# *Labor and Employment Alert*: Impact of Tax Reform on Employers

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On December 22, 2017, tax reform became official. There were several changes in the final version, including renaming the "Tax Cuts and Jobs Act" to the "Act." The Act will have significant impact on business. This alert focuses on the impact of the Act on employee compensation and benefits programs.

## Impact of corporate tax rate changes

The final Act lowered the top corporate tax rate from 35% to 21%. This dramatic reduction to the corporate tax rate has led many companies to attempt to accelerate deductions into the 2017 tax year. For example, companies are considering funding defined benefit retirement plans, creating guaranteed bonus pools and other strategies to accelerate deductions and to defer income recognition.

## Impact of individual tax rate changes on supplemental wage withholding rates

Under the Act, the individual tax rates are compressed to 7 bands: 10%, 12%, 22%, 24%, 32%, 35% and 37%. This change to the individual tax rates affects the tax rate used for withholding on supplemental wages (like bonuses, equity compensation and similar irregular compensation).

Under Treasury Regulation 31.3402(g)-1 an employer must withhold at the highest rate of tax applicable under Code Section 1 if the aggregate compensation paid is over $1,000,000 for the year. This means that the supplemental wage withholding rate for compensation in excess of $1,000,000 will be at 37% instead of 39.6%.

It is not entirely clear what withholding rate should be used for supplemental wages under $1,000,000. Prior to 1993, Code Section 3402 had provided that an employer could elect to withhold tax on supplemental wages at a rate not less than the third lowest rate of tax applicable under Code Section 1(c). The current version of the regulation requires withholding "using a flat percentage of 28% (or the corresponding rate in effect under section 1(i)(2) for taxable years beginning in the calendar year in which the payment is made)." Prior to

the Act, Section 1(i)(2) substituted 25% for 28%, and 25% is currently the third lowest tax rate.

Because the Act provides that Section 1(i) does not apply, it is not clear whether the appropriate withholding rate for supplemental wages below $1,000,000 remains at 25% or should change to 22%. The Act provided a specific good faith interpretation transition rule until guidance is issued.

## Impact of changes to 162(m)

As expected, the final Act significantly expanded the $1,000,000 deduction limit under Code Section 162 (m). The final Act extended the rule to all SEC issuers (not just companies with publicly-traded stock). A public company's compensation expense deduction will be limited to the first $1,000,000 of compensation paid to the primary executive officer (PEO), the primary financial officer (PFO), the top three highest paid officers (re-aligning the list of covered employees with the list of named executive officers), AND anyone who was a covered employee for any tax year beginning after December 31, 2016. The deduction limit is permanent. It covers all taxable compensation payable to the employee during the employee's life and any death benefits payable after the employee's death.

The final Act also eliminated the exception of performance-based compensation and commissions from the compensation cap. These changes have led companies to consider a number of questions:

### Should you rely on the transition rule?

The final Act contained the transition rule proposed in the Senate for "remuneration which is provided pursuant to a written binding contract which was in effect on November 2, 2017 and which was not modified in any material respect on or after such date." It is not clear how broadly this provision will be interpreted. For example, it is unclear if the typical bonus plan provision (which allows negative discretion to reduce the bonus payable for any reason) would make the bonus not a "binding contract." Many companies have chosen to accelerate payment of bonuses to ensure a deduction, while others are assuming that the implementing guidance will adopt a broad transition to exclude bonuses that will be paid for performance periods that had been established prior to November 2, 2017.

This is an important decision, because many performance measures may be affected by the cumulative effect of the Act's changes. An amendment to change the performance criteria to adjust for these changes would be a material change that would cause a loss of the transition rule (and loss of the corporate deduction). Instead of amending the award, some employers are considering a separate bonus to preserve the grandfathered status of the original award, to make up the value lost because of the changes.

### Should you accelerate compensation that would otherwise become non-deductible for an individual who is expected to become a covered employee for a future tax year?

For a calendar year tax-payer, it is too late to consider changes for the people now subject to the limit, like the current PFO. But there are planning opportunities for fiscal year companies and for companies that project that an individual is likely to become a covered employee in the future. Companies will need to consider the cash flow and incentive implications of pre-paying compensation. But there are obvious tax

savings to the extent compensation can be paid to an individual before the deduction limitation would apply.

## Should you consider changes to your mix of fixed and variable pay?

Because the limitation on the deduction of compensation paid to the PEO, the PFO and the top paid 3 other executive officers now lasts forever, and there is no special exemption for incentive compensation, some companies are taking steps to try to minimize the impact of variable compensation on the top 3 list to limit movement of officers onto the list. There is a benefit to the company to maintain the full deduction for the broadest group of employees, but shareholder and employee relations should be considered.

## Should you continue to maintain a 162(m) compliant compensation subcommittee?

There is no longer any magic to the committee under the tax code. If you currently maintain a 162(m) subcommittee because your independent compensation committee includes members who did not qualify as an outside director for 162(m) purposes, consider whether having that subcommittee structure was valued by shareholders. For example, some shareholders are uncomfortable with a former executive setting the compensation for their successors and would prefer to retain a subcommittee that excludes the former executive.

## Should you consider changes to your deferred compensation plans?

Some employers currently require deferral of compensation that would have been subject to the deduction limitation into a nonqualified deferred compensation plan. Employers are considering the employee relations issues that arise from adopting such a policy for a much broader category of compensation.

Many plans are also structured to pay benefits in a single lump sum the year after an employee terminates employment (when they would have historically no longer been subject to the deduction limitation). Treasury Regulation 1.409A-2(b)(7)(i) permits a plan to delay payments that would not be deductible until the amount could be paid without a loss of the deduction, without triggering 409A's penalties, but there are two important limitations to that rule:

1. The deferral must apply automatically to all amounts that would be limited, or the subsequent deferral rules apply. Under the subsequent deferral rules, a re-deferral election must be made at least 12 months before the amount would have been paid and payment must be delayed at least 5 years from the date it would have been paid.
2. The payments are required to be paid no later than the later of last day of the year in which the employee's employment ends (the executive has a separation from service) or the 15$^{th}$ day of the third month after the date of the separation from service.

We hope that the implementing guidance will expand this rule to allow payments to be delayed until they would be deductible even if significantly after the employee's termination or death.

## Impact of new excise tax on 'excessive' compensation for non-profit executives

The final Act included the new 21% excise tax on tax-exempt employers who pay a covered employee: (1) compensation in excess of $1,000,000 (determined based on pay to that executive by the non-profit and any related company, but excluding compensation for medical or veterinary services by a licensed medical professional), and (2) any excess parachute payments (even if the compensation is less than $1,000,000). Similar to the rules for 162(m) described above, the covered employees are the top five highest paid executives and anyone who has been a covered employee for any taxable year beginning after December 31, 2016.

In this context, an excess parachute payment is any payment that is contingent on the employee's separation from employment with the tax-exempt entity where the aggregate present value of the severance benefits (specifically excluding amounts paid under 401(a), 403(b) or 457(b) plans but including amounts payable under a 457(f) plan) exceeds three times the employee's average wages for the 5 years preceding the termination.

Tax-exempt employers with highly paid employees, and tax-exempt employers who currently have agreements that pay significant severance benefits to executives will need to model the impact of this excise tax on the entity's budget, donors and executives.

## Suspension of pre-tax status for moving expenses

The final Act temporarily eliminated an employee's ability to individually deduct or be reimbursed for moving expenses on a pre-tax basis. This only affects expenses between January 1, 2018 and December 31, 2025.

## Eliminated deduction for transportation fringe benefits

Although the final Act did eliminate a company's tax deduction for transportation fringe benefits, the Act did not change the employee's exclusion from income under Code Section 132. This raised the question, which remains open, whether an employee who elects to have compensation deducted to pay for the transportation fringe benefit would transform that otherwise deductible compensation into a non-deductible expense.

Some jurisdictions (like NYC and DC) require an employer to provide employees with the opportunity to pay for commuting expenses on a pre-tax basis, so employers cannot simply terminate this benefit. We have been compiling a list of such mandates if you are considering this change.

Confirmation that the deduction limitation only applies to an employer's subsidy of a transportation benefit and not the employee's pre-tax compensation election would be appreciated.

## Eliminated deduction for entertainment expenses, membership dues and on-premises athletic facilities

Employers will need to review and potentially modify their expense reimbursement policies in light of the elimination of the company's tax deduction for entertainment expenses, membership dues and on-premises athletic facilities.

## Retirement Plans

The final Act included an expanded ability to roll over amounts attributable to a loan default until the due date of the tax return for the year in which the loan default occurred.

## Narrowing of deduction for employee achievement and service awards

The final Act did not change the pre-tax status of employee achievement and service awards for employees (although cash and gift cards are taxable), and did not fully eliminate the employer's deduction for such benefits (as had been proposed). The final Act did narrow the type of benefit that could be provided on a deductible basis. Employers should consider changes to preserve the deductible nature of the benefit (or intentionally decide to forego the tax deduction) if their program currently includes any of the following types of awards:

Cash

Gift Cards

Vacations

Meals

Lodging

Sports Tickets

Stocks

Bonds

Theater Tickets

## New tax credit for paid FMLA leave

The credit only applies to leave programs that cover all FMLA leave, so short-term disability programs will not qualify. In addition, it excludes any leave provided under a state or local mandate. Because of the significant limitations, we expect that few companies will qualify for this tax credit.

## New rules allowing deferral of option and other stock gains for non-public companies making broad based equity grants

Because the eligibility is limited to privately held companies that grant equity compensation to at least 80% of its employees, we expect this new provision to have limited appeal. There are a number of features that seem potentially problematic. For example, an employee may elect to defer taxation up to 30 days after vesting or exercise, but the company's withholding obligation is usually triggered at the time of vesting or exercise. It is not clear whether that will trigger withholding and then refunds. Guidance will be helpful in hopefully minimizing the administrative issues for this new equity tax alternative.

## Topics not included in the final Act

The final act did not include any of the proposed changes to:

- Change the taxation of deferred compensation,
- Eliminate the tax deduction for educational assistance programs,
- Eliminate the tax deduction for child-care assistance and dependent care flexible spending accounts,
- Eliminate the tax deduction for adoption assistance programs,
- Eliminate the ability of employers to provide housing to certain employees on a pre-tax basis,
- Loosen the retirement plan hardship distribution rules,
- Lower the minimum age for in-service distributions from a defined benefit retirement plan.

## Concluding thoughts

The Act significantly changes the taxation of compensation arrangements. Employers should consider whether adjustments should be made. If you have questions or want more information on the Act, contact your Vorys relationship attorney.