
BENEFITS LAW ALERT
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# Employee benefit/executive compensation provisions in the proposed House Tax Bill

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The House Republicans' proposed tax legislation, the Tax Cuts and Jobs Act, has a number of provisions affecting employee benefits and executive compensation. Although there will be adverse ramifications to a number of popular employee fringe benefit plans, some of which would lose their tax advantages, employers can breathe a sigh of relief to the extent some of the adverse changes to 401(k) plans being discussed (e.g., a significant reduction in the cap on 401(k) contributions) were not included in the legislation.

In contrast, executive compensation took a significant hit in the proposed tax bill and, if enacted, the legislation would require many employers to dramatically restructure their executive compensation practices. Generally, nonqualified deferred compensation will be taxed when the compensation is no longer subject to a substantial risk of forfeiture, rather than when it is paid. This would fundamentally alter the tax treatment of many common executive compensation practices, including stock options, and make them much less attractive. Additionally, many publicly traded companies will lose tax deductions for some of the compensation paid to top executives, and an excise tax will be imposed on certain compensation paid to top executives of tax exempt employers.

It is still early in the legislative process. The Senate is expected to release its version of tax reform this week, and House and Senate versions will need to be reconciled before legislation is enacted. Accordingly, employers will need to carefully watch how the tax legislation evolves.

## Provisions affecting employee benefit plans

Provisions in the House Republicans' tax proposal affecting employee benefits, which generally would become effective January 1, 2018, include the following:

- The provision allowing employers to provide employees up to $5,250 of tax-free educational assistance would be repealed, and such benefits would become taxable.

- Qualified tuition reduction benefits provided by educational institutions to their employees and their employees' spouses and dependents would become taxable

- Employer contributions to an Archer MSA would not be excluded from income.

- The tax exclusion for certain employee achievement awards would be repealed and the value of such benefits would be taxable to the employee and deductible by the employer.

- The exclusion for housing provided for the convenience of the employer and for employees of educational institutions would be limited and phased out for highly compensated individuals.

- The tax exclusion for employer-provided dependent care assistance programs would be repealed.

- The exclusion for employer-paid qualified moving expenses would be repealed.

- Employees will be taxed on benefits provided under an employer- sponsored adoption assistance program.

- The limits on employee pre-tax elective contributions to 401(k) plans would not change, but there would be a modest relaxation to some 401(k) plan rules. For example, employees taking hardship distributions would be permitted to continue making contributions to the plan. Additionally, hardship distributions could be made from employer contributions and investment earnings. Finally, employees whose plan terminates or who separate from employment while they have plan loans outstanding would have until the due date for filing their tax return for that year to contribute the loan balance to an IRA in order to avoid the loan being taxed as a distribution.

- Frozen qualified defined benefit retirement plans would be given some relief to more easily pass nondiscrimination testing.

## Executive compensation

***1. Nonqualified deferred compensation.***

The proposed legislation hits executive compensation hard:

- New rules would apply to nonqualified deferred compensation. Rather than taxing individuals on nonqualified deferred compensation when the compensation is paid to them in the future, nonqualified deferred compensation for services provided after 2017, as well as related earnings, would be taxed when the compensation is no longer subject to a substantial risk of forfeiture.

- A substantial risk of forfeiture would be narrowly defined to mean the right to the compensation must be subject to the individual continuing to perform substantial services. Conditions not related to performing substantial services—even if the condition is intended to advance a purpose of the compensation such as conditioning payment on the achievement of a performance goal—would not delay taxation.

- Deferred compensation earned for services before 2018 would become taxable in 2025, unless it had been distributed or otherwise became taxable to a participant before that year.

— Contrary to prior tax rules, stock options would be treated as nonqualified deferred compensation subject to these accelerated taxation rules.

This will fundamentally change the taxation of many common deferred compensation arrangements. For example, stock options will be taxed when the options vest as a consequence of performing services, not when the vested option is exercised. Likewise, elective deferrals to a nonqualified deferred compensation plan will be taxed when the compensation is earned, not when the compensation is paid.

The new rules raise many issues. For example, how do you tax nonqualified deferred compensation that has vested, but whose value is wholly contingent on future events? Will there be a reconciliation of the taxes that are paid when deferred compensation vests with the amount (including earnings) that is eventually paid? Special complications apply to existing awards granted before 2018 but that will not vest until after 2017. The legislation requires the Secretary of Treasury to provide guidance within 120 days of enactment of the legislation as to how taxpayers can amend existing arrangements to conform to the new tax rules without violating existing tax laws. In short, there will be lots for the regulators (and employers!) to sort out if this is enacted.

***2. Deductibility of executive compensation***

Section 162(m) of the Internal Revenue Code generally limits the deductibility of compensation paid to a publicly traded company's "covered employees" (generally, the CEO and the next three highest compensated employees other than the CFO) to $1,000,000, but allows performance-based compensation to be excepted from this limitation. Under the proposed tax changes, the performance-based compensation exception would be eliminated and the definition of "covered employee" will be expanded to include the CEO, the CFO and the next three highest employees. Additionally, an individual who was a covered employee at any time after 2016 would be treated as a covered employee even after the individual ceases to be the CEO, the CFO or one of the next three highest employees (i.e., once a covered employee, always a covered employee). These changes would significantly limit the deductibility of compensation paid to the top corporate executives of many publicly traded companies.

***3. Excise tax on compensation paid to top executives of tax exempt organizations***

A 20% excise tax would be imposed on compensation paid to the covered employees of a tax exempt organization to the extent such compensation exceeds $1 million. A covered employee is an individual who was one of the employer's top five highly compensated employees in the taxable year or a prior taxable year after 2016.

Additionally, a 20% excise tax would be imposed on excess parachute payments paid by a tax exempt organization to a covered employee. A parachute payment is defined as compensation that is contingent on the employee's separation from service where such amount equals or exceeds three times the average compensation paid to the employee in the five preceding years.

As noted above, we are still early in the legislative process so it is difficult to predict how this will unfold. However, employers would be wise to consider the legislation, particularly in their year-end executive compensation planning.

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