

Labor and Employment Alert: Compensation and Benefits Issues under Tax Reform

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Jennifer Bibart Dunsizer

Anthony C. Ciriaco

Christine M. Poth

Margaret "Peggy" M. Baron

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The U.S. House and Senate have both passed tax reform proposals, which are currently being reconciled. These proposals will have significant impact on compensation and benefit programs. The table below outlines the proposed changes and potential impact on employers and employees:

Current Law

House Version

Senate Version

Comment

Changes to Code §162(m)

Code Section 162(m) generally limits the deduction recognized by companies with publicly traded stock for compensation in excess of \$1M:

- Allows deduction of "performance based compensation" and commissions, even if in excess of the \$1M cap
- Currently only applies to the CEO and the three next highest paid officers (excluding the CFO)
- Limitation ends when the officer ceases to be the CEO or one of the three highest paid officers

Expands to all SEC issuers (not just companies with publicly traded stock) (§3801)

Substantially similar to House (§13601)

Employers should model the impact of the loss of this deduction and consider:

- Accelerating payment of a portion of performance based compensation for which performance could be certified in 2017 to preserve the deduction
- The mix of performance based (variable) and other (fixed) compensation

When modeling the impact of accelerating payment, the employer should consider the potential tax, employee relations and shareholder relations impacts of any changes to the compensation program

Eliminates exception of performance based compensation and commissions from \$1M deduction cap (§3801)

Substantially similar to House (§13601)

Subjects CFOs to the \$1M deduction cap (§3801)

Substantially similar to House (§13601)

Provides that covered officer status is permanent. In other words, once an individual is a covered officer for any year after 2016, the individual remains subject to the \$1M deduction cap forever. This eliminates one of the most popular compensation strategies (deferring pay in excess of deductible limit until after termination) (§3801)

Substantially similar to House (§13601)

Applies to all compensation paid after 12/31/2017

Generally applies to all compensation paid after 12/31/2016 but excludes amounts paid "pursuant to a written binding contract which was in effect on November 2, 2017" (§13601)

New excise tax on excessive compensation for non-profit executives (New Code §4960)

No current provision

20% excise tax on the non-profit entity for compensation in excess of \$1M paid to its top 5 highest paid executives and on excess parachute payments. Compensation is broadly defined to include amounts paid by related companies. The parachute payment tax would be triggered if an executive receives amounts in connection with termination of employment (excluding amounts paid from retirement plan under 401, 403(b) or 457(b)) in excess of 3 times the executive's average compensation for the 5 years preceding the termination (calculated excluding any compensation that wasn't deductible under 162(m)) (§3802)

Same as House except clarifies that amounts are treated as paid (potentially triggering the tax) when no longer subject to a substantial risk of forfeiture, specifically including 457(f) benefits (§13602)

Non-profit companies should consider the impact of this tax on their compensation structures (including compensation paid by related taxable entities)

Changes to the taxation of fringe benefits

Current law allows employers to deduct entertainment expenses that directly relate to the company's business and further allows employers to deduct 50% of reimbursed employee entertainment expenses (Code §274)

Eliminates employer deduction for entertainment expenses (§3307)

Substantially similar to House (§13304)

Companies that currently utilize these deductions and income tax exclusions will want to model whether the company should continue to provide such benefits on a taxable and/or nondeductible basis

Current law allows employers to deduct the payment of certain membership dues for employees (Code §274)

Eliminates deduction for entertainment related membership dues (§3307)

Substantially similar to House (§13304)

Current law allows employers to deduct the cost of providing a transportation fringe benefit to employees (Code §274) which is not taxable to the employee under Code §132

Eliminates employer tax deduction for transportation fringe benefit (§3307)

Substantially similar to House (§13304)

Current law allows employers to deduct the cost of providing on-premises athletic facilities (Code §274)

Eliminates employer tax deduction on-premises athletic facilities (§3307)

Substantially similar to House (§13304)

Current law allows employers to reimburse employees up to \$13,570 in adoption expenses on a pre-tax basis (Code §137)

Eliminates the tax exclusion so any such adoption assistance would be taxable to the employee (§1406)

No provision

Current law allows employers to reimburse employees for up to \$5,250 of qualified educational expenses on a pre-tax basis (Code §127)

Eliminates the tax exclusion so that any such educational assistance would be taxable to the employee (§1204)

No provision

Companies that currently utilize these deductions and income tax exclusions will want to model whether the company should continue to provide such benefits on a taxable and/or nondeductible basis

Current law allows employers to provide certain awards to employees to recognize achievements (like periods without an accident) or service thresholds on a pre-tax basis and to deduct the cost of such awards (Code §274(j) and §74(c))

Eliminates the tax exclusion so any service or safety awards would be taxable to the employee and also eliminates employer's tax deduction for any such awards (§1403)

Eliminates employer deduction but does not change pre-tax status for employee (§13310)

Current law allows employers to provide up to \$5,000 in child care assistance to employees on a pre-tax basis (Code §129), allows employees to pay for dependent care provided by others on a pretax basis through a dependent care flexible spending account. Current law also allows an employer that provides employees with child care or referral services with a tax credit equal to 25% of the child care expenses and 10% of resource and referral expenses paid (up to \$150k)

Eliminates the tax exclusion so any dependent care expenses would be taxable to the employee effective 1/1/2023. Also eliminates the employers tax credit for company provided child care effective 1/1/2023 (§1404 and §3402)

No provision

Current law allows an employer to deduct the cost of certain substantiated moving expenses of an employee (Code §132(a)(6)) and provides that any such moving expenses reimbursement is not taxable to the employee (Code §217)

Eliminates ability to reimburse moving expenses on a pre-tax basis and corporate deduction for those expenses after 12/31/2017 (§1301 and §1405)

Temporarily eliminates ability to reimburse moving expenses on a pre-tax basis and corporate deduction for those expenses between 1/1/2018 and 12/31/2025 (§11049 and §11050)

Companies that currently utilize these deductions and income tax exclusions will want to model whether the company should continue to provide such benefits on a taxable and/or nondeductible basis

Currently employers are permitted to provide housing to certain employees on a pre-tax basis (Code §119)

Significantly reduces the tax exemption for employees who are required to live in employer-provided housing as a condition of employment. Capped at \$50,000 (\$25k if married filing separately) and reduced for compensation in excess of the HCE limit (\$120k for 2017) (§1401)

No provision

Provisions affecting retirement benefits

Under current law, in-service distributions may not be distributed from a defined benefit plan before age 62 (which is higher than the 59½ age threshold for defined contribution plans)

Allow in-service distributions at age 59½ (§1502)

No provision

No change required but may be advantageous for employers desiring a phased retirement structure

Under current law, defined contribution retirement plans may allow an in-service distribution to an employee if the employee:

- has a financial hardship
- suspends contributions for 6 months
- takes distribution only from employee deferrals (not earnings or employer contributions)

Eliminates 6 month contribution ban and allows distribution of account earnings and employer contributions (§1503 and §1504)

Allows distribution of account earnings and employer contributions but does not affect 6 month contribution ban (§11033(c))

Under current law, if an employee fails to follow the terms of a plan loan, the outstanding loan balance is taxable income. This commonly occurs when an employee terminates employment

Allows rollover until the due date of the employee's tax return for the year (§1505)

Same as House (§13613)

Certain governmental and tax exempt entities may grant length of service awards, not to exceed \$3,000, to volunteers providing fire-fighting, emergency medical and ambulance services (Code §457(e))

No provision

Increases the \$3k limit to \$6k and adjusts that limit for inflation (§13612)

Other new provisions

Currently, stock options are taxable at the time of exercise (unless the option qualifies as an incentive stock option)

Adds the ability to defer taxation on option gains otherwise due on exercise of options on privately held company's stock for 5 years (or an earlier date such stock becomes publicly traded) (Code §83(i)) (§3803)

Similar to House (§13603)

Current law allows taxpayers to recharacterize contributions to a Roth IRA as a contribution to a traditional IRA and to undo a Roth IRA conversion under Code §408A(d)(6)

Repeals the ability to recharacterize Roth IRA contributions and conversions (§1501)

Same as House (§13611)

Currently there is no incentive for employers to provide paid FMLA leave

No provision

New employer tax credit for paid FMLA equal to 12.5% (if 50% of wages paid) – 25% (if 100% of wages paid) of compensation paid during an FMLA leave. Excludes paid leave provided under state or local mandate. Only get credit if provide at least 2 weeks (prorated for part time) of paid FMLA per year (STD programs won't qualify because limited to employee's own illness or injury)