IslerDare PC

EMPLOYEE BENEFITS UPDATE

November 6, 2017

Key Features of the Tax Reform Bill That Could Affect Your Benefit Plans and Executive Compensation Practices

Executive Summary

- The Tax Cuts and Jobs Act (the "Tax Reform Bill"), introduced on November 2, 2017, would make significant changes to your benefit plans and executive compensation practices. In particular, the proposed changes to nonqualified deferred compensation arrangements, incentive programs, and equity awards (like stock options and stock appreciation rights), would mark a dramatic departure from the current ways in which those programs are used to attract and retain talent.

What You Should Do

- Stay abreast of new developments, because the Tax Reform Bill has a long way to go before it becomes law. Congressional leadership has set an ambitious timeframe to have tax reform legislation finalized and signed into law before the end of the year, so it is likely that the Tax Reform Bill will change as it goes through the legislative process (and the intensive lobbying that will likely follow).

KEY FEATURES AFFECTING QUALIFIED RETIREMENT PLANS

- **No change in contributions to 401(k) plans.** Despite much speculation that the Tax Reform Bill might limit the amount that employees can contribute, on a pre-tax basis, to a 401(k) plan, the final version of the Bill does not change the amount that employees can contribute to a 401(k) plan, on either a pre-tax basis or after-tax "Roth" basis, nor does the Bill mandate that a certain amount or percentage of employees' contributions be made as after-tax "Roth" contributions.
    - Note that, as announced in our October 20, 2017 Employee Benefits Update, for 2018, employees can contribute up to $18,500, plus $6,000 of "catch-up" contributions for employees who are aged 50 or older.

- **Lowering the age for in-service distributions under defined benefit plans from 62 to 59½.** Currently, defined benefit pension plans may, but are not required to, allow actively-employed participants to begin receiving a distribution of their accrued benefits, at age 62. Under the Tax Reform Bill, this minimum age would be lowered to age 59½.

- **Changing the rules for hardship distributions from 401(k) plans.**

    - Under current law, hardship distributions can be made only from the amount that the employee contributed to a 401(k) plan; under the Tax Reform Bill, hardship distributions could also be made from employer contributions and investment earnings.
    - Currently, a 6-month suspension period is imposed on a participant who receives a hardship distribution, which precludes the employee's ability to continue to contribute to a 401(k) plan. The Tax Reform Bill eliminates this suspension period and would allow employees who take hardship distributions to continue making contributions to the plan.

- **Providing flexibility for repayment of plan loans.** Currently, employees who have 401(k) plan loans outstanding when their plan terminates or when they separate from employment may only have 60 days to repay the loans if they want to avoid taxes and penalties. Under the Tax Reform Bill, these employees would have an extended period of time (until the due date for filing their tax return for the year of termination or separation) to contribute the loan balance to an IRA to avoid having the loan being taxed.

KEY FEATURES AFFECTING FRINGE BENEFIT PROGRAMS

- **Repealing exclusions from income of employer-provided educational assistance, dependent care assistance, and adoption assistance.** The Tax Reform Bill would impact many popular fringe benefit programs by repealing the exclusion from income of certain reimbursements or benefits that employees currently receive under:

    - Employer-provided educational assistance programs (up to $5,250 annually).
    - Dependent care assistance programs (up to $5,000 annually), which are often part of an employer's cafeteria or flexible benefits plan.
    - Adoption assistance programs (up to $13,750).

KEY FEATURES CHANGING EXECUTIVE COMPENSATION ARRANGEMENTS

Although they are not getting much attention in the press, a number of provisions of the Tax Reform Bill would turn existing executive compensation practices on their head. In large measure, these provisions can be classified as "be careful what you wish for", because the much-maligned provisions of Section 409A of the Internal Revenue Code would be repealed and replaced with a new Section 409B that would, among other things, include equity awards in the classification of what is "deferred compensation" and would provide for immediate taxation upon vesting.

Key features of the Tax Reform Bill affecting executive compensation arrangements include the following:

- **Immediate taxation of deferred compensation upon vesting.** All nonqualified deferred compensation plans or arrangements would become taxable as soon as the compensation is vested (no longer subject to a substantial risk of forfeiture), even if not yet paid.

- As currently written, vesting would be delayed only while an executive was still performing services for the organization; other standards, such as performance-based conditions that currently delay vesting of certain deferred compensation benefits would no longer cause vesting (or immediate taxation) to be delayed.
- The current rules would apply to existing arrangements only through 2025; the new rules would apply to any amounts attributable to services performed after December 31, 2017.
- These rules would mark a dramatic departure from existing law and would strip away the effectiveness of any deferral elections or payment schedules that are in place.
- The rules would also sweep in stock options; equity appreciation rights; and incentive awards into being classified as "deferred compensation". These awards would be includible in income upon vesting, whether or not exercised.
- As currently drafted, there is no exemption for severance plans or arrangements, so it is possible that under these rules, severance pay would be taxed upon an executive's termination, even if the business terms provide for severance to be paid over time or conditioned on the executive's compliance with restrictive covenants, such as a non-compete agreement.

- **Elimination of performance-based compensation exception to $1M deductible cap on compensation.** Compensation in excess of $1M payable to the CEO, CFO and three other highest-paid executives of publicly-traded companies (each, a "covered employee") would not be deductible, and the Tax Reform Bill would eliminate the important exception for performance-based compensation and stock options, which have been widely used by publicly-traded companies to increase compensation packages for their top-tier talent. In addition, once an individual is considered a "covered employee", he or she would remain a covered employee for subsequent years.

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If you would like more information about how the proposals under the Tax Reform Bill might impact the benefit programs and executive compensation practices of your organization, please feel free to contact the members of our Employee Benefits group below.

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