TAX REFORM 2018

Executive Compensation and Employee Benefits Following the Tax Cuts and Jobs Act of 2017

By Charles A. Bruder

Effective December 22, 2017, the Tax Cuts and Jobs Act of 2017 (the "Act") made significant changes to certain provisions of the Internal Revenue Code of 1986 (the "Code"). While there was much discussion and analysis of the Act leading up to its enactment, the Act contains many changes to the federal income tax treatment of executive compensation and/or employee benefits of which corporate executives, officers and human resource personnel should be aware to ensure the proper federal income tax treatment and reporting of such items, while satisfying the financial goals to be attained by the recipient employees.

"Excessive Compensation" – Publicly Traded Companies and Tax-Exempt Organizations

While publicly traded companies and tax-exempt organizations initially appear to have little in common, affected companies and organizations that pay annual compensation to executives in excess of $1 million (so-called "excess compensation") may incur negative income tax consequences under the Act as a result of such payments.

Public companies generally are subject to Code Section 162(m) – which disallows an income tax deduction for "excess compensation" paid to certain of the company's officers. However, public companies previously have avoided this result by characterizing the affected compensation as "performance-based" (as defined in the Code). So long as the compensation was "performance-based" and the executive was employed on the last day of the year, the company generally could deduct this compensation (even if it exceeded $1 million).

Under the Act, this "performance-based" deductibility exception has been eliminated – thereby significantly increasing the costs of compensating executives. While certain transition relief is available for binding compensatory contracts in effect as of November 2, 2017, public companies will need to carefully review their current compensation agreements to ensure tax compliance with revised Code Section 162(m).

As many tax-exempt organizations are comparable to their for-profit brethren, the Act imposes penalties upon "excess compensation" paid to their executives too. However, for these organizations, the Act utilizes another time-tested income tax tool – an excise tax. Under the Act, an excise tax of 21% is imposed upon annual "excess compensation" paid to any of the organization's 5 highest paid executives. The Act also imposes this excise tax on severance benefits if they exceed three times an executive's annual wages (similar to the "golden parachute" excise tax). Notably, this excise tax is payable upon vesting – regardless of when such compensation is paid to the executive. As such, this excise tax provides a formidable potential trap for unaware tax-exempt organizations.

Deferred Income Taxation on Private Company Stock-Based Compensation

Stock options and restricted stock units have long been awarded under private company incentive compensation arrangements. By receiving an interest in the employer, executives are afforded a compensation opportunity that may increase based upon the future success of the company. In an effort to increase the popularity of these arrangements, the Act introduces Code Section 83(i) – which provides for a potential income tax deferral, but only under certain circumstances.

Under Code Section 83(i), an employee may elect (within 30 days of the vesting of an award) to defer for 5 years the federal income tax liability that the employee would otherwise incur due to the vesting event, if:

- The award(s) are issued under an arrangement in which at least 80% of the full-time U.S. employees of the company receive similar awards; and
- The electing employee is not the CEO or CFO of the company, a shareholder of 1% or more of company stock, or one of its 4 highest-paid employees during the past 10 years.

While Code Section 83(i) may have limited application, its provisions are significant – an electing employee generally defers federal income recognition until the 5th anniversary of the award vesting date. Thereafter, the employee realizes the taxable income that he or she would have recognized upon the prior vesting date.

Deductibility of Business-Related Entertainment and Meal Expenses

Somewhat surprisingly, the Act changed the deductibility of business meals and entertainment expenses. While Code Section 274 has historically been a source of difficulty for companies – due to its fact-specific nature and potential for abuse – revised Code Section 274 may have a significant impact upon many employer business expense reimbursement policies.

Under revised Code Section 274, business-related meal expenses continue to be subject to a 50% deduction limit. However, the deduction for business-related meal expenses will sunset after 2025 – so employers will not be able to deduct any business meal expenses thereafter.

More importantly, Code Section 274 generally disallows any income tax deduction for "entertainment, amusement or recreation" expenses – regardless of whether these expenses are business-related. As such, expenses for "night clubs, cocktail lounges, theaters, country clubs, golf and athletic clubs, sporting events… and similar trips" are non-deductible under Code Section 274. The full scope of "entertainment" activities for tax deduction purposes has yet to be determined, so employers should take a conservative approach to their deductibility. As the non-deductibility of entertainment expenses may significantly increase the costs associated with these activities, employers should also review and revise their expense reimbursement policies to account for this new reality.

Other Health and Welfare Employee Benefits Considerations

In addition to the above items, certain provisions of the Act also impact the following areas:

- Qualified Transportation Fringe Benefits - Qualified transportation benefits generally are non-deductible by employers beginning in 2018. Employee fringe benefits remain non-taxable to employees, excluding bicycle commuter reimbursements.
- Qualified Moving Expenses - Qualified moving expenses paid by an employer are taxable beginning in 2018.
- Employer Credit for FMLA – The Act includes a tax credit of up to 25% of wages paid in 2018 and 2019 during a FMLA leave, subject to certain wage requirements and leave provisions.
- Employee Achievement Awards – Commencing in 2018, employee achievement awards are generally includable in the income of the recipient employee.

Considering the potentially significant provisions of the Act, employers should take a fresh look at their executive compensation and employee benefit arrangements to ensure that they are properly accounting for the changing federal income tax treatment of these items.

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