



# What's News in Tax

Analysis that matters from Washington National Tax

## Employer Challenges and Opportunities in Potential Tax Reform

February 20, 2017

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Change can present challenges as well as opportunities. Tax law is no different. In light of recent proposals, the impact of possible tax reform affecting employers is significant: There is the potential for changes in tax rates, repeal of the alternative minimum tax, modification of carried/profits interest treatment, increased emphasis on reasonable compensation, and repeal of the Affordable Care Act (“ACA”), among numerous other proposals.

Businesses are keenly interested in the implications of current tax reform proposals on their compensation and benefit arrangements. Even though specific legislation has yet to be enacted, there are several key proposals that may present opportunities for employers willing to plan ahead.

Several tax reform proposals have been formulated and discussed during recent years, but the one receiving most of the current attention is referred to as the House Republican “Blueprint.”<sup>1</sup> House Republicans released the Blueprint in June 2016 as a conceptual framework intended to guide future legislation. The current administration also drew heavily from this Blueprint and expanded on some of the concepts during the recent presidential campaign. In addition, Congress recently passed budget

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<sup>1</sup> *A Better Way—Our Vision for a Confident America* (June 24, 2016) (the “Blueprint” published by the House of Representatives Republican Tax Reform Task Force).

reconciliation instructions and the administration issued an Executive Order,<sup>2</sup> both measures focused on reducing the expense associated with ACA implementation. The discussion below addresses a number of issues and opportunities presented by the Blueprint and President Trump's campaign tax plan ("the campaign plan") that could present challenges as well as opportunities if ultimately enacted.

## Changes in Corporate Income Tax Rates

The campaign plan and the Blueprint both discuss corporate tax rate reductions. The campaign plan would reduce the highest corporate income tax rate from 35 to 15 percent. The Blueprint would reduce the highest corporate income tax rate to 20 percent. Both the campaign plan and the Blueprint propose to repeal the corporate alternative minimum tax.

If a business takes a deduction in a year before the proposed rate change, the deduction effectively has a greater economic benefit because it offsets income at a higher tax rate. Potential compensation and benefit related deductions for which there may be an opportunity to accelerate (subject to special deduction provisions such as sections 162(m), 162(m)(6), 280G, etc.<sup>3</sup> when applicable) include, but are not limited to, the following:

- Qualified retirement plan contributions
- Self-insured employee medical expenses (IBNR)
- Annual bonuses (fixed and determinable amounts paid within 2.5 months of year-end, etc.)
- Nonqualified deferred compensation plans designed under the short-term deferral exceptions
- Vacation / personal time off
- Payroll taxes

Early planning to secure these and other deductions is key. In some instances, plans may require amendments by certain dates, compensation committee action, and payment procedure modifications well in advance.

Note that it may be possible in some instances to take the deduction even though a payment is not made until the following year.<sup>4</sup>

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<sup>2</sup> EO 13765, 82 FR 8351 (Jan. 20, 2017) (Minimizing the Economic Burden of the Patient Protection and Affordable Care Act Pending Repeal).

<sup>3</sup> Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

<sup>4</sup> This is fairly common with certain year-end bonuses and short-term deferrals of compensation. See Rev. Rul. 2011-29.

Example of potential loss of corporate tax deduction if amount cannot be accelerated and deducted into an earlier tax year:

	<b>Deductible Amount</b>	<b>Rate</b>	<b>Value</b>
<b>Pre-reform (2017?)</b>	\$10,000,000	35%	\$3,500,000
<b>Post-reform</b>	\$10,000,000	20%	\$2,000,000
<b>Difference</b>		15%	\$1,500,000 loss/expense

Under this scenario, the company would face a remeasurement of its deferred tax asset and income tax expense of \$1,500,000. Accelerating the deduction to a pre-reform tax year would eliminate the tax expense.

## Changes in Personal Income Tax Rates

The campaign plan and the Blueprint both consider personal income tax rate reductions. In addition, both the campaign plan and the Blueprint propose to repeal the individual alternative minimum tax. The ordinary income tax brackets under both the campaign plan and the Blueprint are 12 percent, 25 percent, and 33 percent. The campaign plan's proposal specifically applies the top tax rate to income above \$225,000 for married filing jointly and \$125,500 for single taxpayers.

### *Deferred Taxation*

If an individual expects to include certain compensation in taxable income in 2017 but there is a chance to delay that inclusion to a later tax year with a lower individual tax rate, then an economic benefit to the delayed taxation may exist. The benefit of a change in rates is dependent upon income level and whether an individual is a single filer or married-joint filer.

Potential compensation- and benefit-related items for which there may be an opportunity to defer (subject to compliance with section 409A, etc.) include, but are not limited to, the following:

- Short or long-term deferred compensation arrangements
- Annual bonuses earned in 2017
- Severance
- Settlement of equity-related compensation

Early planning is key and the ability to defer amounts can be limited to the extent compensation is already earned. Some arrangements must be amended by certain dates and procedures may need to begin a year in advance in some instances.

Note that it may be possible in some instances to recognize income in the next year although the employer recognizes a deduction in the current year

Example of potential individual tax benefit (assuming all amounts at the highest tax bracket) if the amount can be deferred into a later tax year:

	<b>Compensatory Incentive Amount</b>	<b>Rate</b>	<b>Applicable Tax</b>
<b>Pre-reform (2017?)</b>	\$500,000	39.6%	\$198,000
<b>Post-reform</b>	\$500,000	33%	\$165,000
<b>Difference</b>		6.6%	\$33,000 tax reduction

### *Accelerated Taxation*

Tax rates throughout history have fallen and risen over time, and favorable rates seldom stay in place for more than a few years. If individual tax rates are reduced, there can be an economic benefit to including amounts in income in a relatively low tax rate year even though the amounts might otherwise be deferred until a later date. As such, acceleration of deferred income may be attractive to certain individuals.

There are several compensation and benefit opportunities for including compensation (subject to compliance with section 409A, etc.) in a tax efficient year, such as:

- Terminating deferred compensation arrangements to pay out earlier than scheduled
- Accelerating vesting of restricted stock
- Exercising options
- Reducing elective deferral contributions for future years

- Making Roth 401(k) contributions rather than pre-tax contributions (to the extent allowed by the plan)
- Converting into Roth savings accounts—401(k) in-plan conversions, IRAs to Roth IRA conversions, etc.—when appropriate.

Non-tax considerations (such as the retention benefits of a particular deferral and incentive structure) will also undoubtedly factor into any such decision. As with deferral, early planning is key. Also, plans may require amendments to provide the desired benefits. Determining whether paying tax now, at a lower tax rate, rather than later, at an unknown but potentially higher tax rate, requires a cost-benefit analysis.

### Repealing Alternative Minimum Tax (“AMT”)

Both the campaign plan and the Blueprint would repeal corporate and individual AMT. The potential corporate planning relative to AMT in the context of this article is similar to the corporate rate reduction discussion above. The impact of repealing individual AMT is also similar to the individual rate reduction discussion above, but with one additional potential benefit—incentive stock options (ISOs).

AMT was initially designed to affect wealthy taxpayers. However, the AMT tax now affects middle-class taxpayers (the Tax Policy Center estimates that approximately 4.1 million taxpayers paid AMT in 2015).

Currently, ISOs are considered preference items that are subject to AMT upon exercise.<sup>5</sup> As a result, the benefit of ISOs (deferral of tax until sale) is essentially negated for many taxpayers.

If AMT is repealed, employers should consider including ISOs in their equity-related plans in both form and operation as well as the impact of AMT repeal on overall compensation packages.

ISOs are not perfect for employers because there are lost deductions associated with ISOs. To the extent no ordinary income is picked up by the individual (which is that case so long as ISO acquired shares are held by the individual for at least two years from the date of grant and one year from the date of exercise),<sup>6</sup> an employer does not realize a deduction.

### Repealing Carried/Profits Interest

The campaign plan highlighted carried interest as an area ripe for reform and proposed changing the current taxation of carried/profits interests<sup>7</sup> by generally treating them as ordinary income rather than capital gains.

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<sup>5</sup> See section 56(b)(3).

<sup>6</sup> See section 422(a).

<sup>7</sup> See Rev. Proc. 93-27 clarified by Rev. Proc. 2001-43. Provided certain facts are satisfied, profits interest under these revenue rulings are not taxed upon grant, but taxed upon distribution at more favorable rates than compensation income.

Tax reform directed at carried/profits interest would likely be enacted in concert with reduced tax rates overall and elimination of the net investment income tax as well as possible reductions in the capital gains tax rate. Under the campaign plan's proposal, there would be three tax brackets on capital gains: 0 percent, 15 percent, and 20 percent. Under the Blueprint, a 50 percent deduction on ordinary income tax rates would apply, generating rates of 6 percent, 12.5 percent, and 16.5 percent. However, the Blueprint also provides for a 25 percent rate on active business income for pass-throughs and sole proprietorships.

Key considerations and alternatives include:

- Other types of equity compensation (restricted capital interests, options, etc.)
- Incentive compensation that tracks equity (phantom units, appreciation rights, etc.)
- Equity at various levels within a structure

Such changes may affect payroll taxes and other compensation arrangements. Direct equity compensation, such as transferring restricted capital, has one set of tax rules, while incentive plans (which promise future equity or cash transfers) are under deferred compensation rules (which may have greater flexibility, but must be designed with care to avoid the 20 percent additional income tax under section 409A).

### Reasonable Compensation

Under the Blueprint, sole proprietorships and pass-through entities (such as S corporations and partnerships) would be required to pay reasonable compensation to owner service providers. Compensation would be deductible to the business, but subject to ordinary income tax rates for the individual. The campaign plan does not contain this provision and it is unclear what guidelines would apply specifically to such a determination. Nonetheless, businesses that could be affected by such a requirement will want to give some thought to the potential impact of such a provision.

### Repeal of the ACA

The Trump Administration has ACA repeal/reform at the top of its agenda and evidenced this through the first Executive Order of the administration. In addition, Congress has already passed budget reconciliation instructions intended to facilitate the passage of legislation designed to reduce the expense associated with ACA implementation.

Although there has been significant discussion on revising and repealing the ACA, the potential framework of such reform is undoubtedly fluid. However, certain concepts have received traction, including the elimination of a mandate to purchase health insurance and encouraging use of Health Savings Accounts (HSAs).

If an employer or employee mandate is eliminated from the ACA or replacement legislation, the expenses associated with employer reporting and filing compliance (including, but not limited to, provisions for reporting and filing within Forms W-2, 1094, and 1095) will likely decrease. In addition, employers with globally mobile workforces will likely not have to include seconded employees in health care plans if such individuals wish to remain in their home country plans. Repealing a mandate also takes some pressure off the potential exposure of independent contractor and employee classifications.

With respect to ACA repeal/reform, it is apparent that HSAs are viewed favorably by many lawmakers as a means to allow individuals to save for health care expenses. Although the exact tax impact relative to HSAs remains open, some discussion has focused on enhancing deductions and/or tax credits with respect to HSAs. Companies that do not currently have HSAs or that underutilize HSAs may want to review their HSA-related arrangements and consider how these tax-favored savings vehicles might factor into compensation and benefit design going forward.

## Other Challenges and Opportunities Affecting Employers

### *Payroll Reporting and Withholding*

Aside from the compliance-related reporting requirements of repealing/reforming the ACA, there are other carryover considerations to proposals contained in the campaign plan and the Blueprint that could have significant payroll implications.

If individual tax rates are revised as proposed, then the withholding rates would follow suit. In particular, supplemental wages below \$1 million (which is set at the third highest tax rate) would be subject to a 12 percent withholding rate. Such a relatively low withholding rate is likely unsustainable and could invite change in both the withholding rate and procedures. As a result, it is anticipated that any legislation lowering individual tax rates will also address withholding and could present an opportunity for Congress to address some of the practical withholding issues highlighted by recent accounting rule changes in ASU 2016-09.<sup>8</sup> In particular, many employers are struggling to accommodate additional withholdings in light of accounting rules permitting them. As such, potential changes to these rules may present opportunities for employers to more easily withhold in alignment with employee wishes.

### *Section 162(m)*

Although neither the campaign plan nor the Blueprint suggest an expansion of Section 162(m), such a proposal may have some traction as a revenue raiser. There may be an appetite for expanding the compensation limit to all companies or some variant thereof and for the tightening of exceptions. Recently, the “Tax Reform of 2014”<sup>9</sup> proposed a number of expansions to Section 162(m), such as

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<sup>8</sup> Tammy Whitehouse, *In stock options, accounting simplicity begets payroll complexity*, Compliance Week (Jan. 24, 2017).

<sup>9</sup> H.R. 1, 113<sup>th</sup> Congress, Second Session (Dec. 10, 2014) (also known as the “Camp Bill” after its sponsor, then-Ways and Means Chairman Dave Camp (R-MI)).

including the CFO as a covered employee<sup>10</sup> and providing that once an individual is a covered employee the deduction limit applies to all future compensation. An expansion of Section 162(m) would undoubtedly present challenges and tensions between the compensation of executives and other business-related deductions.

## Next Steps

What does all this mean for employers navigating tax reform? Employers may wish to consider the potential benefits of significant opportunities to realize tax deductions this year and the potential impact of possible reduced tax rates on the payments of compensation. Employers should keep future plans fluid, continue to monitor developments, and be prepared for changes. Businesses planning ahead may reap significant tax benefits. With regard to the ACA, companies should continue to comply with reporting requirements (including Forms 1094 and 1095).

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<sup>10</sup> See IRS Notice 2007-49. *But see* CCA 201543003, in which the CFO of a small issuer is considered a covered employee.