Public companies

Year-End Tax Guide 2017

As a public company, your shareholders expect you to understand and respond to the risks and opportunities created by the legislative process.

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Introduction: Double down

It's time to take your chips off the rail and ante up. If the prospects for tax reform have you paralyzed, you're making a big mistake. We're looking at a historic opportunity for tax reform that could dramatically reshape business taxation.

It's tempting to stand pat because the legislative process is ongoing and the proposals are still evolving. Don't be fooled. As a public company, your shareholders expect you to understand and respond to the risks and opportunities created by the legislative process. The most critical steps require action now, even before we know the outcome of the legislative process.

The prospect of a corporate rate cut makes your normal tax planning doubly effective. You need to contemplate doubling down on deferral — accelerating deductions into 2017 while rates are higher and deferring income into 2018 when rates may be lower. Even if tax reform doesn't happen or the rate cuts take place later (or earlier) than expected, you still benefit from cash flow and the time value of money.

Your competitors aren't hesitating. Government scorekeepers have found that tax receipts are down this year because so many companies are shifting income. Many disclosures by public companies also reveal significant planning ahead of tax reform. You need to understand how tax reform could affect your structures, activities, investments and international arrangements.

Our *Year-End Tax Guide for Public Companies* is your reference tool for understanding some of the most important tax issues facing C corporations this year-end. We've organized your planning considerations into easy-to-understand sections covering corporate income taxes, international planning, state and local taxes, executive compensation, and benefit plans. To make tax planning easier, we've also included:

- Comprehensive tables that lay out important tax rules, limits and rates
- Explanations of many important new tax law changes
- Planning tips you can use right now

But remember, this guide can't cover all possible strategies, and tax reform deliberations were ongoing as this guide was being published. **Major tax law changes may have occurred since this guide was written.** Check for the most up-to-date tax rules and regulations before making any tax decisions, and contact your local Grant Thornton LLP professional to discuss the tax legislative outlook.

Tax law changes: What's new this year?

Businesses received a brief respite this year from the usual barrage of ever-evolving tax rules. The change in presidential administrations slowed the guidance process at Treasury and the IRS.

At the same time, Congress put most other tax legislation on hold while they focused almost exclusively on tax reform. But the slowdown isn't all good news. Many companies were hoping Congress would extend a handful of popular tax provisions that expired at the end of 2016. Unfortunately, as this guide was being published, Congress had not yet dealt with these "extender" provisions.

Expiring provisions

The biggest change to tax law this year is the expiration of the temporary tax provisions known as extenders. In the past, businesses could generally count on Congress to reinstate these provisions as they expired. The outcome this year appears a little more uncertain.

Some of the most popular extenders, such as the research credit, were made permanent as part of a sweeping tax deal at the end of 2015. Most of the leftover provisions were extended only through the end of 2016. These provisions generally aren't as widely used, but are still very important to businesses that engage in specific activities.

Key provisions that expired at the end of last year include:

- Alternative fuel and biofuel credits
- Energy-efficient new home credit
- Energy-efficient commercial building property credit
- Empowerment zone incentives
- Special expensing for film and television products
- Three-year depreciation for racehorses
- Seven-year cost recovery for motor sports entertainment complexes
- Expensing for advanced mine safety equipment

The fate of these tax provisions may depend on tax reform. If tax reform is successful, many tax incentives are expected to be sacrificed to pay for a rate cut. Most of the extender provisions seem unlikely to survive this kind of culling. If tax reform really is enacted before the end of the year, Congress may see little point in extending these provisions retroactively for 2017.

On the other hand, if tax reform turns into a longer-term process, or fails altogether, Congress appears likely to at least temporarily reinstate these provisions while they deliberate. The danger is that lawmakers won't feel as much pressure to address these provisions as in the past when the list included the research credit and other popular items.

Republicans could try and bundle the extender provisions with a delay of a pair of unpopular taxes that are scheduled to reappear in 2018. The medical device excise tax and the health insurance industry fee are both suspended for 2017. Republicans tried to repeal these taxes altogether as part of health care reform but have not been able to pass a bill. If the GOP cannot revive health care reform or address these taxes as part of tax reform, they will be under pressure to delay them again. Neither health care nor tax reform legislation had been completed as this guide was being published. Check with a Grant Thornton professional for the latest on legislation.

Distinguishing debt from equity

The Treasury Department created sweeping new regulations for characterizing corporate debt and equity in one of its last major projects during the Obama administration in 2016. The rules were originally intended to limit interest deductions to combat "earnings stripping" after an inversion transaction, but can have broader consequences for routine related-party debt. The good news is that the burdensome documentation requirements were recently delayed until 2018, and Treasury also announced it is considering revoking them altogether in favor of a "substantially simplified and streamlined" version. Still, the regulations provide many other rules that are currently effective and could significantly affect transactions. Make sure you understand how the rules affect your company's financing arrangements.

New filing deadlines

Your company now has more time to file its annual tax return. For tax years beginning in 2016 or later, recent legislation pushed the filing deadline back by one month for all C corporations except those with a fiscal year ending on June 30. The filing deadline is now generally three-and-a-half months after the year closes, with a full six-month extension available. For calendar-year corporations, this means the original filing deadline is April 15 (April 18 in 2018 because of a holiday) and the extended deadline is Oct. 15. C corporations with fiscal years ending on June 30 only receive two-and-a-half months to file until 2026, but are allowed a seven-month extension. The IRS has ruled that any short year ending in June will be considered a fiscal year ending on June 30 for purposes of the filing deadline rules.

Country-by-country reports required for 2017

If your company has multinational operations and more than $850 million in revenue, you should be preparing to report specific information on a country-by-country basis for the 2017 year. The reports on Form 8975 are required to be filed with the company's income tax return for any tax year beginning on or after June 30, 2016. The IRS also provided rules allowing taxpayers to voluntarily file the form for earlier years. This could be beneficial if your company has subsidiaries in foreign jurisdictions that would otherwise require reporting if the parent entity's jurisdiction does not. The reporting represents a significant evolution in how tax authorities approach multinationals, and Form 8975 requires jurisdictional information on revenues, taxes paid, number of employees, functions performed and certain other indicators of profit allocation within the group.

Other changes

This guide notes other important changes to specific areas covered by the guide in tax law change alerts. Look for our updated information on refundable alternative minimum tax (AMT) credits, internet sales taxes, transfer pricing, deductions for employer-provided meals and information reporting in later sections.

The starting point: Corporate income tax

The rate schedule for C corporations may be the only thing easy about income taxes for public companies. Unlike the individual tax brackets, the corporate brackets are not indexed for inflation.

Most large public companies generate enough income to pay a flat effective rate of 35% (see our table). Actually calculating the amount of income subject to that rate is another story.

For a public company, managers and shareholders may be more focused on your book income for financial statements. Taxable income can deviate far from book income thanks to scores of specific tax rules that treat many items differently than the financial accounting rules. Your taxable income will depend on unique tax provisions affecting things like intracompany transactions, depreciation, consolidated returns, inventory, and the timing rules for recognizing all sorts of revenue and expensing items.

Too often, public companies fail to take advantage of favorable tax rules that can defer taxes if the timing benefit provides no book benefit for financial accounting purposes. This is usually a mistake solely based on the time value of money, but is an even bigger missed opportunity this year because of the possibility that tax reform will bring a rate cut.

C corporation income tax brackets

Tax rate	Tax bracket
15%	$0–$50,000
25%	$50,001–$75,000
34%	$75,001–$100,000
39%	$100,001–$335,000
34%	$335,001–$10,000,000
35%	$10,000,001–$15,000,000
38%	$15,000,001–$18,333,333
35%	More than $18,333,333

Note: Personal service corporations are taxed at a flat 35% rate.

Tax reform = rate arbitrage

This may be the perfect year to take a second look at your tax accounting, as tax reform could turn a timing change into a permanent benefit. No one knows yet whether the Republican-led Congress will actually achieve reform, or how their proposals may evolve along the way, but you can't ignore the fact that there is the significant possibility that corporate rates will be lower after 2017.

In the long term, rate and rule changes could force your company to re-examine everything from a tax perspective, including supply chains, structuring, geography, activities and investments. In the short term, you should be looking to turn deferral into permanent tax savings. If rates go down next year, accelerating deductions into this year and deferring income until next year could provide a permanent benefit. Your deductions will be more valuable against today's higher rates while your income could generate less tax against potentially lower rates. Correspondingly, your deferred tax assets will be less valuable in the future if rates are lower. It should be obvious that you want to strongly consider using any deductions and existing tax attributes as soon as possible.

One of the best opportunities to accomplish this comes from accounting methods. IRS rules provide many different methods for recognizing certain types of income and expenses. Most public companies employ dozens of separate accounting methods on everything from inventory and rebates to software development and advanced payments. Identifying a more favorable method of accounting often results in a favorable adjustment that can be taken fully in the year a change is made.

The IRS has identified more than 150 accounting method changes that can be made automatically, and there are scores of others you can change after receiving IRS approval. Consider a comprehensive review of all your accounting methods now when deferral is even more powerful. Common opportunities include:

- Deferral of income related to advanced payments
- Deferral of recognition of disputed income
- Acceleration of the deduction for liabilities and expenses related to the following:
  - Computer software development expenses
  - Self-insured medical expenses
  - Prepaid expenses
  - Real and personal property taxes
  - Payroll taxes
  - Rebates
- Reduction of amounts capitalized to inventory

It is also the perfect time to consider your capital expenditures and the recovery period for your fixed assets. Building assets represent a very large expense for most businesses, and public companies don't always carefully examine all the costs associated with these assets to determine which might not need to be capitalized and depreciated over 39 years for tax purposes (See our planning tip at right for more information about this opportunity).

As always, you should consider your entire situation before making any major planning decisions. You want to consider the ongoing impact of any method changes and determine whether tax reform could retroactively take away the tax benefit you are counting on for 2017. It's always possible tax reform won't happen at all, or that rate changes are made effective early or late so that there is no rate difference between 2017 and 2018.

The good news is that deferring tax is typically a good strategy if only for the cash flow benefits and the time value of money. These kinds of timing changes are always good, even when they don't show up on your balance sheet for financial accounting purposes. Nonetheless, this may be the year a rate cut turns them into a permanent benefit.

PLANNING TIP:
CAPITAL COST RECOVERY REVIEW

Commercial real estate is depreciated over nearly 40 years, so one of your biggest opportunities for tax savings might be identifying and reclassifying building assets that can be depreciated using shorter lives.

Many public companies are focused only on book depreciation and don't bother identifying whether costs associated with constructing or substantially remodeling a building must be capitalized and depreciated over 39 years for tax purposes. A cost segregation study can often identify scores of building components that can be segregated and depreciated more quickly.

It is just as important to understand whether any of your capital improvements qualify as repair or maintenance costs that can be immediately deducted instead of depreciated over 39 years. The IRS recently finalized new rules covering this issue, and the rules allow many common expenses that are treated as improvements for book purposes to be deducted as repairs for tax purposes. Plus, you may be able to accelerate deductions to recover the basis in assets that are removed during a project, even when you must otherwise capitalize the costs. Consider a comprehensive review of your recent projects to determine if there are ways to accelerate your deductions.

Losses and AMT

If your company is now or was recently in a loss position, your deductions and credits deserve special consideration. You can generally carry net operating losses (NOLs) back two years and forward 20 years, while general business credits generally can be carried back one year and forward 20 years. The corporate AMT complicates the picture. The AMT rules only allow your NOL carryforwards to offset 90% of your taxable income in any year. The amount of extra tax you pay because of this limit (and for any other AMT adjustments) becomes an AMT credit. This AMT credit can also be carried forward indefinitely, but cannot be used until you have regular tax to offset.

If you are experiencing losses or have built up AMT credits and NOLs to the extent you would not pay regular tax until well into the future, you should consider your timing items carefully. It might not make sense to use accelerated depreciation provisions or make accounting method changes that will only increase an NOL or an AMT amount in the current year. Multiyear planning and projections are critical. Fortunately, Congress also recently enhanced a provision that allows you to monetize AMT credits.

TAX LAW CHANGE ALERT:
REFUNDABLE AMT CREDIT IN LIEU OF BONUS DEPRECIATION

Recent legislation has created new opportunities for corporations to monetize AMT credits. Your business may be able to elect to forgo bonus depreciation and claim up to half of its pre-2016 AMT credits each year until the credits are exhausted or bonus depreciation is not in effect. These AMT credits are fully refundable even in a year in which no tax is due. The election has been available on an annual basis since bonus depreciation was resurrected in 2008, but was previously limited to just 6% of AMT credits generated before 2006. For tax years ending in 2016 or later, this limit is increased to 50% of pre-2016 AMT credits. Unfortunately, budget sequestration rules will trim 6.6% from any refundable credit, but for many companies it is still well worth it to receive a refundable payment on a credit it may have been unable to use for years.

State and local taxes: Multiplicity

You may not have realized that federal tax was the easy part.

Practically all public companies are large enough to cross multiple state lines on a regular basis, subjecting themselves to an even more byzantine collection of tax regimes. Because each state and locality can employ its own set of rules, most companies that do business in multiple states find their state and local compliance burdens more onerous than their federal requirements. In fact, surveys by Grant Thornton have consistently found that an overwhelming majority of financial executives consider their state and local compliance responsibilities as demanding or more demanding than their federal tax responsibilities.

Most states employ some combination of property taxes, sales and use taxes, individual income taxes, and corporate or business income taxes. See our table at right to find out which states give you a break on one or more of the taxes. Local governments are more likely to impose property and sales taxes, but some localities also use income taxes to raise revenue.

States that do not impose a state-level sales, individual or corporate income tax

No sales tax	Alaska, Delaware, Montana, Oregon, New Hampshire
No individual income tax	Alaska, Florida, Nevada, South Dakota, Texas, Washington, Wyoming (New Hampshire and Tennessee tax only certain types of nonwage income)
No corporate income tax	South Dakota, Wyoming (Ohio, Texas, Washington and Nevada have gross receipts taxes)

Income taxes

Income tax rates and rules on businesses vary greatly by state. Most states with corporate income taxes will impose taxes on all of your company's income if your business is a resident, but offer a credit for taxes imposed by other states for business done there. The complexity comes in determining where income is actually earned. States have a dizzying variety of rules for apportioning income among states.

Most states with corporate income taxes use federal taxable income as a starting point, to which a variety of state-specific addition and subtraction modifications are made. Following these modifications, "nonbusiness" income generally is allocated to one state and "business" income generally is apportioned to multiple states through a series of sourcing rules. Much of the complexity in determining how much income tax is owed to states arises from the dizzying variety of sourcing rules that the states use. Following allocation and apportionment, additional modifications and credits may apply, at which point a tax rate (typically between 5% and 10%) is applied.

How much you ultimately have to pay will depend heavily on what kind of work you do, where the work is performed, and the composition of your filing group, which can substantially differ from the federal consolidated return. There are many important tax planning considerations, and you should talk to a tax professional to explore your opportunities for filing methodologies, apportionment and credits.

TAX LAW CHANGE ALERT: STATES STEP UP EFFORTS TO COLLECT ONLINE SALES TAX

States have become increasingly aggressive in their efforts to collect sales tax from online purchases. At least 20 states currently have "click-through nexus" rules that maintain that if an out-of-state seller has an agreement with an in-state business that leads a customer to the seller via a link, the seller has a presence in the state and is required to collect and remit sales tax. The even more aggressive affiliated nexus rules in many states evaluate the out-of-state seller's relationships with other entities to determine whether the seller effectively has a presence.

Several other states are enacting complex reporting and notice rules that require businesses that do not collect and remit sales tax to report out-of-state purchases so the state can more easily impose a use tax. But the most aggressive challenges come from states like Alabama, Tennessee and South Dakota, which are enacting laws and regulations intentionally noncompliant with *Quill* with the plan to litigate the issue and overturn the decision. Federal legislation is also possible in this area. Congress has been deliberating over replacing the *Quill* standard through legislation for years, but has yet to reach a consensus.

PLANNING TIP: MAKE SURE YOU'RE NOT OVERPAYING ON EXEMPTED PURCHASES

Many states and localities offer exemptions from sales and use taxes for certain items, such as machinery and equipment or property bought for further manufacture or resale. If your company makes frequent or large purchases that result in significant sales and use tax, consider performing a sales and use tax "reverse audit." In a reverse audit, professionals review your purchase records over the past three to four years to identify potential missed exemptions, misapplied rates and overpayments. The reviews can often generate significant refunds, as well as identify areas of exposure.

Sales taxes

Your company should consider sales taxes from two angles: as a consumer and a vendor. As a consumer, you typically pay sales tax where you make a purchase. Most states also require you to pay a use tax for goods purchased out-of-state and then used in-state, such as mail order or internet purchases. Nearly all sales and use taxes also have provisions that apply the tax to rentals and leases of goods that would be taxed if bought. But as an operating business, many of your company's purchases may be exempt, so see our planning tip for potential tax-savings opportunities.

The more pressing concern is often when and how to collect and remit sales taxes when you sell your products. The rules are complex and evolving, but under the standard set in 1992 by the Supreme Court in *Quill Corp. v. North Dakota*, you are generally not required to collect and remit sales tax on sales made over the phone or online into a state where your business does not have a physical business presence or an association with an in-state individual or business. This standard didn't envision the explosion in online commerce, and has created competitive and practical challenges that often hinge on the geographic footprint of your businesses and your customers, as well as the nature of your business relationships. States have seen how the rules can distort the balance between online and in-person sales and deprive them of important revenue. See our tax law change alert for more information on how this area of law is evolving.

Property taxes

Property taxes can be a significant cost for public companies, especially in states without an income or sales tax or in states with high property values. Property taxes on real estate may be one of your biggest expenses if you have a large physical footprint. Taxes can often be based on a valuation by a state or local assessor who performed only a cursory review of nearby or similarly sized sites, leaving room for a challenge. In addition to real property taxes, many states also impose personal property taxes.

PLANNING TIP:
PROPERTY TAX ASSESSMENT ANALYSIS

Many taxpayers do not understand that they have a right to challenge the valuation a state or local government places on their property in order to assess tax. An analysis can often reveal that the state or local government has overestimated the value of a property by failing to understand its condition or construction, or how it compares to others in nearby locations. If you have not had a property tax review done recently, consider researching local market data and your jurisdiction's assessment records. You may be able to develop an argument for a reduction in valuation if you can document why a lesser valuation is appropriate and present this argument in front of a property tax assessor.

PLANNING TIP:
LEVERAGING YOUR WAY TO CREDITS AND INCENTIVES

Federal, state and local governments want your business. They are often willing to provide subsidies to motivate you to invest capital, create jobs and, in certain cases, retain jobs in their jurisdictions. New credits and incentives are enacted into law frequently, and keeping track of every tax law change is difficult for busy, multitasking tax department personnel. There may be little time to plan for, anticipate, and take advantage of new credits and incentives opportunities.

Don't leave money on the table. Here are two different opportunities your business should consider for turning local credits and incentives into cash in hand:

- **Tax credit review** — With the constantly changing rules and evolving state legislation, it's hard to know if you're taking advantage of every credit to which you're entitled. In a tax credit review, a team of professionals thoroughly and meticulously reviews your business activities and filings to identify any credits or incentives you missed the first time around. This can often turn up significant refunds.
- **Negotiated incentive services** — You don't have to settle for what's already on the books. As a large public company, states and local governments may actively compete to attract or retain your business with specific credit or incentive offers. It is important to have highly experienced negotiators work on your behalf to ensure the offers you receive are as strong as possible.

International taxes: Worldwide wish list

Nowhere does tax reform promise to have a more profound effect than on international taxation.

In fact, one of the primary drivers of the entire legislative effort is the perception that our high corporate rates and unfavorable international tax rules discourage business investment in the United States and hurt U.S. multinationals (see table). The leading reform proposals would all dramatically reshape our international tax system.

Corporate tax rate of top U.S. trading partners

Country	Rate
Canada	15%
China	25%
Mexico	30%
Japan	23.4%
Germany	15.83%
South Korea	22%
UK	19%

Statutory rate does not include local or provincial taxes

The United States is generally considered to have a "hybrid" international tax system. Unlike most countries, which use a "territorial" system, the United States taxes domestic companies on their worldwide income. It's not considered a pure "worldwide" tax system because domestic companies can generally defer U.S. tax on foreign earnings until the income is actually repatriated. Special rules under "Subpart F" of the tax code only require immediate U.S. taxation of certain passive and highly mobile foreign income. U.S. companies are also allowed a foreign tax credit for taxes paid to foreign government on non-U.S. income.

If Republican lawmakers are successful in tax reform, they plan to shift the United States to a territorial tax system in which all or nearly all foreign income would be exempt from U.S. tax. Unfortunately, this incredibly favorable change would come with a price. Republican proposals would impose a one-time tax on all unrepatriated earnings as of the effective date of the legislation. This one-time tax would include a reduced rate, but the details are still under consideration. President Trump proposed a 10% rate on the campaign trail, while House Republicans released a tax reform blueprint with an 8.75% rate on earnings held in cash or cash equivalents, and 3.5% on reinvested earnings (payable over a number of years).

The effect of this one-time tax on your financial statement could be dramatic. If you treated offshore earnings as permanently reinvested, the one-time tax could be a significant hit to your balance sheet. If you planned to bring the earnings home and already booked the tax at a 35% rate, the reduced rate of the one-time tax would actually give your earnings a lift. More importantly, your company should start planning to take advantage of opportunities and mitigate the risks created by the legislation.

Planning for now and later

The key to your international tax planning is to remain flexible. You have to continue to structure your international operations and activities so they make sense under current law, while leveraging unique planning opportunities created by reform. It's important to consider how your structuring, international entity choice, cost-sharing agreements, and sourcing decisions work now and under tax reform. The prospect of a one-time tax on all unrepatriated earnings may require action before tax reform is effective. Some companies may actually save tax by repatriating earnings at today's high rates, depending on their foreign tax credit situation. You can also consider restructuring to make sure you can net losses against foreign earnings across your controlled foreign corporations (CFCs).

The value of these moves may depend on the actual rate of the one-time tax and the technical details. Make sure you are prepared to act, but consider waiting to pull the trigger until the outlook is clearer. On the other hand, the prospect of enjoying future foreign earnings free from U.S. tax gives you an immediate incentive to defer CFC income. See our planning tip for more information.

PLANNING TIP:
DEFER CFC EARNINGS TO PROFIT FROM TAX REFORM

Tax reform could exempt all future CFC earnings from U.S. tax after imposing a one-time tax on all existing earnings at a reduced rate. This change would create a huge tax difference, depending on whether your CFC recognizes income now or after tax reform is effective. You should immediately look for opportunities to accelerate deductions and defer income in your CFCs so your earnings have the potential to escape U.S. tax. Even if tax reform ultimately isn't enacted, there is little downside to such deferral strategies.

The opportunities for accelerating deductions and deferring income are as widespread in your international operations as they are domestically. Consider scrubbing your accounting methods to see if you can defer income items such as advanced payments, disputed income, and prompt-pay discounts. You may be able to accelerate deductions for things like software development, prepaid expenses, property taxes, and depreciation or repairs that are mistakenly capitalized.

Transfer pricing

Transfer pricing remains a critical issue. The transfer pricing initiative under the Organsation for Economic Co-operation and Development (OECD) program on base erosion and profit shifting (BEPS) is pushing many jurisdictions to scrutinize the issue. Many are making efforts to align the location of taxation with value creation, crack down on hybrid mismatch arrangements and prevent artificial avoidance of permanent establishment. You want to ensure your transfer pricing practices aren't subjecting your company to undue risk. Consider a transfer pricing review if you own valuable nonroutine intangibles, have affiliates in tax havens, suspect your policies are not always followed or charge royalties to affiliates that differ from those charged to unrelated parties. The good news is that taxpayers continue to have success contesting the IRS in transfer pricing disputes. See our tax law change alert for more information.

TAX LAW CHANGE ALERT: TAXPAYERS SCORE ANOTHER TRANSFER PRICING WIN

The IRS has appealed its Tax Court loss in *Medtronic, Inc. v. Commissioner* to the Eighth Circuit Court of Appeals. The Tax Court nullified a $1.2 billion tax assessment for the 2005 and 2006 tax years based on transfer pricing determinations made in connection with a licensing agreement between Medtronic and its Puerto Rican subsidiary. The decision represents the latest in a string of IRS losses on key transfer pricing cases, and shows that the IRS likely faces an uphill battle in trying to enforce transfer pricing rules through the courts. The bad news is what the case says about the IRS's commitment to transfer pricing agreements with the IRS. At the heart of the case, the IRS challenged a pricing methodology it had agreed to respect in an earlier memorandum of understanding.

Compensation without desperation

Designing executive compensation plans for a public company can be daunting. You're stuck balancing the competing interests. On one hand, competitive incentives are key to attracting and maintaining top talent. On the other, shareholders are demanding increasing levels of transparency and accountability.

It isn't just about matching numbers or benchmarking anymore. You need to ensure your compensation plans tie incentives to performance in meaningful ways that shareholder groups won't see as giveaways. This often involves rewarding employees not with one type of performance incentive, but several. You need to think creatively to attract top talent and satisfy shareholders, and that starts with understanding your alternatives.

PLANNING TIP:
DEDUCT BONUSES BEFORE YEAR-END

The potential for a corporate rate cut next year means that it may be more valuable to take deductions for employee compensation this year instead of next year. Unfortunately, many types of executive compensation and stock option plans don't provide much opportunity for immediate employer deductions. You may have more control over employee bonuses.

Tax rules for taxpayers using the accrual method of accounting allow you to take a deduction in 2017 for bonuses paid within the first two and a half months of 2018 if you meet certain conditions. The bonuses must meet the "all-events" test, which generally means that all events have occurred in order to establish your liability and the liability can be determined with reasonable accuracy. For bonuses, this typically means that the full bonus pool must be set before year-end. The bonuses also must only compensate for work performed in 2017. The rules can get tricky, so talk to a Grant Thornton professional to make sure you are compliant.

Benefiting from incentive stock options

There's nothing novel about incentive stock options (ISOs) — they remain one of the most popular types of incentive compensation. ISOs give your employees the option of buying company stock in the future. The price (known as the exercise price) must be set when the options are granted and cannot be less than the fair market value of the stock at that time. The exercise price is customarily set at exactly the fair market value, so the value has to rise before the ISOs have any value. If it does, your employees have the option to buy the shares for less than they're worth.

Employees like them because in most situations they owe no tax when the options are granted or exercised, and they can benefit from capital gains treatment if they hold the shares long enough before selling them. ISOs often create a healthy incentive for employees to increase company value, but they have attributes that can limit their usefulness to employers, including the following:

- The employer receives no income tax deduction for ISOs unless the employee makes a disqualifying disposition by selling the stock before the holding period for long-term capital gains treatment is met.
- There is a per-employee limit of $100,000 on the amount of ISOs that can first be exercised for the employee during any one year. The limit is based on the value of stock at the grant date.

ISOs also come with a long list of restrictions:

- They may be granted only to employees, not nonemployee board members or contractors.
- The exercise price cannot be less than the fair market value of the stock at the time the option is granted.
- The option term cannot exceed 10 years from the date the option is granted.
- The option can be exercised only by the executive and can be transferred only if the executive dies.
- When the option is granted, the executive cannot own more than 10% of the total combined voting power of all classes of stock of the employer, unless the exercise price is at least 110% of the fair market value on the grant date and the option term is five years or less.

Tie performance to pay with restricted shares or RSUs

Restricted stock and restricted stock units (RSUs) have emerged as useful tools for providing executive compensation and long-term incentives. In the past, restricted stock was often considered a giveaway. But the vesting of restricted stock doesn't have to be based on time; it can instead be linked to company performance. Even the grant of restricted stock can be linked to company performance. Performance shares can be a key way to link pay to shareholder interests.

Performance shares link the vesting of restricted stock to company or individual performance, or both. Restricted stock allows employees to control taxation with a Section 83(b) election. And the strategy benefits from a number of potential approaches to develop meaningful but achievable performance goals that motivate participants and drive shareholder value.

- **Market performance** — Based on meeting a specified target such as stock price
- **Operational performance** — Based on specified operational goals such as increasing operating profits
- **Absolute performance** — Based on absolute metrics such as targeted growth or return percentage
- **Relative performance** — Vesting occurs if performance measures exceed those of a peer group
- **Balanced scorecard** — Considers both quantitative and qualitative or strategic performance
- **Corporate focus** — Vesting occurs only if corporate goals are achieved
- **Business unit focus** — Vesting conditions are specific to individual business units

RSUs provide an alternative incentive similar to that of restricted stock awards. An RSU is a promise to an employee to transfer stock in the future, and you can offer employees the right to elect when to receive the stock. But be careful because RSUs are generally subject to the nonqualified deferred compensation (NQDC) rules in Section 409A.

Understanding NQDC

NQDC plans are designed to make payments to employees in the future for services being performed now. They are less about incentive awards and more about allowing your top executives to defer income and tax. Unlike tax-deferred retirement accounts like 401(k)s, NQDC plans can favor highly compensated employees, but they do come with serious drawbacks.

As the employer, you cannot deduct any NQDC until the executive recognizes it as income, and NQDC plan funding isn't protected from your creditors. You also must fully comply with IRS rules governing NQDC plans under Section 409A. The rules are strict, and noncompliance can cause severe consequences for your employees. If a plan fails to comply with the rules, plan participants are taxed on vested plan benefits immediately, with interest charges and an additional 20% tax.

Your employees generally must make an initial deferral election before the year in which they perform the services for the compensation that will be deferred. So if they want to defer 2018 compensation into a future year, they must make the election by the end of this year.

Your plan must also comply with the following rules:

- Benefits must be paid either on a specified date according to a fixed payment schedule or after a specified event occurs, defined as death, disability, separation from service, change in ownership or control of the employer, or an unforeseen emergency.
- The decision about when to pay the benefits must be made when the election to defer the compensation is made.
- Once that decision is made, the timing of benefit payments can be delayed, but generally not accelerated.
- Elections to delay the timing or change the form of a payment must be made at least 12 months before the date the original payment is set to commence.
- New payment dates must be at least five years after the date the payment would have been made originally.

It is also important to note that employment taxes generally are due when the benefits vest. This is true even though the compensation isn't actually paid or recognized for income tax purposes until later years. As the employer, you can postpone the payment of these payroll taxes only when the value of the future benefit payments cannot be ascertained, which is often the case when the plan uses a formula to define the future benefit rather than basing the benefit on an account balance.

Benefit plans: Golden opportunities

In many ways, your benefit plans are more important for attracting talent than your executive compensation plans. While executive compensation helps you maintain top management talent, your benefits are critical to attracting and retaining the best workers throughout your org chart.

At the same time, benefit plans often represent a big cost to employers. You should frequently examine your retirement plans, health coverage offers, fringe benefits and employee relationships for ways to deliver value to your workers while saving on the costs of administration and funding.

Retirement plans

If you're still running a traditional defined-benefit pension plan, premiums and funding requirements are going up (see our tax law change alert on page 24). Most businesses long ago shifted to the more cost-effective defined contribution plans.

Qualified plans, such as 401(k)s, remain among the most popular retirement plans for employers. But administering them can be costly and complex. Unless you operate your 401(k) plan under a safe harbor, you must perform nondiscrimination testing annually to make sure the plan benefits don't favor highly compensated employees over other employees.

The safe harbors require employer contributions. If you operate under a safe harbor but need to conserve cash and cut costs by ceasing 401(k) contributions, you must amend the plan and give employees advance notice. Employees must have the option of changing their contributions during this advance notice window, and the nondiscrimination test must be performed for the entire year.

Despite the challenges of a qualified plan such as a 401(k), it is still an attractive option for the following reasons:

- A qualified plan has significant design flexibility to allow sponsors to provide value to their top executives.
- Nonqualified plans aren't as tax-effective for plan sponsors as qualified plans, because the employer doesn't receive a current tax deduction for contributions to a nonqualified plan.
- Employer contributions to a qualified plan are never subject to Federal Insurance Contributions Act (FICA) or other payroll taxes.
- Distributions can be rolled over on a tax-free basis, so an employee's taxable event is delayed until the actual payout from a tax-qualified retirement vehicle such as an IRA.
- The use of qualified retirement plans avoids Section 409A penalty risks.

Qualified retirement plans: 401(k), 403(b) and most 457 plans	**2016**	**2017**
Maximum employee contribution/deferral	$18,000	$18,000
Catch-up employee contribution/deferral (age 50 and older)	$6,000	$6,000
Maximum combined employer and employee contributions to a defined contribution plan	$53,000	$54,000
Maximum annual benefit in a defined benefit plan	$210,000	$215,000
Limit on compensation under 401(a)(17) that can be considered in calculating contributions to qualified plans	$265,000	$270,000
Limit on compensation under 401(a)(17) for grandfathered employees for governmental plans under "OBRA '93"	$395,000	$400,000
Threshold for designation as "highly compensated employee" for nondiscrimination testing	$120,000	$120,000
Definition of key employee in a top-heavy plan	$170,000	$175,000

TAX LAW CHANGE ALERT: PENSION COSTS SET TO RISE

Congress recently extended pension funding relief to compensate for the effect of low interest rates on funding obligations, but pension costs will rise anyway in the coming years. First, premiums for the Pension Benefit Guaranty Corporation (PBGC) are increasing. The per-participant flat rates for single-employer pension plans will climb from $64 in 2017 to $74 in 2018. The variable rate per $1,000 of unfunded vested benefits will increase from $34 to $38, plus inflation. The variable rate per participant cap is indexed for inflation and will rise in 2018 from its current $517. In addition, the IRS has proposed an updated mortality table to be used for funding requirements beginning with the 2018 plan year. The proposed version would increase both funding requirements and lump-sum payments for participants choosing that option. Consider accelerating payments into 2017 to avoid the premium increases and use the deduction before tax rates could potentially be reduced as part of tax reform.

Health plans

The Affordable Care Act (ACA) continues to withstand all constitutional, legal and political challenges. When Republicans won the presidency and control of Congress last November, major ACA changes seemed all but certain. It hasn't been quite so easy. Republican efforts to repeal and replace ACA quickly bogged down after several intraparty implosions. Legislative action is still possible, but as this guide was being published, Congress had not made much progress on the issue.

As an employer, you should assume ACA will be fully in effect next year unless and until any reform legislation is actually enacted. Among the most significant aspects of the ACA are the excise taxes, also called shared-responsibility payments, imposed on all employers with at least 50 full-time and full-time-equivalent employees if they do not offer health care coverage to at least 95% of full-time employees or if they offer coverage that doesn't meet minimum value and affordability requirements. These thresholds sound simple enough, but the rules are complicated and a small error can be very costly. It is important to understand how IRS rules define a full-time employee and whether your independent contractors could be considered misclassified employees.

PLANNING TIP:
CONFIRM YOUR WORKER CLASSIFICATIONS

Counting your full-time employees is critical for ACA compliance, so knowing whether a worker is an employee or an independent contractor is important. Many other benefit and tax rules also depend on this classification. The IRS understands the benefits to employers of using independent contractors instead of employees and has cracked down on the practice of misclassifying employee-employer relationships as independent contractor relationships.

Misclassifying your workers can be costly. The IRS has an ongoing voluntary reclassification program that allows taxpayers to correct improper classification with greatly reduced back taxes and penalties. If the IRS discovers an issue outside of this program, it is unlikely to be lenient.

To prove the independent contractor relationship, documentation is imperative. You need to establish detailed policies, procedures and systems that employees responsible for hiring contractors can easily understand. To help establish a solid foundation for classifying workers as independent contractors, consider these suggestions:

- Develop a checklist that must be completed before hiring an independent contractor and that includes a mandatory questionnaire asking about factors that indicate the worker's relationship to the company.
- Use a contract with specific language about the worker's relationship to the organization.
- Avoid using contract language that establishes the "right of direction and control," including noncompete agreements, restrictions on hiring subcontractors, and payment of liability or workers' compensation insurance.
- Create a formal internal policy document that clearly defines the required documentation and procedures, and lists the departments responsible for implementing the procedures.

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