COVINGTON

The Tax Cuts and Jobs Act of 2017: Employee Benefit and Fringe Benefit Provisions

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Employee Benefits and Executive Compensation

The Tax Cuts and Jobs Act of 2017 (the "Act") became Pub. Law 115-97 on December 22, 2017. Many of its more startling provisions have become well known since then. Of less dramatic impact are several provisions affecting qualified employer plans, fringe benefits, and certain kinds of compensation. These provisions are described in this client alert. This client alert also briefly describes changes to the Affordable Care Act wrought by the Act.

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$1 Million Limit on Deduction for Annual Compensation

$1 Million Limit on Deduction for Compensation Paid to Covered Employees

Employers generally may take a tax deduction for reasonable salaries and other compensation paid to their employees. However, section 162(m) of the Internal Revenue Code (the "Code") imposes a $1 million annual limit on the amount of compensation—other than performance-based compensation and commissions—that a publicly held corporation can deduct with respect to each of its "covered employees." The Act substantially revises section 162(m) in ways that will significantly limit the amount of compensation that many public companies will be able to deduct.

Key Changes to Section 162(m)

The Act makes the following key changes to section 162(m):

- Expanded Scope of "Covered Employee." Before the Act, a company had only four "covered employees" at any time: the individuals who were, on the last day of the taxable year, the chief executive officer or one of the three other highest paid officers (but not including the chief financial officer). The Act expands the universe of "covered employees" in two respects: (1) any individual who served as the CEO or CFO at any point during the taxable year, as well as the three other highest compensated officers for the taxable year, is a "covered employee," and (2) once an individual becomes a "covered employee" for any taxable year beginning after December 31, 2016, that individual remains a "covered employee" *for all future years*, including after termination of employment or death.
- No Exception for Performance-Based Compensation and Commissions. Previously, performance-based compensation and commissions did not count toward the $1 million cap and thus generally could be deducted. The Act eliminates these exceptions so that all compensation paid to a covered employee will be subject to the $1 million limit.
- Broader Definition of "Publicly Held Corporation." For past years, only corporations with publicly traded equity securities were subject to the $1 million limit. The Act expands the definition of "publicly held corporation" generally to include (1) all domestic corporations with publicly traded equity or debt, and (2) all foreign companies publicly traded through American depositary receipts. The new definition also applies to certain companies that do not have publicly traded securities but are nonetheless subject to certain securities reporting requirements.

Effective Date and Transition Rule

The provision of the Act amending section 162(m) is generally effective January 1, 2018. Under the Act's transition rule, however, the changes to section 162(m) do not apply to compensation provided pursuant to written binding contracts in effect on November 2, 2017, and not materially modified after that date. This creates a number of tax planning challenges, including:

- Employment Agreements. For purposes of the transition rule, (1) any contract renewed after November 2, 2017, will be treated as a new contract as of the renewal date, and (2) a contract that is terminable unconditionally at will by either party without the other's consent (such as a typical "evergreen" employment agreement) will be treated as a new contract on the first date as of which it could be terminated without ending the employment relationship. Employers should review their existing employment,

severance, change in control, and other similar agreements with their executives to determine whether the agreements are grandfathered under the pre-Act law and, if so, for how long. Employers should also make sure to consider the section 162(m) impact of any potential amendments to grandfathered agreements.

- Incentive Plans. Under prior law, stock options, SARs, and certain other equity awards were not subject to section 162(m)'s limit because they were considered to be "performance-based" by their nature. Companies will want to review their outstanding awards to determine which ones are grandfathered under prior law, and will need to carefully consider whether any amendments to these awards or the applicable equity incentive plans to preserve the grandfathering treatment to the extent desirable.
- Nonqualified Deferred Compensation Plans. Before the Act, payments under nonqualified deferred compensation plans generally were fully deductible because they were typically paid after termination of employment when the individuals receiving these amounts were no longer "covered employees." However, the Act provides that, once an individual is a covered employee he or she retains that status for all future taxable years. Thus, amounts paid under nonqualified deferred compensation plans to covered employees after termination of employment will be subject to the $1 million limit on deductibility unless otherwise excluded under the Act's transition rule.
- Severance. Similar to payments under nonqualified deferred compensation plans, severance benefits were generally fully deductible because they were paid after termination of employment when the individual was no longer a "covered employee." Under the Act, severance payments to covered employees will generally be subject to the $1 million limit because once an individual becomes a covered employee that status now continues after termination of employment. Going forward, companies may have an incentive to spread severance pay over multiple taxable years in order to stay within the limit on deductibility.
- 2017 Bonuses. In order for a 2017 end-of-year bonus to be excludable from the $1 million limit, either (1) the company will have to take the deduction for 2017 or (2) the bonus will have to be deductible under the transition rule. For a company to deduct a bonus for 2017, all events establishing the company's liability for the bonus and the amount of the bonus (or, alternatively, the aggregate amount of all bonuses) would generally had to have been fixed by the end of 2017. Satisfying these requirements can be complicated.

Other Issues

- Proxy Disclosures. Proxy disclosure rules require companies to discuss the material elements of compensation, which may include the impact of the accounting and tax treatments of the particular form of compensation. As a result, many companies include a discussion of deductibility under section 162(m) in their proxy statements. Companies should review this disclosure and consider updating how deductibility considerations impact their executive compensation programs.
- Shareholder Approval of Incentive Plans. To satisfy section 162(m)'s exception for performance-based compensation as it existed before the Act, companies had to have their incentive plans (or at least the performance criteria in the plans) approved by shareholders, generally every five years. Companies previously planning to submit their incentive plans to shareholder approval for this purpose should consider whether to

include plan approval in the upcoming proxy season unless it is otherwise required by the terms of the plan or stock exchange listing requirements.

- Plan Design. Additionally, to the extent companies' incentive plans incorporate provisions designed to comply with section 162(m), these provisions may ultimately be revised or eliminated going forward.
- Corporate Transactions. The changes to section 162(m) could raise a number of issues in the context of a merger, acquisition, or other corporate transaction. For example, changes to outstanding equity awards may remove grandfathering, newly created severance arrangements might not be deductible, and the CEO, CFO, and other officers of the acquired company might become "covered employees" of the buyer under the broad definition of that term in the Act. Companies going public should also consider the impact of these changes on their pre-IPO incentive plans.

Affordable Care Act—Repeal of the Individual Mandate

Repeal of the ACA Individual Mandate Effective January 1, 2019

Starting January 1, 2019, the Act permanently repeals the Affordable Care Act's tax penalty on individuals who fail to purchase minimum essential health coverage. Accordingly, any individual who is not covered by a health plan that provides at least minimum essential coverage for any month beginning after 2018 will not be required to pay a shared responsibility payment on their federal tax return.

- The repeal does not affect the "employer mandate" which requires larger employers to offer affordable minimum essential coverage to full-time employees or potentially pay a tax penalty.
- It also does not repeal requirements for an employer to report to the IRS and to employees information related to the employer's health plans (including employees who have been offered, or enrolled in, the health plans).

Possible Effects on Employers

The repeal of the individual mandate could affect employers in a few ways:

- The repeal reduces the incentive for individuals, particularly healthy individuals, to enroll in health coverage, including employer-sponsored coverage. Lower enrollment by healthy individuals could cause premiums for employer-sponsored plans to increase.
- The potential penalties imposed on an employer that fails to offer minimum essential coverage or offers minimum essential coverage that does not meet affordability or minimum value requirements are triggered only if one or more full-time employees purchase coverage on a health exchange with federal subsidies (*e.g.,* premium tax credits). Eliminating the individual mandate is expected to cause fewer individuals to obtain subsidized coverage on a health exchange. This would allow employers to at least potentially pay lower penalties related to any violations of the employer mandate, and in some cases could allow employers to potentially avoid paying any such penalties.
- The IRS will no longer need to receive information necessary to enforce the individual mandate. Accordingly, the employer reporting requirements that are currently designed to help the IRS enforce the individual mandate may be reduced or repealed completely.

Section 401(k) Plans and Other Qualified Plans

Adopted Provision: Extended Rollover Deadline for Plan Loans

A 401(k) plan may permit participants to borrow amounts from their plan accounts. If the participant defaults on repayment of the loan, the terms of the loan may require the outstanding loan balance to be repaid by offsetting the participant's plan account balance by the amount of the unpaid balance (*i.e.,* a loan offset). The offset is includible in income in the year in which the offset occurs, unless the participant rolls over the amount of the offset to an IRA or another qualified plan.

Before the Act, in order to qualify as a tax-free rollover, the rollover had to occur by the 60th day following the date of the offset. For certain loan offsets beginning after 2017, the Act allows tax-free rollovers more than 60 days following the date of the offset. Specifically, a tax-free rollover will result if:

- the rollover is completed before the due date for filing the tax return for the tax year in which the distribution occurs; and
- the loan offset is made because of either (1) termination of the plan or (2) failure to repay the loan because of severance from employment.

Provisions Not Adopted

The following are among the more significant changes to retirement plans that were included in earlier versions of the Act originally passed by the House or the Senate but are *not* included in the final version of the Act:

- Lowering the age for in-service distributions from defined benefit pension plans from age 62 to age 59½;
- Eliminating the six-month prohibition on contributions to a 401(k) plan following a hardship withdrawal;
- Allowing hardship withdrawals from not only elective deferrals, but also qualified nonelective contributions, qualified matching contributions, and earnings on all such amounts;
- Relief from nondiscrimination requirements for certain frozen defined benefits plans that are closed to new participants but continue to allow benefit accruals; and
- Conforming contribution limits under 401(k) plans, 403(b) plans, and governmental 457(b) plans.

Hidden Opportunity: Deducting 2018 Pension Contributions Against 2017 Income

At the end of 2017, many businesses scrambled to find expenses before year-end that could be deducted on their 2017 federal income tax return against the higher income tax rates in effect for last year. For most expenses, the deadline to act passed on New Year's Eve 2017. However, businesses that sponsor a tax-qualified defined benefit pension plan may have the opportunity to generate deductions on their 2017 return by making contributions to the plan during 2018.

In order to do so, the contributions will need to satisfy the general deductibility requirements for expenses, the specific deductibility requirements for pension contributions, and the minimum funding rules. This combination of requirements and rules is difficult to navigate, but in general, a deduction should be available to the extent the contribution (1) is made no later than September 15, 2018, (2) is otherwise deductible under the income tax provisions of Chapter 1 of the Code, (3) is designated as a contribution for the 2017 plan year on Schedule SB of the plan's 2017 Form 5500, and (4) does not cause the plan to be more than 150-percent funded, measured in a very specific way provided under the Code.[1]

Fringe Benefits

Moving Expenses No Longer Excludible or Deductible

Under prior law, when an employer paid for an employee to move from one city to another, the employee could exclude from his income the value of any qualified moving expenses paid by the employer. The Act eliminates this exclusion, and thus employees will be taxed on the value of all moving expenses paid or reimbursed by their employers. Similarly, employees who incur these expenses will no longer be able to claim a deduction for them. (Members of the Armed Forces may still claim the benefit.) The suspension of the exclusion and deduction for moving expenses sunsets in 2025.

Elimination of Bicycle Commuting Benefits

Prior to the Act, when an employee regularly used a bicycle for a substantial portion of the commute between work and home, the employee generally could exclude from wages up to $20 per month of reimbursed qualified bicycle commuting expenses. The Act eliminates the exclusion of these benefits from January 1, 2018 through December 31, 2025.

Repeal of Deduction for Other Commuting Fringe Benefits

Under prior law, employers generally were allowed to deduct the expenses incurred in providing qualified transportation fringe benefits to employees, such as qualified van pools, qualified parking at or near the workplace, or subway and transit cards. The Act generally eliminates the employer's deduction for expenses incurred in providing qualified transportation benefits to employees. The Act generally continues to allow employees to exclude these benefits from income. (Qualified bicycle commuting benefits, however, are treated differently that the other qualified transportation benefits—these benefits are deductible to employers and taxable to employees.) The Act also eliminates the employer's deduction for expenses incurred in providing any transportation benefits for travel between the employee's residence and place of employment, except as necessary to ensure the safety of the employee. *Note that additional considerations may apply to commuting benefits provided by tax-exempt organizations.*

[1] The discussion above applies to single-employer plans subject to the minimum funding requirements of Code section 430 that have a calendar plan year and are maintained by employers that have a calendar taxable year. The analysis and relevant deadlines will differ in the case of multiemployer plans, plans not subject to the minimum funding requirements of Code section 430, plans with non-calendar plan years, and plans sponsored by employers with non-calendar tax years. An analogous deduction may be available with respect to contributions to defined contribution plans, but the opportunity is likely to be more limited.

Changes to Deductions for Entertainment and Meal Expenses

The Code generally does not permit deduction of entertainment expenses. Under prior law, however, entertainment expenses that had a business purpose and that met certain other criteria could be deducted at 50% of the amount expended. The Act disallows deductions for *all* costs of entertainment (so that not even 50% of the cost is deductible). As for meal expenses, the Code disallows deductions unless the meal expenses are incurred for a business purpose, in which case 50% of the amount expended is generally deductible. Under prior law, in some circumstances—such as when the meals were served on the employer's "business premises" or when meals were a *de minimis* fringe benefit—100% of the meal expenses could be deducted. The Act repeals the "business premises" and *de minimis* meal rules and thus limits the deduction for *all* business-related meals to 50% of their cost, from January 1, 2018 through December 31, 2025. And starting in 2026, for meal expenses (i) related to the operation of an employer-operated eating facility or (ii) provided for the convenience of the employer, the Act denies the deduction in full.

Deductions for Settlement of Sexual Harassment Cases

Elimination of Deduction if Settlement Cannot be Disclosed

The Act adds a new provision to the Code, section 162(q), that eliminates deductions for settlement payments related to sexual harassment or sexual abuse "if such settlement or payment is subject to a nondisclosure requirement."

- The new provision also prohibits, in a separate subsection, deductions for attorney's fees "related to such a settlement or payment."
- Thus, if an employee asserts a claim of sexual harassment against of coworker or supervisor, and the employer enters into an agreement to settle the claim that includes a standard confidentiality provision, neither the amount of the settlement nor any amount of the settlement allocated to attorneys' fees can be deducted as a business expense.

Uncertainties

The new provision leaves several questions unresolved:

- It does not include a definition of the phrase "related to sexual harassment or sexual abuse," which creates uncertainty about the scope of the new prohibition, especially as applied to settlement agreements covering multiple types of employment claims in addition to sexual harassment or abuse claims.
- It is also unclear, because of the structure of the new provision, whether the denial of a tax deduction for legal fees is independent from or contingent upon the presence of a nondisclosure clause.
- Traditionally, plaintiff-employees have been permitted an above-the-line deduction for attorneys' fees related to their employment claims. The new provision purports to disallow any deduction for any party to the settlement. The Act's drafting history arguably supports a narrower interpretation, but it is hard to predict how IRS will interpret the plain language of the new provision.

Deferral of Income for Equity Awards Issued by Private Companies

Income Inclusion for Equity Awards

When an employee exercises a stock option or receives shares of stock from the settlement of a restricted stock unit (or "RSU"), generally the employee recognizes income equal to the value of the stock. The income is treated as wages to the employee, so income tax and Social Security and Medicare ("FICA") taxes are due for the year of exercise or settlement. The employer must withhold and report these taxes, and is allowed a deduction equal to the income recognized by the employee.

Employees of publicly traded companies usually can sell shares in the public market to cover the cost of their taxes. However, there is typically no market for shares of privately-held companies, such as start-ups. As a result, employees receiving shares of a private company through a stock option exercise or RSU settlement must come up with the cash to pay the IRS.

New Section 83(i)

The Act adds a new section 83(i) to the Code that allows certain employees of private corporations that broadly grant stock options or RSUs to elect to defer income tax for up to five years. This is referred to as an "83(i) election". The election does *not* apply to FICA taxes.

Requirements

An employee is eligible to make an 83(i) election if the following requirements are met:

- In the year in which the stock option or RSU was granted, the employer granted at least 80% of its full-time U.S. employees stock options, or RSUs, with the same rights and privileges. The 80% threshold is applied separately to options and RSUs.
- The employee is not an "excluded employee"—defined generally to mean the current and former CEOs and CFOs, certain current and former highly compensated employees, and employees who own more than 1% of the employer.
- The employee is not able sell the shares to (or receive cash in lieu of shares from) the employer.
- The employer has not repurchased any of its shares in the prior year, unless shares subject to an 83(i) election represented at least 25% of the value of the shares repurchased.

Effect of an 83(i) Election

If an employee makes an 83(i) election, income tax is deferred until the earliest of:

- The stock becoming publicly traded (for example, in connection with the employer's IPO);
- The stock becoming transferable (*e.g.*, in connection with a sale of the employer);
- The employee becoming an "excluded employee";
- The employee revoking the election (to the extent permitted by the IRS, though there is not yet guidance from the IRS on this); or
- Five years after the original exercise or settlement.

The income recognized in the later year is equal to the amount that would have been included at the time of exercise or settlement, even if the value of the stock has since increased or decreased. The employer may take a corresponding deduction when the employee recognizes income, and will have income tax withholding obligations.

Effect on ISOs and ESPPs

An employee may make an 83(i) election with respect to incentive stock options ("ISOs") or options granted pursuant to an employee stock purchase plan, but this will result in a loss of the tax-favored treatment that normally applies to these types of equity.

Notice and Reporting

Several notice and reporting requirements apply:

- An employer must provide a notice to employees explaining the availability of the 83(i) election at the time the income would be recognized by the employee absent the election, generally at exercise or settlement. There is a $100 penalty for each failure to provide the notice, with a maximum penalty of $50,000 per year.
- An employer must report on an employee's W-2 both (1) the amount being deferred pursuant to one or more 83(i) elections as of the end of the year and (2) the amount includible in gross income under section 83(i) for that year.
- An employer must also report on its return the value of shares it repurchased for any year in which shares are covered by an 83(i) election.

Implications for Private Employers

Section 83(i) was presented as a way to make it easier for employees of start-ups and other private companies to share in their employer's success. However, for a number of reasons, the application and benefit of section 83(i) may be limited:

- Limited applicability. The requirements of section 83(i) raise questions about the likely applicability of the provision. As noted above, an employee is only eligible to make an 83(i) election with respect to an option if *in the year that option was granted* the employer also granted options to at least 80% of its other employees. A typical start-up might grant a stock option to each new hire and make occasional grants in connection with a promotion or other notable achievement, but usually will not make grants to all continuing employees on an annual basis. In fact, there is a significant incentive for stock option grants to be front-loaded, since options must have an exercise price of at least the fair market value of the shares on the grant date, and, in general (although not always), the share price of a successful start-up will increase over time. An employee joining a start-up in its early days will prefer a single option grant at hire, instead of grants spread throughout the employee's tenure. RSUs, which are less common than stock options among private companies and do not require an exercise price pegged to the fair market value at grant, may be better suited to a program of annual grants, as contemplated by section 83(i).
- 83(i) elections are not available if the employer has repurchased stock in the prior year unless the repurchase meets certain requirements. Private employers often reserve the right to repurchase shares, for example, upon an employee's termination of employment, and this could make section 83(i) unavailable for their options and RSUs.

- ISO rules already offer employees preferential tax treatment. The general rule that income and employment tax is due on exercise of an option does not apply to ISOs. No income tax is due on exercise, and generally employment tax is never due for an ISO. The exercise of an ISO is included for purposes of the alternative minimum tax ("AMT"), but only relatively high earners are subject to the AMT. Unlike the 83(i) rules, under the ISO rules tax is deferred until the employee sells the shares and, depending on the circumstances, the amount of income tax may be less than under section 83(i). Dollar value limits apply to ISOs, and ISOs granted to employees who are 10% shareholders are subject to additional restrictions, but, as noted above, highly compensated employees and others are not eligible to make 83(i) elections. For employees eligible for ISOs, these may be preferable to the tax treatment under section 83(i). Whether section 83(i) is available for any employees affected by the ISO limits or with AMT liability may depend on the particular facts.
- Potential disadvantages to section 83(i). Employers may see disadvantages with an equity program that is subject to section 83(i). As noted above, the employer's deduction will be delayed if an employee makes an 83(i) election. If income is recognized under section 83(i) because of an employer's IPO, employees may be subject to a lock-up so that they are unable to sell their shares immediately for cash to cover their taxes. An employer also will want to consider how employees will react to other possible scenarios under section 83(i)—for example, if the deferred tax becomes due because the five year maximum deferral period ends before an IPO or sale, or the shares decrease in value after the 83(i) election is made, with the amount of income to be recognized having been fixed based on the higher value.

Effective dates

The provisions of section 83(i) are generally effective for stock options exercised, or RSUs settled, in 2018 and later years. This means that an 83(i) election might be available for stock received pursuant to a stock option or RSU granted in an earlier year, if the exercise or settlement occurs in 2018 or a later year. Particularly given the notice, withholding, and reporting requirements, private employers should review their equity arrangements and consider whether 83(i) elections are available for any currently outstanding stock options or RSUs, and whether (and how) they will offer, on a going-forward basis, stock options or RSUs that will be subject to section 83(i).

Excise Tax on Compensation Paid to Top Employees of Tax-Exempt Organizations

The Act imposes on tax-exempt employers and related entities a new excise tax on certain compensation paid to the organization's "covered employees." An organization's "covered employees" include the five most highly compensated employees for the taxable year and each employee or former employee who was one of the five most highly compensated employees during any taxable year after 2016. Exempt organizations subject to this excise tax include schools, nonprofit hospitals, and other public charities, foundations, trade associations, VEBAs, and other organizations exempt under section 501(a) of the Code, as well as farmers' cooperatives, governmental entities with excludable income, and certain political organizations.

Amount of the Excise Tax

The excise tax is equal to 21% of the employee's remuneration (a) that exceeds $1 million or (b) that constitutes "excess parachute payments."

Parachute Payments

Drawing on concepts from the golden parachute rules in section 280G of the Code, a parachute payment is compensation that is contingent on separation from service and, when combined with all parachute payments to the employee, equals or exceeds three times the employee's "base amount."

- The employee's "base amount" is determined under section 280G and generally is the employee's average compensation for the preceding five years (or shorter period of service).
- For purposes of this new excise tax, parachute payments do not include payments (i) to a nonhighly compensated employee, (ii) to a licensed medical professional for medical or veterinary services, or (ii) from a tax-qualified plan, 457(b) plan, or 403(b) arrangement.
- An "excess parachute payment," which is subject to the new 21% excise tax, is the amount of parachute payments in excess of the employee's base amount.

Compensation Taken into Account

The remuneration taken into account for the excise tax is generally the employee's wages that are subject to wage withholding. However, remuneration for this purpose includes amounts included in gross income under section 457(f) of the Code when no longer subject to a substantial risk of forfeiture, and excludes designated Roth contributions.

Related Organizations

Remuneration also includes amounts paid to a covered employee by an entity that is related to the tax-exempt organization. Related organizations include entities that control, or are controlled by, the tax-exempt organization.

- Regarding VEBAs, related organizations include the entities that establish or contribute to the VEBA.
- Supporting or supported organizations, as defined in section 509(a)(3), are also considered related organizations.
- Accordingly, exempt organizations may need to determine whether any of their highest paid employees also receive compensation from a related entity and whether the total remuneration would trigger the excise tax.

Effective Dates

The new excise tax takes effect beginning in 2018 and applies with respect to any employee who is one of the top five highest paid employees in 2017 or any later year. Accordingly, once an employee is covered by this excise tax, the employee will always be covered by it, even after termination of employment.

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