Rutgers NJ/NY Center for Employee Ownership

Impact of US Tax Reform on Employee Compensation and Benefits Programs

October 26, 2018

Sharmon Priaulx, PwC Global Human Resource Services

Agenda

Tax Reform Changes

- The Basics of the Tax Cuts and Jobs Act of 2017
- New Section 162(m) Rules
- Multi-national Taxes
- Deferral Potential for RSUs and Stock Options Granted by Private Companies
- Changes for Certain Fringe Benefit Deductions
- Other Employment Related Items
- Significant Changes to Individual Deductions/ Exemptions
  - The Case for Deferred Compensation
  - The Case for Incentive Stock Options
- Potential Action Items

The Basics of the Tax Cuts and Jobs Act of 2017

The Basics of the Tax Cuts and Jobs Act of 2017

- Most significant tax reform proposal since 1986
- Simplification (?) of the Internal Revenue Code for both corporations and individuals
  - Major reduction in the corporate tax rate from 35% to 21%
  - Fundamental change to the taxation of multinationals
  - New regime for taxation of partnerships
  - Reduce and flatten individual tax brackets
  - Eliminate deductions and exemptions for individuals
  - Reduce burden of the “death tax”

The Basics of the Tax Cuts and Jobs Act of 2017

Tax Reform 2017 Overview

- Individual Tax Rate Changes
- Supplemental Tax Rate Changes (from 25% to 22% and 39.6% to 37%)
- Section 162 (m) changes
- Corporate tax rate and reduction of DTA (changed tax rate from 35% to 21%)
- 83(i) for private companies
- Alternative Minimum Tax ("AMT")

New Section 162(m) Rules

Section 162(m) Overview

Basic Rules:

- For "covered employees", there is a $1 million limit to total compensation to be tax deductible for the company. There were exemptions to the type of compensation that is subject to the $1 million rule.
- Determination of "covered employees" is done annually, composed of key officers and top three highly compensated employees (other than the key employees)

Exemptions before 2018

All compensation that would otherwise be deductible except for the following types of pay which receive specific exemptions from the deduction limit under Section 162(m).

- Payments to or from a tax-qualified retirement plan.
- Commission-based compensation.
- Amounts excludable from gross income (e.g., miscellaneous fringe benefits and employer-provided health benefits) and pay deferrals.
- **Qualified performance-based compensation**
  - Stock options, SARS, performance shares were typically exempt from limit as performance-based compensation

Covered Employees before 2018

- Covered employees were defined as: the CEO as of the close of the taxable year and the three highest paid executive officers as reported in the proxy
  - The CFO was excluded from the definition of covered employee.
- An executive officer whose employment terminated during the year was not covered by Section 162(m), and therefore termination payments such as severance payments were not subject to the deduction limit.

New Section 162(m) Rules

- Compensation deduction is limited to $1 million per year no matter what type of compensation is paid (no more exception for performance based compensation)
- Notice 2018-68 released August 2018
  - Regulations expected in 2019
- Effective Date: Tax years starting after 12/31/2017
  - Impacts equity compensation DTA balances as of 12/31/17
  - Notice in August 2018 impacts 2018 Q3 financial statements

New Section 162(m)
Covered Employee Changes

- Covered employees are CEO, CFO and 3 most highly compensated employees (prior rules excluded CFO)
  - Companies with fewer than 5 people reported on proxy must still identify 5 executive officers each year (Notice 2018-68)
- For CEO and CFO, covers anyone who holds that position during the year (no longer just look at last day of tax year)
  - For covered employees based on compensation, based on all executive officers during the year
- Once a covered employee, always a covered employee
- Must look back at all covered employees for tax years starting after 12/31/2016

New Section 162(m)
Exemption Changes

- Performance based equity exemption is revoked
  - Performance shares, stock options and SARS
- Will this change granting behavior?
  - Yes – level playing field allows company to choose
  - No – Shareholder activists guidelines did not change

New Section 162(m) Grandfathering

- Performance based compensation is grandfathered if award/ grant was outstanding as of 11/2/2017 and was under a “written binding contract” (cannot “materially modify” after this date)
  - Notice 2018-68 confirms that “binding contract” is determined under “applicable law” such as state contract law
  - Need legal confirmation that under applicable law, a company is obligated to pay the compensation if the vesting conditions are met
    - Does “negative discretion” to lower award payouts eliminate grandfathering?
- Grandfathering applies to all changes made by the new law, which addressed (a) performance-based compensation, (b) covered employee expansion
- Impact of Notice 2018-68 and Regulations

Deferred Tax Asset & Section 162(m)

- Who are your covered employees and who is tracking?
- What is your inventory of compensation arrangements?
- What is the list of grandfathered arrangements?
- Schedule out the executive compensation by year
- How will you track and prove out your results?

Multi-national taxes

Multi-national taxes

- New tax on foreign earnings remaining offshore (BEAT)
  - Many U.S. multinationals have kept earnings offshore as a tax planning strategy
- Many U.S. multinationals use "recharge" or "charge-back" arrangements
  - Parent stock used to compensate foreign subsidiary's employees
  - No compensation deduction for parent, and often not for sub either
  - Recharging equity creates a cost to subsidiary that allows a local deduction
- New "GILTI" tax exists for any intangible income from a CFC
  - Calculated on an aggregate basis, so additional tax deductions in any country will help reduce the taxable intangible income from any other country
- *Action item* – Review current recharging practices to determine whether they help or hurt overall global corporate tax results
- Not a tax, but consider global macro events impacting on equity plans
  - E.g., China/US trade issues, loss of visas for US-based participants

Deferral Potential for RSUs and Option Stocks for Private Companies

Deferral Potential for RSUs and Option Shares for Private Companies

- Deferral of up to five (5) years from normal taxable event available on an elective basis if certain conditions are met
- Can apply to restricted stock units, stock options and employee stock purchase plans
- CEO, CFO and certain highly compensated employees <u>cannot</u> make a deferral
- Deferral elections will be similar to 83(b) elections and must be made within thirty (30) days after shares are issued
- Key conditions to apply deferral are as follows:
  - Must grant equity awards to 80% of employees on same terms- although amounts can vary provided not de minimus- (excluding part time employees and employees that are not eligible for deferral) in year deferral is claimed
  - Shares are not publicly traded at time of issuance (and deferral ends upon IPO)
  - Employees cannot have a right to sell shares to company at time shares are issued
  - Companies that have bought back shares may not qualify for deferral (rules complex)

Deferral Potential for RSUs and Option Shares for Private Companies

- Numerous questions exist that make implementation difficult:
  - How do you know at the beginning of the year who is excluded?
    - CEO, CFO etc. changes
    - Compensation level changes
  - How does company get the withholding at the end of the deferral period?
  - What kind of put/call rights will prevent 83(i) treatment?
  - Is 83(i) mandatory or voluntary by the company?
    - How much needs to be in the written plan?
  - Will anyone use these plans?

Changes for Certain Fringe Benefit Deductions and Other Employment Related Items

Changes for Certain Fringe Benefit Deductions

Significant Changes

- *Entertainment Expenses:* no longer deductible
- *Meals Expenses*: Under both old and new law business meals are 50% deductible (Rules around whether taxable to the employee unchanged.)
  - Notice 2018-76 (issued October 2018) permits employers to retain 50% deduction for business meals associated with entertainment *if* the meals are purchased separately or the cost is broken out on the invoice
- *Qualified Transportation Fringe Benefits:* no longer deductible unless necessary for ensuring the safety of an employee for commuting purposes
  - Still pre-tax for employees
- *Qualified Moving Expenses:* Employee income exclusion for qualified moving expense reimbursements eliminated through 12/31/2025 (although taxable compensation still deductible by the employer)
  - Notice 2018-75 (issued October 2018) allows pretax reimbursement for expenses incurred in 2017 even if not reimbursed until 2018

Other Employment Related Items

- No deduction is allowed for any settlement, payout, or attorney fees related to sexual harassment or sexual abuse if such payments are subject to a nondisclosure agreement.
- 50% deduction limitation extended to employer expenses associated with providing food and beverages to employees through an eating facility that meets requirements for *de minimis* fringes and for the convenience of the employer
- An employer may still generally deduct 50% of the food and beverage expenses associated with operating its trade or business, such as amounts paid for an employee's meals while traveling for business.
  - No deduction is allowed where entertainment expenses are incurred outside of travel

Significant Changes to Individual Deductions/ Exemptions

Significant Changes to Individual Deductions/ Exemptions

- State and Property Tax Deduction limited to $10,000 per year
  - State-based alternatives have been and likely will continue to be knocked down
  - "Alaska trust" idea
  - Locality based charitable funds
- Increase in Standard Deduction
  - Single from $6,350 to $12,000
  - Married filing jointly from $12,700 to $24,000
- Personal Exemptions
  - Eliminated
  - For 2017, personal exemption amount was $4,050/ person (subject to phase out)
- Other changes may affect individual effective tax rates as well
- House Ways and Means Committee passed "Tax Reform 2.0" mid-September
  - Not likely to progress much further, at least in near term

The Case for Deferred Compensation

- Deferrals have greater potential benefit for numerous reasons
  - Cost to company of allowing the deferral is greatly reduced
  - Because of loss of state tax deduction, deferral for those who move to a lower bracket state have greater value
  - Because highest rate kicks in at a higher amount, there is a greater likelihood that an individuals post employment tax rate will be lower than their rate while working
  - May mitigate Section 162(m) cost by spreading use of annual $1M deduction limit
- Consider "Q-SERPs" and NQDC plans that pay over life or 10 years
  - Chance to avoid state taxes

The Case for Incentive Stock Options

- Incentive Stock Options will now become the most tax effective way to deliver equity based compensation
- Why?
  - AMT impact has been reduced
  - Tax is only imposed when the shares are monetized and are taxed at a reduced rate if the one year holding period is met
  - The cost of the lost tax deduction to the company is greatly reduced (21% vs. 35%)
    - The lost or delayed deferred tax asset benefit is greatly reduced
- ESPPs also will experience the same benefits, although less so for lower income taxpayers
- Significant drawback is the value limitations in both ESPP and ISO plans

Potential Action Items

- Revisit Recharges for Equity Awards
  - Consider whether keeping cash overseas or bringing it back into the U.S. is preferable
- Analyze Grandfathering Potential for Awards under 162(m)
  - Assess which awards are grandfathered
  - Flag awards that are grandfathered
  - Make sure grandfathered awards are not modified
- Adjust DTA for Loss of Anticipated Deductions due to Section 162(m) Changes
- Start Thinking Through Growing List of "Covered Employees" under Section 162(m)…
- Educate Employees as to Changes to Tax Rates, Deductions, Exemptions and Encourage them to Revisit their W4s.

Contact Information

Sharmon Priaulx

Managing Director, PwC Boston
(617) 530-5279
sharmon.priaulx@pwc.com