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## Employee Benefits and Executive Compensation

# Tax Reform Becomes Law: Impact of the Tax Cuts and Jobs Act on Executive Compensation and Employee Benefits

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***The Jenner & Block Tax Practice recently issued its own Client Alert discussing the current state of tax reform and the House and Senate bills in more general terms. This Client Alert is focused on executive compensation and employee benefit provisions in the proposed bills.***

## Introduction

On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act (the Act). The law rewrites the tax code by removing numerous deductions and exclusions and reforming major aspects of taxable compensation. As indicated in our previous Client Alert, key provisions will have a significant impact on the taxation of executive compensation, particularly for the top-five officers of public companies. Other provisions of the Act create smaller changes to the employee benefits landscape.

Many of the provisions related to qualified retirement plans did not make it into the final version of the Act. The Tax Cuts and Jobs Act makes no changes to rules related to qualified plan in-service or hardship distributions, contribution limits, nondiscrimination testing or normal retirement age. In addition, the sweeping changes to nonqualified deferred compensation, including stock options, did not make it into the final law, and Code Section 409A remains intact.

Even though qualified retirement plans came out mostly unscathed, there are significant changes to the executive compensation landscape. As a result of Code Section 162(m) reform and the reduction of the corporate tax rate to 21%, **companies may want to consider accelerating bonuses and other incentive awards, and the accompanying deductions, into 2017**. However, companies should be careful to be aware of accounting implications, if any, and should watch compliance with current Code Section 162(m) requirements, plan documents and Code Section 409A restrictions on accelerated payments.

In the coming years, changes to the ability of companies to deduct executive compensation may impact the design, if not the magnitude, of compensation programs. Further, with respect to all but the most senior executives, the combination of the reduction in corporate tax rates and the $1 million alternative minimum tax (AMT) threshold may lead companies to reevaluate the use of incentive stock options (also sometimes referred to as qualified options or ISOs). However, it may take years until the overall impact and unintended consequences of the Tax Cuts and Jobs Act are truly known. During this time, clients should consult with their legal and financial advisors on how to assess the implications and requirements of the final tax changes.

The following is a brief summary of the forthcoming changes to the taxation of executive compensation and other features of the Act affecting qualified retirement plans and employee fringe benefits. All provisions are effective in 2018, unless otherwise noted.

## Executive Compensation

- **Code Section 162(m) reform**
  - The Act eliminates the performance-based compensation exemption to the $1 million annual deduction limitation for public companies. No more deductions (in excess of $1 million) for stock option grants, performance long term incentive awards or "162(m) wrap bonus" plans.
  - The CFO is also added to the list of covered employees, fixing the glitch created when the SEC changed the proxy reporting requirements in 2006.
  - Companies with publicly traded debt will be subject to Code Section 162(m) in addition to those with publicly traded equity.
  - The deduction limit will continue to apply to covered employees for as long as they receive compensation from the company, even once they are no longer employed.
  - Binding compensation arrangements already in effect on November 2, 2017, are exempted from the new requirements.

- **Excise taxes on tax-exempt and governmental organizations for excessive executive compensation**
  - The Act imposes an excise tax at the corporate rate of 21% – paid by the employer – for compensation in excess of $1 million to the top five highest paid employees of tax-exempt organizations.
  - The $1 million annual threshold continues to apply to a covered employee even if a higher paid employee is hired, which removes that person from the top five highest paid.
  - The excise tax will also apply to employers paying severance in excess of three times the employee's base compensation (using the Code Section 280G concept for base compensation) to a highly compensated employee.

- **New Code Section 83(i) will allow deferral on certain qualified private company equity grants for up to five years after vesting**
  - The Act adds a new tax deferral feature for grants of private company stock options. Section 83(i), however, may have limited impact due to its narrow scope and complex requirements.
  - Eligible employees may elect to defer the recognition of income from illiquid private company stock acquired from the exercise of stock options or the settlement of restricted stock units (RSUs) for up to five years after vesting, if certain requirements are met. Deferral is limited to companies that grant stock options or RSUs to at least 80% of their employees in any given year. Moreover, companies may not combine the number of stock options and RSUs granted to reach the required 80%.
  - Elections must be made no later than 30 days after the vesting date. At the end of the deferral period, income would be recognized based on the value of the qualified stock on the vesting date.
  - Section 83(i) deferral arrangements are generally exempt from Code Section 409A.

- **Profits interest holding period for long-term capital gains treatment extended to three years**
  - The holding period needed for profits interest (also known as carried interest) to qualify for long-term capital gains treatment will change from one year to three years.

- This provision applies to gains on either the sale of an interest in a partnership or the sale of investment assets. Profits interest held less than three years would be taxed at the short-term capital gains rate.

## Noteworthy Provisions
### *(not directly related to executive compensation or employee benefits)*

- **Denial of deduction for settlement (and related attorney's fees) of sexual harassment or abuse claims that are subject to a nondisclosure**
  - Business deductions for settlements or fees paid in connection with sexual harassment or sexual abuse claims are disallowed if the payments are subject to a nondisclosure agreement. As most general releases typically include a release for sexual harassment and abuse (along with everything else), releases going forward may need a carve-out that any confidentiality does not prohibit discussion of sexual harassment or abuse – if the company wants the payments and fees to remain deductible. **This provision is effective upon the Act's enactment date.**

- **Employer credits for amounts paid to employees on FMLA leave available through 2019**
  - Eligible employers can claim a tax credit for wages paid to qualifying employees on leave under the Family and Medical Leave Act (FMLA), as long as the wages are at least 50% of the employee's normal wages. The credit can only be applied to employees who earn less than 60% of a highly compensated employee ($72,000 a year, which is subject to change).
  - The credit starts at a rate of 12.5% of the wages paid during the period of leave, and increases by 0.25% for each percentage point above the 50% wage threshold, up to a maximum allowable credit of 25%.
  - The credit will be available for 2018 and 2019 and will be followed by a Government Accountability Office (GAO) study to measure its effectiveness.

- **Repeal of individual mandate effective 2019**
  - The individual mandate from the Affordable Care Act (ACA) is effectively repealed by reducing the penalty to zero beginning in 2019. Under current law, the individual mandate creates penalties for non-exempt individuals who do not obtain minimum essential health insurance coverage.
  - The ACA's employer mandate and annual reporting obligations are not affected. Employers with 50 or more employees will still need to provide full-time employees with ACA-compliant health insurance or face stiff penalty taxes.
  - The repeal may have direct or indirect consequences on employer-sponsored plans thorough cost shifting and possible increased insurance costs resulting from healthier individuals leaving the health insurance marketplace.

- **Individual AMT exemption amounts increased which may make ISOs more attractive again**
  - The individual AMT exemption amounts are increased, and the phase out thresholds are significantly increased to $1 million for married taxpayers filing a join return and $500,000 for all other taxpayers.
    - The increased exemptions mean that fewer individuals will be subject to the AMT. The increased phase outs will make executives less likely to trigger the AMT after exercising ISOs.

    - Accordingly, ISOs will become more attractive than they have been in the past, as they will reap greater benefits to both employees and will be less costly to employers in terms of the lost corporate tax deduction (due to lower corporate tax rates).

## Employee Benefits and Qualified Plans

- **Repeal of exclusions and deductions for receipt of certain fringe benefits**
  - The Act eliminates certain deductions and exclusions for employee fringe benefits.
  - Effective 2026, the employer deduction for employer-provided transportation fringe benefits, including parking, transit pass and vanpool reimbursements, will be cut, including the accompanying exclusion from the employee's taxable income. Employees may still elect to make pre-tax contributions for qualified transportation expenses from their own compensation.
  - Effective 2026, the 50% business deduction for entertainment expenses will be eliminated, however, the 50% deduction for business meals will remain.
  - Effective 2018, employer-paid moving expense reimbursements will now be included in an employee's taxable income and business deductions will be eliminated, except for certain active-duty members of the armed forces.

- **No more unwinding of Roth IRA conversions**
  - The Act repeals the rule allowing re-characterizations of Roth IRA conversions back to Traditional IRAs (i.e., no longer able to convert Traditional IRA to Roth IRA and back to Traditional IRA).
  - Other types of re-characterizations are still allowed. The ability to convert traditional IRAs to Roth IRAs or to re-characterize a Roth IRA contribution as a traditional IRA contribution is not affected – only the unwinding of a Roth conversion is affected.

- **Easing of plan loan rollover time limit**
  - The Act allows employees whose plans or employment terminate to rollover outstanding plan loans to an IRA or other eligible retirement plan by the due date for filing their tax returns without the loan balance being deemed a distribution. This provision extends the previous 60-day limit.

- **Qualified plan provisions for 2016 disasters**
  - Tax relief is provided to individuals affected by the 2016 flooding in the Mississippi Delta region. Individuals who suffered economic losses can receive distributions from their eligible retirement plans before the age of 59½ without incurring the 10% early withdrawal tax. The distributions must occur between January 1, 2016 and January 1, 2018.

For additional information on the 2017 Tax Cuts and Jobs Act, please visit our dedicated page with other Jenner & Block updates. If you have questions about this Client Alert, please contact any team member listed below or your usual Jenner & Block contact.

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