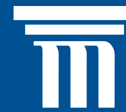
Matters of Interest

Executive and Director Benefits and COLI



M Benefit Solutions®

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The Potential Effect of Low Interest Rates on Nonqualified Plan Funding

Interest rates are a significant factor in the calculation of the present values of pension liabilities. Low interest rates keep pension liabilities high and decreasing interest rates will increase those liabilities. High liabilities in an employer's qualified pension plan can push the plan into a category the IRS terms "at risk" (discussed more fully below). An at-risk qualified plan can, in turn, limit the employer's ability to fund its nonqualified deferred compensation plans.

Under Internal Revenue Code Section 409A(b)(3), the ability of the employer to set aside or transfer funds to rabbi trusts or "other arrangements" to fund a nonqualified plan will be restricted during any period during which the employer's qualified defined benefit plan is considered at-risk by triggering adverse taxation to certain executives covered by the nonqualified plan if any such transfer of assets is made.

Given the adverse tax consequences of funding a nonqualified plan during the time a qualified plan is considered at-risk, it is important for employers to monitor the funding level of their qualified plan prior to funding their nonqualified plan.

At-Risk Rules

A qualified defined benefit plan will be considered at-risk for a particular plan year if, for the preceding plan year, its assets were both (i) less than 80% of its funding target attainment percentage (FTAP) using its actuarial assumptions and (ii) less than 70% of its FTAP using certain special actuarial assumptions. Code Section 430(i)(4).

The FTAP for a plan year is the ratio that the value of the plan's assets (reduced by any credit balance carryovers from prior years) bears to the plan's funding target for the year. A plan's funding target for a plan year is the present value of all benefits accrued or earned under the plan as of the beginning of the plan year. The funding percentage, or FTAP, is generally determined by the qualified plan's actuary as of the beginning of a plan year.

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Nonqualified Plan Funding Restrictions (Code Section 409A(b)(3))

The nonqualified plan funding restrictions restrict assets being set aside or reserved (directly or indirectly) in a trust (or other arrangement as determined by the Treasury Secretary) or transferred to such trust or other arrangement in order to pay nonqualified deferred compensation. These restrictions also apply if a nonqualified deferred compensation plan provides that assets will become restricted to the provision of benefits under the plan in connection with the restricted period with respect to the qualified defined benefit plan or if the assets are, in fact, so restricted. Although no guidance has been issued under this provision, the rules would appear to freeze the nonqualified plan funding with respect to the covered employees from the time at which the employer's qualified defined benefit plan (or the qualified defined benefit plan of any member of the controlled group that includes the employer) becomes at-risk, as discussed above.

If a transfer is made to a rabbi trust or other funding vehicle during the restricted period, then the amounts transferred are treated as a transfer of property under Code Section 83 (regardless of whether the amounts are available to satisfy the claims of general creditors) and therefore would be subject to taxation (if vested). The amounts included would be subject to an additional 20% tax and interest at the IRS underpayment rate plus 1% from the date of the initial deferral or vesting under Section 409A. In addition, any tax gross-up payments to the executive to ameliorate these adverse tax consequences would also be subject to the same adverse tax treatment (i.e., immediate income inclusion, additional 20% tax and interest at an increased rate). Any such payments would also be nondeductible by the employer.

New Tax Proposals in the President's 2016 Budget

In *Matters of Interest*, Fourth Quarter 2014, we outlined some of the major tax provisions in the President's 2014-15 Budget Proposal. The President's 2016 Budget renews all of the proposals outlined there and adds a few important new proposals, including: (1) the highest tax on capital gains and dividends would be increased from 23.8% (including the 3.8% Medicare tax on net investment income) to 28%; and (2) the transfer of appreciated property (whether through bequest or gift) generally would be treated as a sale of the property.

Capital Gains and Dividends Tax Rate Increase

The increase in the top capital gains and dividend tax rate from 20% to 24.2% is being proposed in conjunction with the proposal to end the "stepped-up basis" rule for inherited property. The Budget Proposal sees falling tax rates on capital gains and dividends as a contributing factor to increasing income concentration in the highest income groups. The rate increase is proposed as a response to this increasing concentration.

To reduce middle class tax and compliance burdens, decedents would be allowed a $200,000 per couple ($100,000 per individual) exclusion for capital gains income, along with a $500,000 per couple ($250,000 per individual) exclusion for personal residences. Tangible personal property other than art and similar collectibles (e.g., bequests or gifts of furniture or other household items) would also be excluded. In addition, family members that inherited small, family-owned and operated businesses would not owe tax on the gains unless and until the asset were sold, and closely-held businesses would have the option to pay tax on gains over 15 years.

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Repeal of Stepped-Up Basis Rule

Under current law, capital gains on assets held until death are never subject to income taxes. The tax basis (cost) of inherited assets is increased ("stepped up") to the value at the date of death. For example, if an individual, who owns stock worth $5 million which she bought for $1 million, were to sell the stock, she would owe capital gains tax on the $4 million. However, if she bequeaths that same stock to an heir, the heir may sell the stock immediately without any capital gains tax imposed on it. The stock would completely escape capital gains taxation because the tax basis is "stepped-up" from $1 million to $5 million upon death.

The Proposal would eliminate the "step-up" in basis at death by treating bequests and gifts as realization events triggering tax liability for capital gains at the time of the bequest or the gift.

Employer Who Fails to Properly Withhold Non-qualified Plan FICA Taxes May Be Liable to Employee

In *Matters of Interest*, Third Quarter 2014, we discussed FICA taxation under the "special timing rule" applicable for FICA taxes on contributions to nonqualified deferred compensation plans and the failure of an employer to apply the rule in *Davidson v. Henkel*, 2013 U.S. Dist. LEXIS 103185; 112 A.F.T.R.2d (RIA) 5520; 56 Employee Benefits Cas. (BNA) 1121 (E.D. Mich. 2013). That case has now been adjudicated and summary judgment granted to a former employee (and fellow class members in a class action lawsuit) in *Davidson v. Henkel*, 2015 U.S. Dist. LEXIS 722; 115 A.F.T.R.2d (RIA) 369 (E.D. Mich. 2015).

FICA Taxes and Nonqualified Deferred Compensation Plans

The general rule of Internal Revenue Code Section 3102(a) requires that employers deduct FICA taxes from an employee's wages when they are actually or constructively paid. However, Code Section 3121 and Treasury Regulations promulgated under it provide a "special timing rule" applicable to FICA taxes on contributions to nonqualified deferred compensation plans.

In general, for a defined contribution nonqualified deferred compensation plan, the special timing rule provides that FICA tax is due on the date on which the right to the compensation is no longer subject to a substantial risk of forfeiture. This rule applies to deferred compensation that is voluntarily deferred by the employee and to defined contributions made by employers, such as matching and profit sharing contributions.

For defined benefit deferred compensation plans, FICA taxation on vested benefits can be delayed until the amount of deferred compensation to be paid is "reasonably ascertainable." Most often the amount of the benefit will become "reasonably ascertainable" when the participant retires or terminates employment.

For both types of benefit, defined contribution and defined benefit, once the contribution or benefit is taxed, a "nonduplication rule" eliminates additional FICA tax when benefit payments are made.

Thus, when the special timing and nonduplication rules are properly applied to a defined benefit type of nonqualified benefit, the participant's benefit is subject to FICA taxes once. If the employer fails to apply these rules, the general FICA timing rule applies, and FICA taxes are assessed on a payment-by-payment basis, which can result in overall higher FICA taxes.

Davidson Facts

Plaintiff and Class Representative John Davidson participated in the Henkel Corporation Deferred Compensation and Supplemental Retirement Plan (the Plan), a top hat nonqualified deferred compensation plan maintained by Henkel Corporation (the Company)

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that included defined benefit payments. Prior to his retirement, Plaintiff discussed his options with the Plan administrator, including benefit and tax calculations. Plaintiff relied on the Plan administrator's representations when deciding to retire in 2003.

After his retirement, Plaintiff received his monthly retirement benefits. On September 19, 2011, Plaintiff received a letter from the Director of Benefits, advising that:

"During recent compliance reviews performed by an independent consulting firm, it was determined that Social Security FICA payroll taxes associated with your nonqualified retirement benefits have not been properly withheld.

At the time of your retirement, FICA taxes were payable on the present value of all future nonqualified retirement payments. Therefore, you are subject to FICA Taxes on your nonqualified retirement payments on a 'pay as you go' basis for 2008 and beyond, which are the tax years that are still considered 'open' for retroactive payment purposes."

After the compliance review, the Company remitted the full FICA tax due to that date on behalf of itself and the affected retirees. The Company did not deduct the entire amount owed for FICA taxes from the retirees' accounts; rather they reimbursed themselves by reducing the retirees' monthly benefit payments for a 12–18 month period. Effective January of 2012, the Company began adjusting participants' monthly payments under the Plan.

Court Holding

The court held that the Company was liable under ERISA because the Plan gave the Company discretionary control over participants' funds and their tax treatment and the Plan authorized and obligated Company to properly manage the tax withholding from Plaintiffs' benefits.

Rather than properly withholding the Plaintiffs' taxes as required by the Plan, the Company paid these taxes at the time of each benefit payment. The Company acknowledged that it had not properly withheld taxes. Defendants then placed the Plaintiffs on a pay as you go basis, which, at this point, was the only way to adhere to the law. This approach resulted in the Plaintiffs losing the benefit of the nonduplication rule and owing more in FICA taxes than they would have owed had the Company properly and timely paid taxes when they were due. Accordingly, the Court found that the Plaintiffs were entitled to summary judgment because the Company failed to adhere to the purpose and terms of the Plan resulting in a reduced benefit to the Plaintiffs.

Conclusion

The case is significant in standing for the proposition that nonqualified deferred compensation plan sponsors may be liable for damages for failure to properly withhold FICA taxes under the IRS's special timing rule. It would also appear to support employees' lawsuits for recovery of Section 409A penalties and interest in the event of a Section 409A violation under which a participant had to pay Section 409A penalties because the employer operated its plan in noncompliance with Section 409A.

Deferred Compensation and the Report of the Senate Finance Committee Democratic Staff

Early in March the Senate Finance Committee Democratic Staff under the leadership of Senator Ron Wyden (D, Oregon), issued a report titled: "How Tax Pros Make the Code Less Fair and Efficient: Several New Strategies and Solutions."

This report describes several "little known tax avoidance strategies" identified for Senator Wyden by the nonpartisan staff of the Joint Committee on Taxation (JCT) and outside independent experts. The report

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focuses on various financial products and deferred compensation. We discuss here the presentation on deferred compensation.

The report takes the position that the tax code should treat all taxpayers fairly and not include rules that allow executives and management employees to receive favorable tax treatment of their compensation that is not available to all employees. In other words, because ERISA does not permit nonqualified plans to be offered to rank-and-file employees due to the inherent risks of unfunded retirement plans, then employers should not be permitted to offer these plans to executives and management employees.

The report refers favorably to some proposals to roll back nonqualified plans. It refers to the Camp proposal from early 2014 under which all compensation deferred under a nonqualified plan would be included in gross income for the taxable year of vesting. It also refers to a proposal that would limit the permitted amount to be deferred or held under a nonqualified plan (for example, a cap of $1 million).

The report also discusses the ability to avoid the Code Section 162(m) limitations on deductible compensation by deferring executive compensation until retirement and recommends that policymakers close this "abusive loophole."

The report has received little press to this point. However, it illustrates the interest of both Republican and Democratic members of Congress in further limiting nonqualified deferred compensation.

SSAE 16 Audit Report

In order to maintain its first-rate service to our clients, M Benefit Solutions made a corporate commitment in 2003 to undergo external audits to ensure our internal structure is continually reviewed and improved. As a consequence, we underwent an annual SAS 70 audit through 2010.

Thereafter, the Statement on Standards for Attestation Engagements ("SSAE") No. 16 Reporting on Controls at a Service Organization was adopted and replaced SAS 70 as the authoritative guidance for reporting on service organizations.

The SSAE 16 report represents that a service organization has been through an in-depth audit of their control activities which generally include controls over information technology and processes which relate to the data belonging to their clients.

In 2014, M Benefit Solutions received a clean opinion without exception on our SSAE 16 SOC Type II report, an indication of our ongoing success in assessing and improving our internal control activities for the benefit of our clients.

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