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CODE SECTION 409A…HERE TODAY BUT POSSIBLY GONE TOMORROW AND OTHER PROPOSED CHANGES IN THE TAX CUTS AND JOBS ACT

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Last week the House unveiled its tax overhaul plan, the Tax Cuts and Jobs Act ("Act"). The Act's proposals related to employee benefits and compensation are as follows:

Nonqualified Deferred Compensation

Perhaps one of the most talked about aspects of the Act (at least among benefits practitioners) is the demise of Code section 409A and the creation of its replacement, Code section 409B.

Under the proposed Code section 409B regime, nonqualified deferred compensation would be defined broadly to include any compensation that could be paid later than the March 15 following the taxable year in which the compensation is no longer subject to a substantial risk of forfeiture, but with specific carve-outs for qualified retirement plans and bona fide vacation, leave, disability, or death benefit plans. Stock options, stock appreciation rights, restricted stock units, and other phantom equity are included expressly in the definition of nonqualified deferred compensation.

All nonqualified deferred compensation earned for services performed after 2017 would become taxable once the substantial risk of forfeiture no longer exists, even if payment of the compensation occurs in a later tax year. As a result:

- Stock options and stock appreciation rights would become includible in income in the year in which the award vests, without regard to whether they have been exercised.
- An employee's deferral of any salary under a nonqualified deferred compensation arrangement until separation from service or otherwise would result in the inclusion of such amount in the employee's income in the year earned.
- All salary continuation payments under a severance arrangement would be taxable in the year in which the termination of employment occurs.

Further, a substantial risk of forfeiture exists only so long as the compensation remains subject to the service provider's continued substantial future services. The satisfaction of performance conditions would no longer qualify as a substantial risk of forfeiture.

All nonqualified deferred compensation earned for services performed before 2018, to the extent not previously includible in income, will be included in income in the last tax year beginning before 2026 or, if later, the date the substantial risk of forfeiture with respect to such compensation no longer exists. A limited period of time would be provided during which such nonqualified deferred compensation may be amended to conform the date of distribution to the date such amount would be required to be included in the participant's income without violating Code section 409A.

Performance-Based Compensation

The Act also would eliminate the exception to the Code section 162(m) limit on deductible compensation for performance-based compensation, effective January 1, 2018. The definition of a "covered employee" for purposes of application of Code section 162(m) would change to include an employee who is the principal executive officer or principal financial officer at any time during the taxable year or one of the top three highest-paid employees (or who has ever been a covered employee after 2016).

Since satisfaction of the specified performance targets would no longer constitute a substantial risk of forfeiture, an employee who participates in a long-term incentive plan that does not require continued employment through the end of the performance period as a condition to receiving the bonus (or the Company subsequently waives such requirement) would be required to include the bonus amount in income in the year in which no additional services are required (even if the final performance results are unknown).

Beginning in 2018, tax-exempt organizations would become subject to a 20% excise tax on all compensation (cash and the cash value of all remuneration, including benefits paid in a medium other than cash, except for payments to a qualified retirement plan and amounts that are excludable from the employee's gross income) in excess of $1 million paid to the five highest-paid employees.

Retirement Plans

Many of the proposed changes for qualified plans would be favorable for participants.

Hardship distributions would no longer require participants to cease making contributions during the six-month period after the distribution. In addition, a defined contribution plan could permit participants to receive a distribution from qualified nonelective contributions (QNECs), qualified matching contributions (QMACs), profit sharing contributions and earnings on any such contributions. In addition, participants would no longer be required to seek any available plan loan first to alleviate their financial need.

The minimum age at which a defined benefit pension plan could permit commencement of in-service benefits or a state and local government defined contribution plan could permit an in-service distribution is reduced from age 62 to age 59 ½.

A participant would have until the due date for filing his or her tax return to roll over a loan balance from a qualified plan to an individual retirement account (IRA), instead of the current 60 day period, before such amount is treated as a distribution.

Miscellaneous and Fringe Benefits

Effective January 1, 2018, the following benefits would become taxable to the employee:

- Reimbursed dependent care expenses under a dependent care assistance program (DCAP) and employer-provided onsite daycare
- Qualified tuition reimbursement plan benefits
- Adoption assistance plan benefits
- Qualified moving-expense reimbursements
- Employee achievement awards given in recognition of length of service or safety achievement
- Employer contributions to an Archer Medical Savings Account (accounts could not be established after 2005). Such contributions also would be non-deductible by the employer.

Transportation fringe benefits would continue to be excludible from employees' income, but an employer would no longer be entitled to a deduction.

As expected, the House is engaged in intense negotiations on various parts of the Act so the extent to which any of these provisions will remain in their current iteration in the final version is yet to been determined.

RELATED PRACTICE AREAS

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MEET THE TEAM

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