Executive Compensation, Employee Benefits and ERISA Alert

November 8, 2017

Tax Cuts and Jobs Act

On November 2, 2017, the Committee on Ways and Means of the U.S. House of Representatives released its tax reform bill titled the Tax Cuts and Jobs Act (the "House Bill"). On November 6, 2017, Kevin Brady, Chairman of the House Ways and Means Committee, introduced an amendment in the nature of a substitute (the "Amendment") to the House Bill, which the Ways and Means Committee approved along party lines. Below is a summary of the material executive compensation and employee benefits provisions of the House Bill and the Amendment.

Nonqualified Deferred Compensation

Under the House Bill, the existing deferral rules under Section 409A[1] and Section 457A would be repealed and replaced with a new Section 409B, which will apply to amounts that are attributable to services provided after December 31, 2017.

Under Section 409B, any compensation deferred under a "nonqualified deferred compensation plan" is includable in income when the compensation is no longer subject to a "substantial risk of forfeiture" (i.e., at the time of vesting rather than at the time of payment).

- For purposes of Section 409B, "substantial risk of forfeiture" generally has the same meaning as in former Section 457A, which includes only service-based conditions (i.e., the future performance of substantial services). Under the House Bill, a condition related to a purpose of the compensation other than the future performance of substantial services (such as a condition based on achieving a specified performance goal) does not create a substantial risk of forfeiture, regardless of whether the possibility of forfeiture is substantial. Accordingly, popular vesting conditions, such as EBITDA targets, return on equity or a change in control, would no longer qualify as a substantial risk of forfeiture absent an attached service-based condition (i.e., a service provider must be employed on the date of the attainment of the vesting condition). In addition, a covenant not to compete does not create a substantial risk of forfeiture.
- A "nonqualified deferred compensation plan" is defined broadly under the House Bill and includes any plan, agreement or arrangement that provides for the deferral of compensation other than:
  - A tax-qualified employer plan (e.g., 401(k))
  - Any bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plan

[1] "Section" references are to the Internal Revenue Code of 1986, as amended.

- Any other plan or arrangement designated by the IRS that is consistent with Section 409B.

Customary executive compensation arrangements may be significantly impacted under the House Bill, as follows:

- Traditional deferred compensation arrangements for senior executives (e.g., SERPs, excess benefit plans, top-hat plans) may result in accelerated tax.
- Severance arrangements that provide for the payment of compensation that extends beyond 2.5 months following the year of termination may result in accelerated tax, notwithstanding that severance is paid ratably over time (e.g., severance is paid ratably over 24 months following a termination without cause).

Under the House Bill, a "nonqualified deferred compensation plan" also includes plans that provide a right to compensation (whether in cash or equity) based on the value of, or appreciation in the value of, equity interests. It also appears to include stock options and stock appreciation rights (SARs) (and similar arrangements involving non-corporate entities). Unlike under Section 409A, all stock options and SARs would be considered "non-qualified deferred compensation" and not just those granted with a per-share exercise price that is less than the fair market value of the underlying equity on the date of grant. A "nonqualified deferred compensation plan" does not include the portion of a plan that consists of a transfer of property under Section 83 (e.g., restricted stock and profits interests granted by entities taxed as partnerships).

- Except with respect to certain Qualified Equity Grants addressed by the Amendment and discussed below, it appears that stock options, SARs and restricted stock units (RSUs) would be taxed when they are no longer subject to time-based vesting (rather than at the time of exercise or settlement).
  - It is unclear how stock options and SARs would be valued under the House Bill for purposes of income inclusion (i.e., whether valued based on their intrinsic (in-the-money) value, Black-Scholes value or some other value). Stock options and SARs would likely need to be designed such that exercise coincides with time-based vesting.
  - RSUs would likely need to be settled upon vesting as opposed to payment (which would make them more like restricted stock). This can create significant timing issues, especially in the context of entities whose equity is not liquid or otherwise tradable.
- It is unclear if tax-favored incentive stock options and employee stock purchase plans established under Sections 421 and 423 would be subject to different tax treatment.
- In addition, the House Bill could impact "phantom" carry plans typically sponsored by investment fund managers for their investment professionals. For example, if an employee was promised a bonus upon the disposition of certain assets, provided that there was gain, if such bonus is payable regardless of whether the employee is still in service, that bonus could be subject to taxation based on the value of this contractual right prior to the payment to the individual.

- It is unclear whether the House Bill applies to both cash and accrual method taxpayers. Accordingly, even realization-based and multiyear performance fee arrangements typically maintained by investment fund managers with their clients could be impacted absent a service-based condition.

Grandfather Rule for Existing Arrangements

- For existing arrangements where nonqualified deferred compensation is attributable to services performed before January 1, 2018, to the extent that such amounts are not taxable before 2026, such amounts must be included in income in the last taxable year beginning before 2026 (or, if later, the taxable year in which the amounts are no longer subject to a substantial risk of forfeiture).
  - It is unclear how the IRS would determine the period to which service should be attributed.
    - Under IRS Notice 2009-8, Q&A 23, which applied to an analogous issue under Section 457A, the IRS indicated that, if deferred compensation is still subject to vesting, the deferred compensation must be attributed to a service period on a pro-rata basis. Notice 2009-8 did allow for the waiver of vesting conditions such that the entire amount could be attributable to pre-457A enactment and hence attain the full benefit of the Section 457A grandfather rule.
    - If similar relief is provided under Section 409B, clients must consider whether to waive vesting conditions on stock options, SARs, phantom carry, RSUs, etc.
- The House Bill provides for the adoption of relief measures by the Treasury Department to amend nonqualified deferred compensation plans to alter timing mechanics to comply with Section 409B and not violate Section 409A’s anti-acceleration rules.

Qualified Equity Grants

Notwithstanding the foregoing, the Amendment would permit certain corporations to issue stock options and restricted stock units to eligible employees, and such awards would be exempt from Section 409B. Eligible employees would be permitted to elect to defer recognition of income for up to five years after an option is exercised and/or a restricted stock unit is settled. This limited relief would apply to only equity arrangements of non-public corporations that have broad employee participation (generally 80% non-de-minimis participation). In addition, this limited relief would not apply to the CEO, the CFO or certain other highly compensated employees. If enacted, this new provision may be useful for private companies that wish to avoid having employees hold actual shares prior to a liquidity event. However, due to certain limitations in the rules, its utility may be limited.

Compensation Deduction Limit for Public Companies

The House Bill would repeal the exceptions to the $1 million deduction limit for commissions and performance-based compensation. Therefore, effective January 1, 2018, compensation paid to a covered employee that exceeds $1 million would not be deductible, even if the compensation was a commission or performance-based compensation. The House Bill also would revise the definition of “covered employee” to include the CFO who was previously excluded (in addition to the CEO and the other three highest-paid employees) and apply to companies that are required to file reports under the Securities

Exchange Act of 1934, as amended, due to public debt issuances. Finally, if an individual is a covered employee with respect to a corporation for a taxable year beginning after December 31, 2016, the individual remains a covered employee for all future years.

Excess Compensation Paid by Tax-Exempt Organizations

Effective as of January 1, 2018, the House Bill would impose a 20% excise tax on compensation over $1 million paid by a tax-exempt organization to any of its five highest paid employees (including former employees). The 20% excise tax also would apply to excess parachute payments paid by the tax-exempt organization to such employees. Under the House Bill, an excess parachute payment generally would be a payment contingent on the employee's separation from employment with an aggregate present value of three (or more) times the employee's base compensation.

Tax-Qualified Retirement Plans

Contrary to recent reports in the media, the House Bill would not place a cap on the amount that employees may contribute to tax-qualified retirement plans on a pre-tax basis.

With respect to tax-qualified retirement plans, the following changes would become effective on January 1, 2018:

- The House Bill would no longer permit individuals to recharacterize traditional IRAs as Roth IRAs (and vice versa).
- All defined benefit pension plans and state and local government defined contribution retirement plans would be permitted to make in-service distributions to participants when they attain age 59½.
- Within one year after the enactment of the House Bill, the IRS would be required to change its guidance to allow employees who take hardship distributions from a defined contribution retirement plan to continue making contributions to the plan.
- Employers would be permitted to allow account earnings and employer contributions (and earnings) to be distributed on account of hardship.
- Employees whose defined contribution retirement plan terminates or who separate from employment while they have plan loans outstanding would have until the due date for filing their tax return for that year to contribute the loan balance to an IRA in order to avoid the loan being taxed as a distribution.

In addition, cross-testing between an employer's defined benefit pension plan and defined contribution retirement plan would be expanded for purposes of the nondiscrimination testing rules. This provision would generally take effect on the date the House Bill is enacted.

Employer-Provided Housing

Under the House Bill, effective as of January 1, 2018, the exclusion for housing provided for the convenience of the employer and for employees of educational institutions would be limited to $50,000 ($25,000 for a married individual filing a separate return). The amount of the exclusion would be reduced for highly compensated employees (i.e., those with income of at least $120,000 for 2017, as adjusted for inflation) by an amount equal to 50% of the compensation amount that exceeds $50,000. The exclusion also would be limited to one residence.

Exclusion of Fringe Benefits from Income

Effective as of January 1, 2018, the following benefits would no longer be excludible from an employee's income:

- Employee achievement awards
- Qualified moving expense reimbursements
- Adoption assistance programs.

Dependent Care Assistance Programs

The Amendment would modify the House Bill with respect to dependent care assistance programs. Rather than repealing the exclusion from income of dependent care assistance programs effective as of January 1, 2018, the Amendment would continue the exclusion through December 31, 2022.

Employer Deduction for Certain Fringe Benefits

Under the House Bill, effective as of January 1, 2018, no employer deduction would be allowed for certain fringe benefits, such as 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.

Moving Expenses Deduction

The deduction for moving expenses would be repealed under the House Bill, effective as of January 1, 2018.

Archer Medical Savings Account

Under the House Bill, effective as of January 1, 2018, no deduction would be allowed for contributions to an Archer Medical Savings Account (MSA), and employer contributions to an Archer MSA would not be excluded from an employee's income. Employees with existing Archer MSA balances would continue to be permitted to roll over their balances to a health savings account on a tax-free basis.

Expenses Attributable to the Trade or Business of Being an Employee

Under the House Bill, effective as of January 1, 2018, a taxpayer would not be allowed an itemized deduction for expenses attributable to the trade or business of performing services as an employee. In addition, the only above-the-line deductions allowed for expenses attributable to the trade or business of being an employee would be those for reimbursed expenses and certain expenses of members of reserve components of the United States military.

Contact Information

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