**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 cannot 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 individual's 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.
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