Matters of Interest

Executive and Director Benefits and COLI

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More on FICA Withholding

In *Matters of Interest*, First Quarter 2016, we discussed a settlement of the litigation considered in *Davidson v. Henkel*, 2015 U.S. Dist. LEXIS 722; 115 A.F.T.R.2d (RIA) 369 (E.D. Mich. 2015). In *Davidson* a company was held liable for improper withholding of Federal Insurance Contributions Act (FICA) taxes. Under the company's supplemental retirement plan, rather than withholding FICA taxes at the time when benefits were reasonably ascertainable (generally at retirement) as provided under IRS regulations, the company paid such taxes each time it made a retirement benefit payment. This caused the participants to pay more in FICA taxes than they would have had to pay if the company had paid them at the participants retirement. The ultimate settlement in favor of the participants and their attorneys cost the company $3.35 million.

The case emphasized the importance of withholding FICA taxes in accordance with FICA tax regulations. The importance of proper withholding has now been further emphasized in a memorandum from the Internal Revenue Service Office of Chief Counsel (AM2017-001).

The issue considered in the memorandum was whether the IRS should enter into voluntary closing agreements where employers had not timely taken nonqualified deferred compensation (NQDC) into account for purposes of FICA taxes.

The employers involved in these requests discovered that they had failed to withhold FICA taxes in years that were statutorily closed for tax collection purposes and sought to pay the taxes currently rather than wait until the participants' retirement payments were made and withhold FICA at that time, as prescribed by FICA tax regulations. The counsel memorandum concluded that as a policy matter, since regulations exist which govern and contain methods for the correction of NQDC FICA reporting failures, it is not appropriate to enter into a closing agreement for taxable years statutorily barred from assessment.

By not permitting the use of closing agreements, the IRS is requiring the employer to wait until the deferred compensation is actually paid to participants. It is likely this will cause an increase in FICA taxes payable by the participants both because the payments will more likely be part of the Social Security wage base in payment years, subjecting the payments to the 6.2% Social Security portion of the FICA tax, and because all earnings on amounts deferred will be FICA taxable when paid.

This is essentially the same situation presented in the *Davidson* case, in which the participants had to pay more in FICA taxes because of the employer's failure to follow the FICA regulations.

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The clear dictate of *Davidson* and the IRS memorandum is for employers to follow FICA regulations on withholding when compensation vests (or at least by the time benefits are "reasonably ascertainable," as provided under IRS regulations). Otherwise, they may need to pay their employees' increased FICA tax costs.

Accounting Standards Update Amends Defined Benefit Pension Accounting Rules

On March 10, 2017, the Financial Accounting Standards Board (FASB) issued an amendment to the defined benefit pension and postretirement benefit cost accounting standards codified in ASC 715, Compensation—*Retirement Benefits*. The amendment can be found in *Accounting Standards Update (ASU) 2017-07, Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost.*

Summary of Amendment

ASU 2017-07 separates out the service component of net periodic pension costs from the other costs that make up pension costs. Specifically, the ASU does the following:

Income Statement Presentation

When Operating Income is Presented. The ASU requires employers that present a measure of operating income in their income statement to include only the service cost component of net periodic pension cost in operating expenses (alongside other employee compensation costs). The remaining components of net benefit cost are to be included in nonoperating expenses.

When Operating Income is Not Presented. Employers that do not present a measure of operating income are required to include the service cost component in the same line item as other employee compensation costs. Employers are required to include all other components of net benefit cost in a different line item(s). The line item(s) in which the components of net benefit cost other than the service cost are included need to be identified as such on the income statement or in the disclosures.

Capitalization of Service Cost

The ASU stipulates that only the service cost component of net benefit cost is eligible for capitalization in assets.

Who is Affected

The amendments in the ASU apply to all employers, including not-for-profit entities, which offer to their employees defined benefit pension plans, other postretirement benefit plans, or other types of benefits accounted for under ASC 715.

Effective Dates

The amendments are effective for public business entities for annual periods beginning after December 15, 2017, including interim periods within those annual periods. For other entities, the amendments are effective for annual periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019.

The amendments are to be applied retrospectively for the presentation of the service cost component and the other components of pension and postretirement benefit costs in the income statement and prospectively, on and after the applicable effective date, for the capitalization of the service cost component of costs in assets. The amendments allow an employer to use the amounts disclosed in its pension and other postretirement benefit plan note for the prior comparative periods as the estimation basis for applying the retrospective presentation requirements.

M Benefit Solutions' Response

Going forward, in order to enable our clients to comply with the ASU, accounting exhibits provided by M Benefit Solutions that would otherwise provide the net periodic pension cost as one line item will show

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two separate line items—"service cost" and "nonoperating expenses." Exhibits that present the individual components of net periodic pension cost (i.e., service cost, interest cost, amortization of gains/losses and prior service costs) will now include a subtotal for the nonoperating expenses.

Updates to Disability Claims Procedure Regulations

Employee benefit plans subject to ERISA, including nonqualified deferred compensation plans maintained for executives, must establish and maintain reasonable claims procedures. Late in 2016, the Employee Benefits Security Administration of the Department of Labor (the DOL) issued final regulations updating the benefit claims process for disability claims. Though these changes are likely to have only minor effect on nonqualified deferred compensation plans, plans may want to assess their current claims review procedures and make adjustments and/or amend their plans where they deem it appropriate.

The amended regulations are effective January 18, 2017, and apply to claims of benefits starting January 1, 2018. The intent of these changes is to provide enhancements in procedural safeguards and to increase the fairness of disability claim and appeal processes. Organizations with benefit plans that contain provisions for disability claims will want to consider what adjustments are necessary to ensure their processes remain compliant.

The primary concerns of the new regulations fall roughly into four categories:

- Improvements to disclosure requirements,
- The right of claimants to review and respond to evidence,
- The independence and impartiality of the persons determining disability, and
- The consequences of non-compliance.

Many organizations will find that these regulations require relatively modest adjustments to existing plans. The penalty for a violation is a deemed exhaustion of administrative remedies, which would permit a claimant to go directly to a court for a decision on their claim.

Disclosure Requirements

In keeping with its desire for greater fairness, the DOL increased notice and communication disclosure requirements. Its goal was to reinforce existing requirements, increase transparency, and foster communication between claimants and plans. To this end, adverse benefit determinations must include a discussion of the decision that explains the basis for the determination, reasons for disagreeing with any Social Security administration, medical, vocational, or third party determinations, and any internal criteria used in making the determination. If no internal criteria exist, a statement to that effect must be included in the adverse determination.

Right to Review and Respond

Claimants must be informed in the same document that they have a right to receive any documents relevant to the determination upon request. This right to receive documents extends through the claim appeals process, and any documents with new evidence generated during the appeal of a denied claim must be provided to the claimant within a reasonable time frame to allow the claimant to respond. In effect, the claimant is granted the right to the last word in any claim determination. Though this creates the potential for multiple rounds of determination and response, the DOL has not increased the 45-day window for appeals, nor included a tolling provision. The DOL's position is that the "special circumstances" provision already in the regulations allows an extension should one prove necessary. The DOL also notes that plans need not generate new evidentiary materials on appeal, especially over multiple rounds of appeal.

Independence and Impartiality

The DOL was concerned about the independence and impartiality of persons determining disability and the

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potential conflicts of interest inherent when a benefit provider hires the person who determines the success of the disability claim. For this reason, the regulations provide that the likelihood that an individual will support denial of benefits may not be considered in the compensation, hiring, termination, or promotion of individuals involved in disability benefit determinations. For example, bonus payments cannot be contingent on benefit denial rates. Likewise, medical experts cannot be hired based on their reputation in contested cases. Hiring decisions must be based on professional qualifications.

Consequences of Non-Compliance

A failure to adhere to these procedures will be deemed an exhaustion of administrative remedies, granting the claimant the ability to move the claim to a court setting. This can only be avoided if the plan can show the violation was:

- De minimus,
- Non-prejudicial,
- With good cause or beyond the plan's control, but
- Part of an otherwise good faith exchange of information, and
- Not reflective of a larger pattern or practice of non-compliance.

Adoption of 2017 CSO Mortality Table

A new life insurance standard mortality table (2017 CSO) has been adopted by the National Association of Insurance Commissioners, effective January 1, 2017; however, the table's incorporation into insurance products will not be mandatory until January 1, 2020. State regulators require the prevailing CSO table to be used to set maximum cost of insurance charges, and determine minimum policy reserves and nonforfeiture values. The prevailing CSO table is also used for 7702 and 7702A tax testing.

The table improves mortality at most ages for both men and women, which may result in lower premiums for a given death benefit.

Other results of incorporating the 2017 CSO table will vary by insurance product and the particular circumstances of clients, but as a general matter it is expected that cash surrender value IRRs and income streams will be reduced when products are funded at the 7-pay maximum limits, as they are in most corporate-owned life insurance scenarios.

Products which benefit from the 2017 CSO mortality table, such as term insurance, will use the table beginning in 2017. Products such as corporate-owned life insurance and other cash value accumulation products will generally be negatively affected by the table and are not expected to be issued until January 1, 2020.

For reserve purposes in-force policies are grandfathered to the prevailing CSO table on which the policy form was issued. For tax compliance, policies issued prior to January 1, 2020 are likewise expected to be grandfathered.

Tax Reform Talk Continues

Talk continues in Washington, DC, about a tax reform bill in 2017. Given the controversies that continue to plague the Trump administration and Congress' stated desire to pass reform through reconciliation, it is difficult to judge how likely a tax bill is to pass. However, if anything close to the Trump Tax proposal, as outlined in late April by his administration, is passed, there will be very large tax cuts for Americans in the highest tax brackets and many U.S. corporations.

The Trump Tax proposal provides for a reduction in individual tax brackets from 7 to 3 and a lowering of the top individual rate from 39.6% to 35%, a repeal of the 3.8% investment income tax, a repeal of the alternative minimum tax, a repeal of the estate tax, a reduction in the corporate tax rate from 35% to 15% and a top rate of 15% for pass-through entities, such as partnerships and subchapter S Corporations.

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TRUMP TAX PROPOSAL

Tax Provisions	Current Law	Trump Tax Blueprint
Individual Income Tax Rates	7 brackets: 10%, 15%, 25%, 28%, 33%, 35%, 39.6%	3 brackets: 10%, 25%, 35%
Capital Gains Tax Rates	0%, 15%, and 20%	No change
Net Investment Income Tax	3.8%	Repealed
Corporate Tax Rate	35%	15%
Pass-Through Entities		
Pass-Throughs to Individuals	7 brackets: 10%, 15%, 25%, 28%, 33%, 35%, 39.6%	15%
Alternative Minimum Tax		
Tax Year 2017	Applies to income over $54,300 (single) $84,500 (married filing jointly)	Repealed
Estate Tax	40% (estates over $5.49 million)	Repealed
Mortgage Interest Deduction	Allowed as an itemized deduction	No change
Charitable Giving	Allowed as an itemized deduction	No change
State and Local Income Taxes	Allowed as an itemized deduction	Repealed
Standard Deduction		
Tax Year 2017	$6,350 (single) $12,700 (married filing jointly)	$12,700 (single) $25,400 (married filing jointly)

The information incorporated into this presentation has been taken from sources, which we believe to be reliable, but there is no guarantee as to its accuracy.

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M Financial Plaza, 1125 NW Couch Street, Suite 900, Portland, OR 97209 ■ 503.238.1813 ■ www.mben.com