SIDLEY

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SIDLEY UPDATE

Final 2017 Tax Cuts and Jobs Act: Executive Compensation and Employee Benefits

On December 20, 2017, Congress passed the legislation known as the Tax Cuts and Jobs Act (the Tax Act), which the president is expected to sign into law. Sidley's general update on the final version of the Tax Act has been posted on our U.S. Tax Reform: Developments and Insights webpage.

Below is a summary of the material provisions in the Tax Act that relate to executive compensation and employee benefits. Generally, these changes will be effective for taxable years beginning after December 31, 2017, unless otherwise noted below.

Executive Compensation

Excessive Compensation of Public Company Executives — Section 162(m)

Current Law	New Law
Section 162(m) imposes a $1 million cap on the tax deduction that a public company can take on compensation paid to each of its CEO and three other highest paid executive officers (other than the CFO) — generally, the "named executive officers" included in the annual proxy, other than the CFO. However, most companies rely on an exemption for performance-based compensation, which is fully deductible even if it exceeds $1 million. The deduction limit applies only to companies whose common stock is registered with the SEC. The deduction limit applies only if the executive is employed as named executive officer on the last day of the taxable year.	Eliminates the performance-based compensation exemption that currently allows public companies to avoid the tax deduction limit under Section 162(m) of the Code, causing most compensation payable to senior officers of a public reporting company to be nondeductible. Expands coverage of Section 162(m) to include all SEC reporting companies (including those with publicly traded debt). Expands the group of executives who are subject to the deduction limit to include not only the named executive officers during the current taxable year (including the CFO), but also any person who ever was a covered executive for any prior taxable year beginning after December 31, 2016. The bill provides transition relief for any written binding contract in effect on November 2, 2017 and not materially modified after that date. The conference report indicates that a compensation plan will be considered a binding contract if the

	participant has a binding right to participate in the plan at a nondiscretionary level that cannot be terminated by the employer. There is some uncertainty about the scope of the transition rule. For example, it is unclear whether an executive has a "binding right" if: • the Board has a right to reduce the payout under an award (i.e., through "negative discretion") or • the executive has a contractual right to receive an award having a specific value, but not all of the terms have been finalized. We expect that the IRS will issue further guidance on the scope of the transition rule.

Excise Tax on Excessive Compensation for Executives of Tax-Exempt Organizations

Current Law	**New Law**
Not applicable	Would impose a 21% excise tax on tax-exempt organizations (not the executives) to the extent they pay compensation in excess of $1 million (other than severance pay, described below) to any of the covered employees, described below. In addition, if a tax-exempt organization pays severance pay to such a covered employee that equals or exceeds three times the executive's average annual wages, then the tax-exempt organization (not the executive) would be subject to a 21% excise tax on the excess of the value of the severance benefit over one times such average wage amount (similar to the calculation of the golden parachute excise tax that applies to corporations upon a change in control). The excise tax would be payable at the time the applicable compensation becomes vested, rather than when it is payable. Under the final bill, the covered employees whose compensation is subject to the excise tax include any person who is, or was in a prior tax year beginning after December 31, 2016, one of the five highest paid employees of the organization, except that the final bill excludes employees who are not considered "highly compensated employees" (i.e., with compensation less than $120,000 for 2018). In addition, under the final bill, compensation paid to doctors, nurses and veterinarians for medical

	or veterinary services is disregarded. However, compensation paid to a doctor for administrative or other non-medical services would be taken into account.

Deferred Taxation on Option/RSU Shares Issued to Employees of Start-up Corporations

Current Law	New Law
Not applicable	Through the addition of a new Section 83(i), non-executive and non-highly compensated employees of a privately held corporation could elect up to a five-year deferral in the taxation of illiquid shares issued to them upon the exercise of nonqualified options or the settlement of restricted stock units (RSUs) if certain conditions are satisfied. The options or RSUs must be granted under an equity compensation plan under which at least 80% of all full-time U.S. employees are granted awards with the same rights and privileges. The amounts of the awards may vary by employee, as long as each employee receives more than a *de minimis* grant. This deferred tax election is not available to the CEO or the CFO (or certain persons related to them) or to any person who in the past 10 years was one of the four highest paid officers of the corporation or a 1% shareholder ("excluded employees"). If an employee makes a tax deferral election within 30 days after the award becomes vested, the shares would be included in taxable income on the fifth anniversary of the date the shares became vested or, if earlier, when the shares become transferable or publicly traded, the employee becomes an excluded employee, or the employee revokes the election. Even though the timing of taxation is delayed, the amount includible in taxable income is measured at the time of vesting or exercise. Due to the many restrictions that apply, we would be surprised if this type of plan became widely used.

Alternative Minimum Tax — Incentive Stock Options

Current Law	New Law
Employees who exercise tax-qualified incentive stock options (ISOs) can be subject to alternative minimum tax in the year they exercise the option.	Retains existing alternative minimum tax, but increases the exemption amount.

Earlier versions of the Act as proposed by the House or Senate included changes in the taxation of deferred compensation, nonqualified stock options and stock appreciation rights. These changes were not included in the final version of the Tax Act.

Retirement Plans and Savings

Rollover Rules as Applicable to Loan Amounts

Current Law	New Law
Amounts attributable to plan loan offset amounts from qualified plans (i.e., §401(a)), tax deferred annuity plans (i.e., §401(a)) and governmental eligible deferred compensation plans (i.e., §457(b)) can only be rolled over during the 60-day period beginning on the day of the offset.	A loan offset amount distributed by reason of the plan's termination or the participant's failure to repay the loan due to separation from service may be rolled over prior to the due date, as extended, for filing the participant's federal income tax return for the year of the termination or separation. Effective for loan offset amounts arising in taxable years beginning after December 31, 2017.

Length of Service Award Programs for Bona Fide Public Safety Volunteers

Current Law	New Law
Certain length of service award programs for bona fide public safety volunteers are excluded from the deferred compensation rules of IRC §457(f).	The maximum benefit limit for such plans is increased from $3,000 to $6,000 with respect to any year of service and is adjusted for cost-of-living increases. Effective for taxable years beginning after December 31, 2017.

Recharacterization of Contributions to Individual Retirement Accounts

Current Law	New Law
Contributions to a traditional or Roth IRA can be recharachterized by transfer as a contribution to the other type of IRA before the due date for the individual's income tax return for the year of the contribution. Upon a recharacterization, the contribution is treated as having been made to the transferee IRA as of	Recharacterization does not apply to a conversion contribution to a Roth IRA and therefore can no longer be used to unwind a Roth conversion *(e.g.*, which under current law is oftentimes done if the Roth IRA's asset value significantly declines after the conversion date). Recharacterization is still permitted with respect to other contributions. For

the date of the original contribution. Both regular contributions and conversion contributions to a Roth IRA can be recharacterized as having been made to a traditional IRA.	example, a contribution for a year to a Roth IRA can, before the due date for the individual's income tax return for that year, be recharacterized as a contribution to a traditional IRA. Effective for taxable years beginning after December 31, 2017.

Earlier versions of the Tax Act as proposed by the House or Senate included other retirement plan changes that would have impacted employers and/or employees, such as lowering the earliest age at which in-service distributions may be received from certain tax-advantaged retirement plans, and changing the eligibility for and consequences of receiving hardship withdrawals from qualified cash or deferred arrangements (i.e., §401(k) arrangements). These changes were not included in the final version of the Tax Act.

Welfare, Fringe Benefit and Leave Changes

As an initial matter, the Tax Act is notable for health items that <u>are not</u> included in the Tax Act—most significant, the Tax Act does not change the exclusion from income of employer-provided health coverage. The Tax Act also does not change the Affordable Care Act's employer mandate or Cadillac tax or, except as described below with respect to the individual mandate, otherwise alter the Affordable Care Act's provisions in any material respect.

Affordable Care Act Individual Mandate

Current Law	New Law
Subject to limited exceptions, individuals must maintain health coverage to avoid tax penalties.	Effectively repeals the individual mandate by reducing the tax penalty for not having coverage to zero, effective for months after December 31, 2018.

Fringe Benefits

Fringe Benefit	Current Law	New Law
Moving Expense Reimbursement	Qualified moving expense reimbursements provided to an employee by an employer are excluded from income.	Eliminates employee income tax exclusion (except for certain military moves) for tax years 2018 – 2025.
Employee Achievement Awards	Certain employee achievement awards (i.e., recognition for length of service or safety achievement) are excluded from an employee's income and deductible by the employer.	Prohibits cash, cash equivalents, gift cards/coupons/certificates (other than if conferring a right to select from a limited number of employer pre-approved tangible personal property items), vacations, meals, lodging, theater and sporting event tickets and securities from qualifying as employee achievement awards potentially excludable/deductible.
Qualified Transportation Benefits	Qualified transportation benefits are excluded from an employee's income and deductible by the employer.	Employers can continue to offer qualified transportation benefits <u>other than</u> bicycle commuter

Fringe Benefit	Current Law	New Law
		reimbursements to their employees on a tax-free basis. Eliminates employee income tax exclusion for bicycle commuter reimbursements for tax years 2018 – 2025. Eliminates employer deduction for qualified transportation benefits.
Entertainment and Meals Expenses	Taxpayers are generally allowed a deduction for up to 50 percent of entertainment and meals expenses directly connected to business activity. Meals furnished for the convenience of the employer on the employer's business premises are generally deductible.	Eliminates deduction for entertainment expenses. Generally retains deduction (subject to the 50% limitation) for meals expenses directly connected to business activity (including for the convenience of the employer on the employer's business premises). However, after 2025, eliminates deduction for meals provided for the convenience of the employer on the employer's business premises.
Certain Fringe Benefits — Tax-Exempt Organizations	Tax-exempt organizations generally may provide their employees with qualified transportation benefits, and on-premises gyms and other athletic facilities, free from income tax at the employer level and excludable from employee income.	Treats funds used by tax-exempt organizations to pay for qualified transportation benefits, and on-premises gyms and other athletic facilities, as unrelated business taxable income.

Paid Leave Credit for Employers

Current Law	New Law
Not applicable.	Adds a general business tax credit for eligible employers equal to 12.5% to 25% of wages paid to qualifying employees during certain family and medical leave. To be eligible for the credit, employers must pay employees taking family and medical leave at least 50% of their normal wages, and provide qualifying full-time employees not less than two weeks of annual paid family and medical leave. Would apply to the 2018 and 2019 tax years.

Earlier versions of the Tax Act as proposed by the House or Senate included other fringe benefit changes that would have impacted employers and/or employees, such as changes to the tax treatment of dependent care assistance programs, adoption assistance programs, educational assistance programs, contributions to an Archer Medical Savings Account, employer-provided child care and employer-provided housing. These changes were not included in the final version of the Tax Act.

If you have any questions regarding this Sidley Update, please contact the Sidley lawyer with whom you usually work, or

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