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LEGAL UPDATES AND NEWS

New Tax Law Changes: Employee Benefits and Executive Compensation

The Tax Cuts and Jobs Act (the "Act") became law in December, and most provisions of the Act took effect as of January 1, 2018. This update focuses on the major changes to the taxation of employee benefits and executive compensation as result of the Act. The changes in the tax laws and the additional guidance that we expect the Treasury Department to issue in the next several months will likely impact the design of many compensation arrangements in the future. Companies, therefore, should consider reviewing their existing compensation arrangements and practices to determine if any changes may be appropriate in order to comply with the Act or to provide greater flexibility in determining compensation packages. Although the Act has resulted in numerous changes to existing tax laws, companies should also consider how these changes may affect other compliance issues such as proxy statement disclosures.

$1.0 Million Tax Deduction Limit for Compensation

Internal Revenue Code (the "Code") section 162(m) ("162(m)") limits the paid compensation deduction for publicly held corporations to $1.0 million for each "Covered Employee." Under prior law, the term Covered Employee included the CEO as of the end of the taxable year and up to the four other most highly paid officers, excluding the CFO.

The Act expands the definition of Covered Employee to now include any employee who has served as the CEO, CFO and up to the three most highly paid officers or any employee who has been a Covered Employee for any year beginning after December 31, 2016.

The major changes under the new provision are that the CFO will be included as a Covered Employee and that the Covered Employees of prior years continue to be Covered Employees forever, i.e., even after termination of employment. Therefore, companies likely will need to maintain a growing list of Covered Employees.

Performance-Based Compensation Exception Repealed

The Act also repeals the popular performance-based compensation exception to the $1.0 million deduction limit under 162(m).

Under prior law, compensation to a Covered Employee which qualified as performance-based was excepted from the 162(m) deduction limit and remained deductible from a corporation's taxable income.

Compensation qualified as performance-based if it met certain conditions, including being contingent on pre-established and objective performance goals.

Although the repeal of the performance-based compensation exception will generally reduce a corporation's tax deductible compensation, it also eliminates the necessity for corporations to comply with the stringent rules surrounding performance-based compensation. For example, performance-based compensation plans may now be structured to include upward discretion to increase a bonus even if the performance goals have not been met (however, the additional payment would be reflected in the "bonus" column of the Summary Compensation Table of the Company's proxy statements). Further, *there is no longer a need for performance-based plans to be approved by shareholders in order to satisfy 162(m).* Therefore, many companies will continue to pay performance-based compensation but will have greater latitude in structuring such compensation.

> ***Not*e:** While repealing the performance-based compensation exception under 162(m) will reduce the incentives for a company to allocate a substantial portion of its annual compensation based on the satisfaction of certain performance goals, best practices and the demands of institutional shareholders and proxy advisory firms, such as ISS, are likely to result in companies' continuing to pay performance-based compensation.

Grandfather Exception to 162(m) Changes

The Act's changes to 162(m), however, will not apply to compensation paid pursuant to a written binding contract that was in effect as of November 2, 2017, and which was not materially modified or renewed on or after November 2, 2017. Accordingly, compensation paid under those arrangements is generally still deductible.

> ***Note*:** It will take time to fully understand all the implications of these changes including the full scope of the grandfathering provision for written binding contracts and what, if any, provisions of the performance-based regulations under 162(m) remain intact. Any proposed change to a grandfathered contract should be carefully reviewed to determine whether it may cause the loss of grandfathered status.

> ***Note:*** This change could also increase the costs of merger and acquisition transactions as amounts paid or income realized under employment agreements and vesting equity plans for Covered Employees and other arrangements that are not grandfathered may no longer be tax deductible.

New Excise Tax on Compensation over $1.0 Million
Paid to of Credit Unions and other Tax-Exempt Organization

The Act imposes an excise tax of 21% on tax-exempt organizations (including credit unions) for compensation over $1.0 million paid to "covered employees." For these purposes, "covered employees" are defined similarly to Covered Employees under 162(m), to include (i) the five most highly paid employees for the taxable year; and (ii) employees who were covered employees of the organization (or a predecessor organization) for any taxable year beginning after December 31, 2016.

For these purposes, compensation includes wages, as defined for purposes of Code section 3401(a) for income tax withholding purposes (which, for tax exempt organizations, includes deferred compensation for which there is no longer a substantial risk of forfeiture), but does not include any designated Roth contributions.

> ***Note*:** The Conference Report to the Act warns that the excise tax may be imposed on the value of compensation that is vested (and any increases in such value or vested compensation), even if not yet received. Additional guidance is needed to further clarify what is intended by this statement.

The excise tax would also apply to excess "parachute payments." A payment would be a "parachute payment" if it is contingent on the separation from service of the employee and if the total present value of all parachute payments exceeds three times the covered employee's "base amount" (i.e., the employee's average taxable compensation over the preceding five years). If an excess parachute payment exists, the amount of the parachute payment in excess of the base amount would be subject to the excise tax, which would be payable by the employer.

> ***Note*:** Unlike excess parachute payments that are paid to employees of for-profit corporations on certain amounts paid contingent on a change in control, excess parachute payments paid by tax-exempt employers do not require a change in control -- only a separation from service. Moreover, the excise tax in this case is paid by the employer - not the former employee.

As with Covered Employees under 162(m), an employee of a tax-exempt organization who is covered by this provision in any year will remain subject to excise tax consideration after termination of employment.

Tax-Qualified Plans - Extension of Plan Loan Offsets

The Act does not change pre-tax deferral limits, hardship distributions, in-service distributions, or nondiscrimination testing for tax qualified plans. However, the Act extends the deadline for treating a loan from a tax-qualified retirement plan as a rollover. Under prior law, if an employee with an outstanding loan from a tax-qualified plan terminated employment, the employee had sixty (60) days to roll the amount of the loan into an IRA or other eligible retirement plan to avoid being subject to tax penalties on an early distribution. Under the Act, an employee has until the employee's tax return is due, including any extensions, for the year in which the employee terminated to roll the amount of the loan into an IRA or other eligible retirement account.

Fringe Benefits

The Act eliminates or modifies many deductible and excludable fringe benefits:

Entertainment Expenses:

Under prior law, an employer could generally deduct 50% of entertainment (including meals), amusement or recreation if it could demonstrate that the activity was directly related to (or in certain cases associated with) the active conduct of the employer's trade or business. The Act generally repeals this deduction for payments after December 31, 2017. Certain exceptions remain, including an exception that would allow

deduction of expenses for recreational, social or similar activities primarily for the benefit of employees, other than certain owners and highly compensated employees.

> ***Example*:** An employer pays for an employee to treat clients to a baseball game to entertain the clients and to discuss business. Before the Act, the employer could deduct up to 50% of the cost of this outing. As a result of the Act, after December 31, 2017 the cost is no longer deductible.

> ***Example:*** An employer provides tickets to its rank and file employees once a year to attend a baseball game. The employer can fully deductible the cost of the tickets for its non-highly compensated employees.

Meals Provided for Employer's Convenience and Meals Provided at Employer-Operated Eating Facilities after 2025:

The Act retains the 50% deduction for qualified meal expenses (i.e. meals provided on work travel). Effective for amounts incurred or paid after December 31, 2017 and until December 31, 2025, the Act imposes a 50% limit on the employer deductions for meals provided for the employer's convenience and meals provided through an employer-operated eating facility as a de minimis fringe benefit. For amounts incurred or paid after December 31, 2025, the Act does not allow any deduction for meals provided for the employer's convenience and meals provided through an employer-operated eating facility as a de minimis fringe benefit. Meals related to recreation primarily for the benefit of employees, such as an office picnic or holiday party for employees, remain 100% deductible.

> *Example*: An employer operates a cafeteria for its employees and provides lunch for its employees at the cafeteria free of charge. Before December 31, 2017, the employer could deduct the full cost of operating the cafeteria. After December 31, 2017, the employer can deduct only 50% of such cost. However, after December 31, 2025, the employer will not be allowed a deduction for any of the cost of operating the cafeteria.

> *Example*: An employer provides a meal for an employee who has to work overtime. Both before and after the Act, the employer may deduct 50% of the cost of the meal.

Qualified Transportation, Commuting, and Parking Expenses:

Prior to the Act, companies could pay for and deduct up to a certain amount for an employee's "qualified transportation fringe benefits," i.e., including employer-provided transit passes, qualified parking expenses, van pooling and qualified bicycle commuting reimbursements, and the employee would not be taxed on these benefits. While the Act repeals the employer deduction for "qualified transportation fringe benefits" paid after December 31, 2017, an employee is not required to take these amounts into income if paid; provided, however, the Act also appears to have repealed the exemption from income for qualified bicycle commuting reimbursements until 2025.

> *Example*: Employer pays $175 in monthly parking fees for its employees as a qualified fringe benefit expense and employees do not recognize such amount as compensation. Commencing January 1, 2018, the employer will no longer receive a tax deduction for the payment of this qualified fringe benefit, but amounts paid by the employer will continue to be tax exempt to its employees.

Qualified Moving Expense Reimbursements:

The Act repeals the exclusion from an employee's income of qualified moving expense reimbursements from 2018 through 2025, subject to a limited exception for members of the armed services. Therefore, an employee generally will be required to include the amount of reimbursement in income for the taxable year in which the reimbursement is paid. However, companies can continue to deduct qualifying moving expense paid for the benefit of employees.

Employee Achievement Awards:

The Act repeals the employer deduction allowed for employee achievement awards in the form of meals, vacations, lodging, theater or sporting event tickets, stocks, bonds or other securities as employee achievement awards.

> *Example*: An employer provides baseball and football tickets to its top producers during the season. The cost of the tickets range from $75 to $200 per ticket. In total, the cost to the employer of providing these achievement awards is approximately $25,000 per year. The employer will no longer be able to deduct this amount.

Paid Family Medical Leave Tax Act (FMLA) Credit:

The Act provides a tax credit to employers that offer paid FMLA programs for tax years 2018 and 2019.

Recharacterization of Traditional and Roth IRAs

Under the Act, recharacterization of traditional and Roth IRA contributions from one form to the other will still be permitted except in the unwinding of Roth IRA conversions.

Non-Qualified Deferred Compensation

No significant changes have been made to non-qualified deferred compensation as a result of the Act.

New § 83(i) Deferral Election for Qualified Equity Awards

For certain privately held corporations, the Act provides a new deferral election for "Qualified Stock" awarded to rank and file employees under Code section 83(i). Qualified Stock is defined as stock received by an eligible employee in connection with the exercise of a stock option or settlement of a restricted stock unit if the stock option or restrict stock unit were granted in connection with services rendered to the employer. The new election allows employees to defer the taxation of Qualified Stock for up to five years after the date of vesting or exercise.

The election is not available for any employee who is (i) a 1% owner of the corporation in any of the past ten taxable years, (ii) the current or former CEO or CFO or a close relative of any current or former CEO or CFO, or (iii) one of the four most highly paid employees of the corporation in any of the previous ten taxable years.

The election may only be offered by a corporation if no stock of the corporation is readily tradable on an established securities market during any preceding year.

If the election is made as to an incentive stock option ("ISO"), then the ISO loses its favorable tax treatment and should be treated as a non-qualified stock option.

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Luse Gorman, PC is a Washington, D.C based law firm specializing in the representation of financial institutions. We advise clients located throughout the nation, ranging in size from small community-based financial institutions to multinational banks. Please contact any of our attorneys below if you have any questions regarding the information contained in this newsletter.

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