



WRMarketplace

An AALU Washington Report



Thursday, 8 June, 2017

WRM #17-23

The *WRMarketplace* is created exclusively for AALU members by experts at Greenberg Traurig and the AALU staff, led by **Jonathan M. Forster, Steven B. Lapidus, Martin Kalb, Richard A. Sirus, and Rebecca Manicone**. *WRMarketplace #17-23* was written by Greenberg Traurig Shareholder **Steven B. Lapidus**.

The AALU *WRNewswire* and *WRMarketplace* are published by the Association for Advanced Life Underwriting® as part of the *Essential Wisdom Series*, the trusted source of actionable technical and marketplace knowledge for AALU members—the nation’s most advanced life insurance professionals.

TOPIC: Executive Compensation Planning: What the Future May Hold & What Can Be Done Now.

MARKET TREND: Although many continue to anticipate tax reform in 2017, there is still time to plan now for certain employee benefit plans.

SYNOPSIS: While President Trump and the Republican-controlled Congress have promised major tax reform, little is known about the specifics that may affect executive compensation and retirement planning. Republican leaders face significant obstacles as they work to enact tax reform this year, however, based upon stated goals and prior legislative proposals, many expect changes to the taxation of deferred compensation, the limits on the deductibility of compensation paid by public companies, the tax rules applicable to “excessive compensation” payable to executives of tax-exempt organizations, and the tax treatment of so-called “carried interests.” Employers who believe that tax rate reductions may take effect this year might want to take advantage of the special tax rules applicable to qualified plans and similar arrangements by making plan contributions in 2017 that are deductible against 2016 taxable income.

TAKE-AWAYS: Despite anticipated tax reform, taking a “wait and see” approach with regard to executive compensation and employee benefits plans may not be advantageous. There are some actions employers may want to take now to reduce their 2016 taxable income, according to longstanding and appropriate tax principles—such as specifically maximizing contributions to defined benefit pension plans, profit sharing plans, and simplified employee pension arrangements.

Neither the current Administration nor Congressional Republicans have released any details regarding their plans for tax simplification or specific tax reforms that would impact executive compensation. This has led many employers to stick with their existing benefit programs, based on current tax principles, while trying to discern possible changes based on the Republicans’ stated goals and prior legislative proposals. There are, however, planning opportunities that employers with tax-qualified retirement arrangements should consider now to reduce 2016 taxable income.

READING THE “TEA LEAVES” - WHAT MIGHT HAPPEN TO EXECUTIVE COMPENSATION?

Bills previously introduced in Congress with regard to executive compensation and employee benefit plans may provide some clues regarding anticipated changes. Accordingly, it may be instructive to review prior and pending legislative proposals, including the draft of the Tax Reform Act of 2014 prepared by Dave Camp, the then Republican Chairman of the House Ways and Means Committee (“**Camp Mark-Up**”).¹ The following provides a brief comparison of the notable provisions of the Camp Mark-Up versus current law:

Non-Qualified Deferred Compensation

Current Law	Camp Mark-Up
Taxes non-qualified deferred compensation under the general principles of Internal Revenue Code (“ Code ”) §409A, constructive receipt, and other common law principles.	Would tax employees on their compensation as soon as their rights to that compensation were no longer subject to a substantial risk of forfeiture. Amounts deferred before the effective date of these provisions would be grandfathered for 10 years, after which any remaining grandfathered vested deferrals would be immediately taxable. ²

✓ **Practical Insight:** Section 409A is one of the most complex provisions in the Code, and while AALU has been told that this Camp provision is not currently being considered for inclusion in a tax reform package, this change could be included in a future bill aimed at tax simplification. Such a change, however, would result in a fundamental shift in the tax principles affecting deferred compensation for taxable entities. Limiting tax deferrals to compensation that remains subject to a substantial risk of forfeiture (similar to the rules currently in effect for non-qualified deferred compensation paid by tax-exempt entities) would have a profound effect upon non-qualified deferred compensation arrangements.

Code §162(m) \$1 Million Deduction Limitation for Public Companies

Current Law	Camp Mark-Up
<p>Provides certain exceptions from the \$1 million deduction limitation imposed on compensation paid by publicly-traded employers to their “covered employees.” For performance-based compensation and commissions, the term “covered employee” currently includes officers who, on the last day of a company’s fiscal year for which the deduction is being claimed, are the CEO or the three next most highly compensated officers of the company other than the CFO.</p>	<p>Would (1) eliminate the deduction limitation exceptions for performance-based compensation and commissions and (2) expand the definition of “covered employee” to include the CEO, CFO, and the three next most highly compensated officers. Also, once an employee qualifies as a covered employee, the deduction limitation would continue to apply for as long as the employee (or his/her beneficiary) received compensation. Pending Senate bill S. 82 (introduced by two Democratic Senators)³ contains a similar proposal but expands the deduction limitation to all current and former employees, officers, and directors.</p> <p>Both proposals would apply to taxable years beginning in the year of or after enactment, with no grandfathering for amounts earned in prior years that are paid after enactment.</p>

- ✓ **Practical Insight:** Compensation consultants, and the companies they advise, understand the need to structure executive compensation so that a significant portion is “performance-based,” allowing the interests of a company’s management to align with its shareholders. Accordingly, it is unlikely that this change would have any significant effect upon the structuring of executive compensation programs. Such a change, however, could affect the amount of compensation paid (due to the increased cost of such non-deductible compensation).

Another issue would be how such a change might affect the deductibility of compensation that has been deferred in prior years but becomes payable after the new deduction limitations take effect. Currently, an employer may not deduct non-qualified deferred compensation until the year in which the compensation is paid, and Code §162(m) generally would **not** apply to such compensation (even if it was not performance-based), if the employee was not a covered employee on the last day of the year for which the compensation could be claimed as a deduction. Under the Camp Mark-Up, however, the deduction limitation **would apply for compensation paid to any employee who at any time was a covered employee**, even in the year employment terminates.

Excise Tax on Excess Tax-Exempt Organization Executive Compensation

Current Law	Camp Mark-Up
<p>For persons who exercise substantial influence over the affairs of certain tax-exempt organizations (i.e., “disqualified persons”), a 25% excise tax applies as an “intermediate sanction” upon the amount by which the compensation paid to the disqualified person exceeds the value of the services provided. A 10% tax also applies on the amount of such “excess benefit” upon any manager of the organization who knowingly participates in such a transaction.</p> <p>Existing Treasury Regulations provide that compensation is presumed reasonable, and thus does not result in an excess benefit, if (1) it is approved in advance by an authorized body of the organization composed entirely of individuals who do not have a conflict of interest with respect to the compensation, (2) the authorized body obtained and relied upon appropriate data as to comparability before making its determination, and (3) the authorized body adequately documented its determination. If these requirements are met, then the IRS can rebut the presumption “only if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body.”</p>	<p>Would:</p> <ul style="list-style-type: none"> • Eliminate the current Treasury Regulations’ presumption of reasonableness. • Impose a 10% excise tax on the tax-exempt organization itself unless it followed certain minimum standards of due diligence to ensure that excess benefits are not paid. • Provide the IRS with an additional weapon -- an objective standard -- by subjecting the tax-exempt organization itself to a 25% excise tax on compensation in excess of \$1 million paid to any of its five highest paid employees (“covered employees”) for any taxable year. • Subject certain excessive payments on account of a covered employee’s separation from service from a tax-exempt organization to a 25% excise tax, similar to the excise tax on excess parachute payments under Code §4999, to the extent that the payments exceeded three times the employee’s “base compensation,” defined in a manner similar to the definition used to determine “excess parachute payments” under Code §280G.

✓ **Practical Insight:** The strong “reasonableness” presumption under current Treasury Regulations, coupled with the somewhat subjective standard regarding the reasonableness of compensation, makes it difficult, in many cases, for the IRS to challenge compensation paid by tax-exempt organizations under existing intermediate sanctions. The rules and excise taxes under the Camp Mark-Up, however, would greatly simplify the enforcement of limits on excessive compensation paid by tax-exempt entities by applying objective tests to determine when compensation is deemed to be excessive.

Carried Interests

Current Law	Camp Mark-Up
<p>“Carried interests” -- generally profits interests provided to financial managers of private equity and hedge funds as compensation -- are largely taxed as capital gains rather than as ordinary income.</p>	<p>Includes proposals (similar to other Congressional bills introduced by Democrats and Republicans) designed to treat carried interest income more like ordinary compensation income rather than capital gains⁴ (the tax plan issued by President Trump during his campaign also proposed changes to carried interest taxation).</p>

- ✓ **Practical Insight:** It is not possible at this time to predict whether future legislation could change the tax-treatment of carried interests, what the scope of any such legislation would involve (e.g., whether it would apply to all types of investment funds and/or would extend to service providers of all types of businesses),⁵ or whether it would include any grandfathering provisions. In light of this uncertainty, however, some advisors suggest caution in the issuance of new profits interests, especially interests granted to managers of investment funds. Yet, many in other industries continue to issue carried interests because they believe that (1) the changes will not be broad enough to cover non-investment operating companies, (2) interests issued before enactment of any new rules may be grandfathered, and/or (3) the downside might be limited if a protective Code §83(b) election is made to have the value of the interest taxed immediately, when that value may be relatively small.

SO WHAT CAN BE DONE NOW – DEDUCTIBLE PLAN CONTRIBUTIONS FOR 2016

Believe it or not, it may not be too late to take action now that will result in deductions that reduce 2016 taxable income according to longstanding and appropriate tax principles. This may be good news for those who believe that tax reform will make tax rate reductions effective for 2017.

Qualified Plan Contributions for 2016

Code §404(a)(6) generally permits an employer to claim a **tax deduction for a taxable year that has already ended, for contributions made to a qualified retirement plan on account of that prior taxable year that are made on or before the due date for the employer’s tax return for such year, including extensions.**

- ✓ **Planning Option - Maximize Defined Benefit Plan Contributions.** Many employers with unfunded benefits under their existing defined benefit plans are making (or considering making) in 2017 the greatest deductible contributions permitted under Code §404 for the 2016 plan year, given the possibility that their tax rates, and thus the tax benefits resulting from those contributions, may be significantly higher in 2016 than in future years.
- ✓ **Planning Option - Maximize Discretionary Profit Sharing Contributions.** Many employers have profit sharing plans that permit employers to exercise discretion each year as to the amount of any profit sharing contribution that it makes on behalf

of participants for that year. Under this type of plan, the contribution amount can be determined after the end of the 2016 plan year and still be claimed as a deduction on the employer's 2016 tax return, if the contribution is made on or before the due date for the employer's 2016 tax return (including extensions) and is allocated among the accounts of eligible participants as of the last day of the 2016 plan year. Employers may wish to maximize their contributions (under Code §404(a)(3), the deduction generally cannot exceed 25% of the compensation paid or accrued to plan participants during the year) for the 2016 plan year, thereby maximizing the benefit to be derived from claiming the deduction in a year in which its tax rates are high.

Note that, to satisfy the requirement that benefits under qualified plans be "definitely determinable," any contributions made for the 2016 plan year would need to be allocated among eligible participants in accordance with the allocation formula specified in the plan on the last day of the 2016 plan year. Also, if the plan provides for profit sharing contributions to be made pursuant to a fixed formula, rather than on a discretionary basis, the formula could not be retroactively changed to increase 2016 contributions.

Simplified Employer Pension. Code §408(k) defines a "simplified employee pension" ("SEP") as an arrangement where an employer establishes individual retirement accounts ("IRAs") for its eligible employees to which the employer makes tax-deductible contributions. To qualify as a SEP, the employer must make contributions for each employee (1) who has attained age 21, (2) performed service during at least three of the immediately preceding five years, and (3) received at least a specified indexed amount of compensation (\$600 for 2016) from the employer for the year. Also, the employer must not have more than 25 employees who are eligible to participate for the year.

SEP contributions must not discriminate in favor of the employer's highly compensated employees. For this purpose, contributions are considered to be non-discriminatory if they bear a uniform relationship of up to an indexed amount of \$270,000 in 2017 (\$265,000 in 2016) of compensation paid to each eligible participant (or satisfy certain rules relating to "permitted disparity"). Contributions are excluded from an eligible employee's taxable income to the extent they do not exceed the lesser of (1) 25% of the employee's taxable compensation from the employer, and (2) as indexed amount that is \$53,000 for 2016.

✓ **Planning Option – Establish SEP IRAs.** An employer can establish SEP IRAs for its eligible employees to which it can make contributions deductible on its 2016 tax returns by no later than the due date, including extensions, for its 2016 tax return.

Roth IRA Contributions. Taxpayers who have made non-deductible Roth IRA contributions for 2016 may re-characterize those contributions as traditional deductible contributions by transferring the amounts previously contributed (increased or decreased by any investment losses on those contributions) to a traditional IRA on or before the due date for their 2016 tax returns (and by filing a Form 8606 with the taxpayer's tax return, along with a statement explaining the re-characterization).⁶

✓ **Planning Option – Re-characterize Roth IRA Contributions.** The re-characterization

(1) allows the participant to claim a deduction for the 2016 contribution before a potential drop in tax rates and (2) causes the benefits (including the earnings) attributable to the re-characterized contribution to be subject to income tax when later withdrawn from the IRA, potentially when the individual is in a lower tax bracket (because tax rates are lower and/or the individual has less taxable income and is in a lower tax bracket for that reason). Note, however, that this differential in tax rates may not offset the benefits otherwise to be derived from a Roth IRA. Whether current re-characterization is preferable depends upon a variety of factors, including the rate of return on the amount contributed, the number of years between the date of the contribution and the date of withdrawal, and, of course, the differential in tax rates, all of which may be difficult to predict.

Similarly, a taxpayer who elected to convert a traditional IRA account balance into a Roth IRA account in 2016 can avoid recognizing the income from such a conversion by transferring the converted amount back to a traditional IRA on or before the due date (including extension) for the taxpayer's 2016 return, thereby avoiding having to pay tax in 2016 on the original conversion.

Note, however, that this approach **does not work for in-plan transfers of amounts held in 401(k) plans**, since the special rule allowing for this type of retroactive re-characterization or conversion does not apply with respect to transfers from a traditional account to a Roth account, or vice versa, within a 401(k) plan.⁷

TAKE-AWAYS

Despite anticipated tax reform, taking a “wait and see” approach with regard to executive compensation and employee benefits plans may not be advantageous. There are some actions employers may want to take now to reduce their 2016 taxable income, specifically maximizing contributions to defined benefit pension plans, profit sharing plans, and simplified employee pension arrangements.

DISCLAIMER

This information is intended solely for information and education and is not intended for use as legal or tax advice. Reference herein to any specific tax or other planning strategy, process, product or service does not constitute promotion, endorsement or recommendation by AALU. Persons should consult with their own legal or tax advisors for specific legal or tax advice.

NOTES

TCO 362568329v3

¹ Hank Gutman, a former chief of staff of the Joint Committee on Taxation in the '90s was recently quoted as saying that, in this difficult political environment, the odds are against broad tax reform, and that he expects that "we are going to end up with something that looks very much like the Camp tax reform."

² As proposed, this provision would be effective for compensation for services performed after the year in which the law changed.

³ Introduced on January 10, 2017 by Democratic Senators Reed and Blumenthal.

⁴ See, e.g., the Carried Interest Fairness Act of 2015, introduced by several Democratic Congressman on January 25, 2015 into the House as HR 2889 and Senate as S1686 (the "2015 Carried Interest Bill").

⁵ E.g., the Camp Mark-Up would not have applied to real estate, and the 2015 Carried Interest Bill would only have applied to partnerships substantially all the assets of which were invested in securities, commodities, partnerships, or options or derivatives with respect to those assets.

⁶ See Code §408A(d)(6).

⁷ See IRS Notice 2010-84, Q&A-6.