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JOSEPH PERRY: The new tax rules have less publicized provisions that often, but not always, provide relief to companies. || Photo by Judy Walker

Taking stock

By: Claude Solnik March 19, 2018

While a corporate tax cut that brought the top rate down from 35 percent to 21 percent is widely seen as the centerpiece of the recent tax rules, there also were a number of changes to compensation for executives and employees.

The Tax Cuts and Jobs Act includes provisions, which frequently attracted less attention, including disallowing public company deductions for compensation of more than $1 million.

The new rules also could lead to fewer people paying taxes on incentive stock options, or ISOs, turning these into a more widely used means of compensation.

And they could open the door to deferring taxes on qualified equity grants in which firms use stock to reward executives and employees.

“This is probably buried,” Joseph Perry, tax and business service leader at Marcum, with large operations in Melville, said of private equity grants. “I guarantee that three years from now, you’ll hear more about this.”

The rules include at least one provision that removes tax benefits from some companies.

In the past, public companies that must report to the Securities and Exchange Commission and pay executives more than $1 million could get deductions if they showed some of the pay was performance-based.

“In the old law, that was the case,” Perry said. “To the extent that compensation was performance-based, if you met performance metrics, that would not subject you to the million dollars.”

Still, those public companies could frequently structure pay, so it could be classified as performance-based, retaining deductions for paychecks of more than $1 million.

“Anything over $1 million is not going to be deductible,” Perry said. “If it’s over$ 1 million, the performance-based went away. Why are people not jumping up and down about it? Corporations got a reduction of their rate from 35 percent to 21 percent. They’re ahead of the game, even with that disallowance.”

There also were changes that could further reduce individuals’ taxes, including on incentive stock options.

There has long been a big problem with ISOs, at least for anyone in the alternative minimum or AMT tax bracket. However, this problem does not affect anyone who pays the regular tax.

Employees in the AMT granted an ISO are taxed based on the spread between the current stock value and the strike price at the exercise of the options.

If shares worth $10 are issued at $1, the government considers that $9 taxable income, if you’re in the AMT.

“The reason there is a tax when you receive it is that it’s deemed as compensation. However the company does not receive a compensation deduction,” said Peter Michaelson, a tax partner in the Syosset office of EisnerAmper. “Why is it for AMT purposes and not regular taxes? The IRS found another way to raise revenue.”

Under the new law, more people will be pushed out of the AMT by the $10,000 limit on state and local property tax deductions for regular taxes. As a result, an ISO recipient will benefit from the exercise of the options.

“In the past, AMT was the killer to these ISOs for the recipient,” Michaelson said. “Now the majority of people will not be impacted by the AMT. Fewer people will be in the AMT, particularly in states like New York and California, which have high state and local and property tax rates.”

The change allows individuals to figure out early whether they will be in the AMT with the help of projections by accountants.

“I have clients who have received them. They were holding off exercising them,” Michaelson said. “Now it might be beneficial to exercise them.”

In the past, taxes on these options levied in the AMT also resulted in a credit that could be used to reduce taxes in years when taxpayers are not in the AMT.

“Most people received this credit, but it would take years for them to utilize it,” Michaelson said. “People who have been carrying this credit for years will be able to utilize the credit, since they are no longer in the AMT.”

The new rules also allow private companies to offer tax benefits related to qualified equity grants, or stock options or restricted stock granted to employees if it meets certain requirements.

“Qualified equity grants can be a useful tax strategy for employees and an excellent recruiting, retention and incentive program for employers,” Michaelson said.

The new rule essentially allows employees of private companies to defer taxes on stock options and restricted stock units for up to five years after they become vested in the stock.

“It’s an incentive for private companies to incentivize people,” Perry said. “If you think about how the tax bill was touted, it was to help companies.”

Start-ups without large amounts of cash, for instance, can use these stock options and stock to pay employees, who could benefit from the new rules.

These, however, must be deemed as qualifying for the rules, which means they can’t be issued to excluded employees including those who own or owned 1 percent of the company at some point during the current or 10 preceding years

Current and previous CFOs and CEOs also are excluded as well as members of the owners’ family or one of the four most highly compensated executives for the current or ten preceding years.

They must be given to at least 80 percent of employees and be connected with the performance of a service rather than simply ownership of shares.

“This is really to help your employees. Generally, you put a stock option in place for your top executives,” Perry continued. “This is to create growth in companies, to create innovation in companies.”

If a firm goes public, these benefits no longer apply. If employees want, they can declare income from options in a year when the employee had losses.

“Why would you do that?” Perry said. “Let’s say you had a bunch of losses that year. Maybe you pick up the income and offset it with the losses.”