Tax Reform: Provisions Relevant to Compensation, Benefits, & Qualified Plans

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Introduction

On December 22, 2017, H.R. 1, originally known as the "Tax Cuts and Jobs Act" was signed into law. The legislation includes substantial changes to the taxation of individuals, businesses in all industries, multi-national enterprises, and others. Overall, there are estimates of a net tax reduction of approximately $1.456 trillion over the 10-year "budget window" (according to estimates provided by the Joint Committee on Taxation (JCT) that do not take into account macroeconomic/dynamic effects).

This report includes analysis and observations regarding the myriad of changes in H.R. 1 related to the taxation of compensation and benefits, including, but not limited to discussions of (1) the changes to the limit on excessive employee remuneration under section 162(m); (2) disallowance and deduction limits for certain expenses and fringe benefits; and (3) a new provision under section 83(i) to delay the taxation of certain types of equity compensation.

This is one of a series of reports that KPMG has prepared on tax reform legislation. To follow KPMG's reports and coverage of legislative developments, see ***TaxNewsFlash-Tax Reform***.

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Compensation

As noted in the Introduction, the new law contains several significant changes to compensation and benefits, including the changes to the limit on excessive employee remuneration under section 162(m); disallowance and deduction limitations for certain expenses and fringe benefits; and a new provision under section 83(i) to delay the taxation of certain types of equity compensation. The final legislation does not include some of the notable provisions within the initial draft bills. For example, it does not include provisions relating to the elimination of deferred compensation, rules regarding qualified plan in-service distributions and hardship withdrawals, and/or provisions regarding the termination of deductions and exclusions for contributions to medical savings accounts.

The provisions described below are in the new law.

Modification of limitation on excessive employee remuneration under section 162(m)

The new law expands the scope and repeals the exceptions to the section 162(m) $1 million deduction limitation. The provisions expand the definition of "covered employee" to include the principal executive officer, principal financial officer, and the top three other highest-paid officers. Further, once an employee is treated as a covered employee, the individual remains a covered employee for all future years, including with respect to payments made following termination, retirement, death, etc. The conference report's Joint Explanatory Statement provides that any individual who is a covered employee in a tax year beginning after December 31, 2016 remains a covered employee for future tax years.

The definition of a "publicly held corporation" is expanded to include all domestic publicly traded corporations, private companies with publicly traded debt, and certain foreign private issuers with ADRs traded on the U.S. market. Although the Joint Explanatory Statement implies that the definition may include some corporations that are not publicly traded, such as large private C or S corporations, the Code provisions do not appear to extend beyond SEC filers and, potentially, acquirers of prior public companies.

The new law provides a transition rule to the section 162(m) amendments. Under this rule, the new provisions do not apply to any remuneration paid under a "written binding contract" in effect on November 2, 2017, which was not materially modified on or after this date. The Joint Explanatory Statement provides that compensation paid under a plan qualifies for this transition relief provided that the right to participate in the plan is part of a written binding contract with the covered employee in effect on November 2, 2017, even if the covered employee was not actually a participant on November 2, 2017.

The Joint Explanatory Statement provides an example of a grandfathered arrangement. The example includes a covered employee, newly hired and covered by an employment agreement in effect on October 2, 2017. The written employment contract provides that the employee was covered by the company's deferred compensation plan after six months of employment. The plan terms provide amounts payable under the plan are not subject to discretion, and the corporation does not have the right to amend materially the plan or terminate the plan, except prospectively before services are provided for an applicable period. It is noted that such payments would be grandfathered. The Joint Explanatory Statement specifies that a plan in existence on November 2, 2017 is not by itself sufficient to meet the exception for written binding contracts. Additionally, the statement clarifies that a contract that renews after November 2, 2017 is treated as a new contract on such renewal.

The provision is effective for tax years beginning after 2017.

The JCT has estimated the provision will increase revenues by approximately $9.2 billion over 10 years.

KPMG observation

The elimination of the exception for performance-based compensation from the $1 million dollar deduction limitation is a substantial change to the pre-enactment rules. The performance-based exception, while complex, was frequently relied upon exception to preserve a publicly held corporation's deduction for covered employee compensation. The new law's expansion of the covered employee definition to include the principal financial officer in alignment with the definition used by the SEC has been a long discussed and expected change. But, expanding the definition to apply even after officers terminate employment was a major unexpected change. How the deduction limitation applies following a corporate transaction (acquisition, merger, etc.) or to service a former employee provides in another capacity, such as a nonemployee director, is unclear.

There are a number of open questions on the exact application of the transition rule.

The new law expands the definition of publicly held corporation to include any corporation required to file reports under section 15(d) of the Securities Exchange Act.

Articles on section 162(m) changes:

- H.R. 1 section 162(m) changes and tax provision review implications

- Revisions to section 162(m) bite as hard as they bark

- Update on H.R. 1 Provisions on section 162(m)

Excise tax on excess tax-exempt organization executive compensation

This new law imposes an excise tax equal to the corporate tax rate (21%) on remuneration in excess of $1 million and on excess parachute payments paid by an organization exempt from tax under section 501(a), an exempt farmer's cooperative (section 521(b)(1)), a political organization (section 527), or a state or local governmental entity with excludable income (section 115(1)), to any of its current or prior (beginning after December 31, 2016) five highest-paid employees.

Remuneration includes cash and other benefits paid in a medium other than cash and is treated as paid when there is no substantial risk of forfeiture of the rights to such remuneration. However, it does not include any designated Roth contribution (section 402A(c)), amounts that are excludable from gross income, or payments to licensed medical professionals (e.g., doctors, nurses, or veterinarians) for the performance of medical or veterinary services. Remuneration would also include payments from certain related organizations, including organizations that control, or are controlled by, the tax-exempt organization. However, remuneration that is not deductible by reason of the $1 million limit on deductible compensation (section 162(m)) is not taken into account for purposes of the provision.

A "parachute payment" generally is defined as a payment contingent upon an employee's separation from employment if the aggregate present value of such payment equals or exceeds three times the employee's base amount. Parachute payments do not include payments under a qualified retirement plan, a simplified employee pension plan, a simple retirement account, a tax-deferred annuity (section 403(b)), or an eligible deferred compensation plan of a state or local government or tax-exempt organization (section 457(b)). Further, parachute payments do not include payments to licensed medical professionals for the performance of medical or veterinary services or to individuals who are not highly compensated employees under section 414(q). The excise tax is applied to the excess of the parachute payment over the portion of the base amount allocated to the payment.

The provision applies to remuneration and parachute payments paid in tax years beginning after December 31, 2017 (though it would define covered employees in tax years beginning after December 31, 2016).

The JCT has estimated the provision will increase revenues by approximately $1.8 billion over 10 years.

KPMG observation

The new law follows the Senate bill with some modifications:

- Determining the excise tax by reference to the corporate rate (rather than as a fixed percentage)
- Defining substantial risk of forfeiture by reference to section 457(f)(3)(B)
- Exempting payments to non-highly compensated employees (as defined in section 414(q)) from the definition of parachute payment
- Excluding remuneration paid to a licensed medical professional (e.g., doctor, nurse, or veterinarian) that is directly related to the performance of medical or veterinary services.

Specifically, the new law provides rules for tax-exempt entities that are similar to section 162(m) limits on the deductibility of compensation paid by publicly traded corporations, but it does not incorporate a transition rule similar to that included in the changes to section 162(m), under which remuneration paid pursuant to a written binding contract in effect on November 2, 2017, would be excluded from the new rule, so long as the agreement is not later modified.

The new law also provides rules for tax-exempt entities that are similar to section 280G rules on excess parachute payments that may be applicable to taxable corporations. The provision related to “excess parachute payments” relies upon section 280G guidance for determining the “base amount” calculation.

By excluding remuneration directly related to the provision of medical services, the new law should help alleviate concerns of tax-exempt hospitals that commonly pay certain specialist physicians more than $1 million.

The provision imposes the excise tax on the employer and related organizations, each sharing the liability in proportion to the compensation paid. As a result of the provision’s broad definition of related organizations, it appears that a taxable organization could be subject to the excise tax.

The provision adds an additional layer of complexity to the rules governing compensation paid by tax-exempt organizations. Sections 4941 and 4958 impose excise taxes on the recipients of unreasonable or excess compensation paid by certain tax-exempt organizations. In addition, the inurement prohibition that applies to most tax-exempt organizations, the violation of which may result in loss of tax-exempt status, guards against the payment of unreasonable compensation. The provision appears to not take into account some of these existing rules.

Treatment of qualified equity grants

The new law allows certain employees to defer the timing of compensation for certain stock options and restricted stock unit (RSU) plans for private companies. Under this provision, if “qualified stock” is granted to a “qualified employee,” then the employee may make an election within 30 days of vesting to have the tax deferred. In such case, the employee would have income the earliest of:

- The first date the stock is transferable
- The date the employee becomes an “excluded employee”
- The first date the stock becomes readily tradable on an established securities market
- The date that is five years after vesting, or
- The date the employee revokes the election.

This election would only be allowed on “qualified stock,” which includes stock from the exercise of a stock option or the settlement of an RSU provided that the option or RSU was granted for the performance of services in a calendar year for which the corporation was an “eligible corporation.” In order to be an eligible corporation, the stock of the company may not be readily tradable on an established securities market during any previous year. In addition, the company must have a written plan during the year and not less than 80% of all employees who provide services in the United States may be granted options and RSUs with the same rights and privileges. The 80% rule could not be satisfied in a year with a combination of options and RSUs. All employees must be granted stock options or RSUs. Stock would not be qualified stock if the employee can sell or receive cash in lieu of stock from the corporation at the time of vesting.

The election could not be made by an “excludable employee”, which includes:

- An individual who has been a 1% owner during the calendar year or was a 1% owner at any time during the last 10 years
- An employee who is or has at any time been the CEO or CFO or an individual acting in such capacity
- A person who is a family member of an individual descripted in the above two bullets, or
- A person who is one of the four highest compensated officers or has been one of the four highest compensated officers of the corporation in the 10 preceding tax years.

The election must be made by the employee within 30 days of vesting. The employer must provide the employee with notice of eligibility to make the election.

An election may not be made if the stock is readily tradable on an established securities market, or the company has purchased outstanding stock in the prior year (unless at least 25% is deferral stock and the individuals eligible to participate were determined on a reasonable basis).

A qualified employee would be allowed to make an election on qualified stock from a statutory option, but the option would no longer be treated as a statutory option. Further, the option would be treated as a nonqualified stock option for FICA withholding purposes.

The new law specifies that section 83 does not apply to RSUs, except for the section 83(i) election. RSUs are not eligible for section 83(b) elections.

The election would be valid only for income tax purposes and would not change FICA and FUTA timing. In the tax year the income is ultimately required to be included in the employee's income as wages, the employer would be required to withhold at the highest individual income tax rate. The employer would be required to report the amount of the election deferral on the Form W-2 in both the year of the election and the year the deferral is required to be included in income. Also, the employer would be required to report annually on the Form W-2 the aggregate amount deferred under such an election.

As part of a transition period and until additional guidance is provided, the new law provides that a company is in compliance with both the 80% rule and the notice requirements so long as the company complies with a "reasonable and good faith" interpretation of the requirements.

The provision is effective for options exercised, or RSUs settled, after December 31, 2017.

The JCT has estimated that the provision will decrease revenues by approximately $1.2 billion over 10 years.

KPMG Observation

This provision may have been added to assist private companies that give broad groups of employees equity compensation but have no market for the shares. The exercise of the options or transfer of the stock in private companies with no liquidity generally results in illiquid income with federal and state withholding requirements. Note that the deferral is limited to five years and will result in illiquid income if company shares are not liquid within that period.

There are also questions about whether the employer must opt into the program or whether it is automatic in situations that satisfy the provisions in light of the penalty for failing to give employees notice when there is an opportunity to defer under this provision.

Article on section 83(i):

- A new paradigm for equity deferrals in private companies – Section 83(i) elections

Fringe benefits

Limitation of deduction by employers of expenses for entertainment and certain fringe benefits

The new law repeals deductions for entertainment, amusement, and recreation even when directly related to the conduct of a taxpayer’s trade or business. The new law provides that no deduction is allowed for (1) an activity considered entertainment, amusement, or recreation, (2) membership dues for any club organized for business, pleasure, recreation, or other social purposes, or (3) a facility or portion of a facility used in connection with entertainment, amusement or recreation.

The 50% deduction limitation for food and beverage expenses associated with a trade or business is generally retained. However, the provisions expand the 50% limitation to certain meals provided by an employer that previously were 100% deductible. The expanded 50% limit applies to food and beverages provided to employees as de minimis fringe benefits, to meals provided at an eating facility that meets the requirements for an on-premises dining facility, and to meals provided to employees under section 119 for the convenience of the employer. The 50% deduction limit applies for years after 2017 and before 2026. The on-premises meals and section 119 meals expenses and the expenses for the related on-premises facilities would be nondeductible after 2025.

The new law disallows any deduction expense of any qualified transportation fringe (as defined in the section 132(f) rules). Separately, the new law disallows the deduction for expenses to provide transportation or to reimburse for the expenses for commuting between the employee’s residence and place of employment (unless the expenses are “necessary for ensuring the safety of an employee”). These costs appear to include employee buses, van pools, subway or transit cards, and qualified parking fees.

JCT has estimated this provision will increase revenue over 10 years by approximately $23.5 billion for meals and entertainment expenses and $17.7 billion for qualified transportation fringes.

KPMG observation

Meals, including de minimis food and beverages that used to be 100% deductible, are generally 50% deductible under the new law. There remains uncertainty regarding whether the meals provided during a recreational event fall under the meal or recreational deduction limit, such as a meal in connection with a business meeting at a ballgame.

The new law essentially provides the employer with a choice to include certain de minimis or convenience of employer meals in employee taxable income and take a 100% tax deduction or exclude the amounts and take a lesser deduction.

Commuting expenses are not deductible under the new law except to ensure the safety of the employee. The factual situations that would satisfy the safety exception remain uncertain. This new law language could be read to suggest that even taxable commuting may not be deductible, but it seems unlikely that this was intended. When the same sort of language was added for spousal travel, the IRS clarified in regulations that taxable spousal travel is still deductible.

Additional articles on section 274:

- Tax Reform Takes a Bite Out of Employer Fringe Benefit Deductions
- Dishing Out Tax Reform: Impact on Employer Provided Meals in Food Service Sector

Unrelated business taxable income increased by amount of certain fringe benefit expenses for which deduction is disallowed

The new law modifies the definition of unrelated business taxable income (UBTI) to include amounts paid or incurred by tax-exempt organizations in providing certain transportation fringe benefits (i.e., any qualified transportation fringe defined in section 132(f) and any parking facility used in connection with qualified parking defined in section 132(f)(5)(C)) and on-premises athletic facilities (defined in section 132(j)(4)(B)) if such benefits would be nondeductible (under section 274) if provided by taxable employers. The modification does not apply to the extent the amount paid or incurred is directly connected to an unrelated trade or business regularly carried on by the organization.

These changes apply to amounts paid or incurred after December 31, 2017.

The JCT estimate of the effects of this provision on revenue is included in the estimate above for the repeal of the deduction for qualified transportation fringes.

KPMG observation

The new law follows the House bill, and conforms in part to the disallowed deductions as set forth in section 13304 of the new law, which disallows deductions for qualified transportation fringes (see "Limitation of deduction by employers of expenses for entertainment and certain fringe benefits," discussed above). However, section 13304 does not appear to disallow a deduction for on-premises athletic facilities.

Suspension of exclusion for qualified bicycle commuting reimbursement

Pre-enactment law excluded up to $20 a month in qualified bicycle commuting reimbursement from an employee's gross income. The new law suspends this exclusion for years 2018–2025 such that any reimbursement of this expense would be taxable.

The new law provision applies for tax years beginning after December 31, 2017.

The JCT has estimated this provision (subject to a December 31, 2025 sunset) will increase revenue by less than $50 million over 10 years.

Suspension of exclusion for qualified moving expense reimbursements

Under pre-enactment law, qualified moving expense reimbursements were excludable from an employee's gross income and from the employee's wages for employment tax purposes. Such expenses included amounts received (directly or indirectly) from an employer as payment for (or reimbursement of) expenses that would have been deductible as moving expenses if directly paid or incurred by the employee. Qualified moving expense reimbursements did not include amounts actually deducted by the individual. For members of the U.S. Armed Forces (and family members), moving and storage reimbursements and allowances for these expenses were excluded from gross income.

The new law suspends the exclusion from gross income and wages for qualified moving expense reimbursements for years 2018–2025. The exclusion is preserved for U.S. Armed Forces members (and family members).

The effective date is for tax years beginning after December 31, 2017.

The JCT estimated that this provision (subject to a December 31, 2025 sunset) will increase revenues by approximately $4.8 billion over 10 years. The estimate includes policy that retains the exclusion (under section 217(g)) related to members of the U.S. Armed Forces.

Suspension of deduction for moving expenses

Under pre-enactment law, individuals were permitted an above-the-line deduction for moving expenses paid or incurred in connection with starting work either as an employee or as a self-employed individual at a new principal place of work. These expenses were deductible only if specific distance and employment status requirements were met. In the case of certain members of the U.S. Armed Forces (and family members), the rules governing moving expenses also provided a special rule creating a targeted income exclusion for moving and storage expenses furnished in kind.

The new law suspends the deduction for moving expenses for years 2018–2025. However, the targeted rules providing income exclusions to members of the U.S. Armed Forces (or their spouse or dependents) are retained.

The effective date is for tax years beginning after December 31, 2017.

The JCT estimated that this provision (subject to a December 31, 2025 sunset) will increase revenue by approximately $7.6 billion over 10 years. (Note that the retention of the target income exclusion rules for military families appears to be included in the revenue analysis for the general exclusion rule described above.)

KPMG observation

Repeal (or suspension) of the deduction for moving expenses can be expected to increase the cost of relocating employees. Businesses required to move employees to meet their business needs could face significantly higher costs after taking into account the gross-up for taxes.

Retirement savings

Repeal of special rule permitting recharacterization of IRA contributions

The new law provides that the special rule allowing contributions to one type of IRA to be recharacterized as a contribution to the other type of IRA does not apply to a conversion to a Roth IRA. The new law provides that a conversion contribution to a Roth IRA during a tax year may no longer be recharacterized as a contribution to a traditional IRA and unwinding the conversion. Recharacterization is still be permitted for other contributions. This provision does not prohibit a contribution to an IRA and a conversion to a Roth IRA.

The effective date is for tax years beginning after December 31, 2017.

The JCT has estimated the provision will increase revenues by approximately $500 million over 10 years.

Extended rollover period for the rollover of plan loan offset amounts

The new law extends the period allowed for a qualified plan loan offset amount to be contributed to an eligible retirement plan as a rollover contribution from 60 days to the due date, including extensions, for filing the Federal income tax return for the tax year the loan offset occurs. This extension would apply to a qualified plan loan offset amount distributed from a qualified retirement plan, section 403(b) plan, or governmental section 457(b) plan solely because of a termination of the plan or the failure to meet the repayment terms because of a severance from employment.

The effective date is for plan loan offsets amounts treated as distributed in tax years beginning after December 31, 2017.

The JCT has estimated the provision would have negligible revenue impact over 10 years.

KPMG observation

The pre-enactment rules only allowed an employee 60 days to pay the qualified loan offset amount to an IRA or retirement plan upon termination of employment or the loan is treated as a distribution. The new law provides an employee with additional time to contribute the loan offset amount before it is characterized as a taxable distribution.

Modification of rules for length of service award plans

The new law provides an increased aggregate amount of length of service awards under the section 457 exemption that may accrue for a bona fide volunteer to any year of service to $6,000 with an annual cost of living adjustment after the first year. If the plan is a defined benefit plan, the limit applies to the actuarial present value of the aggregate amount of length of services awards accruing to any year of service.

The effective date is for tax years beginning after December 31, 2017.

The JCT has estimated that the provision will decrease revenues by approximately $500 million over 10 years.

Relief for 2016 disaster areas

The new law provides tax relief for any area for which a major disaster has been declared by the president during 2016.

The new law provides an exception to the 10% early withdrawal tax related to a qualified 2016 disaster distribution from a qualified retirement plan, a section 403(b) plan, or an IRA. In addition, income attributable to such distribution is included in income ratably over three years. Further, the amount of the distribution may be recontributed to an eligible retirement plan within three years. The total amount of distributions from all eligible retirement plans that may be treated as qualified 2016 disaster distributions is $100,000 per individual.

The provision is effective on the date of enactment.

JCT has estimated the provision will decrease revenues by approximately $4.6 billion over 10 years.

Miscellaneous

Modification to individual AMT

The new law temporarily increases the AMT exemption amounts and the phase-out thresholds for individuals.

For married taxpayers filing a joint return (or for a surviving spouse): The AMT exemption amount for 2018 increases from $86,200 under pre-enactment law to $109,400. The phase-out threshold increases from $164,100 to $1,000,000.

For married taxpayers filing a separate return: The AMT exemption amount increases from $43,100 (under pre-enactment law for 2018) to $54,700. The phase-out threshold increases from $82,050 to $500,000.

For all other individual taxpayers: The exemption amount for 2018 under pre-enactment law is $55,400. The new law raises this amount to $70,300. The phase-out threshold increases from $123,100 to $500,000.

The increased exemption amounts and phase-out thresholds are scheduled to sunset after December 31, 2025.

The JCT has estimated that the temporary increase in the exemption amounts and phase-out thresholds will decrease revenues by approximately $637 billion over 10 years.

Reduce Affordable Care Act individual shared responsibility payment to zero

The individual shared responsibility provision requires individuals to be covered by a health plan that provides at least minimum essential coverage, or be subject to a tax for failure to maintain the coverage. The tax is imposed for any month that an individual does not have minimum essential coverage, unless the individual qualifies for an exemption.

Under the new bill, the amount of the individual shared responsibility payment is reduced to zero, starting in 2019.

This provision is not subject to the December 31, 2025, expiration date applicable to many other provisions affecting the taxation of individuals in this bill. The JCT has estimated that reducing the individual shared responsibility payment to zero will increase revenues by approximately $314 billion over 10 years.

Employer credit for paid family and medical leave

The new law allows eligible employers to claim a credit equal to 12.5% of the amount of wages paid to qualifying employees during any period in which such employees are on family and medical leave (FMLA) if the rate of payment under the program is 50% of the wages normally paid to an employee. The credit is increased by 0.25 percentage points (but not above 25%) for each percentage point by which the rate of payment exceeds 50%.

An eligible employer is one that allows all qualifying full-time employees not less than two weeks of annual paid family and medical leave, and that allows all less-than-full-time qualifying employees a commensurate amount of leave on a pro rata basis. A qualifying employee means any employee who has been employed by the employer for one year or more, and who for the preceding year, had compensation not in excess of 60% of the compensation threshold for highly compensated employees.

The new law also requires the Secretary to determine whether an employer or an employee satisfies applicable requirements based on employer-provided information as the Secretary determines to be necessary or appropriate.

The employer credit is generally effective for wages paid in tax years after 2017 and before 2020.

The JCT has estimated that the provision will decrease revenue by approximately $4.3 billion over 10 years.

KPMG observation

The new law adopts the Senate bill’s new general business credit for eligible employers without change.

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