The Tax Cuts and Jobs Act of 2017 (TCJA) made a definite impact on executive compensation planning for 2018 and future years. On a broad level, the reduced corporate tax rates free up funds at the company level. In some cases, the expansion of the excise tax on what the Internal Revenue Code calls “excessive employee remuneration,” as well as a new excise tax on tax-exempt organizations with highly paid executives, will make companies rethink how they plan for executives.

Future guidance will undoubtedly influence the finer points of how executive benefits are shaped in the coming years, but clear trends can be anticipated, based on the changes that have already become law. Some of these changes primarily affect large for-profit corporations (mostly publicly traded, with some exceptions) and nonprofit or tax-exempt organizations that have employees earning more than $1 million. However, planning for employees who earn near $1 million now, and whose career track will likely lead them to higher paying positions, may be affected the most, because keeping them outside the definition of “covered employee” could become a priority.

Under the new law, “covered employees” essentially cost the employer more. In a for-profit publicly traded company, no deduction is available on compensation above $1M for covered employees. In a tax-exempt or nonprofit, an excise tax applies. Either way, the population of “covered employees” can potentially grow each year, as described below, due to the new concept of the “eternal covered employee.”

Publicly traded corporations (and certain other large companies)

The deduction for compensation paid to certain executives of publicly traded companies has long been limited to $1 million annually, but the limitation has been expanded in several ways.

1. The definition of pay subject to this $1 million limit was expanded by the TCJA to include “performance-based compensation and commissions,” which were previously exempt from the limit. Detailed regulations under prior law explained the requirements for “qualified performance-based compensation.” This included certain compensation paid under an objective, nondiscretionary formula, as well as stock options, stock appreciation rights, and other equity compensation. A grandfather rule applies to binding, performance-based incentive contracts that were in effect as of November 2, 2017, and that are not materially modified. Future guidance is expected to provide details on the impact of this rule on existing plans.

2. The deduction limitation now applies to certain companies that have registered debt under Sec. 15(d) of the Securities and Exchange Act of 1934. Under prior law, the limitation applied only to publicly traded companies.
(3) The provision was expanded to cover not only the top five employees (defined as the CEO, CFO and top three other executives), but to also include any employee who was previously a “covered employee” (after 2016). This concept, dubbed “the eternal covered employee” (or, “once covered, always covered”) will make it a priority in many companies to keep people out of that group, where possible.

Example
Cyberdistribution Corp. is a publicly traded company with 6,000 employees worldwide. Approximately 50 employees are in senior leadership ranks earning over $1M annually. In 2018, the CEO, CFO and next three top-paid executives are the “covered employees.” However, due to performance pay fluctuations and shifting responsibilities, three other executives become top paid employees in 2019, along with the three who were covered in 2018. If this happens each year, and the CEO and CFO retire and are replaced, by 2025 there will be 28 employees in the “covered employee” group. As the group expands, the amount of nondeductible compensation could grow each year.

These strategies could help with controlling the expansion of the covered employee group:

• **Nonqualified deferred compensation:** Deferral of income may be helpful to delay or prevent an executive from becoming a covered employee, as well as spreading out the deduction in years after an employee’s retirement. Although Internal Revenue Code Section 162(m) now includes compensation received after retirement (by virtue of the once-covered/always-covered rule), it does not require a present value calculation of amounts payable in the future, even where they are vested. For companies subject to the limit, discussions to identify covered or potentially covered employees should be part of the design/administrative review, to reconcile company and participant objectives.

• **Endorsement Split dollar:** The tax impact of TCJA on endorsement split dollar plans during the life of the insured is generally minimal, because it's limited to the value of the economic benefit. The policy would likely be owned by the employer and potentially subject to a split dollar endorsement until “rollout.” If the insured dies, the death benefit paid will generally be income tax-free to the beneficiary and nondeductible to the employer under standard split dollar rules. Therefore, this would be unaffected by the changes to the deduction limit under Section 162(m). The income tax impact can be very low throughout the duration of the arrangement. (Note that loan split dollar in a publicly traded company is prohibited under the Sarbanes Oxley Act of 2002.)

(4) Compensation subject to the $1 million limitation has also been expanded to include any amounts payable to a beneficiary of the executive, whether during the executive’s life or after death. This means that once an employee is a “covered employee,” taxable death benefits payable to the employee's family or trust will be subject to the limitation.

The reduction of the income tax rate on C corporations (see below) makes these possible loss of deduction changes less costly than under prior law. The compensation deduction changes are seen by many as a tradeoff for broadly lower C corporation rates.
Nonprofit/tax-exempt organizations

A new excise tax equal to the private sector corporate tax rate (21%) applies to nonprofit and tax-exempt organizations, to the extent that the organization has employees earning over $1 million a year. The five top-paid employees are considered each year, along with any employees formerly covered in a previous year. 8 Again, the consequence of an executive’s compensation package triggering this excise tax is that for as long as the executive receives current or deferred compensation exceeding $1 million, the organization is subject to the excise tax, even if the executive has retired.

Compensation covered under the new provision will be considered paid when there’s no longer a substantial risk of forfeiture (as defined under Section 457(f)). Exceptions to the tax are provided for compensation paid for medical or veterinary services provided by a licensed medical professional, 9 as well as for designated Roth contributions to an employer retirement plan (e.g., 457(b) or 403(b) plan).

Although the provision initially covers only the five top-paid employees, regardless of title, once an employee has been covered (after 2016), he or she is always a covered employee. So, keeping people out of that group, where possible, may become a planning objective.

The provision also makes compensation paid to the same executive from “related organizations” subject to the excise tax. 10 This includes organizations that control the tax-exempt/nonprofit entity, are controlled by it, or are related in certain other ways. Future regulations might offer more clarity on the application of these provisions.

Planning tools

These may become more important tools:

- **Loan split dollar:**Having an excise tax on amounts exceeding $1 million means that strategies that generate minimal taxable income will be attractive. For this reason, loan split dollar may be attractive in nonprofit/tax-exempt organizations. 11 Note that a split dollar death benefit is generally received income-tax free by the beneficiary and, thus, would not trigger the excise tax regardless of amount.

- **Deferred compensation:** When a deferred comp benefit is payable as a lump sum such as under a Principal® Select Reward Plan, it can defer taxable income until a future year when a desired term of service is completed, thereby also delaying the excise tax. Spreading deferred comp over several years after retirement could also minimize the impact of the excise tax.

- **Bonus plans:** Lower individual income tax rates make bonus plans an attractive option now, to use extra company cash as a benefit. Providing potentially income tax-free payouts in the future can also be attractive in the future when the lower rates are scheduled to sunset.

Privately held businesses

C corporations

Corporate-owned life insurance has become more attractive for large C corporations, due to the repeal of the corporate alternative minimum tax (AMT). Concerns under prior law about cash value increases or death benefit triggering the AMT will no longer be an issue.

Regardless of the size of the C corporation, the lower flat tax on C corporations means that more funds will be available for business protection needs. Although C corporation owners cannot accumulate unlimited amounts of cash in the company (due to the accumulated earnings tax), key person needs, buyout protection and employee retention plans are among the reasonable business needs of a company for cash accumulation. Life insurance can provide an attractive means for funding all of these.
Because the tax rate of C corporations is now lower than that of most individuals, the after-tax cost of paying premiums in a C corporation will typically be less than paying them on an individual basis.

- Depending on the employer’s objectives, deferred compensation can be more attractive under the new tax regime.
- Loan split dollar\(^{12}\) can provide an opportunity to minimize income for the duration of the plan. It can provide access to retirement income that’s already in the hands of the employee after separation from service, and therefore, not subject to the excise tax on compensation over $1 million.
- Bonus plans can take advantage of extra corporate dollars and lower individual income tax rates to accumulate amounts that can produce income tax-free payouts in the future, when individual rates may be higher.
- For qualified plans, increased corporate dollars can also be used to fund deductible contributions to these plans, which accumulate tax-deferred.

**Passthrough entities (S corporations, partnerships, sole proprietorships and most LLCs)**

The new passthrough business deduction of up to 20% has the potential to lower the business owner’s tax on passthrough income from a top bracket of 37% under the new law, to a top rate of 29.6% (80% x 37%). The actual amount any business owner will get to deduct can be a complex determination, but in many cases, wages and unadjusted basis will play a role.

- **Deferred compensation:** Lower business rates can free up funds for various forms of deferred compensation, allowing the business to meet goals for rewarding and retaining key employees.
- **Bonus plans:** For some business owners, the deduction will be maximized if they are able to increase the amounts treated as wages paid by their business. For those who have retention/recruitment goals for employees, bonus plans could help with boosting wage amounts. In addition, sunsetting individual rates provide an opportunity to fund tax advantaged vehicles such as cash-value life insurance for future needs. Withdrawals could be particularly favorable in the future when individual rate reductions sunset.
- **Loan split dollar:** Can help employers minimize current income tax to the employee while providing a strong retention incentive and future income that is potentially income tax free.
- **Qualified plans:** Wage amounts, for purposes of the passthrough business deduction, can also be increased by higher contributions to qualified plans.

In many cases, the new law treats nonservice businesses more favorably than service businesses. As a result, some service businesses that include a nonservice component (or own real estate, for example) may benefit from splitting the business into separate entities to take advantage of more favorable treatment of the nonservice components of the business.

**Summary**

Key employee retention and retirement plans will continue to be effective tools in this post tax reform environment. But, as we’ve outlined, there are changes in executive compensation rules that need to be considered. However, some careful planning with your professional advisors can help ensure you have solutions in place that work best for your organization.
1 See IRC Sec. 162(m).
2 See Reg. §1.162-27(e). These regulations set forth detailed rules for keeping compensation outside the limit under prior law, but they could also be viewed as a description of the types of compensation intended to be encompassed by the new law.
3 TCJA 2017 (P.L. 115-97) §13601(e)(2).
4 Defined as corporations issuing securities required to be registered under section 12 of the Securities Exchange Act of 1934.
5 IRC Sec. 162(m)(3).
6 IRC Sec. 162(m)(4)(F).
7 The 21% rate is tied to the new corporate tax rate under IRC Section 11(b).
8 IRC Sec. 4960, as added by TCJA 2017.
9 According to the Conference Committee report (P.L. 115-97), p. 349, “licensed medical professional” includes a doctor, nurse or veterinarian.
10 See IRC Sec. 4960(c)(4).
11 Loan split dollar in tax-exempt and nonprofit companies might not be available in all states. State laws can vary; consult local counsel for guidance.
12 The discussion of loan split dollar is applicable for nonpublicly traded corporations only.