On November 2nd, the House Ways and Means Committee, introduced the Tax Cuts and Jobs Act (the “Bill”), which would make sweeping changes to the Internal Revenue Code of 1986, as amended (the “Code”). While it is unlikely that the legislation will pass in its current form, the Bill appears to be the product of a coordinated effort by House Republicans (including the Speaker of the House) with the “full support” of the White House.

Set forth below is a high-level analysis of the portions of the Bill affecting employee benefits and executive compensation.

**EXECUTIVE COMPENSATION ARRANGEMENTS**

**Modifications to the $1 Million Deduction Limit of Code Section 162(m):** Currently, Code Section 162(m) limits the annual deduction that applicable public companies may take on the compensation paid to the chief executive officer and the next three highest paid officers (other than the chief financial officer (CFO) to $1 million, per individual. Under current law, payments that qualify as commission-based compensation or performance-based compensation under Code Section 162(m) are not subject to this $1 million limit. Further, the limit applies only to named executive officers in the employer’s proxy who are employed by the employer on the last day of the employer’s fiscal year.

The Bill modifies – and greatly expands – Code Section 162(m) in the following several important ways:

- *Increased Number of "Covered Employees."* Under the Bill, Code Section 162(m) would, once again, include the CFO in the individuals subject to Code Section 162(m). In addition, any individual who is treated as a “covered employee” of an applicable public company under Code Section 162(m) would continue to be considered a “covered employee” with respect to that company so long as the company continues to provide remuneration to such individual.

**Winston Take-Away**

Subjecting the CFO to 162(m) is not surprising. After the proxy disclosure rules changed in 2007 and the Internal Revenue Service (IRS) issued follow up guidance, it was clear that a legislative change...
was needed if CFOs were to be subject to Code Section 162(m). More troubling is the change to continue to subject individuals to the Code Section 162(m) limits even after they cease to be named executive officers. That proposed change would eliminate public companies’ ability to preserve deductions by deferring amounts until the individuals terminated employment (or otherwise ceased to be named executive officers).

- **Important/Prevalent Code Section 162(m) Exceptions Repealed.** The Bill would eliminate the performance-based compensation and commission exceptions under Code Section 162(m).

**Winston Take Away**

If passed, this provision of the Bill would have a dramatic impact on the tax cost of compensating covered employees. Typically, a covered employee’s compensation consists of between 50% to 75% in performance-based compensation, which generally is intended to be deductible under Code Section 162(m), without regard to a cap. If there is no need to create pre-established performance goals in order to preserve important corporate deductions, companies may create compensation arrangements that include less of the traditional rigid/objective factors and that include more subjective factors (or complete discretion). On a related point, many companies regularly presented their incentive arrangements to shareholders in order to qualify for the performance-based pay exemption; that will no longer be required under Code Section 162(m) (but listing exchange rules will continue to apply). However, even if performance goals no longer provide any tax benefit for Code Section 162(m) purposes, Compensation Committees may nevertheless want to continue to maintain performance-based compensation, as part of their overall pay for performance philosophy, especially in light of scrutiny by proxy advisory firms, such as ISS and Glass Lewis and consistent with their fiduciary duties to shareholders.

- **New Companies Subject to 162(m).** Finally, the Bill would treat corporations that issue public debt as being subject to Code Section 162(m). Previously, only corporations that issued public traded equity instruments were subject to Code Section 162(m).

**Winston Take Away**

In general, as a result of the foregoing, any otherwise deductible compensation paid or accrued with respect to a covered employee of a publicly-held corporation will be capped at $1 million per year with certain very limited exceptions.

**Limitations on Nonqualified Deferred Compensation:** The Bill proposes to effectively replace the Code’s existing nonqualified deferred compensation scheme [e.g., Code Sections 409A, 457A, 457(b) and (f)] with a new Code Section 409B that would apply to services performed by employees after December 31, 2017.

- **New Taxation Timing.** Under the Bill, an employee would be taxed on compensation as soon as there is no longer a “substantial risk of forfeiture” with regard to that compensation (i.e., once the compensation is not subject to future performance of substantial services).

**Winston Take Away**

This provision of the Bill would fundamentally alter the way an employee’s nonqualified deferred compensation is currently taxed. Compensation to employees would no longer be taxed based on a cash basis, but rather such compensation would be includable as income once the employee no longer needs to provide substantial services to the employer (which is different than the substantial risk of forfeiture rules under Code Section 83. For instance, performance conditions could not constitute a
substantial risk of forfeiture, nor could a non-compete). So, for example, if an executive received a cash-based incentive award that vested in one year and was paid out in a subsequent year based on company performance, the employee would nonetheless need to be taxed at the completion of the requisite vesting service—even though the ultimate payment amount will not be known until the end of the performance period. The Bill’s focus on service-based vesting, rather than performance conditions is at odds with the public’s current focus on pay for performance. Similarly, if severance is being paid out over installments—a common approach to help ensure compliance with restrictive covenants like non-compete and non-solicitation provisions—the entire severance amount would be taxable upon the executive’s termination of employment.

- **Additional Amounts Potentially Subject to New Rules.** Under the newly proposed Code Section 409B, nonqualified deferred compensation would specifically include phantom stocks, stock options, stock appreciation rights (SARs), certain restricted stock units (RSUs) and other similar equity instruments. Any other form of equity interest subject to Code Section 83 would be excluded (in addition to other exclusions, like certain short-term deferrals).

**Winston Take Away**

By expanding the types of equity compensation considered nonqualified deferred compensation, the Bill is likely to greatly impact how companies pay their employees. Because stock options and SARs would be taxed when vested (as opposed to when exercised under current rules), it is likely that the use of those vehicles will decline dramatically, in favor of awards/purchases of full value shares and profits interests in limited liability companies (this is the case even though other portions of the Bill repeal the Alternative Minimum Tax and otherwise might increase the use of incentive stock options).

- **Transition rules.** With respect to current deferred compensation amounts, Code Section 409A like rules would continue to govern nonqualified deferred compensation arrangements through the beginning of 2026. Code Section 409A would include amounts currently subject to Code Section 409A in income in the first year before 2026 or if later vested.

**Winston Take Away**

If this provision of the Bill passes, virtually every employer would need to comprehensively review and modify their employee compensation arrangements for the matters discussed below.

**25% Tax on Pass Through Entity Income:** Under the Bill, a portion of net income distributed by a pass-through entity (S-corps, certain LLCs, partnerships, etc.) to an owner or shareholder may be treated as “business income” subject to a maximum tax rate of 25%, instead of ordinary individual income tax rates (which would go as high as 39.6%). Because the Bill would provide incentives to re-characterize wages (e.g., amounts reported on a W-2) as business income, the Bill also proposes some safeguards to discourage the abuse of such tax strategies.

**Winston Take Away**

If this provision of the Bill is passed, pass-through entities would need to do a bottom-up evaluation of their income allocations, compensation determinations and equity awards (e.g., profits interests).

**RETIRED BENEFITS**

**401(k) Limits:** The Bill does not propose any reduction to the current limits on tax-deferred contributions an individual may make to his or her 401(k) plan.
Winston Take Away

For those concerned that the Bill would impact tax planning by limiting their ability to make pre-tax deferrals to a 401(k) plan, this is a welcome development.

Helpful Provisions for Plan Participants: The following provisions of the Bill would give retirement plan participants greater flexibility in their retirement plans:

- **Reduction in Minimum Age for Allowable In-Service Distributions**: Under the Bill, similar to the current rules applicable to defined contribution plans, all defined benefit plans and governmental defined contribution plans could offer participants the option of taking in-service distributions starting at the age of 59½.

- **Removal of Hardship Contribution Suspension and Modification of Withdrawal Rules**: Under the Bill, the Internal Revenue Service would be required, within one year of the date of enactment, to issue guidance providing that: (i) employees taking hardship distributions would be allowed to continue making contributions to the plan (i.e., the six month suspension following a hardship distribution would be repealed) and would no longer be required to take any available loans before requesting a hardship distribution, and (ii) hardship distributions could include earnings on employee deferrals and qualified nonelective contributions.

- **Plan Loan Rollovers**: Under the Bill, employees whose plan terminates or who terminate employment while they have plan loans outstanding would have until the due date for filing their tax return for the year in which the termination occurs to contribute the loan balance to an IRA, in order to avoid the loan being taxed as a distribution.

**Modification of Non-Discrimination Rules for Closed Defined Benefit Plans**: Under the Bill, expanded cross-testing between an employer’s closed defined benefit plan and open defined contribution plan would be allowed for purposes of the nondiscrimination rules.

Winston Take Away

If this provision of the Bill is passed, it would codify and expand the temporary relief provided by Internal Revenue Service Notice 2014-5 and most recently extended by Notice 2017-45.

**Individual Retirement Account (IRA) Re-characterizations**: Under the Bill, re-characterizations of contributions from a traditional IRA to a Roth IRA (and vice-versa) would be disallowed.

Winston Take Away

If this provision of the Bill is passed, it would probably have only a marginal impact on employer-sponsored retirement plans.

**FRINGE BENEFIT PROGRAMS**

The following is a list of popular fringe benefits that would be impacted by the Bill in its current form, if passed. These proposed provisions are generally effective beginning on January 1, 2018.

**Repeal of Deduction Related to Entertainment Expenses and Other Fringe Benefits**:

- No deduction would be allowed for entertainment, amusement or recreation activities, facilities or membership dues relating to such activities, or other social purposes.

- No deduction would be allowed for transportation fringe benefits, benefits in the form of on-
premises gyms and other athletic facilities, or for amenities provided to an employee that are primarily personal in nature and that involve property or services not directly related to the employer’s trade or business, except to the extent that such benefits are treated as taxable compensation to an employee (or includible in gross income of a recipient who is not an employee).

- The 50% limitation under current law applicable to meals and entertainment would apply only to expenses for food or beverages and to qualifying business meals; not entertainment expenses.
- For tax-exempt entities, the foregoing expense would be treated as unrelated business taxable income and taxed at the corporate rate.

**Repeal of Employer Provided Educational Assistance Tax Benefits:** The deduction for qualified tuition and related expenses, the exclusion for qualified tuition, and the exclusion for employer-provided education assistance programs would all be repealed.

**Repeal of Income Exclusion / Deduction for Moving Expenses:** The Code Section 217 deduction (and related income exclusion) for relocation expenses related to starting a new job (whether or not itemized) would be repealed (see the Impact on Reimbursed Expenses below for additional thoughts on Code Section 162 implications).

**Repeal of Income Exclusion / Deduction for Employee Achievement Awards:** The income exclusion for employee achievement awards (e.g., recognition for length of service or safety achievement) and the restrictions on employer deductions for such awards would all be repealed.

**Repeal of Income Exclusion / Deduction for Archer Medical Savings Account (MSA):** No deduction would be allowed for contributions to an Archer MSA, and employer contributions to an Archer MSA would not be excluded from income. Existing Archer MSA balances, however, could continue to be rolled over, on a tax-free basis, to health savings accounts (HSAs).

**Limitation on Income Exclusion Related to Employer Provided Housing:** The exclusion for housing provided for the convenience of the employer and for employees of educational institutions would be limited and would phase out for highly compensated employees. Additionally, the exclusion would be limited to one residence.

**Repeal of Medical Expense Deduction:** Individuals would no longer be allowed to claim a deduction for out-of-pocket medical expenses (these are typically taken as an itemized deduction on Schedule A, but are limited to a 10% adjusted gross income floor).

**Repeal of Income Exclusion for Dependent Care Assistance:** The income exclusion related to employer-provided dependent care assistance programs would be repealed.

**Repeal of Income Exclusion for Adoption Assistance Programs:** The income exclusion related to adoption assistance programs would be repealed.

**Repeal of Employer-Provided Child Care Credit:** The credit for employer-provided childcare would be repealed.

**Impact on Reimbursed Expenses:**

- In general, the Bill proposes to eliminate the ability of an individual to take itemized deductions (on Schedule A of the Form 1040) for expenses incurred in connection with the employee providing services to an employer. However, the Bill would continue to provide for above-the-line
deductions for reimbursed expenses when the expenses are attributable to the individual performing services as an employee.

- In general, under an accountable plan, allowances or reimbursements paid to employees for job-related expenses are excluded from wages and are not subject to withholding. In order to exclude a reimbursable expense from the reporting of income on an employee’s W-2, the reimbursable expense must be have a business connection. Generally, the test for determining whether a reimbursement has a business connection is whether or not the reimbursement would otherwise be deductible by the employee on the employee’s Form 1040.

- While it does not appear that the Bill is intended to directly modify the income exclusion for reimbursed expenses paid under an accountable plan that are attributable to the individual performing services as an employee, employers should carefully monitor developments and clarifications in this area.

Winston Take Away

- In general, the Bill, as currently drafted, would dramatically affect not only an employer’s income tax deductions for fringe benefits, but would also cause the income to be recognized and reportable for the affected employees (note that these income recognition events would not only create adverse tax consequences for the employee, but would also impose additional employment tax obligations on the employer). Based on our experience, many of the fringe benefits targeted in the Bill are a valuable component of an employer’s total rewards package and provide important recruitment and retention value to the employer.

- Depending on which provisions of the Bill are included in final legislation (if any), employers would need to review and revise the governing documentation for their fringe benefit programs, their policies and procedures, and consider the overall impact the Bill would have on the total rewards package offered to its employees. The following are some examples to consider:
  
  - Employers may need to terminate or modify fringe benefit programs that no longer provide tax-efficient benefits to employees (e.g., policies that provide amusement or entertainment activities for the benefit of employees);
  - Employers may need to consider whether to continue to offer fringe benefit programs on a taxable basis to employees (e.g., employer provided on-premises gyms and other athletic facilities) and whether tax gross-ups would be necessary to make employees whole (e.g., employer provided relocation expense benefits); and
  - Employers may need to modify fringe benefit programs to prevent onerous tax consequences to their employees, such as if the employee had to recognize income on the provision of a fringe benefit without sufficient cash to pay for the income recognition (e.g., employer provided education benefits).

We will continue to monitor developments on this front and will provide timely updates as events unfold.

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