THE NEW TAX LAW

Potential Effects on Nonqualified Benefits and Plan Design

On December 22, 2017, the President signed into law a comprehensive tax reform bill known as the Tax Cuts and Jobs Act. Some of the new provisions could impact existing nonqualified (NQ) plans and will most likely impact the design and administration of future plans.

Tax-Exempt Employers

The new tax law imposes a 21% excise tax on tax-exempt employers on annual compensation in excess of $1 million paid to a "covered employee." A covered employee for a given tax year includes (a) the 5 highest paid employees for the current year and (b) any individual who was a covered employee for any preceding tax year after December 31, 2016, including a covered employee's beneficiary (i.e., once a covered employee, always a covered employee). Consequently, many tax-exempt organizations will be subject to the excise tax for current covered employees as well as for former covered employees and their beneficiaries who receive benefits in the future.

POTENTIAL EFFECTS: Annual compensation is based upon W-2 Box 1 compensation[1]. Of particular note is that compensation includes amounts in income under 457(f) plans (i.e., vested benefits). It is not uncommon for a 457(f) plan to carry a vested amount that, on its own or when combined with other compensation in any given year, is in excess of $1 million, resulting in the application of the excise tax.

DESIGN AND ADMINISTRATIVE CONSIDERATIONS: Since "once a covered employee, always a covered employee," it will be important for a tax-exempt organization to track covered employees for years into the future. In order to minimize or eliminate the effect of the excise tax: (i) for future designs, it may be beneficial to "ladder" the vesting over a period of years as opposed to a "cliff vesting" scenario; and (ii) for current plans, it may be possible to accelerate future vesting or delay vesting upon certain conditions. When considering a change in vesting, it is critical to examine the rules of Section 409A and the proposed 457 rules. Consult with The Pangburn Group for further explanation.

Expansion of the Section 162(m) $1 Million Deduction Limit for Public Companies

Prior to the enactment of the new tax law, Section 162(m) limited the ability of public companies to deduct compensation in excess of $1 million paid in the "current tax year" to certain "covered employees." Covered employees consisted of the CEO and a company's 3 most highly compensated officers, excluding the CFO. In addition, performance based compensation was exempt from the consideration of excess compensation.

The new tax law created the following changes[2]:

- Covered employees will consist of the CEO, CFO, and the 3 most highly paid officers.
- Anyone considered a covered employee for any tax year after 2016 will be considered a covered employee in all future years, including a covered employee's beneficiary (i.e., once a covered employee, always a covered employee).

[1] Compensation attributable to medical services for qualified medical professionals and designated Roth contributions are excluded.
[2] There are some limited grandfathering rules for arrangements in effect as of 11/2/2017 that are not materially modified.

- In addition to public companies, the new law will apply to certain foreign companies and private companies.
- Performance Based Compensation is no longer exempt from the consideration of excess compensation.

POTENTIAL EFFECTS: NQ benefit payments count as compensation when considering the $1 million limit. Consequently, it is conceivable that plan benefits paid to covered employees currently or in the future, when combined with other compensation in the year of payment, will generate a non-deductible expense, especially with plans that contain a performance based compensation deferral feature.

DESIGN AND ADMINISTRATIVE CONSIDERATIONS: Companies should examine their existing NQ plans for the possibility of losing a tax deduction for 2018 and subsequent tax years. It may be possible to re-defer benefits to future years to better align the payment of benefits with other potential compensation, in order to minimize or eliminate the impact of the lost tax deduction. Before doing so, however, the permissible re-deferral rules of Section 409A should be considered. When designing new plans, consideration of the applicability of the new provisions should be taken into account. Since a covered employee remains a covered employee permanently, it will be important to keep track of such employees for future potential impact.

Elimination of the Corporate Alternative Minimum Tax (AMT)

The new tax law eliminated the AMT for corporations, apparently to maximize the effect of the new flat corporate 21% tax rate.

POTENTIAL EFFECTS: Prior to its elimination, corporate owned life insurance (COLI) policies were subject to the corporate AMT, which was affected by policy increases in cash surrender value (CSV), and death proceeds received in years when the AMT applied[3]. Consequently, in a year where the AMT applied, this would have created an effective tax rate of up to 15% on COLI policies.

DESIGN AND ADMINISTRATIVE CONSIDERATIONS: With the elimination of the AMT, COLI death benefits and CSV increases will no longer be potentially subject to the additional tax.

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[3] AMT included (a) increase in COLI CSV less premium and (b) death benefits paid less CSV at the beginning of the year.

info@pangburngroup.com
800-634-3287