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CLIENT ALERT

Congressional Efforts at Tax Reform Taking Shape

NOVEMBER 29, 2017

Overview of the Employee Benefits and Executive Compensation Provisions in the Tax Cuts and Jobs Act, as of November 29, 2017

On November 16, 2017, in a vote of 227 to 205, the House of Representatives (the "House") passed the Tax Cuts and Jobs Act (the "Act"), moving Congress one step closer to making good on Republican promises to usher in the most significant update to the Internal Revenue Code of 1986, as amended (the "Code"), in 30 years. As we previously reported, the Act makes significant changes to tax rules affecting employee benefit plans, executive compensation arrangements and fringe benefits.

The following is a brief overview of the history of the Act and expected next steps:

DATE	DESCRIPTION OF ACTION TAKEN
11/2/2017	House Ways and Means Committee introduced the Act.
11/9/2017	The Chairman of the Senate Finance Committee unveiled the "Chairman's Mark," which is essentially the Senate's current version of the Act.

DATE		DESCRIPTION OF ACTION TAKEN
11/16/2017		In a vote of 227 to 205, the House passed its version of the Act, which, as discussed below, was amended in several material respects since its first introduction.
11/17/2017		The Senate Finance Committee approved the "Chairman's Mark" of the Act, which, as discussed below, differs from the House's version of the Act in several material respects.
11/27/2017 – 12/1/2017		The Senate is expected to vote on its version of the Act.
December 2017 or Later		If the Senate's version of the Act passes in its current form, the House and the Senate versions of the Act will have to be reconciled before the Act can be passed by both chambers. Following passage, the Act must be approved by the President before it would become law. Notably, there is a special election in Alabama between Roy Moore (R) and Doug Jones (D) on December 12th that could change the makeup of the Senate. Similar to the Republicans winning the Massachusetts Senate seat during the passage of the Affordable Care Act, if the Republicans lose this Senate seat, it may be more problematic for Republicans to pass the Act, since it has been universally opposed by Democrats.

Below is a summary of the House and Senate versions of the Act that would affect employee benefits, fringe benefits and executive compensation.

Executive Compensation

- *Limitations on Nonqualified Deferred Compensation Removed*

Initially, both the House and the Senate versions of the Act proposed to radically redefine the taxation of deferred compensation. Specifically, each chamber's initial version of the Act proposed that an employee would be taxed on compensation as soon as the compensation was no longer subject to a "substantial risk of forfeiture" (with substantial risks of forfeiture limited to the performance of substantial services and specifically not including risks of forfeiture solely related to performance goals).

Subsequently, both the House and Senate removed these provisions from the Act. Therefore, it appears that some of the more troublesome provisions of the Act (from an executive compensation perspective) are gone.

Winston Takeaway

The removal of these proposed deferred compensation provisions provides welcome relief for both employers and employees for a number of reasons. Employers are saved from having to perform a drastic and costly review of their deferred compensation arrangements. Additionally, in general, employees will continue to be taxed on deferred compensation only when such compensation is actually or constructively received.

- *$1 Million Deduction Limit of Code Section 162(m)*

Both the House and Senate versions of the Act are aligned in the following aspects:

- *Repeal of Performance-Based Compensation and Commission Exceptions*: The existing exceptions to the $1 million cap under Code Section 162(m) for performance-based compensation and commissions would be eliminated.
- *Increased Number and Scope of Covered Employees*: Chief financial officers would once again be subject to Code Section 162(m), similar to other named executive officers. Additionally, once an individual is a covered employee, he or she would continue to be a covered employee, so long as the individual receives remuneration from the company.
- *Tax Exempt Entities*: A 20% employer excise tax would apply to compensation over $1 million or any parachute payment in excess of three times base salary that is paid to a tax exempt entity's five highest compensated employees.

Winston Takeaway

Not much has changed since the House's initial version of the Act was introduced. Considering that both the House and Senate are fundamentally aligned on the most important provisions, employers should be aware that if the Act is passed into law, these changes will be part of the law going forward.

Additionally, if the Act is passed, publicly-held companies should review their plan documents and award agreements to make sure that the final updates to Code Section 162(m) do not create problems in administering their equity incentive arrangements. For example, equity plan documents often defer to Code Section 162(m) with respect to the ability to adjust performance goals for qualified performance-based compensation awards. If the performance-based compensation provision of Code Section 162(m) is repealed, impacted corporations should consider the effect on their ability to adjust performance goals.

- *Increased Scope of Covered Entities*: In terms of the scope of publicly-held corporations subject to Code Section 162(m), the House and Senate versions of the Act only extend the applicability of the Code Section 162(m) limitation to entities that are subject to Sections 12 or 15(d) of the Securities Exchange Act of 1934. However, the Senate version of the Act states that it currently is considering subjecting non-public corporations, including S-corporations, to the provisions of Code Section 162(m). Interestingly, the Joint Committee on Taxation's review of the House's version of the Act includes this same statement. However, that concept was not included in the version of the Act that was passed by the House.

Winston Takeaway

The House and Senate both appear to be aligned in subjecting corporations that have either publicly-traded debt or American Depositary Receipts (ADRs) to Code Section 162(m). However, including privately-held entities would be a significant expansion in the scope of Code Section 162(m). As a result, privately-held entities should be on the lookout for any updates to this proposal.

- *Limited Transition Relief*: The Senate's version of the Act contains a transition rule, such that proposed changes do not apply to any remuneration under a written binding contract that was in effect on November 2, 2017 (which has not been materially modified since November 2, 2017) and that is vested on or before December 31, 2016.

Winston Takeaway

While seemingly helpful, this proposed transition relief has very little practical help. Since the compensation must have vested on or before December 31, 2016, its usefulness may be limited to items such as (a) unexercised and vested options or (b) RSUs that are subject to a post-vest holding period.

- *Optional Deferral Election for Qualified Employees of a Privately Held Corporations*

Both original versions of the Senate and the House Act have been amended to include a very narrow ability for qualified employees (essentially, any employee that is not a 1% owner, CEO or CFO (or a family member), or any of the top four highly compensated employees) to elect to defer, income attributable to options exercised and restricted stock units ("RSUs") received from certain privately-held corporations after December 31, 2017. In general, qualified employees may elect to defer income for up to five years, unless the stock becomes transferable, the employee revokes this deferral or the stock ceases to otherwise qualify. Additionally, certain other requirements have to be met, such as requiring the employer to grant a similar type of equity award to 80% of its employees (and each grant must be more than a de minimis amount).

Winston Takeaway

For a bill that proposes to streamline the Code, this proposal appears to introduce a very complex piece of legislation targeted at a narrow subset of privately-held corporations. The requirement that 80% of employees receive grants that are not de minimis means that many employers may not be able to take advantage of this provision without an overhaul of their equity grant practices (and perhaps their overall compensation structure).

- *Carried Interests*

The original House version of the Act was amended to impose a three-year holding period requirement for certain partnership interests received in connection with the performance of services for an applicable trade or business to qualify for long-term capital gain treatment. In general, an applicable trade or business is limited to those activities carried out by private equity funds or other entities that use similar arrangements. Therefore, it appears that the House's version of the Act is focused on carried interests utilized by private equity funds. Currently, there is no similar provision in the Senate's version of the Act.

Winston Takeaway

Because the Senate version of the Act does not include a similar version of this provision, it is unclear whether this provision will make it into the final Act. However, private equity funds/sponsors and other similar entities will undoubtedly want to carefully watch whether this provision makes it into the final version of the Act, and, to the extent necessary, adjust their compensation processes to account for the new holding periods.

- *Not-for-Profit Entities - Expansion of Excess Benefit Transactions*

In general, the Senate version of the Act contemplates updating the excess benefit transaction law (codified under Code Section 4958) in the following ways: (i) adds a 10% entity level tax on an excess benefit transaction, (ii) eliminates the protections of the rebuttable presumption of reasonableness, (iii) gets rid of the special rule that provides that an organization manager's participation ordinarily is not "knowing" if they rely on professional advice, (iv) expands the definition of disqualified persons to athletic coaches and investment advisors, and (v) expands the scope of application to tax-exempt entities under Code Section 501(c)(5) (labor and certain other organizations) and 501(c)(6) (business leagues and other associations).

Winston Takeaway

The most important part of this provisions is the impact it will have on Code Sections 501(c)(5) and 501(c)(6) entities. While the removal of the presumption of reasonableness is unwelcome, continuing to follow the steps under that provision of the Code will help indicate that the entity has done due diligence, which would help shield the employer from the new entity level tax.

- *Repeal of Alternative Minimum Tax*

Both the House and Senate versions of the Act would repeal the alternative minimum tax.

Winston Takeaway

The repeal of the alternative minimum tax, would, once again, make the exercise of qualified statutory stock options (also known as ISOs) exempt from the imposition of ordinary income tax, so this may cause employers to re-consider whether offering statutory stock options is beneficial to the total rewards package (particularly if corporate tax rates are lower than individual tax rates).

- *Pass-through Entity Income*

Under the House version of the Act, a portion of net income distributed by a pass-through entity (S-corporations, 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 subject to ordinary individual income tax rates (which would go as high as 39.6%). Because the Act would provide incentives to re-characterize wages (*e.g*., amounts reported on a W-2) as business income, the Act also proposes some safeguards to discourage the abuse of such tax strategies.

Under the Senate version of the Act, an individual taxpayer generally may deduct 17.4% of domestic qualified business income from pass-through entities. In the case of a taxpayer who has qualified business income from a partnership or S corporation, the amount of the deduction is limited to 50% of the W-2 wages of the taxpayer.

Winston Takeaway

While a full review of this area of the Act is outside the scope of this alert, depending on what is ultimately enacted, entities would need to do a bottom-up evaluation of their income allocations, compensation determinations and equity awards (*e.g*., profits interests) to make sure those are done in a tax-efficient manner.

Health and Fringe Benefits

The most striking feature of the Chairman's Mark passed by the Senate Finance Committee late on November 17, 2017 was the inclusion of a provision that effectively eliminates the requirement that individuals purchase health insurance coverage or pay a penalty. This provision was a prominent feature of earlier Republican efforts to repeal and replace the Affordable Care Act ("ACA"). Under the Senate bill, the individual mandate penalty would be reduced to zero starting in 2019. Although the elimination of the individual mandate would reduce federal tax collections, it has a positive impact on federal expenditures as it would reduce the number of individuals receiving government subsidized health insurance. Note that the ACA's Employer Shared Responsibility Payment ("ESRP") is not eliminated in either the Senate or House versions of the Act and is currently being actively enforced by the IRS. For additional information, see our prior alert, "IRS Enforcement of ACA Employer Penalties Begins."

Unlike the House version of the Act, the Senate version of the Act does **not** eliminate many popular fringe benefit programs, and thus preserves favorable tax treatment for:

- Employer provided child care credit
- Deduction for entertainment and other business expenses
- Employee achievement awards

- Dependent care assistance programs (this is subject to a sunset in 2022 in the House's version of the Act and the provision was not overridden in the Senate version of the Act)
- Employer-provided educational assistance programs
- Employer-provided adoption assistance benefits
- Employer-provided housing and qualified moving expenses

However, the Senate version of the Act is aligned with the House version of the Act in the disallowance of deductions for certain fringe benefits, such as qualified transportation fringe benefits, on-premises gyms and entertainment, amusement or recreation activities, meals provided for the convenience of the employer, or membership dues relating to activities or social purposes, even if related to a trade or business.

Neither the House nor Senate versions of the Act include the repeal of the 40% "Cadillac Tax" on high-cost health plan coverage, the repeal of the mandate or expansion of health savings accounts, all of which were included in earlier health care reform legislation and still remain a priority for the Trump administration and many Republicans.

Winston Takeaway

Depending on which provisions of the Act are included in final legislation (if any), the following items should be considered by employers:

- The Act could 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 Act are a valuable component of an employer's total rewards package and provide important recruitment and retention value to the employer.
- 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 Act would have on the total rewards package employers offer to its employees, as part of its recruitment and retention of highly valued 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 popular 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 qualified moving expenses); 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).

Retirement Plans

The Senate version of the Act differs in a number of respects from the House version of the Act on treatment of qualified retirement plans. Those differences are highlighted below:

- *Defined Benefit Pension Plans*

Unlike the House's version of the Act, the Senate's version of the Act does not contain any rules that would allow distributions from defined benefit or state and local government defined contribution plans to participants who have attained age 59½ and who are still actively employed by the plan sponsor or its affiliates. Also, the Senate's version of the Act does not include the permanent relaxation of nondiscrimination testing for frozen defined benefit plans that was contained in the House's version of the Act.

Winston Takeaway

The House's version of the Act would provide welcome relief for state and local government defined contribution and all defined benefit plan sponsors and their participants. Since the impact on tax revenues should be minimal (and generally positive), we are hopeful that the Senate's version of the Act will be modified or otherwise reconciled to include these more favorable rules.

- *Hardship Withdrawals*

The Senate's version of the Act does not include two provisions of the House's version of the Act that would ease administrative rules related to hardship withdrawals from 401(k) plans. Specifically, the Senate's version of the Act does not include (i) the elimination of the required sixth month moratorium on making elective deferrals after a participant takes a hardship withdrawal, or (ii) the elimination of the rule that earnings on elective deferrals cannot be included in a hardship withdrawal.

Winston Takeaway

The proposed relaxation of these two onerous hardship withdrawal rules provided in the House's version of the Act raised the hopes of 401(k) plan administrators who had long struggled with administering and communicating to puzzled employees the technicalities of these complicated and somewhat counterintuitive requirements. Again, since the impact on tax revenues of retaining these provisions should be minimal, we are hopeful that the Senate's version of the Act will be modified or otherwise reconciled to include these more favorable rules.

- *Changes Affecting 403(b) and Governmental 457(b) Plans*

The Senate's version of the Act includes several changes to Code Section 403(b) plans maintained by tax-exempt employers, and Code Section 457(b) plans maintained by governmental employers. Under the Senate bill, the dollar limits for contributions made by or on behalf of an individual who participates in both a Code Section 403(b) or Code Section 401(k) plan and a Code Section 457(b) plan maintained by the same governmental or tax-exempt employer would be aggregated. Also, the rule that allows employer contributions to be made to a Section 403(b) plan on behalf of terminated participants for up to five years after termination of employment would be eliminated.

Winston Takeaway

The aggregation of dollar limits between Code Section 403(b)/401(k) plans and governmental Code Section 457(b) plans would align the treatment of employees in governmental 457(b) plans with the treatment of all other employees. The elimination of the rule permitting employer contributions to be made for five years to a Code Section 403(b) plan would likely have little impact on non-governmental Code Section 403(b) plan sponsors, due to the lack of clarity on how nondiscrimination testing would apply to contributions made to former employees under those rules.

- *Other Changes*

Several other key differences between the Senate and House versions of the Act have either been struck from or recommended for inclusion in the Senate version of the Act, which are detailed below:

- *IRA Rollover Contribution Relaxation*: The House's version of the Act would extend the deadline for making a non-taxable rollover contribution to an IRA for a terminated participant with a qualified plan distribution that contained an outstanding loan balance (until the individual's tax filing deadline rather than the current 60 days). The Senate's version of the Act has adopted this provision.
- *Removal of Catch-Up Contributions Prohibition*: The Senate's version of the Act previously contained a provision that would have prohibited individuals age 50 or older with annual wages of $500,000 or more from making

"catch-up contributions" to elective deferral plans. Since its introduction, the Senate has removed this concept from its version of the Act.

- *Removal of New Excise Tax*: The Senate's current version of the Act struck a provision that was not contained in the House version of the Act, which would have imposed a 10% early distribution penalty tax on pre-age 59-1/2 withdrawals of otherwise taxable funds from Section 457(b) governmental plans.

Winston Takeaway

These changes retain the helpful relaxation of rules for terminated participants with loan balances that is contained in the House's version of the Act, while removing some of the more controversial differences from the Senate version of the Act, such as the ban on age 50 catch-up contributions for high wage-earners. Our view is that these changes should be viewed as a win by both employers and employees.

Conclusion

The Senate plans to vote on its version of the Act this week. In order for the Senate to pass the Act under the budget reconciliation process, all elements of the Act will have to be ruled by the Senate parliamentarian to meet the "Byrd Rule," which requires provisions to have an impact on the federal budget in order to be included. If passed, the Senate and House versions will have to be reconciled before the Act can be passed by both chambers and signed into law by President Trump.

Winston Takeaway

While we typically do not recommend that our clients take action on proposed legislation, we do recommend that all employers remain abreast of ongoing developments with respect to the Act so that they are equipped to proactively react to any changes. Unlike many other pieces of legislation, it seems that Congress intends for the Act to become effective almost immediately after it is enacted, which will put a tremendous burden on all affected parties.

Starting in mid-December, employers should review the status of the Act and consider what communications they should be preparing in light of the current status of the Act. We would recommend that employers have these communications reviewed by outside legal counsel.

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

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