

To: Clients and colleagues
From: George Chimento, Rob Webb and Jessica Stanford
Date: Updated through January 29, 2018
Re: **Tax Cuts and Jobs Act**: changes to employee benefits and executive compensation

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I. THE NEW LAW

The Tax Cuts and Jobs Act (“TCJA”) modifies and generally improves some of the rules for employee benefit plans. For employee benefits, this is not the sweeping change of earlier laws this century, such as the PPA or EGTRRA. Fortunately, 401(k) savings limits and employer deduction limits are untouched, and there is some relief from rules which penalized employees unfairly when they needed access to their money.

A tax on “excess” compensation paid by tax exempt organizations, such as hospitals, requires significant planning. Tax deduction rules for compensation of public company top officers are also significantly restricted.

We break this memorandum into three sections: (1) qualified retirement plans, (2) other fringe benefits, and (3) tax on “excess” executive compensation in tax exempt organizations. A later memo will deal with special executive compensation issues for officers of public companies, and a new deferral election for certain types of equity grants.

II. QUALIFIED RETIREMENT PLANS

A. More time to pay loans after employment termination or plan termination.

Many qualified plans require terminated employees to pay off loans promptly when employment terminates or when the plan terminates. Employees often had problems finding money within 60 days to make a rollover, and were taxed on the “loan offset.” Plans can still provide for loan offset in order to get loans off their books. The TJCA reform allows the employee more time – until his or her tax return is due (with extensions) – to roll over an amount equal to the loan offset to an IRA or qualified plan.

No plan amendment is needed. Tax notices should be revised. This applies to loan offsets in 2018 and later. It only applies if the loan came due because of termination of employment or the plan

B. 2016-17 Disaster relief.

Earlier this year, IRS issued Announcement 2017-11 to help victims of Hurricane Harvey. Congress then enacted the Disaster Tax Relief and Airport and Airway Extension Act of 2017, which contains specific relief for all three 2017 hurricanes: Harvey, Irma, and Maria.

TJCA expands protection to any qualified 2016 or 2017 disaster declared by the president.

- (a) No 10% early penalty on Qualified 2016 Disaster Distributions; and
- (b) Tax withholding is optional.

Distributions up to \$100,000 in the aggregate qualify if made during the period January 1, 2016 – December 31, 2017. The individual’s principal residence must have been in the 2016 disaster area and the person must have suffered economic damage due to the disaster.

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- (c) Income can be spread over three tax years

This is optional for the individual, and would require amending a 2016 return for a 2016 withdrawal.

- (d) An amount up to the withdrawal can be recontributed to an IRA or qualified plan within three years of the withdrawal, and negate the taxation altogether.

Note: The \$100,000 is an individual limit. An employer only needs to keep track of withdrawals from its plans. If an employee overwithdraws from plans of more than one employer, there will need to be IRS guidance on what an employer should do. This may be similar to the rules for excess 401(k) deferrals.

These are optional rules. A plan can administer them now, but must be amended by the end of the first plan year beginning in 2019, i.e. December 31, 2019 for calendar year plans.

TJCA does not change the rules in the Disaster Tax Relief and Airport and Airway Extension Act of 2017 for the three 2017 hurricanes. (Those rules are more extensive, allowing for loans up to \$100,000, for example, without regard to the 50%/\$50,000 limits usually applicable to loans.)

C. Recharacterization of Roth accounts no longer allowed.

TJCA closes a great loophole. Under current law, it was possible to convert a before-tax IRA to a Roth. You opened a Roth IRA and transferred money to it from a traditional IRA, for any amount. You paid tax on the conversion and you had a Roth, with no future taxes owed and no minimum distributions required at 70 & ½. That is still allowed.

What is not allowed is to change your mind and “recharacterize” the Roth to a traditional IRA prior to the due date for your tax return for the conversion year. Smart people were converting to multiple Roth IRAs, and recharacterizing only the ones which lost money. They would get their taxes back on the re-characterized IRAs. It was Heads I win, Tails the Treasury loses.

Note: It is still possible to contribute to a Roth IRA and to recharacterize the contribution prior to the due date for your tax return. The new rule only prohibits recharacterization of converted IRAs.

Note: This is effective for 2018 and later taxable years. In the case of 2017 conversions, they can be recharacterized in 2018, provided that is accomplished no later than October 15, 2018.

D. Reforms which were not approved.

- (a) No expansion of sources for hardship distributions

Even though a reform was in each of the House and Senate bills, the current law is unchanged. Hardship distributions may still not be taken from investment earnings on 401(k) deferrals, or from QMAC or QNEC accounts. People with hardship needs are still required to borrow first

prior to taking hardships, although we sometimes counsel plan administrators to ignore this when it is evident the employee does not have the means to repay.

(b) The House bill would have allowed persons who took hardships to resume participation without a 6 month wait. That sensible reform was not added.

(c) In-service distributions from pension plans cannot be before age 62

The House would have allowed age 59 & ½ as a permitted age for in-service withdrawals from defined benefit and money purchase pension plans, which currently cannot allow this before age 62. The final bill does not accept this improvement.

(d) No relief for “closed” pension plans

Some employers close their defined benefit plans to new participants, and allow existing participants to continue accruals. The newer employees are put into defined contribution plans. The House would have permitted easier discrimination testing for this type of maneuver, because the defined benefit participants were often more highly compensated. The final bill does not approve this, which means that more complicated annual testing is still required for this type of structure.

III. OTHER FRINGE BENEFITS

A. **Health insurance: no individual mandate, but the employer mandate remains.**

A big picture change is the repeal of the individual mandate to have health insurance. The employer mandate remains, although bills have been introduced to repeal it. (We doubt that happens, simply because of the cost after so much of the budget has been stretched by TCJA, but stay tuned.) Will the young and healthy continue to enroll in employer plans, now that the individual mandate is removed? We do not expect much change due to the significant employer subsidy in most plans.

Effective January 1, 2019.

B. **Employer's deduction for fringe benefit expenses limited.**

(a) No deduction for most qualified transportation fringes. Although still excludible from wages, an employer may no longer deduct the costs of mass transit and qualified parking programs, or any expense that is essentially defraying the cost of commuting. However, an employer may still deduct an expense if necessary for employee safety.

Query: Many of these plans are funded with pre-tax salary deferrals. Does this mean the employer cannot deduct these amounts, even though they would have been deductible as salary? The answer is: No employer deduction. The employee keeps the tax break of salary exclusion, but the employer loses the deduction. Hopefully, employers do not discontinue offering these plans.

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Special note for tax exempt employers:

Tax exempt employers will now have unrelated business taxable income for the cost of these fringes, presumably to keep them on par with taxable employers who lose deductions.

(b) No deductible entertainment. No deductions will be allowed for the following T&E entertainment : (1) entertainment, amusement and recreation activities, (2) membership dues with respect to any club, even if organized for business purposes, (3) any facility used in connection with any of the above items.

(c) 50% deduction for business-related meals still allowed. As under current law, the 50% deduction is unchanged for business-related food and beverage expense, such as meals consumed on work travel and business related entertainment.

(d) Full deduction for some employee food and beverage expenses. The new law keeps current law for de minimis fringe benefits, like coffee, donuts, picnics and working meals.

(e) Employer eating facilities deduction limited. A 50 percent deduction limit applies to employer expenses associated with providing food and beverages to employees through an eating facility that meets requirements for de minimis fringes and for the convenience of the employer.

Effective for amounts paid or incurred after December 31, 2017. After December 31, 2025, deductions for employer eating facilities will not be allowed.

C. Moving expenses are now fully taxable.

Individuals will no longer be allowed above the line deductions for moving expenses. Employers who pay for such expenses must now include them in employee income. There is an exception for armed forces personnel on active duty who are redeployed. This is effective for taxable years after 2017.

D. No qualified bicycle commuting exclusion.

Employers which provide “qualified bicycle commuting reimbursements” have been allowed to exclude \$20 per month from an employee’s wages. This is effective from January 1, 2018 through December 31, 2025.

E. New credit for employer-paid family and medical leave.

Employers will receive a limited tax credit if they provide paid FMLA leave which would not otherwise be compensable under employer policies as vacation leave, personal leave, or other medical or sick leave. The credit is not available for paid leave mandated by state or local laws. Due to its limited duration for only two years, it is unlikely that employers will utilize this

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credit unless (i) they already have voluntary paid leave programs in place, and (ii) make necessary record keeping adjustments to qualify for the credit.

Amount of the credit:

(a) 12.5 percent of payments to qualifying employees during any period in which such employees are on FMLA leave, provided that the rate of payment is 50 percent of the wages normally paid to an employee.

(b) Credit is increased by 0.25 percentage points (but not above 25 percent) for each percentage point by which the rate of payment exceeds 50 percent.

(c) Maximum amount of family and medical leave that may be taken into account with respect to any employee for any taxable year is 12 weeks.

Written Plan or program is required:

All qualifying full-time employees must be allowed not less than two weeks of annual paid family and medical leave, and less-than-full-time qualifying employees are allowed a commensurate amount of leave on a pro rata basis.

Qualifying Employees defined:

(a) Employed for at least one year, and

(b) Earnings in the previous year were not higher than 60% of the rate used to determine highly compensated employees in a 401(k) plan. (For example, earned \$72,000 or less in 2017 to be a qualifying employee for 2018.)

Effective Date: Wages paid in tax years beginning after December 31, 2017, but not beginning after December 31, 2019.

F. Employee Achievement Awards are limited to some (not all) non-cash items

Under current law, Achievement Awards of “tangible personal property” are excludible from an employee’s wages if limited to \$400 or, if the award is a qualified plan award, \$1,600. These are given to employees in recognition of safety achievement or length of service, and as part of a meaningful presentation or ceremony.

TCJA makes clear that the following are NOT “tangible personal property,” and are therefore taxable: cash, cash equivalents, gifts cards, gift coupons, gift certificates (other than where the employer pre-selected or pre-approved a limited selection) vacations, meals, lodging, tickets for theatre or sporting events, stock, bonds or similar items, and any other form of non-tangible personal property.

Effective January 1, 2018. Note: this is actually the current IRS position, so the law also makes clear it is not blessing gifts of such item as non-taxable in years prior to 2018.

G. No deduction for certain settlements of sexual harassment and abuse claims

No deduction is allowed for any settlement, payout, or attorney fees related to sexual harassment or sexual abuse if such payments are subject to a nondisclosure agreement. If the settlement is in public view, expenses continue to be deductible.

Effective for amounts paid or incurred after the date of enactment.

H. Changes which are not in the final version of TCJA.

The Conference Committee fortunately trimmed back some of the “savings” which were in the House Bill. Preserved in the final legislation are current law tax treatment for:

- Dependent Care Assistance plans (IRC §129);
- Adoption Assistance Plans (IRC §137);
- Employer-provided housing required by an employer (IRC §119);
- Non-discriminatory Educational Assistance Plans (IRC §127).

Note: Management should be aware that IRC §529 plans can now distribute tax-free up to \$10,000 (per student, not per plan) for primary and secondary education.

IV. “EXCESS” COMPENSATION FROM EXEMPT ORGANIZATIONS: IRC §4960

TCJA imposes a tax on exempt organizations if “remuneration” paid to a “covered employee” in any year exceeds \$1 million. The organization is taxed on 21% of the excess, not the covered employee.

The effective date of new IRC §4960 is taxable years beginning after December 31, 2017. There is no grandfathering for existing executive arrangements, even if secured by a binding contract entered into after Board approval.

There is a similar 21% tax if the organization pays an “excess parachute” due to separation from employment. An “excess parachute” is a payment or series of payments “in the nature of compensation” due to separation with value equal to or more than 3x a 5 year average base amount. The taxable portion of an excess parachute under §4960, as written, is the portion in excess of 1x the base amount¹, but it is possible that the Conference Committee intended only that the portion over 3x the base amount would be taxable. (That’s a huge difference in potential tax; see the technical note in Section B later in this memo.)

¹ The §4960 excess parachute penalty is modeled on the penalty under IRC §280G if a golden parachute is provided by a for-profit company after a change in control. Don’t rely on your own calculations for this; use a professional who is used to working with §280G.

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A change in control is not required in order for an excess parachute to be taxable to the organization under §4960, and it's not necessary for the excess parachute to be more than \$1 million.

If a payment is both a taxable excess parachute and over the \$1 million remuneration mark, the "excess parachute" is excluded from "remuneration" so that it is not taxed twice under §4960.

There are obvious flaws in §4960 which cry out for Congressional "technical correction," which is inevitable after major tax legislation that was put together so hastily. We caution readers that this is our first interpretation of a very complicated statute without regulatory guidance. We will be examining more closely for clients and expect both a technical correction from Congress and IRS guidance to resolve ambiguities.

A. Key definitions:

(a) Covered employee is an employee (including any former employee) of the organization if the employee is one of the five most highly compensated employees in the year or was a covered employee of the organization (or a predecessor) for any preceding taxable year beginning after December 31, 2016. An independent contractor is not a covered employee, and Treasury will issue regulations to prevent gamesmanship, such as changing an employee's status to that of a contractor.

(b) Remuneration for the "excess remuneration" over \$1 million tax is "wages" as defined for income tax withholding purposes under IRC §3401(a), excluding Roth contributions.

(1) Remuneration includes non-vested compensation in the year it become vested, *including from §457(f) plans*, even though these plans often compensate an executive for years of past service. (This is grossly unfair. See our note at the end of this memo.)

(2) Remuneration paid to a licensed medical professional (doctor, nurse, or veterinarian) which is directly related to the performance of medical or veterinary services by such professional is not taken into account; remuneration paid to a licensed medical professional in any other capacity is taken into account.

(3) Remuneration from a related government, and from a controlled or controlling organization, and from supporting organizations is aggregated. The tax is apportioned among them based on the amounts of remuneration they have paid to the covered employee.

(4) Treasury will issue regulations to prevent gamesmanship, such as paying through partnership interests or pseudo independent contractor arrangements rather than as employee compensation.

(5) It seems that §457(b) plan payments from a non-governmental employer are counted as remuneration for purposes of the excess remuneration tax. (This odd result, probably not intended and hopefully to be corrected, comes from the use of §3401(a), a withholding statute, to define remuneration for the "excess remuneration" tax.)

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(c) Payments “in the nature of compensation” for the excess parachute tax is probably meant to be broader than “remuneration.”

(1) Although non-taxable fringe benefits, like health insurance, are not considered to be remuneration, they seem to be “in the nature of compensation,” so the value of non-taxable post-retirement health insurance paid due to separation may need to be taken into account for the excess parachute calculation.

(2) There is confusion between the statute and the Conference Committee Report about payments from non-governmental §457(b) plans. The statute says that all §457(b) payments are excluded from the excess parachute calculation, but the Committee report says that there is only an exception for governmental §457(b) plan payments. Hopefully, all §457(b) payments will be excluded.

Note: For purposes of the excess parachute tax, a small organization might have non highly compensated employees, i.e. under \$120,000 under current law, in the top five. There is no excess parachute penalty for payments to those persons.

B. The confusion about excess parachute taxes

What is the taxable amount? As written, payments “in the nature of compensation” which are owed due to separation are an “excess parachute” if the present value of the payment(s) is equal to or in excess of 3x a 5 year average “base amount.” The 21% tax is imposed on the “excess parachute.”

Does that mean that the excess over 1x the base amount (the way §4960 seems to be written) is the taxable portion? Or did Congress intend that only the excess over 3x the base amount be taxable? §4960 looks to IRC §280G for help. Under the §280G penalty, if a payment or series of payments is valued at 3x or more a 5 year average base amount, the penalty applies to the value of the parachute in excess of 1x the base amount.² So what’s the reason for hoping the §4960 penalty might only apply to the excess over 3x the base amount? In their haste, it’s possible that the tax writers thought that the §280G penalty only applied to the excess over 3x the base amount, not the much larger excess over 1x the base amount. The JCTA Conference Committee Report clearly, and incorrectly, confirms that misunderstanding of §280G.

Hopefully, this will be pointed out and corrected. Even more hopefully, some grandfathering protection will be added for agreements already in effect at the time of JCTA enactment. Until this is clarified, we should assume the worst case, that the §4960 tax applies to the portion of the excess parachute which exceeds 1x (not 3x) the average base amount.

² A golden parachute under §280G is penalized only if the parachute is equal to or in excess of 3x a 5 year base amount.

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C. It's unfair to include §457(f) plans as remuneration for a single year when they compensate for multiple years of service.

Many top officers of our great exempt organizations have §457(f) plans to provide for retirement and the plans are meant to compensate for years of service. The plans are promised by contract and, generally, only after a careful fiduciary process.

Under current law, exempt organizations and executives are already handicapped by §457(f). Unlike taxable employers, if an exempt organization pays a non-qualified pension to key officers, the pension value is fully taxable when it is vested (i.e. not conditioned on substantial future services), even though payments may be spread out over many years in the future. For this reason, many exempt organizations defer the vesting date to an expected retirement year, pay a lump sum at that time, and the government collects taxes from the executive, usually at the top rate.

Example: Let's assume that a SERP promised to a 20 year executive is a fully taxable \$2.5 million, which is hardly excessive for a top officer after 20 years, and let's assume in her final year she had \$500,000 in other pay, making the excess amount \$2 million.

From the \$2.5 million SERP, subtract:

- \$ 925,000, the 37% regular income tax on executive under §457(f);
- \$420,000, the 21% tax on the organization under §4960.

That is \$1,345,000 to IRS, 54% of the SERP value, and let's not forget state tax and FICA.

Observation

This penalty – combined §457(f) and new §4960 – comes about for one reason. The employer is tax exempt, so that apparently gives the government the license to grab perfectly fair compensation for top leadership. If the government wants tax exempt organizations, with their generous care of the poor and needy, to be further handicapped in competition with the for-profit sector, it could not have done better than with this new penalty statute. Combined with the likelihood that many donors may now take the larger JCTA standard deduction, and will no longer lower their taxes with an itemized charitable deduction, the JCTA is tough “reform” for tax exempt organizations.

Planning

A reform of new §4960 through the technical correction process is not beyond hope. The JCTA was put together quickly, and the addition of the §457(f) kicker to the definition of remuneration was from the Senate, not the House. Applying the excess parachute penalty to everything over 1 x the base amount also seems unfair because many of these arrangements are already required by binding contracts.

For planning, it may be necessary to consider revision of many §457(f) plans. One possibility will be to accelerate the vesting, perhaps on a graded basis leading up to the retirement year.

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Retirement dates can also be scheduled to be early in a year, when there is not a lot of extra regular compensation.

We wish it were as simple as §457(f). Many executives also have split dollar agreements under new and old split dollar regimes. To the extent they result in taxable remuneration, there will also be a need to consider grandfathering under the split dollar regulations, and whether changes forfeit that status. And let's not forget §409A, that other Congressional beauty which intrudes on virtually all deferred arrangements.

On this happy note, let's adjourn. There is a lot of planning necessary in the near future.

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