WINSTON & STRAWN LLP

CLIENT ALERT

Benefit and Compensation Provisions in the Tax Cuts and Jobs Act

DECEMBER 29, 2017

On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act into law (hereinafter referred to as the 2017 Tax Reform Law). The 2017 Tax Reform Law made sweeping changes to the Internal Revenue Code of 1986, as amended (the Code), including changes to corporate and individual tax rates. While the 2017 Tax Reform Law is current law, most provisions will only affect taxable years beginning after December 31, 2017 (i.e., 2018 tax returns) with many provisions sunsetting in 2026.

Executive Compensation for Public Companies and Tax-Exempt Entities

The 2017 Tax Reform Law has significant implications for how many public companies structure executive compensation arrangements due to new onerous restrictions that no longer allow for deduction of certain compensation. In particular, the 2017 Tax Reform Law repeals the commission and performance-based compensation exceptions to the $1 million deduction limitation under Code Section 162(m), for compensation payable to a public company's covered employees.

The 2017 Tax Reform Law also expands the definition of "covered employee" to include the chief financial officer. This change aligns the definition of covered employee under Code Section 162(m) with the definition of "named executive officer" under Item 402 of Regulation S-K. Moreover, all individuals who were either the chief executive officer or chief financial officer at any time during the year are now included as covered employees, not just those employed on the last day of the year. In addition, once an individual becomes a covered employee, that individual will remain a covered employee so long as he or she receives remuneration from the public company. For example, an individual who was a chief executive officer on any day of a given tax year after December 31, 2016 will continue to be a covered employee for the remainder of that year (regardless of a termination of employment prior to the close of the tax year) and that status will continue to apply in any non-employee role, such as a non-employee director. Deferred compensation payable after the death of a covered employee, is also subject to the disallowance. Lastly, the 2017 Tax Reform Law increases the definition of the companies subject to Code Section 162(m) to now include companies that file reports pursuant to Section 15(d) of the Securities Exchange Act of 1934, but do not otherwise have publicly traded equity securities. This means that companies with only publicly traded debt will now be subject to the limitations imposed by Code Section 162(m). The 2017 Tax Reform Law has limited transition relief for compensatory arrangements that were in effect on November 2, 2017 and are not materially modified after November 2, 2017.

The 2017 Tax Reform Law also impacts executive compensation provided by certain tax-exempt entities. A tax-exempt entity is now subject to an annual 21% excise tax on compensation exceeding $1 million that is provided to any of the entity's five highest compensated employees for the year (or to a former covered employee). This new rule places tax-exempt entities on par with public companies in bearing a tax burden for payment of high amounts of compensation to top executives. Under this provision, compensation is deemed provided when it is no longer subject to a substantial risk of forfeiture. In addition, a tax-exempt entity will be subject to a 21% excise tax on any "excess parachute payments" made to any of its five highest compensated employees that are triggered by separation from service, whether or not linked to a change in control, to the extent that the total payments exceed three times the employee's five-year average total compensation. Exempt from this provision are individuals providing medical or veterinary services or individuals who are not highly compensated employees as defined in Section 414(q) of the Code.

Winston Takeaway

Public companies (including those that file reports pursuant to Section 15(d) of the Securities Exchange Act of 1934) should immediately begin to survey their compensation arrangements in order to determine which arrangements will be affected by the changes to Code Section 162(m) in the 2017 Tax Reform Law. We do not anticipate that many public companies will abandon their pay-for-performance arrangements, especially in light of ISS and Glass Lewis concerns. The silver lining on the cloud of lost deductions is that the loss of the performance-based compensation exception may provide some additional flexibility in terms of plan design and administration. Unfortunately, it is clear that now there can be more (and in some cases many more) covered employees, as compared to the old rule of at most just four covered employees.

Until additional guidance is provided, it will be challenging to interpret the November 2, 2017 transition rule. However, at a minimum public companies should exercise caution before making any modifications to pre-existing plans. The committee report generally provides the following guidance with respect to the transition rule: (1) The "pre-existing plan" rule would apply to an executive who has a written binding contract to participate in a deferred compensation plan in effect before November 2, 2017, even if participation in the plan begins after that date, provided that other conditions are met; (2) The fact that a plan is "in existence" on November 2, 2017 is not sufficient to apply the transition rule; (3) A contract that is "renewed" after November 2, 2017 is treated as a new contract; and (4) A contract that is terminable or cancelable unconditionally at will by either party to the contract without the consent of the other, or by both parties to the contract, is treated as a new contract entered into on the date any such termination or cancellation, if made, would be effective.

In addition, tax-exempt entities should examine their executive compensation arrangements in light of the application of the harsh new 21% excise taxes and determine whether modifications in executive compensation arrangements are possible, necessary, or warranted, either due to the $1 million limitation or due to excessive payments on separation from service.

Qualified Equity Grant Deferrals

The 2017 Tax Reform Law adds a new Section 83(i) to the Code, which permits a qualified employee to elect to defer, for income tax purposes (but not for FICA tax purposes), the inclusion in income of amounts attributable to the qualified stock of an eligible employer received as a result of a stock option exercise or restricted stock unit (RSU) settlement. In general, a qualified employee is an employee of an eligible corporation other than (i) an individual who is or has been a 1% owner at any time during the 10 prior calendar years; (ii) the chief executive officer or chief financial officer (or an individual acting in either capacity); (iii) a family member of an individual described in (i) or (ii); or (iv) one of the highest four compensated officers for any of the 10 prior taxable years. A corporation is an "eligible corporation" with respect to a calendar year if (1) no stock of the employer corporation (or any predecessor) is readily tradable on an established securities market during any preceding calendar year, and (2) the corporation has a written plan under which, in the calendar year, not less than 80% of all employees who provide services to the corporation in the United States (or any U.S. possession) are granted stock options or RSUs, with the same rights and privileges to receive qualified stock.

An election to defer income inclusion ("inclusion deferral election") must made by the employee in a manner similar to Section 83(b) elections, and must be made no later than 30 days after the first time the employee's right to the stock is substantially vested or is transferable, whichever occurs earlier. The election will allow income deferral until the taxable year that includes the earliest of (1) the first date the qualified stock becomes transferable, including, solely for this purpose, transferable to the employer; (2) the first date on which the employee is no longer a qualified employee; (3) the first date on which any stock of the employer becomes readily tradable on an established securities market; (4) the date five years after the first date the employee's right to the stock becomes substantially vested; or (5) the date on which the employee revokes the inclusion deferral election.

A qualified employee may make an inclusion deferral election with respect to a qualified stock attributable to a statutory option in which case it will not be treated as a statutory option. In addition, RSUs and options subject to the deferral elections will not be considered non-qualified deferred compensation.

Several other important requirements must be met in order for employees to obtain the benefits of the maximum five-year deferral, such as employer notice and reporting requirements, restrictions against employer repurchases, and employee withholding agreements.

Winston Takeaway

The new qualified equity grant deferral feature appears to have very limited applicability due to the fact that the RSUs or options must be made available to 80% of employees in a privately held company. The fact that significant owners and certain officers are not eligible further limits the utility of the provision. However, qualified employees of the limited number of eligible corporations under Section 83(i) of the Code will benefit from this opportunity to defer income recognition on common forms of equity awards.

Qualified Retirement Plan Provisions

The House and Senate versions of the bill would have made few changes to rules affecting qualified retirement plans, and most of those were dropped from the final 2017 Tax Reform Law. Not included in the 2017 Tax Reform Law were rules that would have loosened restrictions on hardship withdrawals in 401(k) plans, eased nondiscrimination testing burdens for closed pension plans, provided for age 59-1/2 in-service withdrawals for defined benefit and state and local government defined contribution plan participants, aggregated contribution limits for governmental 457(b) plans with 403(b)/401(k) plans, and struck rules allowing for contributions to 403(b) plans for former employees for five years.

The only significant qualified retirement plan change included in the 2017 Tax Reform Law is a rule allowing participants who terminate employment with a 401(k) plan loan to extend the deadline from the current 60 days to the due date of their tax return for the applicable year for rolling over the outstanding amount tax-free to an IRA. This rule does not affect employers or the reporting of outstanding loan offsets, but does provide a cushion for employees to avoid some of the negative tax consequences of a loan default.

Winston Takeaway

Although the final bill did not include a number of retirement plan-sponsor-friendly (and participant-friendly) provisions, disappointed employers have nevertheless been provided with a number of promising ideas for possible future legislative changes.

Fringe Benefit Provisions

The prior House version of the bill would have eliminated many popular tax-free and employer-deductible fringe benefit programs, such as employer-provided adoption assistance, employer-provided educational assistance, and dependent care spending accounts plans. These programs were all spared in the 2017 Tax Reform Law and current law with respect to these programs remains unchanged. However, the tax consequences of several other popular fringe benefit programs are impacted in the 2017 Tax Reform Law:

Qualified Transportation Fringe Benefits

The 2017 Tax Reform Law disallows employer deductions relating to qualified transportation fringe benefits beginning in 2018, and eliminates the exclusion for bicycle commuting expenses for tax years beginning after December 31, 2017 and ending in 2025. Employees will continue to be able to receive these benefits from the employer or pay for these benefits (other than bicycle commuting) on a tax-free basis through an employer-sponsored salary reduction program. Correspondingly, tax-exempt employers will be taxed on the value of providing qualified transportation fringe benefits, such as payments for public transportation or the cost of employer owned parking facilities, by treating the funds used to pay for the benefits as unrelated business taxable income.

Winston Takeaway

We anticipate that employers will continue to offer these popular benefits, since the ability to pay for qualified parking on a pre-tax basis will still benefit employees who can exclude these amounts from income. There is uncertainty whether the contributions made by employees to pay for pre-tax transportation benefits through salary deferrals would also be nondeductible to the employer. If it turns out that employers may continue to deduct pre-tax contributions made by employees, it is likely that employers who previously subsidized mass transit and parking may exclusively switch to employee pre-tax contribution programs. Elimination of this deduction may have less impact on employers now that the corporate tax rate will be reduced to 21% in most cases. Note that some cities, such as Washington, DC, New York, and San Francisco, require employers to maintain these type of programs, so employers should take care to review local ordinances before terminating transportation fringe benefit programs.

Commuting Benefits

In addition to the exclusion from income for transportation benefits, three different types of commuting benefits may be excluded from an employee's income as a "de-minimis" fringe benefit: monthly transit pass benefits of $21 or less, occasional overtime transportation, and value over $1.50 for non-control employee "unusual circumstances" transportation for safety concerns. Furthermore, even where the value of commuting is not excluded from an employee's income, employers often provide commuting benefits to executives that live in one location and work primarily in another. The 2017 Tax Reform Law adds a new Code Section 274(l), which disallows any deduction for commuting expenses unless due to the safety concerns for the employee.

Winston Takeaway

The new Section 274(l) denial of deduction for non-safety concern commuting is in addition to the new denial of deduction for transportation benefits. It is unclear whether the new disallowance would apply in instances where the commuting expenses are included in the employee's income (generally where amounts are not excluded as de-minimis fringe benefits). For example, employers providing a car service to executives commuting from home to office are required to fully tax the executive on the value of the car service. If new Section 274(l) denied the deduction to the employer, the employer likely would simply pay a cash amount to the executive to pay for the car service directly. It would appear the more appropriate result would be to provide the deduction to the employer where the amounts are taxable to the employee, similar to the treatment for spousal travel or club dues provided in the Section 274 regulations.

Deduction for Entertainment, Amusement and Recreation

The 2017 Tax Reform Law disallows deductions for entertainment, amusement, or recreation activities even if directly related to or associated with the active conduct of the taxpayer's trade or business for amounts paid or incurred after 2017. However, important exceptions to this general 100% disallowance rule that existed prior to the 2017 Tax Reform Law remain, including entertainment imputed as income to employees or independent contractors, food and beverages provided on employer business premises, business meetings of employees, stockholders, agents or directors (including partners), and goods, services, or facilities available to the public. The 50% limit (with respect to entertainment) that previously applied to some of those exceptions has also been repealed.

Winston Takeaway
The new disallowance for entertainment, even if provided in a business context, means that typical client or customer entertainment expenses such as golf, sporting events, and galas, are not deductible. However, because the 50% disallowance no longer applies specifically to entertainment and will only apply to meals, those non-meal entertainment expenses that are allowed due to the pre-existing exceptions, such as employee business meetings, means that employers are now permitted to deduct 100% of those expenses.

Deduction for Meals, Food and Beverages

As described above, entertainment expenses are now generally 100% disallowed unless one of the pre-existing exceptions apply. Meals, food, and beverages, as under prior law, are included in the new modified 100% disallowance for entertainment expenses if the meals, food, and beverages are considered "entertainment". In addition, beginning in 2018, the 2017 Tax Reform Law will impose a 50% limitation on the deduction of food and beverages that can be excluded as de- minimis fringe benefits, including the operation of an employee cafeteria on or near the employer's business premises. Beginning in 2026, the deduction for employee cafeterias and deductions for meals furnished for the employer's convenience on the employer's business premises is eliminated completely.

Winston Takeaway

The change in the 100% disallowance applicable to business-related entertainment expenses will challenge taxpayers to identify which expenses constitute entertainment. Particularly difficult will be business-related travel expenses and meals. For example, a trip to meet with a customer to attend the Super Bowl may result in the cost of the transportation being treated as 100% non-deductible. Also at issue would be the cost of dining with business associates, including clients and customers. No longer can it be taken for granted that business-related meals are subject to a 50% disallowance; a 100% disallowance applies if the meals constitute entertainment. This is because entertainment expenses, even if related to business, are now 100% non-deductible, absent one of the exceptions from that rule as set forth in Section 274(e), none of which apply to the typical client entertainment.

Employee Achievement Awards

Beginning in 2018, length of service and safety employee achievement awards described in Section 274(j) of the Code, are clarified as not including cash, gift coupons, general gift certificates, vacations, meals, lodging, tickets to sporting or theater events, securities and other similar items, but willinclude a gift certificate to select specific items of tangible personal property.

The current exemption from the definition of deferred compensation for length of service awards for volunteers for certain tax exempt and government qualified services (defined as firefighting and prevention services, emergency medical services, and ambulance services) is increased from $3,000 to $6,000 per year, and is subject to cost of living adjustments in the future.

Winston Takeaway

The popular length of service and safety award deductions and income exclusion are not significantly changed, as the statutory definition of the kinds of awards that will qualify reflects the pre-existing IRS position. The length of service awards exemptions from the definition of deferred compensation for emergency service volunteers is clearly favorable.

Moving Expenses

Beginning in 2018 and sunsetting in 2025, the exclusion from income for qualified moving expense reimbursements is repealed. Similarly, an individual will not be able to deduct his or her moving expenses, except for members of the Armed Forces on active duty or who move pursuant to a military order. However, the tax rules for employer-provided housing for the convenience of the employer under Section 119 of the Code remain unchanged.

New Credit for Employer-paid Family and Medical Leave

The 2017 Tax Reform Law creates a new tax credit for wages paid by employers in 2018 and 2019 to employees while on family and medical leave, as defined by the Family and Medical Leave Act (FMLA). While the FMLA currently provides for job-protected leave to care for a family member or an individual's own serious medical condition and in certain other circumstances, federal law does not currently require such leave to be paid. The new credit is available to employers who provide "qualifying employees" no less than two weeks of annual paid family and medical leave providing at least 50% wage replacement to employees. A "qualifying employee" is defined as an employee who has been employed by the employer for at least one year and who for the preceding year did not have compensation in excess of 60% of the compensation threshold for highly compensated employees (for 2018, 60% of $120,000, or $72,000).

To be eligible for the credit, an employer must have a written policy that provides at least two weeks of family and medical leave paid at a level of at least 50 percent of regular earnings. The tax credit will range from 12.5 percent to 25 percent of the cost of each hour of paid leave, depending on how much of a worker's regular earnings the benefit replaces. Vacation leave, personal leave, or other medical or sick leave would not be considered family and medical leave, and leave paid for or mandated by a state or local government may not be taken into account for purposes of the credit.

Winston Takeaway

Employers are already grappling with an array of state and local paid leaves laws and ordinances. While favorable, the federal tax credit for employer paid family and medical leave will add another factor to be addressed and coordinated with respect to these programs.

Affordable Care Act Provisions

Individual Mandate Repeal

The 2017 Tax Reform Law reduces the individual mandate penalty to zero beginning in 2019. Accordingly, for tax year 2019 and later, individuals will not be penalized for failure to be covered by adequate health insurance. The Congressional Budget Office (CBO) has estimated that the elimination of the individual mandate would reduce the federal budget deficit by $314 billion over 10 years by decreasing federal outlays for premium subsidies. It also has the added effect of raising premiums in the individual market as healthy individuals will no longer have a tax incentive to obtain insurance. The CBO also estimated that the number of insured individuals in the individual market would decline by around 4 million people in 2019 and 13 million in 2027 as a result of the elimination of the individual mandate. For 2017 and 2018, the individual mandate for those who are not exempt remains and is calculated as the greater of: (i) the flat dollar amount ($695 per adult not to exceed $2,085 per family); and (ii) 2.5% of the excess of the taxpayer's household income for the taxable year over the threshold amount of income for requiring the taxpayer to file an income tax return, not to exceed the national average annual premiums for bronze level health plans for the applicable family size offered through Exchanges that year.

Winston Takeaway

Employers had also hoped for relief from the employer mandate, but this mandate and the related reporting requirements are still currently in effect and being actively enforced by the IRS. See our prior client alert regarding IRS enforcement of the ACA employer mandate requirements here. Elimination of the individual mandate may discourage healthier individuals from obtaining health insurance, thereby introducing instability into the individual market resulting in increased premiums. Increased cost and uncertainty will make both the private individual market and public exchanges a less viable option for employers to address health insurance needs of their retiree and part-time populations. Fewer individuals with insurance may also result in an increase in uncompensated care, which could result in increased provider costs for remaining payers in the system. Further, inclusion of the individual mandate repeal in the tax bill will make it more complicated to pass efforts to repeal/delay the Cadillac tax and/or employer mandate. It remains to be seen whether a budget bill will serve as a viable vehicle for such efforts or whether separate legislative efforts in 2018 will be required.

Medical Expense Deduction Expansion

The 2017 Tax Reform Law returns the medical expense deduction to its pre-ACA level with some minor modifications. Under the 2017 Tax Reform Law, the floor for itemizing deductions for qualifying medical expenses is reduced to 7.5% of adjusted gross income for tax years 2017 and 2018 (it was raised to 10% under the ACA). In 2019, the 7.5% AGI floor will sunset and only taxpayers age 65 and over will be able to use this lower amount, with pre-65 taxpayers subject to the higher 10% floor.

Winston Takeaway

There will be even fewer taxpayers who itemize deductions under the 2017 Tax Reform Law as the ability to reduce taxable income via personal exemptions was replaced by the following newly increased standard deductions: (i) $12,000 for single and married filing separately taxpayers; (ii) $18,000 for head of household; and (iii) $24,000 for married individuals filing jointly (all indexed) until 2026, when the proposed increases are scheduled to sunset. Therefore, the new expansion will not affect many taxpayers.

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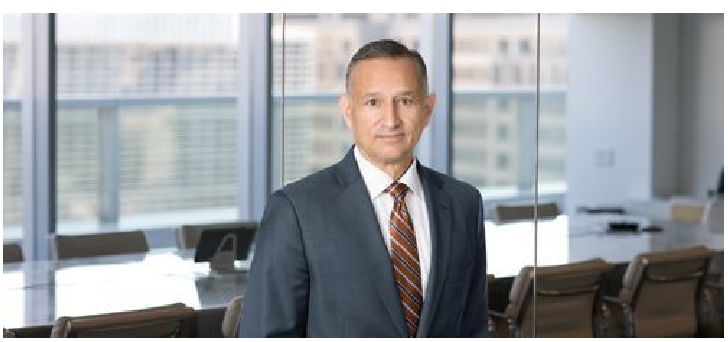

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