Lowenstein Sandler

Client Alert

Employee Benefits & Executive Compensation

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The New Tax Law: Employee Benefits And Executive Compensation Provisions

On December 22, 2017, President Trump signed the final version of the Tax Cuts and Jobs Act (the "Act") into law. The Act will make substantial changes to the taxation of corporations, pass-through entities, and individuals.

Although the more sweeping changes to employee benefits and executive compensation proposed in early drafts of the Act were dropped, there are many compensation and benefits changes in the final Act that will impact employers and executives. Importantly, proposed changes that would have significantly restricted many common forms of nonqualified deferred compensation and equity compensation techniques were not included in the final Act. The Act also largely leaves rules governing tax-qualified retirement plans unchanged. A proposal to sharply reduce amounts that could be contributed to retirement plans on a pre-tax basis, which was reported at one time to be under consideration, was never included in any publicly-released version of the Act.

The table below highlights some of the key changes affecting employee benefits and executive compensation.

Provision	Current Law	New Law	Observations/Comments
Compensation Deductions for Publicly Held Corporations	Under Section 162(m) of the Internal Revenue Code of 1986, as amended (the "Code"), publicly held corporations may not deduct more than $1 million each year for compensation paid to any "covered employee," unless the compensation is "qualified performance-based compensation" or paid on a commission basis. In general, a "covered employee" includes the Chief Executive Officer and the next three highest compensated officers (other than the Chief Financial Officer) as of the last day of the taxable year.	The Act (1) eliminates the exceptions for qualified performance-based compensation and compensation paid on a commission basis, and (2) expands the definition of "covered employee" to include any employee who was the Chief Executive Officer or the Chief Financial Officer at any time during the taxable year. Once an employee is a covered employee for a taxable year beginning after December 31, 2016, the $1 million annual limit would apply to that person for as long as the company pays remuneration to him or her (or to his or her beneficiaries), including following retirement or other termination of employment. The Act also expands the definition of "publicly held corporation" to cover foreign companies publicly traded through American Depository Receipts and corporations that are required to file reports under Section 15(d) of the Securities Exchange Act of 1934, as amended. The changes are effective for taxable years beginning after December 31, 2017 (e.g., January 1, 2018, for calendar year taxpayers). The amendments made by the Act will not apply to remuneration which is provided pursuant to a written binding contract which was in effect on November 2, 2017, unless modified in any material respect on or after that date.	Many public companies have structured compensation arrangements to qualify as deductible under the performance-based compensation exception. In light of the Act's changes, companies will want to reevaluate such programs and may consider eliminating some of the structures erected for compensation to qualify for the former exception. In particular, most companies have structured stock option plans so that options will automatically qualify as performance-based compensation. With the elimination of the performance-based compensation exception, companies will no doubt reconsider their approach when it comes to incentivizing executives. The scope of the grandfathering provision for written binding contracts in effect on November 2, 2017 will lead to questions in the days ahead. Any proposed change to remuneration payable to a covered employee (including any proposed change to a plan in which a covered employee participates or the exercise of "negative discretion" under an "umbrella plan") should be carefully reviewed to determine whether it may cause the loss of grandfathered status.

Provision	Current Law	New Law	Observations/Comments
Taxation of Stock Options and Restricted Stock Units	Non-qualified stock options ("NSOs") are taxable as ordinary income upon exercise. Incentive stock options ("ISOs") are generally not taxable on exercise, but any gain on ISOs at exercise is included as a preference item for purposes of the alternative minimum tax. Shares issued pursuant to an option exercised under a Code Section 423 employee stock purchase plan (an "ESPP") are taxed when the shares are sold or otherwise disposed of, with the exact tax treatment dependent on whether the shares were offered at a discount and the length of time the shares were held prior to the disposition. Restricted Stock Units ("RSUs") are taxed when the shares underlying the RSUs are issued (or cash settled), based on the fair market value of the shares (or the amount of the cash settlement).	Under the Act, non-public companies may permit non-executive employees to elect to defer income tax (but not Social Security, Medicare, or unemployment tax) with respect to stock received in connection with an option exercise or in settlement of an RSU for, generally, up to five years from when the employee's rights in the stock become transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier (subject to earlier taxation on the occurrence of other events set forth in the Act). To be eligible to make such a deferral election, the Act requires, among other things, that the corporation have a written plan under which (1) not less than 80 percent of all U.S. employees are granted either stock options or RSUs in the calendar year, and (2) these employees have the "same rights and privileges" to receive qualified stock.	The new deferral opportunity may yield benefits for employees of closely-held businesses and start-ups, but it remains to be seen whether the restrictions companies must adopt in order to offer these opportunities hinder widespread application. Companies interested in exploring this new deferral opportunity should consult legal counsel.

Provision	Current Law	New Law	Observations/Comments
Tax-Exempt Organizations – Excise Tax on Excess Executive Compensation	As described above, Code Section 162(m) limits a publicly-held corporation from deducting more than $1 million per year for compensation paid to certain covered employees. There is no analogous provision under the Code for tax-exempt organizations.	Under the Act, a tax-exempt organization will be liable for an excise tax equal to 21 percent (the Act's new corporate income tax rate) on (1) any remuneration in excess of $1 million paid to a "covered employee" for a taxable year, and (2) certain severance payments paid to a covered employee. Certain compensation payable to licensed medical professionals may be excluded from tax. A "covered employee" for this purpose includes the five highest compensated employees of the organization for the taxable year, or any employee who was a covered employee of the organization (or any predecessor) for any preceding taxable year beginning after December 31, 2016. The new excise tax is effective for taxable years beginning after December 31, 2017.	Tax-exempt organizations should review their compensation practices and executive employment agreements to determine the impact of the new excise tax on them. Organizations may need to consider restructuring compensation programs, though changes to existing agreements will likely require the executives' consent.
Profits Interests–Long-term Capital Gain Holding Period	Partnerships, limited liability companies, and other "pass-through" entities often compensate key management personnel with "profits interests." Profits interests are equity interests that afford the recipient the opportunity to participate in the growth in the value of the business–much like a stock option or stock appreciation right (but usually without an exercise or purchase price). Under current law, gains on the sale or disposition of profits interests are taxed as long-term capital gains (subject to preferential tax rates) if the interests are held for at least one year.	Effective for tax years beginning after December 31, 2017, capital gains recognized in respect of an "applicable partnership interest" will be treated as long-term capital gains only to the extent the partnership assets producing the gains were held for more than three years. An "applicable partnership interest" is a partnership interest received by a taxpayer in connection with the taxpayer's (or a related person's) performance of substantial services in the trade or business of raising or returning capital and either (i) investing in, or disposing of, securities, commodities, real estate held for investment, cash or cash equivalents, options or derivatives, and similar interests or (ii) developing such assets.	The new provisions clearly were intended to apply to profits interests (as well as carried interests) granted in respect of a portfolio or asset management business. However, until the IRS issues regulations, it is too early to assess the scope of the new holding period rules. Pass-through entities, particularly hedge funds, private equity funds, and asset management firms, should consult with their tax advisors when considering awarding profits interests to key personnel.

Provision	Current Law	New Law	Observations/Comments
Unreimbursed Employee Business Expenses	Unreimbursed employee business expenses are a miscellaneous itemized deduction, deductible to the extent miscellaneous itemized deductions are in excess of 2 percent of adjusted gross income.	The Act suspends miscellaneous itemized deductions that are subject to the 2 percent floor, effective for tax years beginning after December 31, 2017, and before January 1, 2026.	Suspension of a deduction for unreimbursed employee business expenses could lead to more employer reimbursement of such expenses, which are treated more favorably under the Code. To the extent that option is unavailable, individuals with large unreimbursed employee business expenses will lose the benefit of a deduction for these amounts.
Moving Expense Reimbursement	Individuals are generally permitted an above-the-line deduction for work-related moving expenses. Employer reimbursements for qualified moving expenses are excluded from an employee's gross income, as long as the employee has not taken a deduction for these amounts.	The Act suspends the exclusion for employer reimbursements and the individual deduction (other than certain reimbursements and deductions for members of the armed forces or their spouses or dependents). The changes apply for taxable years beginning after December 31, 2017, and before January 1, 2026.	Employers should reexamine moving expense reimbursement policies and consider whether to continue offering moving expense reimbursements. Although no longer excludible from income, moving expense reimbursement will likely remain a valuable tool for recruiting new employees who would be required to relocate. Some employers may consider grossing-up moving expenses to attract qualified talent.
Tax-Qualified Plan Loans	If a participant obtains a loan from a tax-qualified plan, in certain circumstances (such as a separation from service) the obligation to repay the loan may be accelerated. If the loan is not repaid, the loan becomes in default and the participant's account balance is offset (or deemed distributed) by the amount of the unpaid balance. The amount deemed distributed may be rolled over to an eligible retirement plan within 60 days.	Effective for taxable years beginning after December 31, 2017, the Act extends the deadline to roll over a deemed distribution from 60 days to the due date (including extensions) for filing the federal income tax return for the taxable year in which the plan loan default occurs.	The new rule may afford some additional flexibility to 401(k) plan participants who separate from service with an outstanding plan loan and face a taxable distribution of the loan balance. The rollover extension may also prove useful in the context of business transactions where affected employees of the seller terminate employment with outstanding loans.
Miscellaneous Deductions	In certain circumstances, companies can deduct expenses for entertainment, amusement, or recreation activities, qualified transportation fringes (including qualified parking, transit passes, vanpool benefits, and qualified bicycle commuting reimbursements), and employer-provided meals.	The Act removes deductions for entertainment, amusement, or recreation activities, as well as the deduction for providing qualified transportation fringes and, except as necessary for ensuring the safety of an employee, any expense incurred for providing transportation for commuting between an employee's place of residence and place of employment. The deduction for employer-provided meals is limited to 50 percent of such expenses until December 31, 2025; thereafter, such expenses are not deductible.	Removal or limitation of these deductions will increase the cost to employers of providing these benefits. Employers should review entertainment policies and transportation fringe benefit arrangements to determine whether to continue to offer these benefits, or whether the Act's changes merit reduction or elimination of these benefits.

Conclusion

For many companies, the loss of favored deductions, such as the deduction for performance-based compensation, will be offset by the new, reduced corporate tax rate. However, businesses and tax-exempt organizations of all shapes and sizes should examine the impact of the Act on their employee benefits and executive compensation plans, practices, and arrangements to determine whether to make changes in light of the Act.

For further guidance on the tax consequences of the Act, please see our Guide to the New Tax Law, available at:

KEY CORPORATE & BUSINESS TAX PROVISIONS
KEY PARTNERSHIP TAX PROVISIONS
KEY INDIVIDUAL TAX PROVISIONS
KEY FOREIGN TAX PROVISIONS
KEY TAX-EXEMPT ORGANIZATION TAX PROVISIONS
KEY TRUST & ESTATE TAX PROVISIONS
KEY TAX PROVISIONS AFFECTING HEDGE FUNDS, PRIVATE EQUITY FUNDS AND OTHER INVESTMENT VEHICLES

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