment, but remuneration does not include certain retirement benefits (see Code section 3401(a)(12)) or certain directors' fees (see Rev. Rul. 57-246, 1957-1 C.B. 338). Remuneration does not include the portion of any remuneration paid to a licensed medical professional that is directly related to the performance of medical or veterinary services.

According to the Notice, remuneration includes amounts paid to a covered employee by any related organization with respect to the employee's employment by that related organization. As discussed above, the Notice contains rules for allocating the liability for the excise tax when remuneration from more than one employer is taken into account in determining the liability for the excise tax under Code section 4960. In contrast, remuneration paid by another organization, whether or not a related organization, with respect to an employee's employment by an ATEO, is treated as remuneration paid by that ATEO for purposes of Code section 4960.

The Notice states that remuneration is treated as paid for purposes of Code section 4960 when there is no substantial risk of forfeiture of the rights to the remuneration, as defined by Code section 457(f)(3)(b). Therefore, an amount of compensation is subject to a substantial risk of forfeiture only if entitlement to the amount is conditioned on the future performance of substantial services, or upon the occurrence of a condition that is related to a purpose of the compensation if the possibility of forfeiture is substantial. The amount of remuneration treated as paid at vesting-that is, when the substantial risk of forfeiture lapses- is the "present value" of the remuneration in which the employee vests, determined using reasonable actuarial assumptions regarding the time and likelihood of actual or constructive payment.

*Excess Parachute Payments*. The Notice points out that the statute imposes an excise tax on “any excess parachute payment.” The term “parachute payment” is defined to be any payment in the nature of compensation to (or for the benefit of) a covered employee if: (1) such payment is contingent on such employee’s separation from employment with the employer, and (2) the aggregate present value of the payments in the nature of compensation to (or for the benefit of) such individual which are contingent on such separation equals or exceeds an amount equal to three times the base amount.

Generally, the term “base amount” means an individual’s annualized includible compensation for a base period. In turn, the “base period” is the covered employee’s five most recent taxable years ending before the date on which the separation from employment occurs (or the portion of the five-year period during which the covered employee performed services for the ATEO and/or related organization). Any transfer of property is treated as a payment and taken into account at its fair market value. Present value is determined using a discount rate equal to 120 percent of the applicable Federal rate determined under Code section 1274(d), compounded semiannually.

The term “excess parachute payment” is defined to be an amount of any parachute payment made by an ATEO (or related organization) over the portion of the covered employee's base amount that is allocated to the payment. The portion of the base amount so allocated is determined by multiplying the base amount by a fraction, the numerator of which is the present value of the parachute payment and the denominator of which is the aggregate present value of all parachute payments made or to be made to (or for the benefit of) the same covered employee.

The Notice provides that a payment is considered contingent on a separation from employment if the facts and circumstances indicate that the employer would not make the payment in the absence of an involuntary separation from employment. The Notice limits its treatment to payments contingent on an involuntary separation from employment because payments that vest upon a separation from employment typically vest only upon an involuntary separation from employment.

If an employee may voluntarily separate from service and still be entitled to a payment, then the payment either is not subject to a substantial risk of forfeiture or the forfeiture condition is not related to the separation from employment. If, however, there are other types of separation from employment conditions that may result in the lapse of a substantial risk of forfeiture applicable to a payment, the standard in the Notice may be expanded in future guidance to ensure that those payments are also treated as contingent on a separation from employment.

The Notice points out that, for these purposes, separation from employment generally has the same meaning as separation from service as defined in Treas. Reg. § 1.409A-1(h), without regard to Treas. Reg. § 1.409A-1(h)(2) and (5) (application to independent contractors), since generally only an employee may have a separation from employment and a change from employee status to bona fide independent contractor status would also be a separation from employment. In addition, the definition of termination of employment in Treas. Reg. § 1.409A-1(h)(1)(ii) is modified such that an employer may not set the level of the anticipated reduction in future services that will give rise to a separation from employment and that the defaults set forth in the regulations apply.

*Payment in the Nature of Compensation*. The Notice clarifies that any payment—in whatever form—is a payment in the nature of compensation if the payment arises out of an employment relationship, including holding oneself out as available to perform services and refraining from performing services. A payment in the nature of compensation includes (but is not limited to) wages and salary, bonuses, severance pay, fringe benefits, life insurance, pension benefits, and other deferred compensation (including any amount characterized by the parties as interest or earnings thereon). A payment in the nature of compensation also includes cash when paid, the value of the right to receive cash, including the value of accelerated vesting, or a transfer of property. However, a payment in the nature of compensation does not include attorney's fees or court costs paid or incurred in connection with the payment of any parachute payment or a reasonable rate of interest accrued on any amount during the period the parties contest whether a payment will be made.

*Reporting and Paying the Excise Tax*. According to the Notice, the Code section 4960 excise tax must be paid and reported by filing Form 4720 by the 15th day of the 5th month after the end of the employer's taxable year. In any case in which remuneration from a related organization is included to determine the excise tax imposed by Code section 4960, each ATEO and related organization (including a related taxable organization) must file a separate Form 4720 to report its share of liability. ATEOs and related organizations that are not liable for excise tax under Code section 4960 for the taxable year need not a file Form 4720 for the taxable year unless filing is required under other provisions of the Code or regulations.

An employer may file Form 8868, Application for Automatic Extension of Time to File an Exempt Organization Return, to request an automatic extension of time to file Form 4720.

The automatic extension will be granted if Form 8868 is properly completed, and timely filed. Form 8868 does not extend the time to pay tax. To avoid interest and penalties, an employer must pay the tax due by the original due date of Form 4720.

*Effective Date*. The Notice says that Code section 4960 is effective for the first taxable year beginning after December 31, 2017. It provides that amounts paid before the beginning of that taxable year are not subject to the excise tax under Code section 4960. Remuneration that was vested before the effective date is not subject to excise tax under this Section because it is treated as having been paid at vesting. For example, amounts includible in gross income under Code section 457(f)(1)(A) and any vested earnings that accrued before the effective date of Code section 4960 are not subject to the excise tax Code section 4960. However, earnings accrued on those amounts in taxable years beginning after December 31, 2017, may be subject to excise tax under the Section.

*Future Guidance*. The Notice indicates that the IRS and the Treasury Department intend to issue proposed regulations for Code section 4960 that will incorporate the guidance in the Notice. It notes that any further guidance under the proposed regulations will be prospective and not apply to taxable years beginning before the guidance is issued. In the meantime, the Notice states that taxpayers may base their positions on good faith, reasonable interpretations of Code section 4960, including its legislative history. Relying on the Notice is considered to be a good faith, reasonable interpretation of the statute.

## Treatment of Qualified Equity Grants

### Background

Under the existing tax law set forth in Code section 83, specific rules apply to property transferred by an employer to an employee in connection with the performance of services. For convenience, we assume below that any property so transferred is employer stock. Section 83 determines the amount and timing of income inclusion by the employee, and the amount and timing of the employer's compensation deduction, with respect to any such transfer.

Under Code section 83, if in connection with the performance of services, stock in the employer is transferred from the employer to the employee, the employee will recognize taxable income in the first taxable year in which the employee's rights in the stock are transferable or are not subject to a substantial risk of forfeiture, whichever of the two events occurs first (the occurrence of such earlier event is treated as becoming "substantially vested"). The amount of the taxable income is equal to the fair market value of the stock as of the date the employee becomes substantially vested (less any amount paid for the stock). Thus, in the case of stock transferred as compensation for the performance of services, tax arises in the employee's tax year of substantial vesting.

However, another rule may apply. If the employee's rights in the stock is not substantially vested at the time the stock is transferred to employee, under Code section 83(b), the employee may elect to recognize taxable income in the employee's taxable year of the transfer. This election is called a "Section 83(b) election", and must be made within 30 days of transfer. The amount of taxable income recognized due to the election will be the amount equal to the fair market value of the stock as of the date of transfer (less any amount paid for the stock). Why make a Section 83(b) election? The value of the stock could be low or zero at the time of transfer, so that the employee will recognize little or no taxable income with respect to the transfer of the stock.

In general, under Code section 83, the employer is entitled to take a tax deduction at the same time and in the same amount as the taxable income recognized by the employee with respect to the transfer of stock.

## The New Qualified Equity Grants-the Statutory Provision

The Tax Cuts and Jobs Act of 2017 (again, the "Act") introduced Section 83(i) to the Code. Under that Section, a qualified employee may elect to defer, for income tax inclusion, the amount of income attributable to qualified stock transferred to the employee by the employer upon the exercise of a stock option or the settlement of a restricted stock unit (an "RSU"). The qualified stock so transferred is called a "Qualified Equity Grant". An election to defer income inclusion (a "Section 83(i) election") with respect to qualified stock must be made no later than 30 days after the first time the employee's right to the stock is substantially vested. The rules of Code section 83(i) are described below.

*Election to Defer Taxation of Qualified Equity Grants*. If qualified stock is transferred to a qualified employee who makes an election with respect to such stock under Code section 83(i), the employee will include in taxable income the amount attributable to the qualified stock as follows, instead of when the stock becomes substantially vested. The taxable income is included in the employee's taxable year in which occurs the earliest of:

(1) the first date the qualified stock becomes transferable (including, solely for these purposes, becoming transferable to the employer),

(2) the date the employee first becomes an excluded employee,

(3) the first date on which any stock of the corporation which issued the qualified stock becomes readily tradable on an established securities market (as recognized by the IRS),

(4) the date that is 5 years after the first date the rights of the employee in the qualified stock are substantially vested, or

(5) the date on which the employee revokes (at such time and in such manner as the IRS provides) Section 83(i) election with respect to the qualified stock.

Code section 83(i)(1)(A) and (B).

The Section 83(i) election creates a corresponding deferral of the employer's tax deduction for providing the qualified stock. However, FICA tax obligations resulting from the transfer of the qualified stock are NOT deferred, and the employer must remit these FICA taxes when they are normally due.

The amount of the taxable income, when the deferral period ends, is based on the value of the stock at the time at which the rights of the employee in such stock first become substantially vested, even if the stock later declines in value.

*Qualified Stock*. The term “qualified stock” means, with respect to any qualified employee, any stock in a corporation which is the employer of such employee, if: (1) such stock is received in connection with the exercise of a stock option, or in settlement of an RSU, and (2) such stock option or RSU was granted by the corporation in connection with the performance of services as an employee, and during a calendar year in which such corporation was an eligible corporation. Code section 83(i)(2)(A).

However, the term “qualified stock” does not include any stock if the employee may sell such stock to, or otherwise receive cash in lieu of stock from, the corporation at the time that the rights of the employee in such stock first become substantially vested. Code section 83(i)(2)(B).

*Eligible Corporation*. For these purposes, an “eligible corporation” is, with respect to any calendar year, any corporation if: (a) no stock of such corporation (or any predecessor of such corporation) is readily tradable on an established securities market during any preceding calendar year, and (b) such corporation has a written plan under which, in such calendar year, not less than 80 percent of all employees who provide services to such corporation in the United States (or any possession of the United States) are granted stock options, or are granted RSUs, with the same rights and privileges to receive qualified stock. The rule in (b) above does not apply in the case of any calendar year before 2018. Code section 83(i)(2)(C)(i) and (iv).

The determination of the rights and privileges with respect to stock is to be made in a similar manner as under Code section 423(b)(5). However, the following rules apply:

--employees will not fail to be treated as having the same rights and privileges to receive qualified stock solely because the number of shares available to each of the employees is not equal in amount, so long as the number of shares available to each employee is more than a di minimis amount, and

--rights and privileges with respect to the exercise of a stock option will not be treated as the same as rights and privileges with respect to the settlement of an RSU.

Code section 83(i)(2)(C)(ii).

*__Qualified Employee__*. A "qualified employee" means any individual who: (1) is not an excluded employee (or a part-time employee), and (2) agrees in the Section 83(i) election to meet such requirements as are determined by the IRS to be necessary to ensure that the tax withholding requirements of the corporation under chapter 24 with respect to the qualified stock are met. Section 83(i)(2)(C)(iii) and (3)(A).

An "excluded employee", means, with respect to any corporation, any individual:

(a) who is a 1-percent owner (within the meaning of Code section 416(i)(1)(B)(ii)) at any time during the calendar year or who was such a 1 percent owner at any time during the 10 preceding calendar years,

(b) who is or has been at any prior time the chief executive officer (the "CEO") or chief financial officer ("CFO") of such corporation, or an individual acting in such a capacity, or a spouse, child, grandchild, or parent of the CEO or CFO (or individual acting in that capacity), or

(c) who is one of the 4 highest compensated officers of such corporation for the taxable year, or was one of the 4 highest compensated officers of such corporation for any of the

10 preceding taxable years, determined with respect to each such taxable year on the basis of the shareholder disclosure rules for compensation under the Securities Exchange Act of 1934 (as if such rules applied to such corporation).

Section 83(i)(3)(B).

*Making The Election*. An election with respect to qualified stock must be made no later than 30 days after the first date the rights of the employee in such stock are substantially vested. The election must be made in a manner similar to the manner in which an election is made under Code section 83(b). However, the election may NOT be made with respect to any qualified stock if:

(1) the qualified employee has made an election under Code section 83(b) with respect to such qualified stock,

(2) any stock of the corporation which issued the qualified stock is readily tradable on an established securities market at any time before the election is made, or

(3) such corporation purchased any of its outstanding stock in the calendar year preceding the calendar year which includes the first date the that the rights of the employee in the qualified stock were substantially vested, unless—

--not less than 25 percent of the total dollar amount of the stock so purchased is deferral stock, and

--the determination of the individuals from whom deferral stock is purchased is made on a reasonable basis.

Code section 83(i)(4)(A) and (B).

For these purposes, "deferral stock" means stock with respect to which a Section 83(i) election is in effect. However, stock purchased by a corporation from any individual is not treated as deferral stock for purposes of applying the 25% threshold, if such individual (immediately after such purchase) holds any deferral stock with respect to which a Section 83(i) election has been in effect for a longer period than the election with respect to the stock so purchased. Code section 83(i)(4)(C)(i) and (ii).

The 25% threshold and requirement of a reasonable basis for purchasing the stock is treated as met if the stock so purchased includes all of the corporation's outstanding deferral stock. Code section 83(i)(4)(C)(iii).

*Tax Reporting*. Any corporation which has outstanding deferral stock as of the beginning of any calendar year, and which purchases any of its outstanding stock during such calendar year, is required to include on its return of tax for the taxable year in which, or with which, such calendar year ends the total dollar amount of its outstanding stock so purchased during such calendar year and such other information as the IRS may require. Code section 83(i)(4)(C)(iv).

*Controlled Groups*. All persons treated as a single employer under Code section 414(b) shall be treated as 1 corporation for purposes of Code section 83(i). Section 83(i)(5).

*Notice Requirement*. Any corporation, which transfers qualified stock to a qualified employee upon the exercise of a stock option or RSU, is required, at the time that (or a reasonable period before) an amount attributable to such stock would (but for a Section 83(i) election ) first be includible in the gross income of such employee, to:—

(1) certify to such employee that such stock is qualified stock, and

(2) notify such employee that the employee may be eligible to elect to defer income on such stock under Codes section 83(i), and that, if the employee makes such an election—

--first, that the amount of taxable income recognized at the end of the deferral period will be based on the value of the stock at the time at which the rights of the employee in such stock first become substantially vested, notwithstanding whether the value of the stock has declined during the deferral period,

--second, that the amount of such taxable income recognized at the end of the deferral period will be subject to withholding of tax under Code section 3401(i) (special tax withholding on wages for qualified stock) at the rate determined under Code section 3402(t), and

--third, of the responsibilities of the employee (as determined by the IRS) with respect to the tax withholding.

Code section 83(i)(6).

*Restricted Stock Units*. Code section 83(i) does not permit any tax deferral election to be made with respect to RSUs. Code section 83(i)(7).

## IRS Guidance

On December 7, 2018, the IRS issued Notice 2018-97 to provide guidance on new Section 83(i) (for purposes of the discussion below, the "Notice"). The Notice indicates the following.

*The Requirement that Grants be Made to not less than 80% of all Service Providing Employees.* According to the Notice, Code section 83(i) defines an "eligible corporation," in relevant part, as, with respect to any calendar year, any corporation that has a written plan under which, in such calendar year, not less than 80% of all employees who provide services to the corporation in the United States (or any possession of the United States) are granted stock options, or are granted RSUs, with the same rights and privileges to receive qualified stock. A question has arisen as to whether this 80% requirement with respect to a calendar year is applied on a cumulative basis that takes into account stock options or RSUs granted in prior calendar years. The Notice concludes that the requirement is applied on the basis of the stock options and RSUs granted in the current, and not in any prior, calendar years.

The Notice points out that, in calculating whether the 80% requirement is satisfied, the corporation must take into account the total number of individuals employed at any time during the year in question as well as the total number of employees receiving grants during the year (in each case, without regard to excluded employees or part-time employees described in Code section 4980E(d)(4)), regardless of whether the employees were employed by the corporation at the beginning of the calendar year or the end of the calendar year.

*The Application of Federal Income Tax Withholding to the Deferred Income*. The Notice states that deferral stock constitutes wages under Code section 3401(i) and is treated as received on the earliest date described in Code section 83(i)(1)(B) (that is, the date the income tax deferral ends), in an amount equal to the amount included in taxable income under Code section 83 for the taxable year that includes such earliest date. When the wages are treated as paid under Code section 3401(i), and thus become subject to income tax withholding, the employer must make a reasonable estimate of the value of the stock and make deposits of the amount of income tax withholding liability based on that estimate. The wages included under Code section 3401(i) are subject to withholding at the maximum rate of tax in effect under Code section 1, and withholding is determined without regard to the employee's Form W-4. By January 31 of the following year, the employer must determine the actual value of the deferral stock on the date it is includible in the employee's taxable income and report that amount and the withholding on Form W-2 and Form 941. With respect to income tax withholding for the deferral stock that the employer pays from its own funds, the employer may recover that income tax withholding from the employee until April 1 of the year following the calendar year in which the wages were paid.

The Notice indicates that Code section 83(i) provides the IRS with authority to impose any requirements as it determines to be necessary to ensure that the tax withholding requirements of the corporation under chapter 24 with respect to the qualified stock are met. In order to be a qualified employee, an employee making an election under Code section 83(i) must agree in the election to adhere to these requirements. The Notice provides guidance on these requirements.

The Notice states that future guidance on Code section 83(i) may establish alternative or substitute mechanisms to ensure a corporation's income tax withholding requirements are satisfied.

*The Ability of an Employer to Not Allow the Deferral Election*. The Notice says that Code section 83(i) imposes a number of requirements and limitations that must be met for a Code section 83(i) election to be allowed. Although the election, if allowed, may be made by an employee, the corporation is responsible for creating the conditions that would allow an employee to make the election. However, a corporation can preclude its employees from making Code section 83(i) elections by declining to establish an escrow arrangement for income tax withholding described in and required by the Notice, or by otherwise not creating the conditions that would allow an employee to make the Code section 83(i) election. If the corporation intends to act in this manner, the terms of a stock option or RSU may provide that no deferral election under Code section 83(i) will be available This designation would inform employees that no Code section 83(i) election may be made with respect to stock received upon exercise of the stock option or settlement of the RSU even if the stock is qualified stock, and the election would not be permitted.

*Effective Date*. The Notice states that Code section 83(i) applies to stock attributable to stock options exercised, or RSUs settled, after December 31, 2017. The Treasury Department and the IRS anticipate that the guidance in the Notice will be incorporated into future regulations that, with respect to issues addressed in the Notice, will apply to any taxable year ending on or after December 7, 2018. Any future guidance, including regulations, addressing the issues covered by the Notice, such as the establishment of more restrictive mechanisms to ensure that a corporation's income tax withholding requirements are satisfied, will apply prospectively only.

## Other Changes Made By The Act To The Tax Law

### Increase in Excise Tax Rate for Stock Compensation of Insiders in Expatriated Corporations

Prior to the Act, an excise tax, at the rate of 15 percent, was imposed on the value of certain compensation paid in stock of certain insiders (that is, certain officers, directors and 10% owners) of expatriated corporations. Code sections 1(h)(1)(D) and 4985(a).

The Act increases the rate of the excise tax to 20%. The increase is effective for corporations first becoming expatriated corporations after the date of the enactment of the Act. (Dec. 22, 2017).

### Repeal of Rule Allowing Certain IRA Contributions To Be Recharacterized

Prior to the Act, if, on or before the due date for an IRA contribution for any taxable year, a taxpayer makes a trustee-to-trustee transfer of a contribution to an IRA, whether traditional or Roth, made during such taxable year from such IRA to the other type of IRA, traditional or Roth as applicable, then such contribution will be treated as having been made to the transferee plan (and not the transferor plan). Code section 408A(d)(6). In this manner, a contribution to a traditional IRA could be recharacterized as a contribution to a Roth IRA.

In the case of a recharacterization, the contribution will be treated as having been made to the transferee IRA (and not the original, transferor IRA) as of the date of the original contribution. The recharacterization from a Roth IRA can be made with respect to the initial contribution or a contribution that was previously recharacterized (that is, a "conversion contribution").

The Act changes this rule, so that recharacterizations of conversion contributions held in a Roth IRA (but not the original contributions) are no longer allowed. Section 13611(a) of the Act. This change applies to taxable years beginning after December 31, 2017.

## Change to the Rules For Providing Length of Service Award Programs for Bona Fide Public Safety Volunteers

Prior to the Act, under rules requiring an accelerated income inclusion for deferred pay, certain plans are not treated as providing for the deferral of compensation, and thus are not subject to the accelerated income recognition, including any plan paying solely length of service awards to bona fide volunteers (or their beneficiaries) on account of qualified services they perform. Code section 457(e)(11)(A)(ii). An arrangement will NOT be treated as paying solely length of service awards, and therefore as providing deferred pay, if the aggregate amount of length of service awards accruing with respect to any year of service for any bona fide volunteer exceeds $3,000. Code section 457(e)(11)(B)(ii).

The Act increases the $3,000 amount in the foregoing rule to $6,000. It also adjusts that amount in $500 increments to reflect changes in cost-of-living for future years. In addition, under the provision, if the plan is a defined benefit plan, the $6,000 limit will apply to the actuarial present value of the aggregate amount of length of service awards accruing with respect to any year of service. The actuarial present value with respect to any year is to be calculated using reasonable actuarial assumptions and methods, assuming payment will be made under the most valuable form of payment under the plan, with payment commencing at the later of the earliest age at which unreduced benefits are payable under the plan or the participant's age at the time of the calculation.

The changes made by the Act to Section 457(e)(11) apply to taxable years beginning after December 31, 2017.

Extended Rollover Period for the Rollover of the Amount Offsets of Plan Loan

Prior to the Act, if a participant defaults on a loan from a tax-favored plan (generally, a qualified retirement plan, a 403(b) plan or a 457(b) plan), the tax-favored plan is required to offset the participant's benefit under the plan by the remaining loan balance. The amount of the offset is treated as a distribution from the plan, and is included in the participant's taxable income for the participant's taxable year in which the offset occurs. However, the participant could avoid immediate taxation due to the offset, by rolling over the amount of the offset to an eligible retirement plan (e.g., a tax-favored plan or IRA) within 60 days after the day the offset occurs.

Under the Act, the period during which the loan offset amount may be rolled over to an eligible retirement plan is extended from 60 days after the date of the offset to the due date (including extensions) for filing the participant's Federal income tax return for the taxable year in which offset is made. For the extension to apply, the loan offset amount must be treated as distributed from a qualified retirement plan, a section 403(b) plan or a governmental section 457(b) plan solely by reason of the termination of the plan or the failure to meet the repayment terms of the loan because of the employee's severance from employment. See Code section 402(c)(3)(C).

This new rule applies to amounts treated as distributed in tax years starting after Dec. 31, 2017.

## Carried Interest

The Act adds section 1061 to the Code. Under the new Section, certain (applicable) partnership interests received in connection with the performance of services are subject to a three-year holding period in order to qualify for long-term capital gain treatment. Transfers of these partnership interests held for less than three years are treated as short-term capital gain. This treatment affects partnerships in connection with the performance of substantial services to a trade or business which consist of raising or returning capital or investing in, disposing of or developing other specified assets. Under new Code section 1061, the fact that an individual may have included an amount in taxable income upon acquisition of the applicable partnership interest under Code section 83, or may have made a Section 83(b) election with respect to an applicable partnership interest, does not change the three-year holding period requirement for long-term capital gain treatment.

Specifically, new Code section 1061 treats as short-term capital gain, taxed at ordinary income rates, the amount of the taxpayer’s net long-term capital gain, using a one-year holding period,  with respect to the disposition of an applicable partnership interest for the taxable year that exceeds the amount of such gain determined as if a three-year holding period applies.

The new rule applies to taxable years beginning after 2017.