

Higher Taxes Potentially Ahead for Executive Compensation: President-Elect Biden's Proposed Tax Plan's Effects on Executive Pay

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Joe Biden from the Democratic Party ticket has been declared the winner of the presidency in last week's election, and barring any surprises, he will become the 46th President of the United States in January 2021. In addition, the Democratic Party has retained its majority in the House of Representatives in last week's election, while the state of the Senate majority is still unknown as of the date of this alert. With this level of control, the policies and priorities of President-elect Biden likely will be reflected in the congressional legislative agenda at some point in the future. These policies and priorities include President-elect Biden's plans to increase certain taxes that often relate to executive compensation. These increased taxes are discussed below primarily from an employer's standpoint on the amendment of its existing, or the adoption of new, executive compensation programs.¹

Increased Taxes on High Earners. During this year's presidential campaign, then-candidate Biden rolled out a tax plan to increase taxes on individuals earning more than \$400,000 annually. If this tax plan was enacted in its current form, these increased tax rates would apply to high earners (e.g., executives) in several contexts, including with respect to federal income taxes and Social Security taxes, as follows:

- **New Top Federal Income Tax Rate.** The 39.6% federal income tax rate that applied prior to the enactment of 2017's Tax Cuts and Jobs Act (TCJA) would be reinstated (the New Top Rate) in the near term (instead of when the TCJA tax cuts "sunset" in 2025) and would replace the 37% top rate that currently applies.
- **New Social Security Tax and "Doughnut-Hole" Regime.** A new 12.4% Social Security tax would apply on wages (and earnings from self-employment) that exceed \$400,000 (the New SSI Tax). In other words:
 - The existing 12.4% Social Security tax would apply on wages up to the regular Social Security wage base (\$142,800 for 2021).
 - No Social Security tax would apply on wages above the regular Social Security wage base up to \$400,000 (this type of gap in taxation (i.e., between the regular Social

Security wage base and \$400,000) often is referred to as a “doughnut hole”).

- The New SSI Tax (12.4%) would apply on all wages above \$400,000.

As an aside, the obligation to pay Social Security taxes is split 50-50 between employees and their employers, meaning that an employee and their employer each pays Social Security taxes at a 6.2% rate, which adds up to the 12.4% combined rate (in contrast, self-employed individuals are responsible for paying the entire 12.4% Social Security tax on their own). In addition, if the Democratic Party does not gain control of the Senate, it then becomes an open question of whether, when, and to what extent New Top Rate and New SSI Tax (collectively, the Biden Tax Plan) ultimately would become law. Thus, it is possible that the Biden Tax Plan never becomes law. Similarly, a less impactful version of the Biden Tax Plan could be reflected in bipartisan tax legislation in the next five years (i.e., before such time that the TCJA tax cuts would sunset).

Example. For illustrative purposes, and with respect to the Biden Tax Plan in its current form, consider a simplified example involving an unmarried executive who ultimately receives \$900,000 in wages from their employer as taxable income (after taking into account all applicable tax deductions, exclusions, etc.) during a tax year in which the New Top Rate and New SSI Tax (collectively, the Biden Tax Plan) would be in effect. With respect to the last \$500,000 the executive earns for that year (i.e., the amount in excess of the \$400,000 figure that triggers the Biden Tax Plan), the following taxes would apply relative to the tax regime currently in place:

Tax Component	Biden Tax Plan		Current Tax Regime	
	<i>Tax Rate</i>	<i>Amount of the \$500,000 Being Taxed</i>	<i>Tax Rate</i>	<i>Amount of the \$500,000 Being Taxed</i>
<i>Federal Income Tax</i>	39.6%	\$198,000	37%	\$185,000
<i>Social Security Tax</i>	6.2%	\$31,000	0%	\$0
<i>Medicare Taxes</i>	1.45%	\$7,250	1.45%	\$7,250
<i>Additional Medicare Tax</i>	0.9%	\$4,500	0.9%	\$4,500
Totals	48.15%	\$240,750	39.35%	\$196,750

Under the Biden Tax Plan, the executive in this example will pay an additional \$13,000 in federal income tax and an additional \$31,000 in Social Security taxes for a total of \$44,000 in additional taxes overall. In other words, the \$500,000 figure in this example is subject to an overall federal tax rate that approaches 50%, and if state taxes apply to the executive, it is likely that more than half of every dollar the executive earns in excess of \$400,000 will go toward taxes.

Tax Planning Matters. Whenever taxes are expected to increase, we see employers look for planning opportunities under the tax laws to mitigate the effects of the tax increase under their executive

compensation programs. We saw this occur most recently during the fiscal cliff negotiations involving the Obama administration and Republican congressional leaders in late 2012, and we would not be surprised to see this again at some point before the TCJA tax cuts sunset in 2025. In these situations, employers typically look for ways for their executive compensation programs to

- take advantage of the lower tax rates currently in effect (the Pay Taxes Now Approach) and/or
- defer taxes to a time when it's believed that tax rates will be lower (the Pay Taxes Later Approach)

The Pay Taxes Now Approach usually involves some combination of accelerated vesting and accelerated payment of bonuses and long-term incentive compensation (e.g., restricted stock units; performance units). In other words, under the Pay Taxes Now Approach, the goal is to trigger the recognition of this compensation as taxable income in a tax year before the tax increases are set to apply. Thus, amendments or other exercises of discretion (on the part of the employer) are often made to bonus plans and other incentive arrangements to allow for such early vesting and payment. Similarly, there is flexibility under the Social Security and Medicare tax rules (FICA) to trigger early FICA taxation on other deferred compensation amounts, even if those amounts remain unpaid, and we often see those rules being used as part of the Pay Taxes Now Approach. Because tax increases can apply retroactively (if at all, typically for the tax year in which those increases are enacted), we would expect the above actions under the Pay Taxes Now Approach would take place at some level during a tax year that precedes the tax year in which those increases are enacted.

In contrast, the Pay Taxes Later Approach usually involves adopting or amending specialized retirement plans and other programs by an employer in order to delay payment of executive compensation to a tax year when tax rates might be lower or a lower tax bracket might apply to the executive. For instance, a higher proportion of an executive's overall compensation might be paid through supplemental executive retirement plans (SERPs) at retirement and thereafter and/or through other programs designed to allow the executive to make initial and/or secondary deferral elections to push the timing of payment to a later date.

A Note of Caution! Both the Pay Taxes Now and Pay Taxes Later approaches involve compliance with Section 409A of the Internal Revenue Code, a fairly complicated set of tax rules that apply to executive compensation. Significant tax penalties are imposed (mostly on the executive) for noncompliance with those rules. Thus, taking either of the above approaches usually involves a time-consuming process that requires careful planning and the assistance of accountants, lawyers, and compensation consultants.

¹ Also, President-elect Biden is proposing capital gains tax and estate tax increases, and so on, which are not addressed in this alert.

CONTACTS

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