December 20, 2017

Conference Agreement on the "Tax Cuts and Jobs Act" includes significant executive compensation and employee benefits provisions

This Alert highlights the changes in tax law related to compensation and benefits that are included in the Tax Cuts and Jobs Act (H.R.1) (TCJA). The appendix to this Alert is a side-by-side chart showing all compensation and benefits items that have been proposed in the course of the House and Senate consideration of H.R. 1.

Background

The House and Senate conferees to the "Tax Cuts and Jobs Act" (H.R. 1) released a Conference Agreement that is expected to be passed by both houses and sent to the President to be signed into law before year-end.

Generally, the compensation and benefits provisions in the TCJA Conference Agreement follow the Senate bill provisions and amendments with several important changes. Some of the TCJA executive compensation and benefits provisions affect only publicly held employers, others affect only private businesses or tax-exempt organizations, while others affect all businesses. Also of note, certain provisions included in the House and Senate bills were not included in the Conference Agreement, including: (1) proposed Section 409B, which would have governed taxation of nonqualified deferred compensation, (2) a proposal to tax securities sold on a first-in first-out (FIFO) basis, which would have affected stock acquired under a qualified stock option and other equity compensation; and (3) the sunset and repeal of the provisions excluding from employees' income dependent care and adoption assistance expenses. The side-by-side chart at the end of this Alert compares the current law to the compensation and benefits provisions in final TCJA and provides a more detailed list of the compensation and benefits provisions that were not included in the Conference Agreement.

Compensation provisions affecting publicly held corporations

Expansion of the $1 million deduction limitation for executive compensation

Current law

Section 162(m) applies to the compensation paid to a public company's "covered employees," consisting of the CEO and the next three highest compensated officers (but specifically excluding the CFO). The $1 million-per-tax-year deduction limitation applies to compensation that is otherwise deductible in a given year that is paid to an

individual who is a covered employee at the close of the tax year. Thus, compensation paid after an individual is no longer a covered employee (such as severance and other deferred compensation payments) is not subject to the $1 million deduction limit. In addition, a significant exception is provided for performance-based compensation, which includes cash compensation contingent upon the attainment of objective performance goals and meeting other requirements, as well as most stock options and stock appreciation rights. Amounts that constitute performance-based compensation are not subject to the $1 million deduction limit. Only publicly traded companies that are required to register their common stock under Section 12 of the Securities Exchange Act are subject to Section 162(m). Because of the specific definition used in the statute, Section 162(m) does not apply to other companies that register debt, that voluntarily register their common stock or that are foreign private issuers traded on US exchanges via American Depository Receipts (ADRs).

The Tax Cuts and Jobs Act — Expansion of Section 162(m)

The TCJA would amend Section 162(m) to expand the $1 million compensation deduction limitation for covered employees effective for tax years beginning after December 31, 2017. The Conference Agreement follows the Senate amendment of the House bill, which includes a transition rule for compensation paid pursuant to a written binding contract that was in effect on November 2, 2017. A further explanation of the binding contract rule appears later.

The TCJA would eliminate the exception for performance-based compensation and expand the definition of covered employees. Covered employees would include the CFO, plus any individual who has previously been a covered employee, even after the individual no longer holds the position. Thus, once an individual is identified as a covered employee, the deduction limitation would apply to the compensation paid to that individual, even after the individual no longer holds that position or has separated from service. In addition, any executive who is identified as a covered employee for a tax year after December 31, 2016, will remain a covered employee for all future years.

The TCJA would also expand the definition of public company to include other securities registrants. It would include foreign private issuers, as well as private companies that have registered debt offerings and must report under Section 15(d) of the Securities Exchange Act.

The transition rule for binding contracts that first appeared in the Senate amendment was included in the final TCJA. The transition rule would exempt from the TCJA changes to Section 162(m) any compensation paid "pursuant to a written binding contract [that] was in effect on November 2, 2017, and [that] was not modified in any material respect on or after such date." This transition rule is identical in all material respects to the transition rule included in the statute when Section 162(m) was first

enacted in 1993. That rule provided that "the term 'applicable employee remuneration' shall not include any remuneration payable under a written binding contract [that] was in effect on February 17, 1993, and [that] was not modified thereafter in any material respect before such remuneration is paid."

The Conference Report includes a discussion of the interpretation of this transition rule that closely tracks the provisions of the Section 162(m) regulations' interpretation of the 1993 transition rule. The regulations interpret the 1993 transition rule narrowly to provide that it does not apply, unless the corporation is obligated under state law to pay the compensation as the employee performs the services. The Conference Report, similar to the regulations, states that a contract renewed after November 2 is treated as a new contract. In addition, a contract that is terminable or cancelable unconditionally at will by either party without consent of the other is treated as a new contract entered on the date of the termination or cancellation.

The Conference Report confirms that compensation paid pursuant to a *plan* qualifies for the exception under the transition rule, but only if the right to participate in the plan is part of a written binding contract with the covered employee in effect on November 2, 2017. The fact that a plan existed on November 2 is not by itself sufficient to qualify the plan for the exception for binding written contracts. If the covered employee has a written employment contract in effect on November 2 providing that the executive is eligible to receive incentive compensation at a future date in accordance with plan terms, however, that employment contract may be sufficient to "grandfather" the payments made to the executive under the plan, provided that the employer does not have the right to amend the plan materially or terminate the plan (except on a prospective basis).

The Conference Report does not address what constitutes a material modification of a contract or when a modification would constitute a new contract. The Treasury Department and IRS are likely to look to the existing Section 162(m) regulations, which include detailed rules on what constitutes a material modification. Under the regulations, a material modification occurs when the contract is amended to increase the amount of the compensation payable to the employee. A material modification also may occur if payment of the compensation amount is accelerated or the parties agree to supplemental arrangement to pay an additional amount of compensation.

Treasury and IRS likely will rely on the existing Section 162(m) regulations to provide future guidance on what constitutes a binding written contract and also what constitutes a material modification of the contract that would create a new contract that would not be "grandfathered" under the transition rule.

Implications

Upon enactment, public companies will need to determine immediately what compensation awards would have been exempt from the $1 million deduction limit but will no longer be deductible under the new law. This process will require interpretation of the November 2, 2017 grandfather rule and its application to the company's existing arrangements. While the terms of each plan or contract will need to be analyzed specifically, companies may find that the grandfather rule is more limited than originally anticipated given the clarifications provided in the Conference Report.

The question of whether a binding contract exists ultimately would seem to be a question of underlying contract and employment law and whether an individual executive would prevail if he or she sought to enforce the payment of compensation determined as of November 2, 2017. The Conference Report indicates that the right to terminate or materially amend a contract indicates that it is not grandfathered. Therefore, an arrangement, including a performance-based compensation plan that includes so-called negative discretion may not be grandfathered under the transition rule because, under such provisions, the company could choose to materially change or not pay the promised amounts. This interpretation to the "written binding contract" transition rule would severely limit the application of the rule, unless an employer could conclude as a legal matter that the negative discretion was unenforceable and the employee is legally entitled to the stated compensation amount.

Additional questions may arise regarding plans or agreements that may be terminated prospectively and what portion of the deferred compensation accrued under the plan or agreement after the effective date is grandfathered. The Conference Report states that, if a contract is terminable or cancellable by either party (not including a termination solely on account of the employee's termination of employment), then the contract is treated as a new contract on the date that the cancellation or termination could have occurred. For example, assume an executive is participating in a deferred compensation plan that is designed to pay out after the executive leaves employment. Under existing law, the plan is not be subject to the $1 million deduction limit because post-employment payments are exempt. It is not uncommon for such plans to provide that the company may terminate the plan prospectively at any time. In other words, the company may have reserved the right to cease or terminate accrual under the plan prospectively, as long as amounts accrued through that date are not reduced. If such a provision were included in the plan document, then a logical reading of the grandfather rule would indicate that only the account balance as of November 2, 2017, is actually grandfathered since, in theory, the employer could terminate or cancel the plan prospectively on any date after November 2, 2017. Again, an employer may need to determine whether underlying employment law would preclude such a termination in order to satisfy the transition rule grandfather provision for benefits earned after November 2, 2017.

The Conference Report includes virtually the same language as was included in the committee reports when Section 162(m) was originally enacted in 1993. In 1993, however, there was a policy reason to limit the transition rule and apply the written binding contract exception very narrowly because Congress wanted to incentivize employers to immediately adopt performance-based plans rather than try to continue with prior arrangements. Such a policy rationale simply is not present under the TCJA because the performance-based compensation exemption is being eliminated altogether.

More favorably, termination provisions are not as common under certain types of equity grants such as stock option or appreciation right grants. In those cases, grants made on or before November 2, 2017, likely will continue to be grandfathered, but review of the documents is necessary to confirm that analysis. The Conference Report also indicates that a requirement to perform future services is not a bar to grandfather treatment; thus, if a compensation grant is contingent only because the employee must continue to perform services in the future (i.e., it is unvested), that contingency itself does not bar grandfather treatment, assuming that the grant was made on the requisite date.

Given the practical effect of the Conference Report language, further Treasury and IRS guidance is possible on what constitutes a written binding contract. It will be important for companies to monitor those developments.

Going forward, changes will be needed to ensure compliance. Companies will need to track the potentially expanding group of covered employees subject to the $1 million compensation deduction limitation. In addition to adding the CFO to the covered employee group beginning in tax year 2018, over time, the affected group will grow beyond the current covered top five officers as a consequence of the "once a covered employee, always a covered employee" rule.

Companies that are not currently subject to Section 162(m) should monitor the proposed expansion of the definition of businesses that may become subject to the compensation deduction limitation. In particular, companies primarily operating outside of the US may need to consider the extent to which the deduction limit practically affects their tax returns in the US even if they are treated as a publicly traded company for purposes of Section 162(m). For example, potential covered employees could be employed in non-US jurisdictions (so no US deduction limits their compensation). Further guidance should be reviewed to confirm the specific application of Section 162(m) to these companies.

Finally, companies will need to reconsider how they desire to structure their senior executive compensation programs in light of the demise of the performance-based compensation exception under Section 162(m). Undoubtedly, performance-based programs will continue in effect for many non-tax reasons; they may not, however, need

to include some of the more rigid or process-oriented provisions that were needed to preserve the compensation deduction under the Section 162(m) definition of a performance-based compensation plan. Companies may also want to give further attention to potential structures that could preserve more of the compensation deduction. For example, in lieu of lump-sum payments over $1 million on a termination of employment, compensation payments made over time that are less than $1 million per year would allow a corporate deduction.

Compensation and benefits provisions affecting tax-exempt organizations

Excise tax on tax-exempt organization payment of excess executive compensation

Current law

Tax-exempt organizations report employees' compensation in income in the tax year in which the compensation is paid or the year in which nonqualified deferred compensation amounts subject to Section 457(f) become vested. Tax-exempt organizations generally are not subject to limitations on the compensation amounts paid to executives, but are limited by the private inurement rules and potential sanctions under Section 4958 if the executive's compensation is considered excessive relative to the value provided to the organization.

Taxable businesses are subject to limitations on compensation paid to employees in certain circumstances. As discussed earlier, Section 162(m) limits publicly held corporations' compensation deduction to $1 million for compensation paid to "covered employees," subject to applicable exceptions. In addition, taxable publicly held and private businesses may be subject to an excise tax and deduction limitation for severance and other compensation payments that are considered excess "parachute payments" upon a change in control of the business.

Tax Cut and Jobs Act — new Section 4960

The TCJA would add new Section 4960, which would impose a 21% excise tax on any "applicable tax-exempt organization" that paid a "covered employee" in a tax year compensation that: (i) exceeds $1 million (not including excess parachute payments), or (ii) is an excess parachute payment. The intent of the new Section 4960 excise tax appears to be to treat tax-exempt organizations similar to taxable businesses with respect to compensation paid to executives above a specified threshold. The new excise tax would be effective for tax years beginning after December 31, 2017. The

TCJA provides no transition rule for applying the excise tax on compensation paid to covered employees by applicable exempt organizations.

The Section 4960 excise tax would require tax-exempt organizations to undertake a series of steps to determine whether the organization is subject to the excise tax and, if so: which entity is liable for the tax; which employees are considered covered employees; how compensation paid to the covered employee is determined; and what constitutes an excess parachute payment.

— *Is the organization subject to the tax and which entity is liable?* The 21% excise tax would apply only to compensation paid by an "applicable tax-exempt organization" to a covered employee. An applicable tax-exempt organization includes any organization exempt from taxation under Section 501(a), a farmers' cooperative organization under Section 527(b)(1), a governmental entity with excludable income under Section 115(1), or a political organization described in Section 527(e)(1). Liability for the excise tax would be imposed on the employer of the covered employee. The statute does not include a controlled group rule for determining who is considered a covered employee or for liability for the excise tax. As a result, the statute may be interpreted to provide that the 21% excise tax applies on an employer-by-employer (or entity-by-entity) basis. This is an issue that will need to be considered in published guidance.

— *Who is considered a covered employee?* A covered employee is defined as one of the five highest compensated employees of the organization for the tax year, or someone who was a covered employee of the organization (or any predecessor) for any preceding tax year beginning after December 31, 2016. Unlike Section 162(m), which limits the definition of "covered employee" only to corporate officers, the new 21% excise tax provision under Section 4960 would apply to any employee, even if the employee were not an officer of the organization. Similar to the TCJA expansion of the application of Section 162(m), the new Section 4960 provides that, once an employee is a covered employee, the employee will always be a covered employee.

— *What compensation payments are included for purposes of determining who is a covered employee and determining the $1 million threshold?* The statute defines "remuneration" as wages within the meaning of Section 3401(a), excluding designated Roth contributions. This definition is, in essence, the employee's wages reported on Form W-2, Box 1.

Remuneration includes wages paid by the applicable tax-exempt organization and any "related person or governmental entity." The statute is not clear whether "related person" means only related tax-exempt persons or related taxable entities. In the context of the statutory provision, we believe that only compensation from a tax-exempt related person should be included for purposes of the excise tax. We expect the definition of a related entity to be addressed in future guidance. The definition of "related

person" includes not just organizations that are under common control, but also Section 509 "supporting" and "supported" organizations.

The Conference Agreement modifies the definition of "remuneration" for purposes of determining who is a covered employee in a helpful manner for tax-exempt hospital organizations and other medical services organizations. Under the final TCJA provisions, compensation paid to licensed medical professionals (including a doctor, nurse or veterinarian) that is for performing services in their professional capacity is not included in the definition of "remuneration." The Conference Report clarifies that, "[f]or purposes of determining a **covered employee**, remuneration paid to a licensed medical professional … is not taken into account" (emphasis added). Compensation paid to physicians or other licensed medical professionals in a capacity other than for their professional services (e.g., hospital administration services), however, would be included in the definition of remuneration for purposes of determining whether the medical professional is a covered employee. Before this modification of the Senate and House bills, tax-exempt hospital organizations were concerned that highly paid doctors or nurses who were employees of the organization or a related organization could be considered covered employees. Based on the language of the statute and the Conference Report, we would expect Treasury and the IRS to issue guidance providing that: (1) the compensation paid to a licensed medical professional for professional services is not taken into consideration for purposes of determining whether the professional is a covered employee, and (2) the 21% excise tax does not apply to any compensation paid to that medical professional if the individual is not a covered employee.

The new Section 4960 also provides for the coordination of the 21% excise tax provisions and the Section 162(m) compensation deduction limitation. Under this provision, compensation that is not deductible "by reason of [Section] 162(m)" is not taken into account for purposes of the application of the 21% excise tax. We believe this reference is not only to the Section 162(m) $1 million compensation deduction limitation, but also to the Section 162(m)(6) $500,000 compensation deduction limitation applicable to covered health insurance issuers. In other words, a tax-exempt hospital that maintains a related health insurance issuer and has executives who provide services to and receive compensation from both the applicable tax-exempt organization and the health insurance issuer should not be subject to the both the excise tax and the compensation deduction limitation on the same amount of compensation paid to that executive.

— *How are excess parachute payments determined?* An excess parachute payment means compensation payments made by an applicable tax-exempt organization to a covered employee on account of the employee's separation from service if the aggregate present value of the payment equals or exceeds three times the base amount. As defined under Section 280G(b)(3), the base amount is the average

annualized compensation includible in the covered employee's gross income for the five tax years ending before the date of the employee's separation from employment. If the present value of the separation payment to the covered employee equaled or exceeded three times the base amount, the excise tax would be imposed on the amount of the separation payment (i.e., the parachute payment) in excess of the portion of the base amount allocated to the payment. Accordingly, the excise tax may apply to an excess parachute payment even if the covered employee's compensation does not exceed $1 million.

The TCJA Conference Agreement also exempts from the definition of a parachute payment compensation paid to employees who are not highly compensated employees within the meaning of Section 414(q) and compensation paid to a licensed medical professional for the performance of professional services.

The Conference Report clarifies that compensation is treated as paid when it is no longer subject to a substantial risk of forfeiture, as defined under Section 457(f)(3)(B). This rule provides a limited "grandfather" for deferred compensation amounts that vested and were included in income before the 2018 effective date, but have not yet been paid. In this case, when the amount is paid at a future date, it would not be subject to the excise tax. An open question exists whether earnings on the unpaid vested deferred amount are also "grandfathered."

Implications

The new Section 4960 21% excise tax would add a significant financial and administrative burden on tax-exempt organizations with highly compensated employees. Exempt organizations should immediately consider whether all or any part of their executives' deferred compensation was vested and included in income before the 2018 effective date; this vested deferred amount and potentially any earnings on the amount should not be subject to the excise tax, even if the amount is scheduled to be paid after the 2018 effective date.

Exempt organizations will need to identify their five highest compensated employees based on the 2017 tax year. After the 2018 effective date, these employees, as well as the five highest compensated employees in 2018, will be considered the covered employees for the first tax year that the excise tax applies.

As with any new statutory provision, a number of open issues will need to be addressed by Treasury and IRS guidance. Exempt organizations should consider submitting comments on these and any other issues that are unclear or not addressed in the statute.

— One of the most critical issues is whether the Section 4960 excise tax applies on an entity-by-entity basis. Because the statute includes no controlled-group rule for purposes of the application of the excise tax, it appears that this may be the rule. An entity-by-entity application of the excise tax will be financially and administratively burdensome for large tax-exempt organizations with multiple entities. For example, many tax-exempt hospital systems maintain separate exempt organizations for each hospital in the system. Will each hospital entity in the system be subject to the Section 4960 excise tax and required to identify its covered employees?

— How does the Section 4960 related-party rule operate? How is compensation allocated among the exempt organization and the taxable entities organization when an executive provides services to both the tax-exempt entity and the taxable entity? Many executives and other employees of large tax-exempt entities may provide services to and be paid multiple entities; some of these entities may be taxable entities. The statute includes a rule regarding the application of the excise tax among the exempt entities, but is not clear as to how compensation should be allocated among the tax-exempt organizations and the taxable entities.

— Is an employee's compensation calculated based on the calendar year (i.e., Form W-2 wages) or based on the exempt organization's fiscal year?

Unrelated business taxation on certain fringe benefit payments

Current law

Tax-exempt organizations, like taxable entities, may provide their employees with transportation fringe benefits, and on-premises gyms and other athletic facilities, free from income tax at both the employer and employee level. Taxable-entity employers may deduct the costs of such benefits and employees may exclude the values of those benefits from their taxable incomes.

Tax Cuts and Jobs Act — new Section 512(a)(7)

TCJA would add a new Section 512(a)(7) that imposes tax on tax-exempt entities with respect to qualified transportation and qualified parking fringe benefits, and any on-premises athletic facilities effective for amounts paid or incurred after December 31, 2017. The provision generally treats the funds used to pay for these benefits as unrelated business taxable income (UBTI), provided the amounts are not deductible under Section 274. In effect, this subjects the expenses of those employee benefits to a tax equal to the corporate tax rate. This is a companion provision to changes to the deductibility of these benefits for taxable entities.

Implications

Although there may be some disconnects, the provision is intended to mirror a companion provision for taxable entities, which changes the deductibility of certain fringe benefits. The taxable entity provision makes certain benefits nondeductible; this provision attempts to replicate the effect of that change for tax-exempt entities by treating the costs of those benefits as taxable income. This introduces additional complexities for tax-exempt entities, particularly for those that may have a policy against engaging in activities subject to unrelated business income tax (UBIT), but historically have provided employees with transportation fringe benefits or access to on-premises gyms and other athletic facilities.

Compensation and benefits provisions affecting private businesses

Tax deferral on private company stock

Current law

Under Section 83, the value of property transferred in connection with the performance of services in excess of the amount paid for the property is included in the employee's gross income when the property is no longer subject to a substantial risk of forfeiture. This rule applies to the transfer of stock of a publicly held corporation or a privately held corporation. For stock option awards, the employee includes in gross income the value of the vested transferred shares determined on the option exercise date over the amount paid as the exercise price. For restricted stock units (RSUs), the employee includes in gross income the value of the shares that are transferred upon settlement of a RSUs following vesting.

Employees of private companies that receive stock option and RSU awards often have taxable income when the stock option is exercised or the RSU is settled. Some, but not all, private employers, permit employees to sell back to the company a number of shares sufficient to pay the tax. But, if the employer does not offer this liquidity option, the employee may have taxable income, but no cash to pay the tax.

Tax Cut and Jobs Act — New Section 83(i)

The TCJA would add to Section 83 a new subsection (i), which would create a special tax payment deferral election for eligible employees who receive private company stock options and RSU awards (qualified stock). If the eligible employee elected to defer the tax of the stock option exercise or receipt of the shares in settlement of an RSU, the

employer would not be entitled to a deduction until the tax year that the employee pays the tax.

An eligible employee has 30 days from the date that vested qualified stock is transferred to make an election not to recognize income at that time. If this election is made, the amount that would have been included in income when the vested stock was transferred would be locked in. The recognition of this income amount would be deferred to the earliest of five years following the date that the vested shares were transferred and a liquidity date (e.g., when the stock becomes transferable or becomes publicly traded). The amount would also be included in the employee's income as of the date that the employee becomes an excluded employee, as described later, or the date that the employee revoked the election. The election is not available if the employee has previously made an 83(b) election with respect to the stock or the corporation in the prior year bought back certain stock subject to a Section 83(i) election (certain broad-based buy-backs are excepted).

Qualified stock could be granted only by a corporation that has never been publicly held (including predecessor corporations and determined on a controlled-group basis). To grant qualified stock eligible for the inclusion deferral election, 80% or more of the US employees must be granted qualified stock with the same rights and privileges in an amount more than a de minimis amount. Only stock options and RSUs awarded in connection with services would be eligible for the income deferred election. Qualified stock includes incentive stock options or an option under an employee stock purchase plan (ESPP), but an election would disqualify the ISO or the ESPP option. Qualified stock may not include a put right or be eligible to be cashed out at vesting.

The CEO, CFO, one of the four highest paid officers of the corporation, as well as 1% owners would not be eligible to make the inclusion deferral election on any stock option or RSU. All other full-time employees would be qualified to make the inclusion deferral election, provided the employee agrees to comply with withholding rules that will be issued in regulations on the qualified stock.

At vesting, the employer would have to certify to a qualified employee that the stock is qualified stock, and notify the employee: (a) of the Section 83(i) election right, (b) that the amount that will ultimately be included in income is the value at vesting even if that value decreases, and (c) that the included amount will be subject to withholding (to be further specified in regulations) at the time of inclusion. Upon inclusion, withholding would be at the maximum individual rate under Section 1 (i.e., 37%). Failure to provide the notice subjects the employer to a penalty liability of $100 per failure, up to $50,000 per year. The income inclusion would be treated as a non-cash fringe benefit under Section 3501(b), which would allow the withholding to be eligible for certain flexibility in timing. While an election is in place, the employee's Form W-2 must report: (1) the amount excluded from income in the current year by reason of a Section 83(i) election;

(2) the amount included in income in the current year by reason of a Section 83(i) election; and (3) the aggregate amount currently deferred by the employee pursuant to all active Section 83(i) elections.

The provision is effective for options exercised and RSUs settled after December 31, 2017. The provision is expressly self-implementing without regulatory action and may be applied by employers using a reasonable good faith interpretation of the statute.

Implications

Private business employers that award stock options or RSUs to a broad-based group that are interested in compensating employees with stock may find new Section 83(i) to be beneficial for the eligible employees and the business. Eligible employees would be able to defer taxation on the value of their vested shares. The employer would not receive a deduction until the employee is subject to tax on the value of the shares; the employer's cash-flow may improve, however, because the employer would not be obligated or permitted to buy back the shares to provide the employee with liquidity.

Private businesses that establish a stock option or RSU program that is designed to be eligible for the Section 83(i) election will need to educate their employees on the benefit of the inclusion deferral election. If the share value increases, employees will receive capital gain treatment on any increase in the value after the exercise of the option or issuance of the RSU; if the share value declines after the exercise or RSU issuance, however, the employee would still owe tax based upon the original value on transfer.

Profits interests

Current law

A partnership profits interest is an interest that provides the holder with the right to receive future profits in the partnership, but does not generally include a right to receive money or property upon the immediate liquidation of the partnership. Profits interests are often awarded to individuals who provide services to a partnership. Also, notably, many asset management firms grant profits interests (sometimes referred to as "carried interest") to individuals who provide services to the funds that they manage. Profits interests may also be issued to individuals working in an operating business that is held through a partnership.

Section 83 requires property transferred in connection with the performance of services to be included in income when the property is no longer subject to a substantial risk of forfeiture. Under the guidance in Revenue Procedure 93-27, profits interests transferred in connection with services generally are not included in the service provider's income upon grant if the requirements in the guidance are satisfied. Revenue Procedure 93-27

provides that the transfer of a profits interest in connection with the performance of services is not included in income, unless: (i) the profits interest relates to a substantially certain and predictable stream of income from the partnership assets; (ii), the partner disposes of the profits interest within two years of receipt; or (iii) the profits interest is in a publicly traded partnership.

Under Section 83(b), a service provider may elect to include in income the value of property transferred in connection with services that continues to be subject to a substantial risk of forfeiture. The Section 83(b) election must be made within 30 days of the date of transfer. In Revenue Ruling 2001-43, the IRS clarified that it was not necessary for service providers to make a Section 83(b) election on the transfer of an unvested profits interest. The ruling clarifies that the nonrecognition of income treatment applies to unvested profits interests provided that the service partner is treated as a partner (even though unvested) and takes into income his or her distributive share of the partnership income, and the partnership does not deduct any amount either on the grant or vesting of the profits interest. Despite this IRS guidance, many service providers have been advised to make protective Section 83(b) elections on the transfer of a profits interest.

Tax Cut and Jobs Act — new Section 1061

The TCJA includes new Section 1061, which provides that the holder of a profits interest received in connection with the performance of substantial services (referred to as an "applicable partnership interest") would be entitled to long-term capital gain treatment only if the underlying assets of the partnership are held for at least three years. (See Tax Alert 2017-2141 for a discussion on this new provision.)

When the new Section 1061 was first proposed in the House bill, it provided that Section 83 does not apply to the transfer of profits interests subject to the new rule. The Senate bill amended new Section 1061 to provide that Section 83 does apply to the transfer of a profits interest. The final TCJA Conference Agreement follows the Senate amendment.

The Conference Report clarifies the interaction of Section 83 and the new Section 1061 three-year holding period requirement. The Conference Report provides that the three-year holding period requirement applies, even if a Section 83(b) election is made by the service provider.

Implications

The TCJA would effectively codify the IRS administrative rules on profits interests. Service providers receiving a transfer of a partnership profits interest in connection with services may continue to be advised to make a Section 83(b) election within 30 days of

the date of transfer. Under Revenue Procedure 93-27 and the new Section 1061, the service provider recognizes no income on the transfer of a partnership profits interest. Making the Section 83(b) election, however, could protect the service provider from income inclusion when the profits interest is no longer subject to a substantial risk of forfeiture.

Compensation and benefits provisions affecting all employers

Deductions and fringe benefits

Deductibility of meals and entertainment expenses

Current law

Section 274 disallows an otherwise available deduction for expenses relating to entertainment, amusement, or recreation activities and facilities unless the item is directly related to or associated with business. This generally means that the deduction is not disallowed if there was a substantial and bona fide business discussion right before or after the entertainment, amusement or recreation. For these purposes, most leisure activities have been treated as included under the umbrella of entertainment, amusement or recreation. The disallowance is subject to a number of exceptions, including food and beverages for employees furnished on the business premises; expenses treated as compensation; reimbursed expenses; nondiscriminatory recreation for employees; business meetings for employees, stockholders, agents or directors; business league meetings; items available to the public; and entertainment sold to customers.

If an entertainment expense is exempt from disallowance by virtue of one of the exceptions or because the expense was directly related to or associated with business, Section 274(n) nevertheless generally permits deduction of only 50% of the expense. This 50% disallowance also applies to otherwise deductible expenses for meals. An entertainment or meal expense is exempt from the 50% disallowance under one of a number of exception, including if the expense is treated as compensation or reimbursed or if the cost of the meal is excludable from the employee's income under Section 132(e)(2)).

Section 132(e)(2) excludes the value of a meal provided at an employer-operated eating facility if the facility is on or near the employer's business premises and its revenue at least equals its direct operating costs. In the ordinary case, an employee must pay (or be imputed) enough for the meal to allow the facility to break even, as is necessary for the facility to qualify for the Section 132(e)(2) exclusion and the Section 274(n) exception. If the meal is provided for the convenience of the employer within the meaning of Section 119 (a separate exclusion from employee income), however, the

employee is deemed to have paid the direct operating costs attributable to the meal. Moreover, if more than half of the facility's meals are provided for the convenience of the employer, all the facility's meals are treated as provided for the convenience of the employer. Thus, if a facility serves more than half its meals for the convenience of the employer, all the facility's meals are excludible from income even if the employees pay nothing and the costs of the facility are fully deductible. The meaning of "convenience of the employer," "facility," and "business premises" have been the subject of considerable controversy in recent years.

The Tax Cuts and Jobs Act

The TCJA would amend Section 274 to disallow entertainment expenses even if directly related to or associated with business. As a result, for expenses paid or incurred after December 31, 2017, business entertainment is now entirely nondeductible unless eligible for one of the exceptions, which have not been modified.

The 50% disallowance that previously applied to meals and entertainment expenses now applies only to meal expenses. This change generally makes sense within the framework of the statutory change because the Section 274 disallowance now comprehensively disallows entertainment expenses without regard to whether the expense relates to a trade or business. There may, however, be a subset of entertainment expenses that are exempt from Section 274's primary disallowance by virtue of one of the exceptions — such as business meetings of employees, stockholders, agents, or directors, and meetings of business leagues — that would be subject to the 50% disallowance under current law, but would be fully deductible under the TCJA.

The 50-percent disallowance was further amended to remove the exception for employer-provided eating facilities. As a result, in 2018, meals provided at such a facility will be more costly to the employer due to loss of half of the deduction. Additionally, beginning in 2026, there will be no deduction available for meals provided either for the convenience of the employer or at an employer-operated eating facility. The TCJA does not modify the provisions in Section 132 and Section 119 excluding these meal from income.

Implications

The TCJA would significantly affect business deductions to the extent those deductions include a leisure element. All forms of business entertainment, including golf outings, fishing, sailing, sporting events, theater, and resort events, are likely to be entirely nondeductible going forward even if substantial and bona fide business discussions were associated with the activity. Taxpayers will want to consider whether certain activities may qualify for one of the exceptions to the Section 274 disallowance. In

particular, employers may be able to structure activities to be treated as recreational expenses for employees, or as employee business meetings.

Denial of deduction for commuting expenses

Current law

Under current law, a qualified transportation fringe benefit used to defray an employee's commuting expenses is excludable from income up to specified limits. There are four types of benefits that are treated as a qualified transportation fringe: (1) transportation from home to work in a commuter highway vehicle; (2) transit passes; (3) qualified parking; and (4) qualified bicycle commuting reimbursements. An employer may provide more than one of these benefits to employees but an employee receiving qualified bicycle commuting reimbursements may not also exclude other qualified transportation fringe benefits in the same month. In 2017, an employee may exclude up to $20 per month in qualified bicycle commuting reimbursements, and up to $255 per month for any other qualified transportation fringe. Under Section 125, employees may also elect to use pre-tax dollars to fund a qualified transportation fringe benefit through a cafeteria plan. An employer's cost for providing a qualified transportation fringe is deductible under Section 162 as an ordinary and necessary business expense.

The Tax Cuts and Jobs Act

The qualified transportation fringe income exclusion would remain available except that the exclusion for qualified bicycle commuting reimbursements would be suspended until 2026. The employer's deduction, however, generally would be disallowed both for the expense of providing a qualified transportation fringe or for any payment or reimbursement, to an employee in connection with travel between the employee's residence and place of employment, except as necessary for ensuring the safety of the employee. The sole exception from this treatment is the qualified bicycle commuting reimbursement, which would continue to be deductible until 2026. During that time, however, an employee could not exclude the reimbursement from income.

Implications

Since 1984, the Code has subsidized an employee's commute, generally in a manner that incentivizes decongestion of roadways by encouraging commuters to vanpool, take public transportation or bike to work. This subsidization, which combined an employer's deduction with an employee's income exclusion, is now being partially eliminated by disallowing the deduction but retaining the exclusion (with the exception of qualified bicycle commuting reimbursements, for which the reverse is being done). Notably, the changes to Section 274 would not allow the employer to choose between deduction and exclusion, which might have given the employer flexibility to choose the more tax-

efficient approach to its particular circumstances. Unless an employer were indifferent to the deduction (e.g., because it is in a net operating loss position), it would be more tax efficient to pay deductible wages subject to payroll taxes at 7.65% than to provide an excludable benefit with dollars that are taxable to the employer at 21%. Accordingly, employers will have to consider whether continuing to offer qualified transportation fringe benefits to employees, whether through a salary reduction or otherwise, continues to make sense for the organization for reasons other than tax efficiency.

Denial of deduction for expenses attributable to the trade or business of being an employee

Current law

Employees may claim an itemized deduction for unreimbursed business expenses, subject to a 2% floor. For expenses that an employer does reimburse, those reimbursements are excludable to the extent that the working condition fringe and accountable plan rules are met.

The Tax Cuts and Jobs Act

From 2018 to 2026, deductions subject to the 2% floor under present law — including unreimbursed business expenses of employees — are suspended.

Employee achievement awards

Current law

Currently, Section 74(c) excludes from employee income the value of certain employee achievement awards to the extent that an award is deductible by the employer. Section 274(j) caps an employer's deduction at $1,600 per employee for a qualified employee achievement award provided pursuant to a written plan that does not discriminate in favor of highly compensated employees and under which the average value of the award does not exceed $400. For other employee achievement awards, Section 274(j) limits the employer's deduction to $400 per employee. For these purposes, an "employee achievement award" means an item of tangible personal property that is transferred by an employer to an employee for length of service or safety achievement that is awarded as part of a meaningful presentation and under conditions that do not suggest that the award is disguised compensation. Under regulations that were proposed by Treasury and IRS in 1989, "tangible personal property" does not include cash, negotiable certificates, vacations, meals, lodging, tickets to theater and sporting events, or stocks, bonds, and other securities. Although these regulations were not

finalized, the IRS's publications and its enforcement position exclude from "tangible personal property" the categories listed in the proposed regulations.

The Tax Cuts and Jobs Act

Effective for amounts paid or incurred after December 31, 2017, the TCJA would add a definition of "tangible personal property" that may be considered a deductible employee achievement award. The definition would essentially codify the IRS's existing enforcement position, providing that tangible personal property does not include cash, cash equivalents, gift cards, gift coupons or gift certificates (other than arrangements conferring only the right to select and receive tangible personal property from a limited array of such items pre-selected or pre-approved by the employer), or vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities, and other similar items. The Conference Report notes that this amendment is not intended to be understood as a change from existing law.

Repeal of exclusion for qualified moving expense reimbursement

Current law

Section 217 currently allows taxpayers a deduction for moving expenses incurred in connection with a move to a new principal place of work. Section 132(a)(6) also excludes from employee income amounts reimbursed by an employer that could have been deducted by the individual under Section 217.

The Tax Cuts and Jobs Act

Effective for tax years from 2018 to 2026, except in the case of an active duty US military member moving pursuant to a military order, the TCJA would suspend the Section 217 deduction and the Section 132(a)(6) exclusion from income. As a result, during this time, non-military employees will no longer be able to deduct moving expenses associated with a job change or exclude the reimbursement of such expenses from income.

Implications

The TCJA would limit an employer's ability to provide a tax-free incentive to encourage employees to relocate. Employers are likely to continue to fund certain moving expenses of employees who are asked to move for a new position, but the reimbursed amounts will not be excludable from employee income and employees may expect to be grossed-up for the taxes owed on the additional income.

Qualified retirement plan provisions

Recharacterizing Roth contributions as traditional IRA contributions

The Conference Agreement follows the House Bill and the Senate amendment that would repeal the special rule allowing a contribution to one type of IRA (a traditional or Roth) to be recharacterized as a contribution to the other type of IRA. Under the TCJA, recharacterization could not be used to unwind a Roth conversion, but would still be permitted for other contributions. This provision is effective for tax years beginning after December 31, 2017.

Extended rollover period for plan loans

The TCJA follows the Senate amendment and would extend the period during which a qualified plan loan offset amount may be contributed to an eligible retirement plan as a rollover contribution from the current 60 days after the date of the offset to the due date, including extensions, for filing the federal income tax return for the tax year in which the plan loan offset occurs. The provision applies to loan offset amounts distributed from qualified retirement plans, Section 403(b) plans or governmental Section 457(b) plans solely by reason of the termination of the plan or the failure to meet the repayment terms of the loan because of the employee's severance from employment. The provision is effective for plan loan offset amounts treated as distributed in tax years beginning after December 31, 2017.

Tax Reform Changes in certain compensation & benefits provisions		
Compensation provisions	**Current law**	**The Tax Cuts and Jobs Act Conference Agreement**
Provisions affecting publicly held corporations		
Section 162(m) — $1 million compensation deduction limitation	• Section 162(m) limits compensation deduction to $1m for amounts paid to a public company's covered employees	• Expands definition of publicly traded companies subject to Section 162(m)

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	• Covered employees consist of CEO and next three highest compensated officers (but not CFO) • Officers not employed on last day of tax year are not covered employees • Performance-based compensation and commissions are not subject to deduction limitation	• Expands definition of covered employee to include CFO, as well as CEO and the three (rather than four) most highly compensated officers for the tax year • Covered employee continues to be a covered employee after leaving position • Repeals exceptions for performance-based compensation and commissions • Applies transition rule to remuneration provided pursuant to a written binding contract in effect on November 2, 2017 and not modified in any material respect on or after that date
Section 4985	• Certain holders of stock options and other stock-based compensation granted in connection with the performance of services are subject to a 15% excise tax on any gain recognized in whole or in part by reason of a transaction that results in an expatriated corporation (i.e., an inversion)	• Increases 15% rate excise tax to 20%
Provisions affecting private businesses		
Section 83	• Upon vesting, Section 83 taxes individuals on the value of property transferred in connection with the performance of services	• Permits certain employees to defer income inclusion to the earliest of transferability, IPO, five years following vesting, or revocation of deferral election for certain stock options and stock-settled RSUs when certain conditions are met

Profits interests	• Capital gain or loss realized by an individual partner from the disposition of a profits interest is short-term gain unless the partner's holding period in the partnership interest is more than one year • Capital gain allocated to an individual partner as long-term capital gain with respect to carried interest is deemed to be short-term capital gain to the extent the partnership's holding period on the disposed property is a year or less	• Treats capital gain or loss realized by an individual partner from the disposition of a profits interest as short-term gain unless the partner's holding period in the partnership interest was more than three years • Deems capital gain allocated to an individual partner as long-term capital gain with respect to carried interest to be short-term capital gain to the extent the partnership's holding period on the disposed property is three years or less • Applies even if individual makes a Section 83(b) election
Provisions affecting exempt organizations		
Executive compensation of tax-exempt organizations	• Tax-exempt organizations generally are not subject to compensation limitations other than private inurement rules and sanctions for excessive compensation	• Imposes an excise tax on tax-exempt employers equal to 21% of: (1) remuneration paid to covered employees that exceeds $1 million; and (2) any excess parachute payments (under a new definition) made to highly compensated (within the definition of Section 414(q)) covered employees • Defines covered employee as one of the five highest compensated employees for the tax year, or such an employee in a preceding tax year
UBIT on fringe benefits	• Tax-exempt organizations are subject to UBIT only on income that is not substantially related to the performance of the organization's	• Imposes UBIT on expenses paid or incurred by a tax-exempt organization for qualified transportation fringe

	tax-exempt functions, with several exclusions	benefits, parking facilities used in connection with qualified parking, or any on-premises athletic facility, provided these amounts are not deductible under Section 274
Provisions affecting all businesses		
Fringe benefits	• Taxpayers may deduct 50% of expenses for entertainment activities that directly relate to or are associated with substantial and bona fide business discussions or meet certain exceptions • Taxpayers may generally deduct 50% of expenses for meals, but under certain exceptions (such as employer-operated eating facilities), the full expense is deductible	• Repeals the 50% deduction for entertainment expenses directly related to the active conduct of the taxpayer's trade or business, leaving such expenses nondeductible • Allows taxpayers to generally continue deduct 50% of the food and beverage expenses associated with operating their trade or business • Expands the 50% limitation by removing the exception for employer-operated eating facilities • Denies deduction after December 31, 2025, for expenses for employer-operated eating facilities or meals provided for the convenience of the employer
	• Employees may deduct unreimbursed business expenses, subject to a 2% floor	• Suspends through 2025 all itemized deductions that are currently subject to the 2% floor, including the deduction for unreimbursed business expenses of employees
	• Employees may exclude the value of certain "tangible personal property" awarded as an employee	• Codifies existing IRS rule to exclude cash, cash equivalents, gift cards, gift coupons or gift certificates, or

	achievement award to the extent deductible by the employer	vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities, and other similar items from "tangible personal property" that might be treated as an "employee achievement award"
	• Employees may deduct unreimbursed moving expenses incurred by the employee in connection with a move to a new principal place of work, and may exclude from income moving expenses that are reimbursed by an employer	• Suspends through 2025 the deduction and exclusion for qualified moving expense reimbursements, except in the case of a member of the US Armed Forces on active duty who moves pursuant to a military order
Retirement plan provisions	• Taxpayers may recharacterize contributions to Roth IRAs as traditional IRA contributions, and convert traditional IRA contributions to Roth IRA contributions	• Allows taxpayers to convert contributions to a traditional IRA to Roth contributions, but not to unwind a Roth conversion and recharacterize a Roth contribution as a contribution to a traditional IRA after the year of contribution
	• Employees may take loans from their defined contribution plans; however, if the employee terminates employment, rolls over the remaining account balance in the plan to an IRA, and fails to contribute the loan balance to the IRA within 60 days after receiving the loan amount, the loan will be treated as a distribution subject to an additional 10% tax	• Extends the period during which a qualified plan loan offset amount may be contributed to an eligible retirement plan as a rollover contribution from 60 days after the date of the offset to the due date (including extensions) for filing the federal income tax return • Defines a qualified plan loan offset amount as an amount treated as distributed from a qualified retirement plan, Section 403(b) plan or governmental Section 457(b) plan solely by reason of the

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		termination of the plan or the failure to meet the repayment terms of the loan because of the employee's severance from employment)
Individual mandate	• Section 5000A imposes a penalty on individuals who fail to maintain minimum essential health care coverage	• Reduces penalty to zero, effectively repealing the individual mandate
Provisions not included in the conference agreement		
Nonqualified deferred compensation (NQDC)	• NQDC is included in employee income when paid (or constructively received) or when a stock option is exercised • Sections 409A (taxable businesses), 457(f) (tax-exempt and governmental entities), 457A (employers in jurisdictions with no comprehensive income tax) govern NQDC	• Taxed employee income at vesting (original Ways and Means Committee bill and Senate Finance Committee proposal) • Not included in TCJA
FIFO stock provision	• If a taxpayer who acquires different shares of stock in a corporation on different dates or at different prices and later sell or transfers some of the shares, and the lot from which the stock is sold or transferred is not adequately identified, the shares sold are deemed to be drawn from the earliest acquired shares in accordance with the FIFO rule; if a taxpayer makes an adequate identification of the shares sold, however, the shares treated as sold are the shares that have been identified	• Required use of the FIFO method except to the extent the average basis method was otherwise allowed (original Senate Finance Committee proposal) • Not included in TCJA
Fringe benefit provisions	• Employees may exclude from income the value of employer-provided education up to $5,250 per year	• Repealed exclusion for employer-provided education (original Ways and Means Committee bill)

		• Not included in TCJA
	• Employees may exclude from income reimbursements received from an employer under a dependent care assistance program up to $5,000 per year	• Repealed the exclusion for dependent care assistance (original Ways and Means Committee bill) • Not included in TCJA
	• Employees may exclude up to an inflation-adjusted amount ($13,750 in 2017) for qualified adoption expenses paid by an employer under an adoption assistance program	• Repealed exclusion for adoption care assistance (original Ways and Means Committee bill) • Not included in TCJA
Retirement plan provisions	• Defined benefit plans and state and local government defined contribution plans may not permit an employee to take a distribution while still employed until age 62; for defined contribution plans, the in-service distribution rule applies to those age 59 ½ and younger	• Modified the rules to permit all defined benefit plans and state and local government plans to allow in-service distributions beginning at age 59 ½, (original Ways and Means Committee bill) • Not included in TCJA
	• Section 401(k) plans that permit employees to take a hardship distribution from the plan must require the employee to suspend making contributions for a period of six months	• Directed IRS to issue guidance that would allow employees who received hardship distributions to continue making contributions to the plan (original Ways and Means Committee bill) • Not included in TCJA
	• Hardship distributions are limited to the amounts actually contributed by an employee and do not include earnings or amounts contributed by the employer	• Allowed hardship distributions to include earnings and employer contributions (original Ways and Means Committee bill) • Not included in TCJA
	• Qualified retirement plans must comply with specific	• Expanded the nondiscrimination testing

	nondiscrimination and coverage requirements, and employers that allow current employees to continue to accrue benefits under a plan, but have closed the defined benefit plan to new employees, will violate these requirements	between an employer's defined benefit plan and defined contribution plan (referred to as "cross-testing") in a manner that would give employers greater flexibility to satisfy the nondiscrimination requirements (original Ways and Means Committee bill) • Not included in TCJA
	• Employees aged 50 or older are allowed to make additional contributions (generally $6,000 for 2017) to a 401(k), 403(b), or 457(b) plan	• Disallowed catch-up contributions for employees who receive wages of $500,000 for the following year (original Senate Finance Committee proposal) • Not included in TCJA

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