

The Impact of the 2017 Tax Reforms on Employment-Based Benefits and Tax-Favored Compensation

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Whenever the United States Congress takes up “tax reform,” there always is a danger that the Congress will pay for such tax reform, in part, by eliminating many of the tax incentives that enable employers to provide executives and rank-and-file employees with tax-favored benefits, or provide executives and others with the opportunity to defer compensation. After all, the two largest tax expenditures in the federal budget are for (1) employer-provided health insurance and (2) amounts “saved” for retirement under any form of tax-favored pension or profit-sharing plan or Individual Retirement Account (“IRA”).

The tax reform discussions that took place in 2017 were no exception. Early proposals, advanced in both the House of Representatives and the Senate, would have completely upended the tax rules governing how most highly paid workers are compensated, including changes to deferred compensation and equity-based compensation (such as stock options and restricted stock units). Many of those proposals were excluded from the final package that emerged from the House-Senate Conference Committee.

But not everything got left out. Important changes were made and are now part of the final tax reform package, popularly known as the Tax Cuts and Jobs Act (“the Act”), which was signed into law by President Donald J. Trump this morning. Some of the changes are narrowly drawn and only affect certain kinds of taxpayers and organizations, such as tax-exempt organizations and public companies, and the high-level executives they employ. Other changes are more broad-based and apply to anyone with a 401(k) plan or IRA, including a few changes that actually provide relief. Most important, the broader structural changes being made to the federal tax laws – such as those that lower the effective tax rates on business organizations while imposing greater burdens on some tax-exempt organizations – may well alter the way such organizations decide to compensate their

employees (and in particular, their executive employees) and how they deal with pension, profit-sharing and other benefit plan matters.

Our benefits group has prepared this high-level analysis to bring these changes to your attention, explain them and when they each generally take effect, and provide some insight into the opportunities (or burdens) that each one creates.

Expansion and extension of limit on the corporate deduction for compensation in excess of \$1 million

The current limitation on deductions imposed on public companies for executive compensation in excess of \$1 million (sometimes referred to as the “Million-Dollar Cap”) will be significantly expanded under the Act, in terms of the type of compensation which will be applied against the cap, the individuals who will be considered covered employees and the type of employers which will be subject to the deduction limitation.

The Act conforms the definition of “covered employee” under Internal Revenue Code (the “Code”) Section 162(m) to align with the current Securities and Exchange (“SEC”) reporting rules. An employee who is the principal executive officer or principal financial officer at any time during the year, plus the three highest-paid officers during the year, will be covered employees.

More significantly, the Act expands the group of individuals who are treated as covered employees to include, for all future years, anyone who in 2017 or in any year thereafter is treated as a covered employee. Thus, once an individual becomes a covered employee, he or she will remain a covered employee, and any amounts payable to the covered employee, or his/her beneficiaries

thereafter will be subject to the annual Million-Dollar Cap on deductibility. This change in the covered employee determination from a yearend snapshot determination to a permanent status means that amounts which were previously outside the bounds of the Million-Dollar Cap calculation will now fall within its scope, such as:

- severance payments, consulting fees and directors' compensation payable to former executives in years following retirement or other termination of employment; and
- deferred compensation amounts and nonqualified retirement benefits, including amounts payable to a spouse or other designated beneficiary.

The Act also expands the type of remuneration which must be included when determining the Million-Dollar Cap on deductions by eliminating the long-standing exclusion for commissions and qualified performance-based compensation. Stock options, stock appreciation rights and amounts payable under a compensation committee-established objective formula, which in the past would be disregarded when applying the Million Dollar Cap, will now have to be included in the calculation of the deduction limit.

Finally, the Act also expands the type of employers that will now be subject to the Million-Dollar Cap. In addition to those corporations whose common stock is publicly traded, companies with any stock or debt which is publicly traded, including foreign companies whose stock is effectively traded through the American Depository Receipt System, or which are otherwise treated as Reporting Companies under Section 15(d) of the Securities Exchange Act, will now be subject to the limitation on deductions on compensation.

The Act contains transition provisions making the new rules inapplicable to compensation paid to an executive under a written binding contract which is in effect on Nov. 2, 2017. However, that transition relief is lost if the contract is subsequently materially modified.

Employers who will be subject to these new rules under Code Section 162(m) will want to assess how best to respond to the rules' expanded reach. The loss of the performance pay exclusion from the Million Dollar Cap may cause some employers to reassess the formalities of their current executive bonus programs. Other employers may wish to use this change as an opportunity to re-evaluate the current mix of their total executive compensation packages. The ramifications of any changes – including the possible loss of grandfathered status under the transition rules – should be carefully considered prior to implementation.

New taxes affecting tax-exempt organizations

To mirror the effect of the elimination of the performance-based exception to the \$1 million deduction limitation on compensation payable by certain taxable entities, the new tax law imposes a 21 percent excise tax on “remuneration” above \$1 million paid to “covered employees” of “applicable tax-exempt organizations.” The excise tax also applies to certain excess “parachute payments.”

- An **applicable tax-exempt organization** (“ATEO”) subject to the tax includes any organization exempt from tax under Code § 501(a), which notably includes charities, most hospital systems, and numerous trade associations and sports leagues like the NFL, Major League Baseball and the U.S. Chamber of Commerce as well as farmers' cooperatives.
- **Covered employees** include any current or former employee who is one of the five highest-paid employees of the organization for the taxable year, or was one of the five highest-paid employees for any preceding taxable year, beginning with employees who meet the standard in 2017.
- **Remuneration** includes wages paid by the ATEO or any related entity, including deferred amounts that are taxable upon vesting under Code § 457(f), even if not yet payable. Generally, an entity is considered “related” to the ATEO if controlled by the ATEO or by the same persons who control the ATEO, or if the organizations are supporting organizations under the public charity rules.
Of particular importance for large tax-exempt organizations in the healthcare sector, the excise tax does **not** apply to remuneration paid to a licensed medical professional for the performance of medical services. If a licensed medical professional provides other (i.e., administrative) services to the organization, remuneration for those services will be subject to the excise tax, if applicable.
- A **parachute payment** is any payment to a covered employee that is contingent on the employee's separation from employment and has a present value equal to or exceeding three times the “base amount,” which is the average annualized compensation includible in the covered employee's gross income for the five taxable years ending before the date of the employee's separation from employment. The excise tax applies to the excess of any parachute payment over the base amount – not the excess over three times the base amount.

The ATEO that is the employer is generally liable for the excise tax. However, if a covered employee receives remuneration from multiple related entities that in total exceeds \$1 million, each entity will be liable for a pro rata share of the excise tax. Thus, the tax cannot be avoided by having multiple affiliated entities each pay a portion of the compensation under the \$1 million threshold. It is not yet clear, however, whether multiple affiliated entities are also separately subject to the tax for their respective top five highly paid executives, or if the tax will apply only on a controlled group basis. If each entity is subject to the tax independently, it would then clearly be preferable to have all employees with remuneration above \$1 million employed by the same entity in the affiliated group.

Consistent with the elimination of the deduction for expenses related to certain fringe benefits, the Act also changes how tax-exempt organizations should treat those expenses. Under the new provision, unrelated business taxable income (“UBTI”) must include a tax-exempt organization’s expenses for the following fringe benefits: a qualified transportation fringe, a parking facility used in qualified parking, and an on-site athletic facility.

New qualified equity grants

The Act creates a new “Qualified Equity Grant” by adding Section 83(i) to the Code to allow employees of nonpublicly traded companies to elect to defer taxation of stock options and restricted stock units (“RSUs”) for up to five years after the exercise of such stock options or the vesting of RSUs.

Under new Code Section 83(i), rank-and-file employees of such private companies may elect to defer the recognition of income (i.e., taxation) from “qualified stock” until the earliest of (1) the first date the stock is transferable; (2) the date the employee becomes an “excluded employee”; (3) the first date the stock becomes readily tradable on an established securities market (presumably upon a merger with a public company or an Initial Public Offering (“IPO”)); (4) the date that is five years after the stock is “substantially vested” (i.e., the employee’s right to the stock is transferable or is not subject to a substantial risk of forfeiture, whichever occurs earlier); or (5) the date the employee revokes the election.

An “excluded employee,” who may not defer the recognition of income under this new Code Section, is any employee who is (1) a 1 percent owner at any time during the current, or 10 preceding, calendar years; (2) currently, or has at any time been, the CEO or CFO or an

individual acting in such capacity; (3) a family member of an individual described in clause (2); or (4) one of the four highest-compensated officers of the company for the current, or any of the 10 preceding, tax years.

The election to defer income recognition applies only to “qualified stock,” which includes any stock of a company received in connection with the exercise of an option or in settlement of an RSU, and the option or RSU is granted in connection with the performance of services and in a year in which the company is an “eligible corporation.” Qualified stock may also include stock received under an incentive stock option (“ISO”) or employee stock purchase plan (“ESPP”); however, if an employee elects to defer income recognition under this new Code Section on such stock, such ISO and ESPP options will no longer be considered statutory stock options. If an employee can sell or receive cash in lieu of the stock at the time it is substantially vested, then it is not “qualified stock.”

In order to be an “eligible corporation,” the stock of the company may not be readily tradable on an established securities market during any previous year, and the company must have a written plan under which not less than 80 percent of all employees who provide services in the U.S. are granted options or RSUs with the same rights and privileges. However, the number of shares made available to all employees under such a plan need not be equal, so long as the number of shares available to each employee is more than a de minimis amount.

Under Code Section 83(i), the employer is required to provide an employee with notice of eligibility to make a deferral election at the time (or a reasonable period before) the employee’s right to the qualified stock is substantially vested, and the employee must make such election no later than 30 days after the qualified stock is substantially vested. The election is valid only for income tax purposes; the application of Federal Insurance Contributions Act (“FICA”) and Federal Unemployment Tax (“FUTA”) is not affected.

In the tax year the deferred amount is required to be included in the employee’s income, the employer is required to withhold at the highest individual income tax rate. The employer is also required to report on the Form W-2 the amount of the election deferral in the year of the election as well as the year the deferral is included in the employee’s income. Finally, the employer will be required to report annually on the Form W-2 the aggregate amount deferred under such an election.

The new Code Section will apply to options exercised or RSUs settled after Dec. 31, 2017.

Changes impacting retirement plans and individual retirement accounts

Repeal of ‘recharacterization’ of Roth IRA conversions

The Act eliminates the ability of an individual to recharacterize or “unwind” the direct transfer or conversion of amounts that had been rolled over from a traditional IRA into a Roth IRA. However, the Act does not eliminate the ability to recharacterize contributions (i.e., contributions that were not part of a direct transfer or conversion rollover) made to a Roth IRA by transferring the contribution back into a traditional IRA, or vice versa. The repeal of recharacterizations is effective for direct rollovers from, or conversions of, traditional IRAs into Roth IRAs occurring in taxable years after Dec. 31, 2017.

Extended rollover periods for deemed distributions of retirement plan loans

When a participant of a retirement plan defaults on a plan loan, the participant is deemed to have received a taxable distribution to offset the outstanding unpaid loan balance. Because this “offset” amount is treated like an ordinary distribution, the participant could make a tax-free rollover contribution to, for example, an IRA within 60 days of the deemed distribution. The Act extends this rollover period for plan loan offsets from 60 days to the due date (including extensions) for filing the federal income tax return for the taxable year in which the offset or deemed distribution is received. The rollover period extension applies only to participants who defaulted on a plan loan due to termination of the plan, or failure to repay a loan due to the participant’s severance from employment. The extension of the rollover period applies to loan offset amounts that are treated as distributions in taxable years beginning after Dec. 31, 2017. The extension applies to plan loans provided by tax-qualified retirement plans, Section 403(b) plans and Section 457(b) governmental plans.

Tax relief for retirement plan distributions to relieve 2016 major disasters

The Act provides tax relief for certain distributions on or after Jan. 1, 2016, and before June 1, 2018, from eligible retirement plans to participants who were impacted in 2016 by any of the 36 presidentially declared “major disasters,” including Hurricane Matthew. The aggregate

distributions from all eligible retirement plans eligible for tax relief is \$100,000. The tax relief includes the following points:

- relief from the 10 percent early withdrawal tax and from the 20 percent mandatory income tax withholding;
- the distribution will be exempt from certain statutory limitations, such as 401(k) plan restrictions on taking distributions of pretax deferrals before age 59-1/2;
- taxable income from the distribution may be spread out ratably over three years; and
- any portion of the distribution may be recontributed as a “rollover” to any eligible retirement plan to which a rollover can be made within a three-year period from the year of the distributions.

Any retroactive plan amendments made to adopt the tax relief provided by the Act (or by a regulation issued thereunder) may be made by the last day of the first plan year beginning after Dec. 31, 2017.

Other business tax reforms affecting employers and workforce benefits

The following changes are notable for employers and their workforce and will generally be effective after 2017, unless otherwise indicated.

New credit for paid family and medical leave

Currently, employers receive no tax credit for providing paid family and medical leave to employees. Now, eligible employers can claim a business credit equal to 12.5 percent of the wages paid to qualifying employees on family and medical leave who are receiving 50 percent of their normal wage. The credit increases if the employee is paid more than 50 percent. An eligible employer is one with a written policy in place that allows eligible full-time employees at least two weeks of annual paid family and medical leave (and less-than-full-time employees a commensurate pro rata amount of paid leave). Employees are eligible if employed for at least one year, and in the preceding year did not have compensation greater than 60 percent of the threshold for determining highly compensated employees (i.e., \$120,000 for 2017). Family and medical leave is as defined under the Family and Medical Leave Act. Paid leave provided as vacation leave, personal leave, or other medical or sick leave would not qualify. The maximum amount of family and medical leave that may be claimed for this credit with respect to a qualifying employee is 12 weeks per year. This credit is part of a pilot program and only applies to wages paid in tax years 2018 and 2019.

Elimination of deductions for entertainment expenses, transportation benefits and certain meals

Employers can no longer take a deduction for entertainment, amusement or recreation expenses related to their business for social club membership dues; or for a facility used in connection with any of the foregoing. Additionally, employers can no longer take a deduction for providing qualified transportation fringes or for expenses incurred for providing transportation for commuting between an employee's residence and place of employment except for ensuring the safety of an employee.

Under current law, employers may deduct expenses for meals provided through an eating facility that constitutes a de minimis fringe benefit for the benefit of the employer. The Act imposes a new 50 percent limitation on this deduction beginning in 2018, and eliminates the deduction altogether beginning in 2026.

Modification of deduction for employee achievement awards

The Act excludes from the definition of "employee achievement award" the following items: cash, cash equivalents, gift cards, gift certificates, vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities, and other similar items. Such items are not excludable from the employee's gross income as deductible employee achievement awards.

Other changes to fringe benefits affecting employee deductions and taxable income

The Act also makes changes to individual deductions and exclusions for certain employer-provided benefits, including the following:

- suspends the exclusion from gross income and wages for employer-provided qualified bicycle commuting reimbursements for taxable years 2018 through 2025;
- suspends the exclusion from gross income and wages for employer-provided qualified moving expense reimbursements and the deduction by an individual of moving expenses incurred when starting a new job in a new location at least 50 miles farther from the employee's former residence for taxable years 2018 through 2025; and
- lowers the medical expense deduction threshold for those who have yet to attain age 65. For taxable years 2017 and 2018, individuals may take an itemized deduction for unreimbursed medical expenses to the extent such expenses exceed 7.5 percent of adjusted gross income.

ACA changes/repeal of individual mandate

The "individual mandate" – the requirement that all U.S. citizens have health insurance that meets certain minimum standards (known as "minimum essential health coverage") or pay a penalty – has been a political lightning rod since the Affordable Care Act ("ACA") was enacted in 2010. It now is being eliminated, effective Jan. 1, 2019. That means the individual mandate, and the penalty for failing to have minimum essential health coverage each month, **will remain in effect throughout 2018**. Elimination of the individual mandate, and the penalty it nominally imposed, is expected to actually help save taxpayers money (approximately \$80.8 billion through 2022 and \$314 billion through 2027), by reducing the number of individuals who purchase taxpayer-subsidized coverage in order to avoid the individual mandate penalty.

So what does the elimination of the ACA's individual mandate, and its related penalty, mean for individuals and for employers? For individuals, it will remove the pressure to have health coverage that meets minimum standards, or to have any health coverage at all – but only starting Jan. 1, 2019. Until then, individuals still face the possibility of having to pay a penalty if they do not satisfy the requirement. Whether the removal of the individual mandate will prompt millions of Americans to choose to go without coverage or simply choose less expensive (and less extensive) coverage cannot be known. And while the president, last January, issued an executive order directing federal agencies to exercise discretion to reduce the burden of the ACA, it did not repeal the ACA. That means individuals will have to reckon with the requirement for now.

The impact on employers can be expected to be pronounced, and it is likely to come from several sources. First, the elimination of the individual mandate penalty could reduce the tendency on the part of some COBRA-qualifying beneficiaries to elect to remain on their employer's group health plan. Second, employers that purchase fully insured coverage for their eligible employees, or provide employees with an allowance to purchase coverage, could well find that the elimination of the individual mandate penalty will both (1) reduce the pressure their employees now face to have, or purchase, minimum essential health coverage, and (2) make all insured coverages more expensive due to the losses health insurers are likely to experience as more and more healthy individuals decide not to buy coverage (or buy less extensive coverage).

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Sen. Roy Blunt (R-MO) at BakerHostetler's 28th Annual Legislative Seminar on April 26, 2017.



Rep. Peter Roskam (R-Ill.), chairman of the House Ways and Means Subcommittee on Tax Policy, talks tax reform at BakerHostetler's 28th Annual Legislative Seminar on April 26, 2017.

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