New Tax Increases Make Deferral of Compensation a (More) Valuable Benefit for Many Employees

This article was originally published in the Summer 2013 issue of *Employee Relations Law Journal*.

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This article describes how the new additional Medicare tax, tax on net investment income, higher marginal tax rates, and phase-out and reductions of personal exemptions and itemized deductions make the use of compensation deferral techniques a potentially significant benefit to employees.

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The combination of the new additional Medicare taxes on wages, additional taxes on certain investment income of higher income taxpayers, and the new higher marginal income tax rates on both ordinary income and capital gains make income deferral opportunities a potentially valuable benefit for many employees. Because many taxpayers are likely to be subject to these additional taxes or higher tax rates during some or all of their remaining working lives, yet not subject to some or all of these increased taxes in other years or following their retirement, managing the date of recognition of taxable income by use of available deferral techniques can produce actual tax savings. Consequently, many employees are now positioned to use tax deferral techniques to obtain actual reductions in taxes and not just deferral of taxes.

New Additional Taxes or Increased Tax Rates

To summarize, the new additional taxes or increased tax rates, which became effective on January 1, 2013, are as follows:

- An additional Medicare tax of 0.9 percent on wages in excess of $250,000 for married taxpayers filing a joint return and $200,000 for taxpayers filing single.
- An additional tax of 3.8 percent on most "net investment income" to the extent a taxpayer has modified adjusted gross income in excess of $250,000 for married taxpayers filing a joint return and $200,000 for taxpayers filing single.
- The highest marginal income tax rate on ordinary income has been increased to 39.6 percent on taxable income in excess of $450,000 for married taxpayers filing a joint return and $400,000 for taxpayers filing single.
- The long-term capital gains rate (and rate on qualified dividends) is increased from 15 percent to 20 percent for taxpayers with taxable income above $450,000 for married taxpayers filing a joint return and $400,000 for taxpayers filing single.
- The personal exemption of $3,800 begins to be phased out for taxpayers with adjusted gross income in excess of $300,000 for married taxpayers filing a joint return and $250,000 for taxpayers filing single. To illustrate the hidden effect of this provision, a married taxpayer filing jointly with two dependent children (so, four personal exemptions) and with $350,000 in adjusted gross income may appear to be subject to a

marginal income rate of 33 percent but the phase-out of personal exemptions effectively increases that marginal rate by about four percent to approximately 37 percent.

- Itemized deductions are reduced by three percent of the amount by which a taxpayer's adjusted gross income is in excess of $300,000 for married taxpayers filing a joint return and $250,000 for taxpayers filing single, with the reduction not exceeding 80 percent of the taxpayer's otherwise allowable itemized deductions. The practical effect of the itemized deduction limit is to raise the top tax rate of 39.6 percent by nearly 1.2 percent to almost 40.8 percent.

While each of these new or increased taxes kick in at different thresholds, they all present opportunities for better timing of income recognition to reduce taxes for many taxpayers.

Opportunities for Better Timing of Income Recognition

The lower tax rates in effect during the Bush tax cut years combined with the conventional (and correct) wisdom that rates would likely increase in the future made income deferral less attractive over the last couple of years and even encouraged acceleration of income recognition into 2012. Due to the relatively compressed tax brackets that prevailed and the prospect of higher future tax rates, many individuals and their advisors have operated on the assumption that deferral of taxable income might provide some limited benefit by virtue of the deferral but it would not result in the income being subject to a lower tax when it is finally taken into taxable income. However, the new tax regimes and the focus on both increased taxes and loss of itemized deductions and personal exemptions at income levels above certain threshold amounts now allow taxpayers who may be above the relevant thresholds in one year but not in later years to reduce their tax liability if they can better time the date on which recognition of taxable income occurs. In short, in many more situations than would have occurred before the new tax changes, deferral of income recognition may provide an actual savings in the amount of taxes due.

In addition to reducing federal taxes by deferring income into lower income years, a mobile taxpayer who retires from a high state income tax state to a low state income tax state or one of the nine states, such as Florida, Nevada or Texas, which either have no individual income tax or a limited individual income tax, may, depending on the method used for the deferral and the plan design, also achieve state income tax savings by virtue of deferral. In this respect, under federal law, an individual may be subjected to state income tax on distributions from a tax-qualified plan only by the state in which he or she is a resident or domiciled at the time of the distribution. A similar rule applies to payments from nonqualified deferred compensation plans if the payments from the plan are being made over a period of at least ten years or the plan meets other requirements.

It is worth noting that the 3.8 percent additional tax on net investment income is based on whether modified adjusted gross income exceeds the threshold amount. Thus, although an employee subject to the tax is nominally paying the tax on their net investment income, to some extent this is semantics. To the extent a reduction in the employee's current year wages by virtue of a deferral would reduce the employee's modified adjusted gross income below the income thresholds at which the 3.8 percent additional tax applies, the effect on the employee is a savings of the 3.8 percent additional tax. At least for the taxpayer whose modified adjusted gross income is tipping between the modified adjusted gross income threshold of $250,000 for a joint return or $200,000 for a single return, a decrease in either the taxpayer's net investment income or their wages results in a reduced liability for the 3.8 percent additional tax.

Tax Deferral Options

But what can an employer or an employee do? Opportunities for tax deferral come in several forms. The most obvious, and best as we shall see below, are tax-qualified retirement plans, including 401(k) plans, profit sharing plans and, yes, even defined benefit pension plans. Certain incentive plans, such as stock option plans inherently provide a tax deferral opportunity. Finally, nonqualified deferred compensation plans, where available, also provide opportunities for employees to defer the recognition of taxable income.

Tax-Qualified Retirement Plans

Of the three categories of deferral opportunities, tax-qualified retirement plans are clearly the best from several points of view: they provide a current tax deduction to the employer, they are funded in a trust so benefits are not subject to the employer's financial stability and, to top it off, the distributions when made, even if shortly after the contribution, are never directly subject

to either the 0.9 percent additional Medicare tax or the 3.8 percent additional tax on net investment income or, for that matter, any other Social Security or Medicare taxes. And while tax-qualified retirement plans (or the rollover of these benefits to individual retirement accounts) are essentially tax deferral programs, they also commonly offer a participant with significant flexibility on when to recognize taxable income. This flexibility obviously provides an individual with the opportunity to elect recognition of taxable income in his or her lower tax rate years. The combined effect of electing a lower tax rate year for income recognition together with avoidance of Medicare taxes may provide material tax savings in the right cases.

Many employers who sponsor tax-qualified retirement plans are currently unaware that various design techniques are available under current law, which permit the employer to increase contributions or benefits for certain groups of employees but not others. Many employers are under the impression that employer-funded contributions must be established at the same percentage of compensation for all plan participants or the plan will have a discriminatory structure which is not permitted. This is true for plans where the only employer contribution is a matching contribution. However, plans that provide for employer-funded contributions such as nonelective contributions (i.e., contributions made without regard to participants' contributions, such as discretionary profit sharing contributions), or plans which can be redesigned to redirect some of the existing employer contribution from a matching contribution to a nonelective contribution, can certainly have designs which provide higher contribution percentages for certain groups of employees. The amount of increased benefit which can be provided to the targeted group of employees by use of these techniques is dependent on a plan's current benefit structure for other participants and, in certain designs, the demographics of the plan participants. While almost any plan design providing employer-funded contributions can be adapted to take advantage of these plan designs, those employers which already provide relatively rich levels of benefits are uniquely positioned to take advantage of these plan designs targeting higher levels of contributions or benefits to certain employees.

Defined Benefit Pension Plan

While even the thought of a defined benefit pension plan and its related investment risk may send stockholders and corporate directors running, a newer hybrid form of plan, a market-return based "cash balance" pension plan can provide a very significant level of employer-investment risk mitigation. In a case where the defined contribution plan structure has been maximized within the allowable allocation limits, alternative cash balance defined benefit plan designs may be considered. Although cash balance plans are defined benefit plans for funding and benefit limit purposes, they present the benefit accrued by a participant almost as if it were a defined contribution account. These newer hybrid plan designs are now quite common in financial institutions and professional services firms.

Stock Option or Stock Appreciation Rights

Stock option or stock appreciation rights as normally structured have the unusual benefit of allowing the employees to choose when they will be taxable. This form of compensation might not be something an employer would adopt as a tax saving measure for employees, but employees with these benefits should certainly be aware that they can be used to manage their income recognition dates and potentially reduce their tax liability. Employers might want to consider whether extended exercise periods for retiring employees are beneficial. Any benefit to a retiree of allowing an extended period to exercise would, however, need to be weighed against the fact that under current law an employee's and employer's liability for Social Security taxes (but not Medicare taxes) are limited to wages paid during a year which do not exceed the Social Security Wage Base ($113,700 for 2013) and an extended exercise period increases the likelihood that options may be settled in a year following the year during which the retiree was employed and received other wages from the employer.

Restricted stock and restricted stock units do not normally provide employees with flexibility regarding the timing of income recognition. Restricted stock is taxable not later than when the employee's rights become vested. Restricted stock units, which are actually just a nonqualified deferred compensation promise with the value of the benefit measured in stock value, can be structured to provide tax deferral because regardless of earlier vesting, the benefit is not taxable until paid to the employee. As with other nonqualified deferred compensation, which is discussed below, it

is possible to provide employees with an opportunity to make a prior election regarding the payment date of the benefit. The timing of any such election has to comply with applicable rules, but the fact is that participant elections are possible.

Nonqualified Deferred Compensation

While other forms of deferred compensation outside of a tax-qualified plan under a so-called "nonqualified plan" may provide for similar benefits of deferral into lower tax rate years, under the Employee Retirement Income Security Act of 1974 (ERISA), these plans must generally be limited to a select group of management or highly compensated employees. Furthermore, the deferral into these plans must be what for tax purposes is treated as an "unfunded and unsecured" promise to pay. As a result, the employee is subject to credit risks of the employer. Even in those cases where the employer establishes and funds a grantor trust, commonly referred to as a "rabbi trust," the participating employees remain subject to risk of the employer's creditors in the event of the employer's bankruptcy or insolvency.

From a tax perspective, nonqualified plans must comply with a plethora of technical rules. All nonqualified deferred compensation plans must now comply with the rules of Section 409A of the Internal Revenue Code (the Code), nonqualified plans of tax-exempt employers must comply with Section 457 of the Code, and nonqualified plans of certain tax-indifferent entities, such as entities owned by either tax-exempt employers or entities which are foreign corporations not subject to comprehensive income taxes, must comply with Section 457A of the Code. Both Sections 457 and 457A contain substantial limits on the use of nonqualified deferred compensation by employers to which they apply. In such situations, a harder look at the ability to use tax-qualified deferred compensation becomes a higher priority. It is worth noting that nonqualified deferred compensation is generally subject to FICA taxation in the year of vesting. Hence, the 0.9 percent additional Medicare tax will be saved only if the vesting occurs in a year when the employee's total wages, including the nonqualified deferred compensation (even if not yet income taxable) is below the applicable threshold of $250,000 for married filing jointly or $200,000 for single filers. Use of nonqualified deferred compensation is more likely to be helpful in avoidance of the 3.8 percent additional tax on net investment income for an individual near the tipping point for liability for the 3.8 percent additional tax since liability for that tax is based on modified adjusted gross income.

While Section 409A of the Code, the tax provision applicable to all nonqualified deferred compensation plans, generally requires that deferrals be established before the beginning of each year, for an employer without an existing nonqualified deferred compensation plan for which an employee is eligible, it is not too late to establish a new plan for that employee for 2013; an employer without an existing plan for an employee may establish a plan mid-year. Also, even for existing plans, employee elections to defer performance-based bonuses meeting certain requirements may be made mid-year. Regardless of whether an employer is a cash or accrual method taxpayer, an employer providing nonqualified deferred compensation plan may not recognize a tax deduction until the nonqualified deferred compensation is actually paid to the employee. In most cases the "cost" to the employer of this delay in recognition of its tax deduction for nonqualified deferred compensation will be that the tax savings derived from the deduction will be received at a later date, rather than an actual tax rate differential, as is the case for the employee side of the deferral. Because nonqualified deferred compensation plans are subject to claims of the employer's creditors, these plans are best used when long-term outlook for the employer's financial health is strong.

Conclusion

In summary, the new additional Medicare tax, tax on net investment income, higher marginal tax rates, and phase-out and reductions of personal exemptions and itemized deductions make the use of compensation deferral techniques a potentially significant benefit to employees. Employers should consider reviewing their compensation plans and programs in light of the new tax laws.

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