GOP Tax Reform and New Disability Plan Regulations: Impact on Executive Compensation and Employee Benefit Plans

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Overview

- **Tax Reform enacted in late 2017 included key changes to executive compensation**
- **Health and welfare benefits also affected**
- **Disability benefit claims procedures are another development affecting benefit plans now**
  - These procedures are being implemented by the DOL (not under the new tax legislation)

compensation deduction limits for publicly-traded companies

- **"Performance-based compensation" and commission exceptions to the $1 million deduction cap is eliminated**
- **Group of affected corporations subject to the $1 million limit is expanded**
  - Now covers corporations required to file reports under Section 15(d) of the 1934 Act
- **Group of covered executives is expanded, for any year beginning after 12/31/16**
  - PFO (CFO) is now expressly covered
  - Once a covered executive, always a covered executive
    - Can be relevant in transactions; departures

compensation deduction limits for publicly-traded companies (Cont’d)

- **Transition rule is important right now and for the next few years**
  - Grandfather applies to amounts paid pursuant to a written contract in effect on 11/2/17
  - No material modification on or after that date
  - Outstanding bonus or equity awards
  - Compensation promised under employment agreements
    - Fairly limited situation where re-approval of performance measures could be needed

compensation deduction limits for publicly-traded companies (Cont'd)

> **Transition rule – cont'd**
  - Negative discretion
    - See Treas. Reg. sec. 1.162-27(e)(2)(iii)
    - 162(m)-qualifying committee must still certify results in accordance with historic practice

> **Fiscal year employers –limitation applies to taxable years beginning after 12/31/17**
  - Transition rule "contract in effect date" is not changed

> **Non-tax reasons for performance-based components of executive pay remain important – *e.g.*, incentives to attain strategic corporate goals, ISS preferences**

Deferral elections for Stock Option and RSU Plans –Section 83(i)

- **Stock Options and RSUs granted by closely-held employers can result in taxation without liquidity**
- **Employees have some choice in when to exercise an option, but RSUs generally prescribe the vesting or settlement date**
- **New tax law creates an opportunity for certain employees to elect to defer income recognition for up to 5 years**
  - No stock is or has been “readily tradable on an established securities market”
    - This is an open issue for OTC Markets Group Inc. companies
    - As determined by the Secretary – market must be so recognized for at least one other IRC purpose

Deferral elections for Stock Option and RSU Plans –Section 83(i) (Cont'd)

- Not available to certain officers, owners and highly compensated employees ("excluded employee")
- 1% owners; past/present PEO/PFO or their 318(a)(i) relatives; past/present 4 most highly compensated officers ("past" is a 10-year lookback)

> **Elect w/in 30 days of no SRF or, if sooner, transferability**

> **Deferral ends on IPO, if stock becomes transferable (including to company), or individual holding the award becomes an excluded employee**

Deferral elections for Stock Option and RSU Plans –Section 83(i) (Cont'd)

- **New law also creates an employer obligation to <u>notify</u> employees of this right**
  - Must notify at the time, or within a reasonable period of time before, any amount would be includible in gross income
  - Penalties for failure to notify
- **Applies to awards under a broad-based written program, under which at least 80% of employees receive grants**

Deferral elections for Stock Option and RSU Plans –Section 83(i) (Cont'd)

- **ISOs and IRC section 423 ESPPs also covered, but use of deferral election negates special tax treatment**
  - Tax treatment applies only to an employee who makes an election
  - Now, 83(i) compliance is a condition of "423" ESPP status
- **Limits on availability of deferral right:**
  - An 83(b) election has been made
  - Certain stock buy-backs have occurred
  - Employer was previously a publicly-traded corporation

Excise Taxes on Tax-Exempt Employers

- **21% excise tax imposed on tax-exempt employers paying compensation in excess of $1 million**
- **Covered employers:**
  - Employers exempt under IRC section 510(a)
  - State or local governmental entities
  - Farmers' cooperatives
  - IRC section 527 political organizations
- **Applies to taxable years of the employer beginning after 12/31/17**
- **Applies to 5 most highly compensated employees for any taxable year beginning after 12/31/16**

Excise Taxes on Tax-Exempt Employers (Cont'd)

- **Includes compensation from a related person or governmental entity**
- **Health care provider fees for services excepted**
- **Compensation generally means IRC section 3401 wages**
- **IRC section 457(f) deferred compensation deemed "paid" when required to be included in income**

Excise Taxes on Tax-Exempt Employers (Cont'd)

- **Severance pay excise tax is imposed under a structure that is similar to the golden parachute rules**
- **Excise tax is triggered by severance of at least 3x average compensation for the 5-year period ending before the year of severance**
- **Certain compensation is excluded:**
  - Health care provider fees for services
  - Payments under a qualified plan, tax-deferred annuity, or eligible deferred compensation plan of state or local governmental employers
  - 280G principles apply in calculating value of severance

Excise Taxes on Tax-Exempt Employers (Cont'd)

- **Once triggered, excise tax applies to severance in excess of <u>1x</u> base amount (generally, 1 x average compensation for 5-year period ending before year of severance)**
- **Severance need not be in excess of $1 million to trigger the excise tax**
- **The excise tax will not be applied twice to the same amount of pay for an individual who receives excessive severance and compensation in excess of $1 million in a taxable year**

Elimination of the Affordable Care Act Individual Mandate

- **ACA requires individuals to maintain minimum essential (health) coverage**
- **“Individual Responsibility Payment”**
  - 2017 and 2018: $695
  - Reduced to $0 for months beginning after December 31, 2018

Fringe Benefits

> **Suspension of Exclusion for Qualified Bicycle Commuting Reimbursement**
  - Prior law allowed qualified employer reimbursements of up to $20 per month
    - Cost of purchasing and maintaining a bicycle used for commuting to work
  - Suspended for taxable years beginning after December 31, 2017 and before January 1, 2026

Fringe Benefits (Cont’d)

> **Repeal of Exclusion for Qualified Moving Expense Reimbursements**
  - Under prior law, employer-provided moving expense reimbursements were excludible from an employee’s gross income if the expense would have been a deductible moving expense.
  - Exclusion does not apply for taxable years beginning after December 31, 2017 and before January 1, 2026, except for members of the Armed Forces.

New Disability Claims Procedures

> Effective date delayed from January 1, 2018 to April 1, 2018
> Claims Subject to the Regulations
  – *Any* ERISA plan benefit that:
    • is conditioned on the claimant being disabled; and
    • plan administrator must determine whether the claimant is disabled.
  – Disability plans
  – 401(k) plans
  – Nonqualified deferred compensation plans
> Regulations do not apply if the determination is made by another plan or a third party
  – A long-term disability plan
  – Social Security Administration

New Disability Claims Procedures (Cont'd)

> **Requirements**

- Claims adjudicated in a manner that ensures the independence and impartiality of the decision-maker
    - Hiring, promotion, compensation, termination may not be based on likelihood of claims denial
- Notices must be written in a linguistically appropriate manner
- Claimants must be informed of right to access their file
- Denial notices must include a full discussion of the claim including
    - Standards applied in making the decision
    - Why the views of healthcare and vocational professionals or the Social Security Administration were not followed
- Claimants must be allowed to present evidence and testimony
- Appeal determinations may not be based on new evidence or rationales unless the claimant is given an opportunity to respond
- Coverage rescissions treated as claims denials
    - Denial, reduction or termination of a benefit or failure to pay benefit

New Disability Claims Procedures (Cont'd)

> **Next Steps**

- Review plans to determine if they are subject to the new regulations
- Revise summary plan descriptions and amend plan documents
- Update disability claim denial letters
- Confirm that third party administrators will comply

Bipartisan Budget Act of 2018

> **Easing of Hardship Withdrawal Rules**
  - 401(k) and 403(b) plans
  - Effective for plan years beginning after December 31, 2018
  - No requirement to first obtain a plan loan
  - May be made from qualified nonelective contributions and qualified matching contributions
  - Six-month suspension of elective deferrals eliminated

Bipartisan Budget Act of 2018 (Cont'd)

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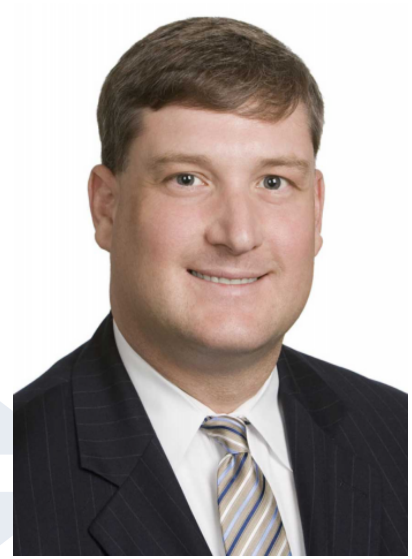
> **Tax Relief for California Wildfire Disaster Distributions**
  - No 10% early withdrawal penalty
  - Not subject to mandatory income tax withholding
  - Include distribution in income over three years

> **Contributing IRS Levy Refunds**
  - Return of amounts withdrawn from a qualified plan or IRA, plus interest, to the plan or IRA

Questions?



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