

## **Slipping Through the “Donut Hole”: Obscure Election Can Avoid Potential Executive Payroll Tax Hike**

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Companies have a unique opportunity to consider minimizing the adverse impact of potential payroll tax increases affecting executives and employers under the Obama administration by taking advantage of various payroll elections available to employers on behalf of executives.

Executives and employers pay FICA taxes on wages, including wages attributable to nonqualified deferred compensation plans such as supplemental executive retirement plans (SERPs). FICA taxes have two components: OASDI (Social Security) and HI (Medicare) taxes. Executives and employers currently each pay Social Security taxes at a rate of 6.2% and Medicare taxes at a rate of 1.45%. Social Security taxes are currently imposed on the first \$102,000 of wages paid to an executive, but not on any wages above that base wage. Medicare taxes are imposed on all wages paid to an executive regardless of the dollar amount.

The Obama administration and the 111th Congress are generally expected to consider increasing Social Security taxes by eliminating the Social Security taxable wage base (\$106,800 for 2009) so that for the first time ever, all (or substantially all) wages will become subject to Social Security taxes, with an exemption for those wages between the current cap and \$250,000. This aspect of Obama’s tax hike plan has been referred to by the President-elect on his website as a “donut hole.” All amounts in excess of this \$250,000 figure would become subject to the Social Security tax hike. President-elect Obama’s official website describes this in terms of a 2% to 4% increase, but others have predicted that this increase will be much higher, possibly as much as 12.4%, raised in increments over a period of several years.

Under current law, an executive retiring in 2008 with a SERP benefit presently valued at \$2,000,000 would be subject to FICA taxes of \$70,648. The same benefit would be subject to FICA taxes of \$287,648 if the FICA rates increase to 12.4% as some predict. The difference of \$217,000 under this scenario would be shared equally between the executive and the employer (although the employer tax is deductible and therefore its net cost is somewhat lower).

While numerous payroll tax savings and refund concepts exist, one tax savings idea should be of particular interest to executives in SERPs if either the employer or its executives believe Social Security taxes will increase under President-elect Obama’s self-described donut-hole plan. Unusual and complex rules apply to the FICA taxation of nonqualified deferred compensation generally and of SERPs particularly. Many of these rules are so complex that most employers choose to simply subject

the SERP wages to FICA taxes when executives retire rather than when these benefits previously vested.

The complex FICA tax rules actually provide employers the opportunity to avoid future Social Security tax increases under this donut-hole plan by taking advantage of various rarely used elections available to employers on behalf of executives. One of the rules unique to SERPs and other plans where vested benefits are “not reasonably ascertainable” is that the FICA taxation can be accelerated to a date of the company’s choosing. Little reason has previously existed to elect such an acceleration, as until now it merely produced a “wash” due to time-value-of-money concepts. However, significant incentive may exist if the FICA increases described above are enacted.

In the example above, the employer may simply choose to accelerate the FICA taxation on the executive’s deferred compensation to a date prior to the anticipated tax hike’s effective date to avoid the anticipated FICA tax increases. Of course, the “price” for making the election is that the employer and the executive must pay a tax currently—albeit at a far reduced rate compared to what would be payable if the FICA increases discussed above are enacted. If done correctly (e.g., the executive cannot be allowed unfettered discretion to make the choice), the executive’s half of the FICA taxes, plus the income taxes owed on this withdrawal (calculated on a gross-up basis), can be paid from the nonqualified plan without violating Section 409A of the Internal Revenue Code. (Notably, such a withdrawal from the SERP would be subject to income taxes at current rates; such an early withdrawal may provide an additional benefit, if separate tax legislation is enacted in the next Congress to increase regular income tax rates.)

This opportunity may not be for everyone, but it is likely to be a hot topic of discussion among corporate executives. For executives who are close to retirement (especially those within three years of retirement), there are few reasons not to accelerate the FICA taxation. Some payroll tax procedural nuances exist for executives who are more than three years away from retirement, but this unique opportunity to avoid FICA taxes should still be thoroughly considered if you believe the FICA tax increases will be enacted. Note that this strategy is effective only with respect to vested benefits.

Although the regulatory provisions that allow these elections were some of the most complex and lengthy payroll tax regulations issued by the IRS in the past 20 years, there are actually few limitations that would prevent an employer from making what is in reality a simple election. An employer may make this election on a plan-by-plan basis and on an executive-by-executive basis. It should be emphasized, however, that there is no assurance that the FICA tax increases described on the President-elect’s website will be enacted or that, if enacted, that they will be effective for the 2009 tax year.

If you would like to discuss this issue and/or receive an education packet for your executives, please contact your Morgan Lewis attorney or one of the attorneys listed below.

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