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Topic: Washington Report 13-09 : Minimizing the Impact of Higher Taxes - Opportunities for Retirement & Deferred Compensation Planning

MARKET TREND: The rising tax rates faced by high income earners likely will increase the popularity of tax qualified plans and nonqualified deferred compensation arrangements.

SYNOPSIS: Recent tax legislation has increased the effective tax rates for high-income earners through implementation of higher marginal income and capital gain tax rates and new health care taxes on wages and net investment income. Retirement plans and deferred compensation arrangements may mitigate the impact of many of these tax increases for certain high income earners but will require careful planning to ensure compliance with IRC §409A.

TAKE AWAYS: Given the significant tax hikes facing many high income earners, insurance producers, planners, and consultants should:

- Identify and contact clients at income levels likely affected (or soon to be affected) by the new tax rates and who can benefit from the use of retirement plans, deferred compensation arrangements, and/or life insurance or annuity products to minimize or avoid tax increases (e.g., executives, closely-held business owners).
- Quantify the client's earned income and investment income to determine the areas of greatest tax exposure and to identify which strategy will best target expected tax liabilities (e.g., retirement or deferred compensation plans for high wages earners, annuity or life insurance products for those with significant investment income).
- Given the technical complexity associated with deferred compensation plans, ensure that clients seeking to implement or take advantage of such planning work with experienced counsel to ensure compliance with IRC §409A and related rules.

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

MAJOR REFERENCES: [IRC §§1411, 3101, 3202](#); [Prop. Reg. §§31.3202-1, 1.1411-1 through -10](#); [“IRS Net Investment Income Tax FAQs”](#); [“IRS Questions and Answers for the Additional Medicare Tax”](#)

Due to the confluence of income and health care tax changes taking place in 2013, many high-income earners will now face far greater federal tax obligations. Fortunately, with careful planning, including the use of tax-qualified retirement plans, nonqualified deferred compensation plans, and/or investments in life insurance or annuity products, taxpayers can manage and potentially mitigate their overall tax exposure.

KEY TAX INCREASES FOR HIGH INCOME EARNERS

The passage of the American Taxpayer Relief Act and the implementation of new health care payroll taxes will significantly increase taxes for high income earners, including as follows:

- **Ordinary Income.** A top 39.6% tax rate (up from 35%) now applies to ordinary income, including wages and compensation, for taxpayers with taxable income over \$400,000 (single filers) and \$450,000 (married, joint filers (“joint filers”)).
- **Long-Term Capital Gains & Qualified Dividends.** A 20% top tax rate (up from 15%) now applies to long-term capital gains and qualified dividends for taxpayers with taxable income over \$400,000 (single filers) and \$450,000 (joint filers).
- **Hospital Insurance Tax (“HI Tax”).** All employees pay (through employer withholding) an HI Tax of 1.45% on total annual wages. As of 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.

✓ **Planning Note:** An employer’s threshold for withholding the added HI Tax begins when the annual wages it pays to an employee reach \$200,000, regardless of the employee’s filing status. ***Thus, the correct amount of HI Tax often will not be withheld from an employee’s wages, leaving the employee responsible for accurately determining and paying the total HI Tax due.***

Example: B earns \$220,000 from her employer. Her spouse, C, does not work. The couple’s combined wages are below the \$250,000 threshold for joint filers, so they will not owe added HI Tax. B’s employer, however, will still withhold added HI Tax when B’s wages exceed \$200,000. Conversely, if B and C each earn \$150,000 in wages, neither of their employers will withhold added HI Tax, even though, as a married couple earning \$300,000 for the year, B and C will owe added HI Tax on \$50,000 (the excess of their joint wages over \$250,000).

Unfortunately, IRS guidance on the added HI Tax does not provide a precise method for addressing these issues. An employee cannot direct an employer to withhold more or less HI Tax. Rather, an employee may direct the employer to withhold more or less income tax, in an attempt to approximate the proper withholding amount for HI Tax purposes, or the employee can address any discrepancy by paying additional tax, or claiming a refund, for the year when s/he files an income tax return.

- **Net Investment Income Tax (“NII Tax”).** For individuals, as of 2013, IRC §1411 imposes a 3.8% NII Tax 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).¹

The rules governing the taxation of net investment income, as currently set forth in proposed regulations and a set of “FAQs” issued by the IRS,² are extremely complex. For our purposes, however, “net investment income” generally:

- **Includes** 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.
- **Excludes** wages, unemployment compensation, operating income from nonpassive businesses, Social Security benefits, alimony, tax-exempt interest and self-employment income.

✓ **Planning Note:** The proposed regulations and FAQs specifically state that ***net investment income does not include distributions from tax-qualified plans***, such as those under IRC §§401(a), 403(a), 403(b), 408, 408A or 457(b). Further, the preamble to the proposed regulations (but not the proposed regulations themselves) states 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.

PLANNING OPPORTUNITIES TO REDUCE NEW TAX BURDENS

Individuals can ***mitigate the impact of higher taxes by maximizing their contributions to tax-qualified retirement plans and their participation in nonqualified deferred compensation arrangements.***

Income Taxes. Participation in qualified and nonqualified plans can defer income recognition to later years, when an individual may have less overall taxable income. If an individual can use income deferral to currently reduce his/her annual income below the applicable income tax thresholds, s/he can lower most rates across the board.³ 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.

Example: B, a married individual, has \$500,000 of earned income. Compare the income tax results if, in 2013, B defers \$50,000 of income under a nonqualified deferred compensation plan or recognizes it as part of his total taxable income:

	No Deferral	\$50,000 Deferred
Income Tax on \$50,000 (39.6%)	\$19,800	\$0
Net Balance for Investment	\$30,200	\$50,000
Annual Investment Return (at 6%)	\$1,812	\$3,000
Returns Currently Taxed	Yes	Deferred (w/in plan)

Note that if B defers amounts under the nonqualified arrangement until retirement, when he has less than \$450,000 in annual income, the amount deferred should forever escape tax at the top 39.6% rate, producing a federal income tax savings of at least 3.6% on the amount deferred.

NII Tax. Similarly, income deferral can assist in limiting NII Tax exposure, since this tax on net investment income only applies 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 exposure to this tax. Again, deferral planning should seek to delay the receipt of the deferred income until the time (if any) when the taxpayer’s annual income is expected to be less than the NII Tax thresholds.

Example: B, a single individual, has \$200,000 in compensation income and \$50,000 in net investment income that results in \$250,000 of MAGI. B will owe \$1,900 in NII Tax on his net investment income (3.8% of \$50,000). If, however, B defers \$25,000 of his compensation, his MAGI will be \$225,000, and he will only owe \$950 of NII Tax (3.8% of the difference between \$225,000 of MAGI and \$200,000 (the single filer threshold)).

✓ **Planning Note:** Deferring compensation also may provide NII Tax planning benefits 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 ameliorated by the deferral of current income* because IRC §3121(v) imposes this tax when the taxpayer performs the services giving rise to those wages (or, if later, when they cease to be subject to a substantial risk of forfeiture), not when the wages are paid. As it is highly unlikely that an individual would defer income subject to a substantial risk of forfeiture, the HI Tax most likely is payable currently.

POTENTIAL LIMITATIONS & RESTRICTIONS ON COMPENSATION DEFERRAL

Tax-Qualified Retirement Plans. Generally, a tax-qualified plan provides only a limited opportunity for deferring the receipt of compensation. In most cases, a taxpayer would accomplish this deferral through a plan with a 401(k) feature. Under the tax-qualification rules applicable to such a plan, the maximum amount that an individual can defer for any calendar year is \$17,500 (although the plan may be subject to certain nondiscrimination rules that could limit a participant’s maximum deferral amount). If the participant is at least 50 years old at any time during the calendar year, the maximum deferral amount increases by \$5,500.

Other means exist to increase the amount set aside under a tax-qualified retirement plan in addition to elective deferral that, as noted above, are subject to the limitations of IRC §401(k) and related provisions. Through the use of techniques like “cross-testing,” or plan designs such as “cash balance” plans, greater amounts can be set aside for high earners under a tax-qualified plan. These arrangements require careful planning and structuring, and frequently involve the provision of some level of additional benefits to at least some portion of the plan sponsor’s rank-and-file employees.

Nonqualified Deferred Compensation Arrangements (“NQDCs”). A NQDC generally offers greater deferral opportunities during any year than a tax-qualified plan. In addition, because NQDCs are not subject to nondiscrimination rules, plan sponsors should not incur additional costs for benefits for other employees. A NQDC is, however, subject to the requirements of IRC §409A, which 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. 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. While a detailed discussion of the requirements of IRC §409A is beyond the scope of this bulletin, advisors should be aware of the following fundamental principles:

- 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. While this rule would appear to restrict severely the planning opportunities for 2013, an exception applies for deferral elections made under new plans. If a taxpayer is not already eligible to participate in a nonqualified plan for 2013, perhaps a new plan could be implemented that would allow him or her to defer compensation for this year.
- 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.
- 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.

USING LIFE INSURANCE & ANNUITIES TO MINIMIZE OR AVOID TAX INCREASES

Unlike deferrals under qualified retirement plans and NQDCs, investments in annuity or life insurance contracts can only be made on an after-tax basis. Nevertheless, these investment vehicles may assist in minimizing the impact of the NII Tax on net investment income, based on the following:

- Although IRC §1411(c)(1)(A)(i) states that net investment income includes gross income from annuities, the preamble to the proposed regulations makes clear that ***net investment income only includes amounts in connection with annuities to the extent those amounts are includible in income***. Since annuity investment income generally becomes includible in income only when distributed, undistributed investment income within an annuity should not be considered net investment income for NII Tax purposes.
- Undistributed annuity income also should not increase the contract holder’s MAGI for purposes of the NII Tax threshold, which may reduce the contract holder’s NII Tax exposure with regard to other investment income.
- Deferring the recognition of annuity investment income may result in the taxation of that income at a lower rate in the year when the income is finally recognized, for example, if the taxpayer’s total income puts him or her in a lower tax bracket or below the NII Tax threshold.
- In the context of a life insurance policy, if no policy distributions are made until the insured’s death, any investment income within the contract may fully escape both income tax and the NII Tax, since life insurance death benefits typically are not includible in income.

In addition, various planning strategies – i.e., taking policy loans rather than distributions, using income in the contract to pay the cost of insurance, investment management fees, etc. – may enhance the net investment income tax savings derived from the use of annuity and life insurance products. The proposed regulations under IRC §1411, however, do not clearly address the role of annuities or life insurance in determining net investment income, and only provide general

guidance in the preamble. As additional guidance on the subject is needed and may well be forthcoming, these issues will be reviewed in further detail in a subsequent Washington Report.

TAKE AWAY

Recent tax law changes mean that many high income earners will face greater tax liabilities. By increasing amounts deferred under tax-qualified retirement plans and nonqualified deferred compensation arrangements, or by increasing exposure to annuity or life insurance products, these individuals may be able to mitigate the impact of most of these taxes. Thus, insurance producers, planners, and consultants should:

- Identify and contact clients at income levels likely affected (or soon to be affected) by the new tax rates and who can benefit from the use of retirement plans, deferred compensation arrangements, and/or life insurance or annuity products to minimize or avoid tax increases (e.g., executives, key employees, closely-held business owners).
- Quantify the client's earned income and investment income to determine the areas of greatest tax exposure and to identify which strategy will best target expected tax liabilities (e.g., retirement or deferred compensation plans for high wages earners, annuity or life insurance products for those with significant investment income).
- Given the technical complexity associated with deferred compensation plans, ensure that clients seeking to implement or take advantage of such planning work with experienced counsel to facilitate compliance with IRC §409A and related rules.

SAMPLE CLIENT LETTER

"Dear Client,

Passage of the American Taxpayer Relief Act of 2012 and implementation of substantial new healthcare taxes on compensation and investment income could ***significantly increase your overall federal tax exposure for 2013 and beyond.*** Specifically, the following tax rules now apply:

- Increases in the top ordinary income tax rate (from 35% to 39.6%), the capital gains rate (15% to 20%), and the tax rate on qualified dividends (15% to 20%).
- A new 3.8% tax on the "net investment income," including dividends, interest, and capital gains, of individuals with income above set thresholds (e.g., \$250,000 - married; \$200,000 - single).
- 0.9% increase (from 1.45% to 2.35%) in the employee portion of the Hospital Insurance Tax on wages above set thresholds (e.g., \$250,000 - married; \$200,000 - single).

Fortunately, you may be able to ***mitigate the impact of these higher taxes by taking advantage of tax-qualified retirement plans and/or nonqualified deferred compensation arrangements or by increasing your exposure to other tax-deferred planning vehicles,*** such as annuities and life insurance products.

We can assist you in reviewing your potential tax exposure based on the breakdown of your income between earned income (wages) and investment income, as well as the availability of suitable tax-deferral options. These efforts can help you to lay the groundwork for a tax-efficient, long-term financial plan. Please contact us if you have any questions or to set up a time to discuss these important developments."

¹ The NII Tax also applies to estates and certain trusts, based on the lesser of the estate's/trust's (1) undistributed net investment income, or (2) adjusted gross income in excess of the top income tax threshold for trusts/estates (i.e., \$11,950 in 2013, inflation adjusted).

² A detailed analysis of these rules is beyond the scope of this Washington Report.

³ For a technical reasons described herein, deferring income generally does not reduce the amount of a taxpayer's "wages" subject to HI Taxes. Thus, most deferrals will not eliminate the 0.9% added HI Tax.