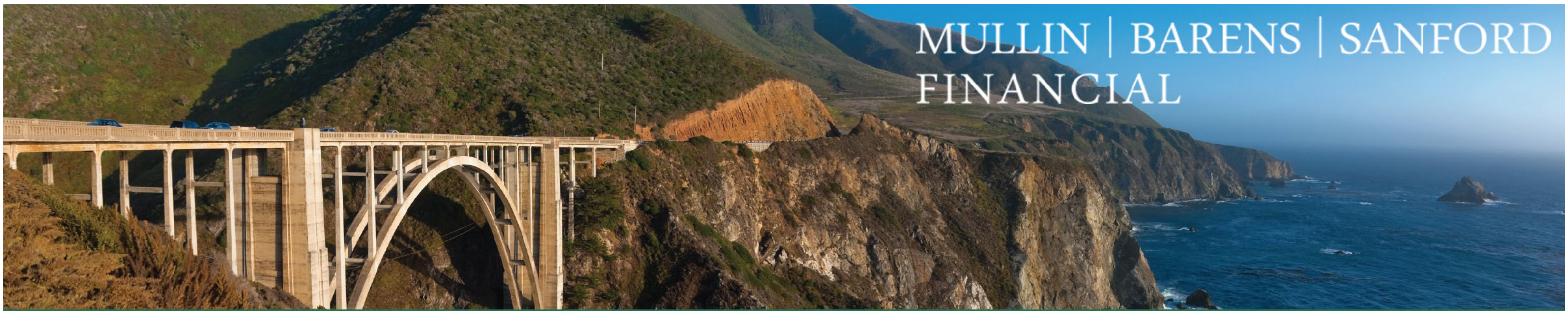


Client Alert

INCOME TAX PROVISIONS OF THE TAX AND JOBS ACT

Specifically - How do the new tax provisions impact executive benefits?

On December 20, 2017, Congress enacted the most comprehensive tax reform measure since 1986. This alert focuses on just the application of the new rules as they relate to executive compensation arrangements.

Overview of Changes Applicable to Highly Compensated Individuals

- **Effective Dates**

  Virtually all the provisions in the Act affecting individuals will sunset or expire after 2025.

- **Maximum Individual Tax Rate**

  The Act lowers the maximum income tax rate applicable to individuals to 37 percent beginning in 2018. The maximum rate will become applicable when taxable income exceeds $600,000 on a joint return, $500,000 on the return of a single individual.

  The maximum tax rate on long-term capital gain income and qualified dividend income will remain at 20 percent and the 3.8 percent Medicare tax is also retained.

- **Itemized Deductions**

  - State and local taxes. Beginning in 2018, the Act will repeal all deductions for state and local taxes in excess of $10,000.

  - Home mortgage interest. The Act reduces the maximum amount of home mortgage loan on which interest can be deducted from $1,000,000 to $750,000 after December 31, 2017.

  - Medical expenses. For 2017 and 2018, the adjusted gross income threshold above which medical expenses may be deducted is lowered from 10 percent to 7.5 percent.

  - Alimony payments. The Act repeals the deduction for alimony payments, but not until after 2018. The spouse receiving alimony will not be taxed on such amounts after 2018.

  - Casualty losses. The Act limits the deduction for casualty losses to losses sustained from events declared by the president to be disasters, beginning in 2018.

  - Overall limitation on itemized deductions. The phase-out of itemized deductions is repealed for tax years after 2017.

- **Alternative Minimum Tax**

  The alternative minimum tax ("AMT") will remain a part of our tax system for individuals. Many people who were subject to AMT in the past will find it does not apply to them beginning in 2018 due to the new cap on property tax and state income tax deductions as well as loss of miscellaneous itemized deductions. The Act repealed the corporate alternative minimum tax.

  > ***Impact:***

  Highly compensated individuals will most likely experience an overall higher tax bill given the loss of itemized deductions. In particular those highly paid executives in high income tax states will see a more significant tax increase which will mean the ability to defer compensation pre-tax in a nonqualified plan will be even more appealing.

Overview of Changes Applicable to Businesses

- **No Limitations on Nonqualified Deferred Compensation**

  Earlier versions of the Act included limitations on nonqualified deferred compensation, however, these changes were not included in the final version of the bill.

- **Limitations on Executive Compensation** Code Section 162(m)

  Prior law imposed an annual limit of $1 million on the deductibility of compensation paid by a public company to each of its covered employees (the CEO and the three other highest-paid executive officers excluding the CFO).

  The Act repeals prior exceptions for performance-based compensation (including stock options) and expands the list of covered employees to include the CFO, and once an employee is covered, they will continue to be included for as long as they receive compensation from the company (including after termination of employment). Previously this rule only applied to corporations with publicly traded equity; the Act expands the impacted companies to include those with publicly traded debt and foreign companies publicly traded through American depositary receipts. The new law applies to taxable years beginning after December 31, 2017, with a grandfather provision for contracts that were binding on November 2, 2017.

  > ***Impact:***

  Historically public companies have structured compensation as performance based or have pushed executive compensation into retirement to avoid application of the $1 million annual cap. Now that performance-based compensation will no longer be excluded, there will be an even greater incentive to defer compensation in excess of the limit.

Since employees will continue to be covered employees even after termination of employment, public companies will need to reevaluate their retirement compensation arrangement possibly to further spread benefits to avoid the loss of the tax deduction.

More guidance on the implementation of the 162(m) provisions is anticipated by mid-year 2018, therefore it is advised to hold off on amending any existing arrangements that could jeopardize the grandfathering provision.

- **Excise Tax on Executive Compensation Paid by Tax Exempts**

  The Act imposes a 21% excise tax on tax exempt employers for payment of compensation in excess of $1 million to the five highest paid employees of the organization. The tax is imposed on the organization, not the employee.

  The Act also imposes the 21% excise tax on tax-exempt employers who pay excessive termination compensation to covered employees referred to as "excess parachute payments". An excess parachute payment generally includes a payment contingent on the executive's separation from employment with an aggregate present value of at least three times the executive's base compensation. Similar to existing golden parachute rules for taxable organizations under Section 280G, the base amount is equal to the executive's trailing five-year average W-2 compensation.

  The million-dollar cap and golden parachute limit are both effective for tax years beginning after December 31, 2017 and there are currently no grandfathering rules.

  > ***Impact:***

  This excise tax is likely to cause significant problems for deferred compensation plans of tax-exempt organizations which are subject to Code Section 457(f). The Act specifically includes income under Section 457(f) and there are currently no grandfathering rules for existing arrangements. Since amounts are required to be included in income under Section 457(f) at the time they vest (i.e., are no longer subject to a substantial risk of forfeiture), such plans typically cliff vest an executive's entire stream of retirement benefits on his or her retirement eligibility date. The present value of a supplemental retirement benefit for a top executive of a tax-exempt university, hospital or credit union is likely to exceed $1 million especially when combined with the executive's other compensation in the year of vesting.

  Tax-exempt employers need to review all nonqualified executive plans in order to restructure to avoid these excise taxes.

- **Deferral of Qualified Broad-Based Equity Awards**

  The Act allows employees who are granted stock options or restricted stock units through a broad-based employee plan covering at least 80% of employees, to elect to defer recognition of gain on exercise of the options or vesting of the units for up to 5 years if such election is made within 30 days after such rights vest or become transferable. However, such plan and election are not available to 1% owners or the four highest compensated officers.

  > ***Impact:***

  The limitations on this provision make it unlikely that it will get significant use.

- **Corporate Tax Rate Reduction**

  The Act permanently lowers the income tax rate for C corporations to 21 percent beginning in 2018. The significant reduction in the corporate tax rate is the justification for reducing corporate deductions generally, including the limitations on executive compensation discussed above. The Act repealed the corporate alternative minimum tax.

  > ***Impact:***

  Most Companies whether C, S or LLC structures will see a reduction in their tax rate which means the cost of providing deferred compensation plans will go down as the deferred tax deduction for these types of arrangements is now lower.

- **Limitation On Deduction Of Net Operating Losses**

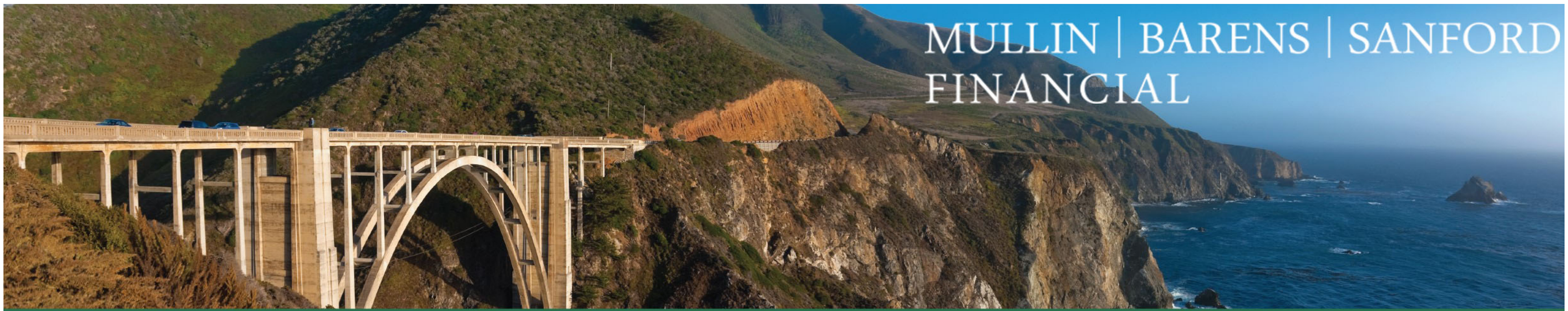
  The Act repeals the two-year carryback period for net operating losses incurred after 2017 but allows an indefinite carryover period. Only 80% of taxable income may be eliminated by a net operating loss deduction after 2017.

- **Business Income Received By Individuals and From Pass-Through Entities**

  New IRC Section 199A provides a deduction in the amount of 20 percent of the taxpayer's net qualified business income which, when coupled with the 37 percent maximum income tax rate, results in a maximum effective income tax rate on qualified business income of 29.6 percent.

  > ***Impact:***

  Overall there have been a lot of questions and confusion around how this new deduction will work and numerous technical revisions may be necessary before it is truly equitable.



- **Transfer For Value**

  One section of the Act contains new rules related to COLI acquisitions in corporate transactions.

  An exception to tax-free death benefits, one of the key features of life insurance, applies to policies transferred for "valuable consideration." This exception has generally not applied when a company acquires another company with COLI assets because of a key provision that has maintained the tax-free status of death benefits in corporate transactions. This provision allows the basis of the acquired COLI to be determined, in whole or in part, by reference to the acquired company's tax basis.

  The Act, however, provides that if a transfer of a life insurance policy is a "reportable policy sale," then the tax carryover exception to the "transfer for value" rule does not apply, and any death benefit received over the tax basis would be taxable. A reportable policy sale occurs when the life insurance policy is acquired by an individual or entity with no substantial family, business, or financial relationship to the insured.

  In a corporate acquisition, the acquiring company has a substantial business relationship with all remaining employees of the acquired company. However, when policies insure former employees, officers, and directors, it could be argued that there is no business relationship; the transfer of those policies may fit the definition of "reportable policy sale," triggering potential taxation of death benefits.

  > ***Impact:***
  It is our understanding that these new rules were not intended to apply to COLI policies transferred in corporate transactions. Efforts are underway to clarify these rules and ensure that policies for former employees, officers, and directors maintain their tax-free benefit status when transferred in a tax carryover transaction.

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