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# The Newly Revised U.S. Tax Code Will Influence Executive and Employee Pay, but How Much?

*In addition to the changes to corporate and personal income tax levels, the new tax bill is likely to influence incentive compensation for executives and the broader employee population.*

In a highly partisan vote that came down to the final days of 2017, the U.S. Congress struck a deal to pass the Tax Cuts and Jobs Act (the Act), which President Donald Trump signed into law on December 22. The Act is the most sweeping tax overhaul in three decades and its hallmark feature is a reduction in the corporate tax rate from approximately 35% to 21%. Below, we focus on the provisions of the Act that will influence the design of incentive pay beginning in 2018.

## No Tax Deductibility for Performance-Based Compensation Over $1 Million

Corporate deductions at public companies for executive compensation paid to Named Executive Officers (or NEOs – the CEO, CFO, and the next three highest paid officers) will be limited to $1 million per year, with no exceptions for performance-based compensation. The limit will apply to all compensation, including amounts previously exempt from the limit such as stock options, stock appreciation rights, performance shares and units, as well as restricted stock units and other various forms of nonqualified deferred compensation, severance, and certain retirement benefits paid after termination of employment.

- **Effective Date:** This provision will be effective for tax years beginning after December 31, 2017. Amounts payable under a written binding contract that was in effect by November 2, 2017, will be subject to the Section 162(m) rules in force prior to amendment. *We expect the IRS to update existing regulations and guidance to address the amendment and any transition relief.*

- **Covered Employees:** The Act applies to any individual who was or who became a Section 162(m) “covered person” for taxable years beginning *after 2016*. Such individuals will remain a covered person for as long as he or she receives compensation from the company. The Act corrects the previous 162(m) definition, and includes the CFO and all NEOs for a given fiscal year.

We do not see the loss of the tax deduction having any immediate impact on forms of pay used. While investors and proxy advisory firms will still expect a close link between pay and performance, companies may feel more

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flexibility under the new tax bill to exercise positive discretion where warranted, due to the fact that there will no longer be a penalty under Section 162(m) for doing so.

## What Actions Should You Be Taking Now?

- **Non-Calendar Filer:** If you are a company whose tax year-end is other than December 31, there may still be an opportunity in 2018 to lock in a tax benefit at a higher rate by meeting the "all events test" for a bonus accrual before your fiscal year-end, or by accelerating the vesting (and settlement) of any restricted stock or restricted stock units that will otherwise vest shortly after your fiscal year-end. Generally, a short acceleration of vesting will result in a small acceleration of the related book expense, but the tax gain of doing so should offset the expense. Accelerating the vesting should not result in your employees having taxable income recognized in a different tax year because employees' tax year end will occur after vesting.

- **Open Performance-Based Plans:** Begin considering how the change in corporate tax rates may affect the results of your incentive performance metrics and determine if adjustments in the performance score should be made for any outstanding performance-based plans. In particular, multi-year plans that are not complete until 2018, 2019, or beyond. Also consider how the change in corporate tax rates may affect set goals for any new performance-based plans. For open equity-based plans, we recommend consulting with your executive or equity compensation expert to determine whether there is a material impact to your equity performance goals, and how modifying these goals could trigger incremental expense. For current performance cycles, companies should plan on normalizing final performance results so that the change in tax law does not cause an undue windfall to executives. This can occur in cases where performance metrics might include return on equity and show more favorable results due to a lower corporate tax rate.

- **Inventory of Historical 162(m) Compliant Plans:** Make sure you have properly catalogued the performance-based compensation as well as compensation that may be paid following termination of employment that is eligible for Section 162(m) transition relief. This helps ensure that you do not inadvertently give up a valuable tax deduction for a covered employee.

- **Covered Employees:** This will now require companies to track the covered employee list over time, which will both increase administrative time and, more importantly, increase the individuals who will potentially cause a loss of tax deductibility. Accordingly, we recommend creating and maintaining lists of covered employees for tax years beginning after 2016. This is a "living list" for any employee who is covered, as the individual remains covered through termination of employment.

- **Earnings Guidance:** Consult with others in your company or organization with respect to tax, accounting and financial reporting implications of the tax reform bill. Also, consider whether there would be any impact on your 2018 earnings guidance to the investment community.

- **Plan Documentation:** Consider updating 162(m) language in annual and long-term incentive plan documents as well as respective committee charters to be consistent with the Act.

## Credit Unions: Additional Tax on Compensation Over $1 Million for Tax Exempt Organizations

The final bill also provides that if a tax-exempt organization pays compensation to any of its five most highly compensated employees in excess of $1 million (subject to certain exclusions), the organization would be liable for a 21% tax on excess amounts. (The excise tax rate is tied to the amended corporate income tax rate.) This provision applies to amounts paid during taxable years commencing after December 31, 2017. Like the amended Section 162(m) provision explained above, the determination of the five most highly paid employees begins with tax years commencing *after 2016*. If an individual became a covered person under this section, such individual would remain a covered person for as long as he or she receives compensation from the organization.

The Act also imposes a 21% tax on excessive amounts contingent on separation from service paid to such covered employees. This provision is somewhat similar to the golden parachute change-in-control provisions under Section 280G; meaning it only applies if the present value of the contingent amounts are equal to or exceed three times the employee's average taxable wages during the preceding five year period. If the contingent amounts equal or exceed this safe harbor, the tax applies to the amount in excess of one times the five-year average. This provision does not apply to amounts paid under Section 457(b) or qualified plans.

*This is a material item for credit unions. The additional excise tax on employees receiving more than $1 million for tax years after December 31, 2017 will grow over time, along with the definition of covered employees.*

To speak with a member of our compensation consulting group about the tax bill and related changes to incentive compensation, please contact us.

# Author Contact Information

**Todd Leone**
Partner, McLagan
Aon | Talent, Rewards & Performance
1.952.886.8254
todd.leone@mclagan.com

**Mark Behnke**
Partner, McLagan
Aon | Talent, Rewards & Performance
1.203.602.1203
mark.behnke@mclagan.com

**Greg Camarco**
Associate Partner, McLagan
Aon | Talent, Rewards & Performance
1.203.517.3804
gregory.camarco@mclagan.com

**Gayle Appelbaum**
Partner, McLagan
Aon | Talent, Rewards & Performance
1.952.886.8242
gayle.appelbaum@mclagan.com

**Katrina Gerenz**
Associate Partner, McLagan
Aon | Talent, Rewards & Performance
1.952.886.8247
katrina.gerenz@mclagan.com

**Bryan Lemke**
Director, McLagan
Aon | Talent, Rewards & Performance
1.952.886.8272
bryan.lemke@mclagan.com

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