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Tax Reform: Spotlight on Compensation and Benefits Provisions

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The new tax bill (the "Act") − a culmination of months of back-and-forth between the House and Senate Republicans − was signed into law on December 22, 2017. The Act fulfills many of the promises made by the Trump Administration and others in the Republican-controlled legislature, and makes sweeping changes in numerous areas of federal tax law, including the areas of employee compensation and benefits. A summary of a few of the key provisions affecting these areas follows.

Employer Credit for Paid Family and Medical Leave

For 2018 and 2019, "eligible employers" are entitled to claim an income tax credit equal to at least 12.5 percent and up to 25 percent of the amount of wages paid to "qualifying employees" during any period of up to 12 weeks per year during which such employees are on family and medical leave.

For purposes of applying this credit, an "eligible employer" is one that has a written policy in place that meets specified requirements, including a requirement that the rate of pay under the policy is not less than 50 percent of the amount normally paid to the subject employee. The credit increases gradually as the level of paid wages increases.

The employer must offer at least two weeks of paid family and medical leave per year for full-time employees, and a proportionately reduced allowable leave period for part-time employees.

A "qualified employee" is one who has been employed by the employer for at least one year and, for the preceding year, did not receive compensation in excess of 60 percent of an indexing amount specified by the IRS for each year (currently $120,000).

Paid leave for vacation, personal, and all but certain medical reasons will not qualify for the income tax credit, and therefore it is important that employers carefully consider the limitations set forth in the new Act when designing, reviewing, and implementing their paid leave policies in connection with tax planning objectives.

The leave policy must specifically include anti-retaliation or discrimination provisions.

Executive Compensation

Public Companies

Section 162(m) of the Internal Revenue Code of 1986 (the "Code") previously limited the ability of public companies to deduct remuneration for services to $1 million if paid to the principal executive officer and the next four highest-paid executives (other than the principal financial officer) on the last day of the taxable year. "Performance-based" compensation, commissions, certain amounts grandfathered by 1993, and other limited exceptions were not included in the amount that was subject to the deduction limit. The new Act, however, expands the application of this limit in several ways. Companies that are required to file reports under Section 15(d) with the SEC are covered as well as companies with registered securities. Chief financial officers are now included with the chief executive officer as a named "covered employee." The covered employees for any year now include at least the principal executive officer, principal financial officer, and the three other highest-

paid officers. Any person who was ever a covered employee for any prior taxable year beginning after 2016 remains as a covered employee forever, even if no longer an employee. Likewise, beneficiaries of covered employees are treated as covered employees. Covered companies now include those that are required to file reports with the SEC, as well as those with stock that is registered with the SEC. Performance-based compensation and post-termination compensation (including severance and other parachute payments) are also included in the amount that is subject to the limitation.

Importantly, these changes will not apply with respect to binding written contracts entered into and effective on or before November 2, 2017, provided they are not renewed and are not subsequently materially modified. This "grandfathering" exception does not apply after the possible effective date of termination if the contract is terminable at will by either or both parties, unless termination of the contract necessarily involves a termination of employment. Accordingly, companies with public securities or debt should determine whether the exemption applies for existing agreements and use caution when considering an amendment or revision to an existing compensation plan or employment contract for its highly paid executives.

Tax-Exempt Employers

In similar fashion, the new Act subjects an "applicable" tax-exempt organization (a Code Section 501(a), 521(b)(1), 115(l), or 527(e)(1) organization) to a 21 percent excise tax (or the then current corporate income tax rate) on remuneration in excess of $1 million paid to certain "covered employees" other than an excess parachute payment (see the following paragraph). The term "covered employee" includes the five highest-paid employees in the subject tax year, as well as any person who was a "covered employee" in any tax year beginning after December 31, 2016 (in perpetuity). Individuals who are not "highly compensated employees" (an indexing amount, currently $120,000 in a year) are excluded. The term "remuneration" is defined broadly under the Act to include all wages paid during a given tax year, and remuneration is considered "paid" once the employee's right of receipt is no longer subject to a substantial risk of forfeiture. Amounts that vest under a Code Section 457(f) deferred compensation arrangement are included in compensation for this purpose, as is other remuneration that is not subject to a substantial risk of forfeiture (no longer conditioned on the performance of future services), but designated Roth IRA contributions by the employer and contributions to tax-qualified retirement arrangements are not included. There is currently no grandfathering provision for arrangements that are already in place.

A similar excise tax applies separately to excess parachute payments. Parachute payments for this purpose generally include severance payments made to former covered employees if the payment exceeds three times such person's former annualized wages (averaged over a five-year period). In that case, the excise tax applies to the extent the payment exceeds one time the averaged compensation. Certain severance payments are excluded.

This excise tax does not apply, however, with respect to payments made to a licensed medical professional in connection with the performance of medical services by such professional, but compensation for non-medical services would be considered.

Interestingly, many commentators have focused on the impact this excise tax will have on the compensation packages (including buyouts) for coaches of major college football programs, particularly because the income that is subject to the tax includes income from "related organizations." If income from more than one related organization is involved, the tax is apportioned based upon the wages paid by each.

Qualified Equity Grants

The new Act includes a new form of income tax deferral available for most employees who are recipients of qualified equity grants. A deferral is not allowed for the CEO, CFO (or anyone who has ever acted in those

capacities), or family members of those persons, nor for any one percent shareholder or any person who was among the highest-paid officers in the prior ten years. This provision permits a deferral of federal income tax for up to five years in connection with the receipt of "qualified stock" from an "eligible corporation." The deferral option is restricted in some cases if the corporation repurchased any of its stock in the prior year. A deferral election with respect to an incentive stock option eliminates the favorable tax treatment otherwise available for such shares.

The deferral period will end, in any event, if the shares become transferable to the employer or otherwise, or become readily tradable on an established market, the employee revokes the deferral election, or the employee becomes part of the excluded class. The amount included at the relevant time is determined at the time of exercise of an option or vesting of a grant, as applicable, even if the value is lower at the end of the deferral period. The employer is required to withhold taxes at the highest marginal rate at the end of the deferral period.

If the income tax of the employee is deferred, the corporate compensation deduction is deferred until the deferred amount is includable in the individual's income.

Employees must be notified of their deferral right, and a tax of $100 per failure to notify applies (up to $50,000).

For this purpose, "qualified stock" means shares of stock received in connection with an employee's (i) exercise of options or settlement of restricted stock units, and (ii) performance of services during a calendar year in which the employer is an "eligible corporation." Qualified stock does not include any shares of stock that were received by the employee in lieu of a cash payment (at such employee's election).

The term "eligible corporation" includes any corporation or its predecessor that (i) does not have any shares of stock readily tradeable on a public exchange, and (ii) has a written plan in place, under which not less than 80 percent of all full-time employees (30 or more hours per week) of the corporation who perform services to or on behalf of the corporation within the United States (or its possessions) receive stock options or are granted stock units. Options and restricted stock units are treated as separate for purposes of the 80 percent rule. Awards may vary by individual, but all eligible employees must receive more than a de minimis grant.

To be eligible for this deferral, a recipient of qualified stock must make an affirmative election (in the same manner as a Section 83(b) election) within 30 days following the date such stock becomes transferrable or is no longer subject to a substantial risk of forfeiture, whichever occurs first.

Deductions for Payments Related to Sexual Harassment or Abuse

The Act specifically disallows deductions for settlements or payments related to sexual harassment or abuse if such arrangement is subject to a non-disclosure agreement and attorney's fees related to such a settlement or payment. This limitation applies to all amounts paid or incurred after December 22, 2017.

Limitations to Miscellaneous Deductions and Exclusions

The Act significantly curtailed or eliminated the availability of several other exclusions and deductions for fringe benefits previously enjoyed by taxpayers, among which include the following:

- Employee Achievement Awards – The Act generally eliminates employers' ability to provide non-taxable cash or cash-equivalents, gift cards, or certificates that are restricted to gifts selected by the employer, tickets to events, vacations, meals, securities, and other similar items as gifts to employees in recognition of years served and other meaningful recognitions. In many cases, these gifts were previously excludible from the employees' incomes and deductible by the employer.

- Exclusion/Deduction for Moving Expenses – The Act temporarily suspends an employee's ability to exclude from income amounts received from an employer to reimburse moving expenses. Likewise, the Act temporarily suspends the ability of an employer to claim a deduction for amounts paid to employees to reimburse moving expenses. Both of these suspensions apply for tax years beginning after 2017 and before 2026.
- Deduction for Transportation/Commuting – The Act eliminates an employer's ability to deduct most costs incurred in connection with transportation fringe benefits provided to employees for travel between the employee's residence and his or her place of employment, except in the case of transportation provided to employees necessary for ensuring the safety of such employees.
- Deduction for Meals and Entertainment – The Act eliminates all deductions for the costs associated with entertainment, amusement, and recreation, as well as those incurred in connection with membership dues for any club organized for pleasure, recreation, or other social purposes. The Act does, however, permit the deduction of 50 percent of the costs of meals incurred in connection with an employer's business, including on-site dining facilities.

Other Benefit-Related Provisions

- Rollovers of Plan Loan Offset Amounts – Under prior law, if a loan to a tax-qualified plan participant is treated as an offset to the amount distributable, that amount was includable in income unless the individual can provide cash in that amount to roll to an IRA or another plan within 60 days. Under the new Act, if a post-2017 offset results from a termination of the plan or separation from service, a rollover of the offset amount may occur by the due date of the person's federal income tax return (including extensions) for the year which includes the plan termination or separation from service.
- Repeal of Individual Mandate – Effective for months after 2018, the tax penalty under the Affordable Care Act for not maintaining qualified medical coverage is reduced to zero.
- Recharacterization of Roth IRA Contributions – An individual has been allowed to convert funds in a traditional IRA to a Roth IRA, and the IRA owner could revoke a conversion election until the due date for their federal income tax return for the taxable year in which the conversion occurred. After 2017, individuals may no longer revoke a conversion election.

If you have questions regarding the content of this alert, please contact Tyler Ball, Bill Robinson, or any other member of Baker Donelson's Tax Group.