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Topic: Minimizing the Impact of Higher Taxes – Guidelines for Implementing Non-Qualified Deferred Compensation Arrangements

MARKET TREND: New taxes and higher tax rates may make the deferral of income from 2013 to a future year desirable.

SYNOPSIS: Deferred compensation arrangements can be used to manage the impact of the recent tax increases. They are, however, subject to strict regulation under IRC §409A. Compliance with IRC §409A is essential to avoid the imposition of significant tax penalties and requires: (1) generally electing to defer compensation only through an election made before the beginning of the calendar year in which the services giving rise to the compensation are performed (though an exception to the general rule may yet allow taxpayers who are not currently eligible to participate in a plan to make an effective deferral of compensation during the remainder of 2013); (2) specifying the time of payment of the deferred compensation at the time of the election to defer (with extremely limited ability to change the time selected for payment); and (3) limiting the time of payment only to one or more of the six payment triggers permitted under IRC §409A.

TAKE AWAY: Clients with income at levels and/or of the type that would subject them to the new taxes and the increased tax rates may very well benefit from the use of deferred compensation arrangements to reduce the impact of most of the increased taxes. Clients need to be prepared, however, to comply with strict restrictions on their access to deferred amounts for these planning strategies to be effective.

RELATED REPORTS: 13-01; 07-44; 07-38.

MAJOR REFERENCES: *IRC §409A*

Recent changes to the Internal Revenue Code will expose many high-income earners to significantly greater federal tax burdens. With appropriate use of nonqualified deferred compensation arrangements, these taxpayers may be able to reduce these tax burdens significantly. It is likely worthwhile for executives and their HR teams to review the existing opportunities the employer makes available to the executives to determine whether a nonqualified deferred compensation arrangement can be implemented to increase the executives' ability to defer income and taxation.

Before participating in a nonqualified deferred compensation arrangement, however, executives must be made aware that these arrangements are subject to significant restrictions on a participant's access to current income and to the amounts deferred. Failure to comply with these restrictions will likely actually increase a participant's overall tax liabilities. But proper attention to these restrictions and careful planning around them can prove highly advantageous.

SUMMARY OF SIGNIFICANT TAX INCREASES

Recently effective tax law changes affect all types of income and taxes.

- **Ordinary Income.** The top tax rate on ordinary income, including wages, has increased ***from 35% to 39.6%*** tax rate for taxpayers with taxable income over $400,000 (single filers) and $450,000 (married, joint filers ("**joint filers**")).

- **Long-Term Capital Gains & Qualified Dividends.** For these same taxpayers, the top tax rate on long-term capital gains and ordinary income has increased ***from 15% to 20%***.

- **Hospital Insurance Tax ("HI Tax").** All wages paid to employees have long been subject to an HI Tax (often referred to as the Medicare Tax) equal to 1.45% of total wages. Beginning in 2013, an ***added 0.9%*** tax (the "**added HI Tax**") applies to wages in excess of $200,000 for single filers and $250,000 for joint filers.

- **Net Investment Income Tax ("NII Tax").** Many of the same individuals who are subject to the added HI Tax generally are, as of 2013, subject to a NII Tax ***at the rate of 3.8%***. This tax is imposed on the lesser of a taxpayer's (1) total net investment income and (2) modified adjusted gross income ("**MAGI**") in excess of specified thresholds ($200,000 single filers, $250,000 joint filers).

- Complex rules beyond the scope of this Washington Report govern the imposition of the NII Tax. For present purposes, it should be sufficient to note that "net investment income" generally ***includes*** passive forms of income such as interest, dividends, capital gains, rental and royalty income, non-qualified annuities, income from businesses involved in trading of financial instruments or commodities, and businesses that are passive activities to the taxpayer, and ***excludes*** wages, unemployment compensation, operating income from nonpassive businesses, Social Security benefits, alimony, tax-exempt interest and self-employment income. It is also significant to note that guidance issued by the IRS indicates that amounts paid to an employee in connection with or under a nonqualified deferred compensation plan are not included in net investment income, even if those amounts include or are calculated by reference to amounts otherwise treated as net investment income.

USE OF NONQUALIFIED DEFERRED COMPENSATION ARRANGEMENTS TO REDUCE NEW TAX BURDENS

Individuals who receive a significant amount of their income from wages or compensation may be able to mitigate the impact of the higher tax rates and some of the new taxes by deferring a portion of their compensation under a nonqualified deferred compensation arrangement. As described below, such an arrangement may be advantageous with respect to income taxes and the NII tax. Unfortunately, participation in a nonqualified deferred compensation arrangement has no impact on the added HI tax or on the increased tax rate imposed on capital gains.

Income Taxes. Participation in a nonqualified deferred compensation arrangement can reduce a participant's tax burden in one or both of two regards. First, these arrangements defer income recognition to later years, when an individual may have less overall taxable income and, therefore, be paying taxes at a lower marginal rate. In addition, if a taxpayer can defer sufficient compensation to reduce current annual income below the applicable income tax thresholds, he or she can lower most rates across the board. In addition, as deferrals under these plans generally are "pre-tax," the amounts that can be "invested" and the earnings thereon may exceed those generated through after-tax investments.

NII Tax. Deferring income under a nonqualified deferred compensation plan can similarly limit a taxpayer's NII Tax liability, as this tax applies only if a taxpayer's MAGI exceeds set thresholds ($250,000 joint filers; $200,000 single). Thus, reducing MAGI through income deferral will limit, and may eliminate, an individual's current exposure to this tax. Also, if properly planned, the receipt of the deferred income may be deferred until the time (if any) when the taxpayer's annual income is expected to be less than the NII Tax thresholds.

Deferring compensation may, in an additional manner, reduce overall NII Tax liability by effectively converting net investment income into ordinary income not subject to the NII Tax. For example, most nonqualified deferred compensation plans provide hypothetical investment benchmarks that determine the "earnings" accruing with respect to the deferred compensation during the deferral period. As noted above, these "earnings" within the plan are not treated as net investment income, even if they are determined by reference to items that would otherwise give rise to net investment income. If, however, a taxpayer did not defer his/her compensation and invested it in the same investment used as a hypothetical benchmark by the nonqualified plan, NII Tax would apply to the investment earnings (assuming the taxpayer's MAGI exceeded the specified threshold).

HI Tax. Unfortunately, the HI Tax on wages, including the 0.9% added HI Tax, cannot be affected by the deferral of current income. This is because, under IRC §3121(v), this tax, unlike most other taxes, is generally payable when the taxpayer performs the services giving rise to the deferred wages, rather when the wages are paid. Thus, the HI Tax is most likely payable currently.

Capital Gains. Nonqualified deferred compensation plans generally do not affect an individual's capital gains tax exposure. The amounts ultimately paid to the participant are considered wages when paid and are taxed at ordinary income tax rates.

PLANNING TO ACCOMMODATE RESTRICTIONS APPLICABLE TO NONQUALIFIED DEFERRED COMPENSATION ARRANGEMENTS

While, for the reasons discussed above, a nonqualified deferred compensation arrangement may be a highly effective tax planning tool in many respects, it is critical that a taxpayer contemplating using such a vehicle and his or her advisors be aware of the specific restrictions applicable to the use of such an arrangement. Specifically, care must be taken to ensure that the arrangement complies with the rules of IRC §409A, because failure to comply with these rules will actually create a significantly higher income tax liability for the participant. In particular, failure to comply with IRC §409A will subject the taxpayer to current taxation on amounts deferred, interest on that tax liability calculated from the time the compensation was deferred, and an additional tax equal to 20% of the amount deferred.

IRC §409A, severely restricts both (1) the time at which an election to defer compensation can be made and (2) the time(s) at which the deferred compensation can be paid to the participant. An examination of each of these restrictions would be very helpful to advisors to taxpayers considering income deferral.

Time for Making Deferral Election. A taxpayer generally must make an election to defer compensation ***before*** the beginning of the calendar year in which the taxpayer performs the services giving rise to the compensation to be deferred. Thus, in most cases, an election to defer compensation earned in 2013 would have had to have been made in 2012 to be effective. There is, however, an exception to this rule that may permit some taxpayers still to defer compensation earned in 2013. Specifically, if a taxpayer's employer does not currently have in place a nonqualified deferred compensation arrangement that permits participants to elect to defer amounts, the employer can implement a new plan and participants will have a period of up to 30 days to make an election to defer compensation earned in the current year. The ability to defer compensation

under this exception, however, is limited to compensation earned after the date of the election. There are complicated proration rules associated with this exception and its application to bonus compensation that are beyond the scope of this Washington Report, so consultation with legal counsel or tax advisors experienced in working with IRC §409A may be prudent if this approach is contemplated.

Time for Payment of Deferred Compensation. When a taxpayer makes an election to defer compensation, that election must specify the time at which the deferred compensation is to be paid. Subject to very limited exceptions, the date elected for distribution of the deferred compensation cannot subsequently be changed. Generally, the date chosen for payment cannot be accelerated, and it can only be deferred further to a later date if the further deferral election is made at least 12 months before the deferred amount is originally scheduled to be paid and the date for payment is deferred by at least five years. Thus, a taxpayer considering deferring compensation under a nonqualified arrangement must, in addition to planning to maximize the tax advantage of deferring compensation, carefully consider his or her needs for cash in the coming years and elect payment dates for his or her deferred compensation that are reasonably expected to coincide with his or her cash flow needs.

In addition to requiring an individual to specify the time for payment of deferred compensation at the time of deferral, IRC §409A also limits the times that can be specified for payment. Nonqualified deferred compensation can be paid **only** upon the occurrence of one of six triggers: (1) separation from service with the employer owing the deferred compensation; (2) death of the service provider; (3) disability of the service provider; (4) unforeseeable financial emergency; (5) change of control of the employer owing the deferred compensation; or (6) upon the occurrence of a specified date or pursuant to a specified schedule. No other "event" can trigger payment of deferred amounts. Thus, for example, a participant in a nonqualified deferred compensation plan cannot specify that payment be made when his or her child goes to college; if that is a desirable payment date, the participant must specify the years in which he or she thinks the child will be in college and take the distributions scheduled for those years, regardless of whether a child is in college.

TAKE AWAYS

Deferral of current income may lower high income taxpayers' overall tax burdens by reducing their current incomes sufficiently to put them in a lower marginal tax bracket and/or lessen their exposure to the NII Tax.

Most nonqualified deferred compensation arrangements provide for the crediting of earnings on deferred amounts and these amounts are not subject to tax until distributed.

To take advantage of a nonqualified deferred compensation arrangement effectively, an individual needs to project his or her long-term financial needs because the individual must irrevocably elect now when he or she will receive the compensation deferred.

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