

Employee Compensation and Benefits Changes Under the Tax Cuts and Jobs Act

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The following post is a general summary of the changes to the Internal Revenue Code made by the recently enacted Tax Cuts and Jobs Act (the “**Act**”) that affect employee compensation and benefits: **Executive Compensation Updates Loss of Deduction for Compensation in Excess of \$1 Million** Currently, Section 162(m) of the Internal Revenue Code limits the ability of publicly held corporations to deduct annual compensation paid to a “covered employee” in excess of \$1 million, with an exception to this limit for certain performance-based compensation. Beginning on and after January 1, 2018, the Act amends Code Section 162(m) to eliminate the exception for “qualified performance-based compensation” (which includes stock options, stock appreciation rights, and compensation paid upon the attainment of pre-established performance goals) and commissions. There is limited grandfathering relief available under the Act that preserves the deductibility of existing arrangements that pay out after 2017, provided the “written binding contract” for such arrangement was in place as of November 2, 2017, and is not materially modified thereafter. **Expansion of “Covered Employees” under Code Section 162(m)** Currently, Code Section 162(m) defines “covered employees” as the CEO and the three most highly compensated officers for the taxable year (other than the CEO or CFO) as of the close of the taxable year. The Act modifies the definition of “covered employees” subject to the \$1 million deduction limit to now include CFOs and also adds a “once a covered employee, always a covered employee” concept for any individual who was a covered employee on or after January 1, 2017. This means the rule will continue to cover former employees. For example, compensation paid after termination of employment (such as severance pay or nonqualified deferred compensation beyond separation) is generally exempt from the limits under Code Section 162(m). However, under the Act, once an employee is covered by Code Section 162(m), he or she will remain covered for all future years (even after death, with respect to compensation payable to his or her estate or beneficiaries), which will potentially result in subjecting severance and other post-termination compensation to the deduction limit. **Expansion of Covered Companies under Code Section 162(m)** Currently, Code Section 162(m) covers companies with publicly traded equities required to be registered under Section 12 of the Securities Exchange Act of 1934. The Act modifies this rule to also apply to companies that are required to file SEC reports under Section 15(d) of the Securities Exchange Act of 1934, which will pick up companies that report due to publicly traded debt, as well as certain foreign companies. **Private Company Qualified Stock Grants** The Act includes new Code Section 83(i), which permits an election to delay income tax for up to five years on compensation paid to employees of “eligible corporations” in the form of “qualified stock.” An “eligible corporation” is one with stock that is not readily tradable on an established securities market and that has a written plan in place to grant stock options or restricted stock units (“**RSUs**”) with the same rights and privileges to receive qualified stock to at least 80 percent of all full-time, U.S.-based employees. “Qualified stock” is stock received in connection with the exercise of options or upon settlement of RSUs that were granted for an employee’s performance of services during a calendar year in which the corporation was an eligible corporation. Stock is not considered “qualified stock” if the shares can be liquidated by permitting the employee to transfer the stock back to the corporation for cash once it first becomes transferable or no longer subject to a substantial risk of forfeiture. To defer income taxes on qualified stock, employees must make an affirmative election (a so-called “83(i) election”).

within 30 days of the date of grant. Once this election is made, income taxes on qualified stock would become due upon the earliest of the following:

- The date the stock is transferrable, including to the employer,
- The date the employee first becomes an “excluded employee” (i.e., CEO, CFO, or a one percent owner or one of the top four highest paid employees for any of the 10 preceding taxable years, determined on the basis of the SEC disclosure rules for compensation, as if such rules applied to such a corporation),
- The first date any stock of the employer becomes readily tradable on an established securities market,
- The date five years after the date the employee’s right to the stock is no longer subject to a substantial risk of forfeiture, and
- The date on which the employee revokes an 83(i) election.

The deferral election is generally not available if the employee made an 83(b) election, the stock is readily tradable, or the corporation has bought back any outstanding stock in the preceding calendar year (unless at least 25 percent of the total dollar amount the company bought back is stock to which an 83(i) election is in effect and the determination of which individuals from whom such stock is purchased is made on a reasonable basis). The employer would be subject to certain reporting requirements regarding the qualified stock, and the employer would also be required to provide notice to employees about their right to defer tax on the stock as well as the consequences of the deferral. Qualified stock under Code Section 83(i) would not be treated as deferred compensation for purposes of Code Section 409A. An option cannot be treated as an incentive stock option within the meaning of Code Section 422 if an 83(i) election is made with respect to the stock received in connection with the exercise of such option.

Twenty-One Percent Excise Tax on Nonprofit Executive Compensation Exceeding \$1 Million

For tax years beginning after December 31, 2017, tax-exempt organizations will be required to pay an annual excise tax on compensation exceeding \$1 million paid to any of its “covered employees.” The “covered employee” category consists of the five highest-paid current or former employees for the year, as well as former employees who were previously among the “high five” in any year after 2016 and are still being paid any form of post-termination compensation subject to withholding that exceeds \$1 million in the current year. This excise tax applies to: (i) current compensation, (ii) deferred compensation, and (iii) “excess parachute payments” to any high-five employee triggered by separation from employment, to the extent that the total “parachute payments” exceed three times the individual’s five-year average total compensation. The Act includes a limited carve-out, so the excise tax will not apply to payments made to licensed medical professionals (physicians, nurses, and veterinarians), to the extent compensation payments relate directly to performance of medical services.

Recharacterization of Capital Gains for Certain Profits Interests for Services

The Act partially addresses the tax treatment of certain carried interests issued by a partnership as profits interests for services by adding a new Code Section 1061 relating to the taxation of “applicable partnership interests.” Under this new provision, if a taxpayer holds one or more “applicable partnership interests” at any time during the tax year, the amount of the net long-term capital gain with respect to such applicable partnership interest for such year that exceeds the amount of such gain, calculated as if a three-year holding period applied, would be treated as short-term capital gain (taxed at ordinary income rates). In essence, the provision would require that, to obtain long-term capital gain treatment for applicable partnership interests, the required holding period must be greater than three-years (not one-year). To qualify as an “applicable partnership interest,” the taxpayer would have to receive, or hold, the partnership interest in connection with the performance of substantial services by the taxpayer (or a related person) in any “applicable trade or business.” An “applicable trade or business” is an activity that is conducted

on a regular, continuous, and substantial basis and that consists (in whole or in part) of (i) raising or returning capital and (ii) either (a) investing in or disposing of “specified assets” (or identifying such specified assets for investing or disposition) or (b) developing specified assets. “Specified assets” include securities, commodities, real estate held for rental or investment, cash or cash equivalents, options, or derivative contracts with respect to the foregoing assets, or an interest in a partnership to the extent of the partnership’s interest in the foregoing assets. An applicable partnership interest would not include a partnership interest held by a corporation or a capital interest that provides the partner with a right to share in partnership capital commensurate with either the amount of capital contributed or the value of the interest subject to tax under Code Section 83 upon receipt or vesting. The fact that a taxpayer may have included an amount in income upon acquisition of the applicable partnership interest, or that an individual may have made a Code Section 83(b) election with respect to such interest, does not change the three-year holding period requirement for long-term capital gain treatment with respect to the applicable partnership interest. In addition, the rule would not apply to income or gain attributable to any asset that is not held for portfolio investment on behalf of third party investors. **Health, Welfare, and Fringe**

Benefit Updates **Employee Achievement Awards** Code Section 274(j) generally provides a tax deduction for certain employee achievement awards that are tangible personal property, subject to certain limitations. The Act clarifies that “tangible personal property” that may be considered a deductible employee achievement award does not include cash, cash equivalents, gift cards, gift coupons, gift certification, vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, or similar items. The Conference Report to the Act states that this clarification is not intended to represent a change in law. **Meals** Generally, employers may continue to deduct 50% of the food and beverage expenses associated with operating their business. Between January 1, 2018 and December 31, 2025, the Act applies this 50% limitation to the deduction of on-site eating facility expenses that are considered *de minimis* fringe benefits (which are benefits of such a small value that accounting for them would be unreasonable). After December 31, 2025, employers can no longer deduct such on-site eating facility expenses or expenses for meals furnished for the convenience of the employer. **Moving Expenses** Between January 1, 2018 and December 31, 2025, moving expenses will no longer be deductible by an employer or employee, or excludible from an employee’s gross income. **Qualified Transportation Benefits** Beginning January 1, 2018, employers may continue to provide qualified transportation plans that enable employees to pay for certain tax qualified transportation benefits on a pre-tax basis (up to \$260/month for parking or transit/vanpooling in 2018), but employers will no longer be able to deduct the expense of any subsidy that the employer provides toward employees’ transportation fringe benefits unless the expense is necessary for employee safety. Subsidies provided by tax exempt employers will be treated as unrelated business taxable income. Bicycle commuting reimbursement benefits receive separate treatment under the Act. Between January 1, 2018 and December 31, 2025, employers may continue to deduct expenses for qualified bicycle commuting reimbursements (up to \$20/month in 2018), but any reimbursements will be treated as taxable income to employees.

Denial of Deduction of Certain Sexual Harassment Claim Settlement Amounts Under current Code Section 162, companies can deduct ordinary and necessary expenses paid or incurred in carrying on any trade or business, which would include amounts paid to settle employee sexual harassment claims. The Act amends Code Section 162 to eliminate deductions for any settlement amounts or payments (including attorney’s fees) related to sexual harassment or sexual abuse claims if the payment of the settlement amount or related payment is subject to a nondisclosure agreement. This amendment is effective for amounts paid or incurred after the date of the Act’s enactment, which was December 22, 2017. **Employer Tax Credit for Paid Family and Medical Leave** Between January 1, 2018 and December 31, 2019, employers may receive a tax credit for providing paid family and medical leave to “qualifying employees.” A qualifying employee is an employee: (i) who has been employed by the employer for at least one year; and (ii) whose

prior year compensation did not exceed 60 percent of the highly compensated employee (?
 HCE?) threshold under Code Section 414(q) for the prior year (\$120,000 for 2017). This means the qualifying employee compensation limitation for 2018 is \$72,000. To be eligible for the credit, an employer must provide paid family and medical leave pursuant to a written program that pays qualifying employees at least 50 percent of their wages for at least two weeks (the minimum duration is pro-rated for part-time employees) and up to a maximum of 12 weeks. The credit is equal to 12.5 percent of paid wages and increases 0.25 percent for every percentage point wages paid to employees while on leave exceed 50 percent. For example, an employer paying 60 percent wages to qualifying employees on paid family and medical leave could claim a 15 percent tax credit. The program must permit qualifying employees to take leave for the reasons permitted under the Family and Medical Leave Act (?
 FMLA?), but employers do not have to be subject to FMLA in order to qualify for the tax credit. Other forms of paid leave, including paid leave mandated under state or local law or employer-provided vacation or personal leave, do not qualify as paid family and medical leave for purposes of this tax credit. **Retirement Plan Updates Rollover of Plan Loan Offset Amounts** Currently, if a participant incurs a termination of employment and, under the terms of the plan, is required to repay any outstanding plan loans but is unable to do so, the participant's account balance will be offset by the amount of the unpaid loan. Such amount is treated as having been distributed to the participant, and the participant has 60 days to contribute the offset amount in a tax free rollover to another qualified retirement plan. Effective January 1, 2018, terminated participants (as well as participants whose loans become due because of a plan's termination) will have until the due date for their personal income taxes for the year in which the plan loan offset occurred to rollover any loan offset amounts into another tax qualified plan. **Re-characterization of Roth Contributions** Currently, individuals who made contributions to a traditional IRA or a Roth IRA may, prior to the due date for their personal income taxes for a given year, re-characterize those contributions as being made to the other type of IRA through a trustee-to-trustee transfer of assets from the original type of IRA (traditional or Roth) to the other type of IRA. Effective January 1, 2018, funds initially invested in a traditional IRA and subsequently re-characterized as contributions to a Roth IRA may not be recharacterized again so as to unwind the prior conversion to a Roth IRA. **Tax Relief for Distributions to Participants Affected by Major Disasters in 2016** The Act provides tax relief for retirement plan distributions of up to \$100,000 in the aggregate that are made between January 1, 2016 and June 1, 2018, to participants impacted by any of the events in 2016 declared to be "major disasters" by the President. Tax relief for such distributions includes (i) exemption from the 10 percent early withdrawal penalty and 20 percent income tax withholding that could otherwise apply to the distribution, (ii) permitting taxable income from the distribution to be spread equally over three years, and (iii) the ability to repay all or a portion of the distribution as a rollover to another retirement plan within three years from the distribution date. Any plan amendments necessary to permit 2016 disaster distributions must be adopted no later than the last day of the first plan year beginning after December 31, 2017 (December 31, 2018 for calendar year plans).