Matters of Interest

Executive and Director Benefits and COLI

M Benefit Solutions®

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Comprehensive Tax Reform on the 2017 Agenda

During 2017, one priority for Republicans, who now control both the Senate and the House of Representatives, as well the Presidency, will be tax reform that significantly lowers the corporate tax rate and lowers individual tax rates. Other significant adjustments in measuring income for both businesses and individuals will likewise be on the agenda.

House Republican Tax Reform Blueprint

While it is likely final tax legislation will contain significant changes from the House Republican tax reform blueprint, it is worthwhile to look at some of the major elements of the blueprint to see where tax legislation could be headed. These include:

Proposed Changes for Individuals

- Set ordinary income tax rates at 12%, 25%, and 33%
- Cap the rate on profits of pass-through businesses that are taxed at individual rates at 25%
- Increase the standard deduction and child tax credit
- Repeal personal exemptions and all itemized deductions except those for charitable contributions and home mortgage interest
- Eliminate the alternative minimum tax (AMT), estate and gift taxes, and all taxes associated with the Affordable Care Act (ACA) (e.g., 3.8% surtax on net investment income and the 0.9% additional Medicare rate on high-income workers)
- Tax capital gains, dividends, and interest as ordinary income with a 50% exclusion

Proposed Changes for Corporations

- Set corporate tax rate at 20%
- Allow immediate deduction for all investments in equipment, structures, and inventories
- Disallow businesses' net interest expenses
- Eliminate the corporate AMT and a number of "special interest" business tax provisions
- Exclusion of business income from exports
- Disallowance of deductions for imports

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Treatment of Deferred Compensation

The House blueprint does not specifically address the tax treatment for nonqualified deferred compensation, which would have received extensive changes under Representative Camp's tax reform proposal set forth several years ago. However, the blueprint does make the following comments, which suggest that there is no plan to change the current tax treatment of deferred compensation:

> *"Under this Blueprint, the core component of the individual tax base will be compensation received. As discussed below, businesses will deduct compensation paid to their employees and workers. Generally, the tax system should use the same definition for taxable compensation of employees as it does for compensation employers may deduct."*

Prospects for Tax Law Changes

While Republican control of the legislative and executive branches of government indicates that Republicans should be able to pass whatever legislative changes they desire, there are several factors that may lead to changes to the scope of current tax reform proposals, a slowdown in passage, or even a failure to pass tax reform changes at all.

- If Republicans decide to work with some Democrats to avoid a filibuster of a tax package, there will be changes to the legislation in exchange for the agreement not to filibuster.
- If Republicans decide to pass tax reform under reconciliation procedures, then under the Byrd Rule, the provisions cannot raise deficits beyond a specified budget window. The reforms thus would end at the end of the budget window in a manner similar to the sunsetting of the Bush tax cuts. The reforms could be re-enacted, as some parts of the Bush tax changes were re-enacted, at the end of the budget window.
- Republicans will need to address internal inconsistencies in their positions as well. For example, Treasury Secretary Steven Mnuchin identified tax reform as a priority, but he also said there will be no "absolute tax cut" for high income households. This is inconsistent with the House blueprint and President Trump's own tax proposal, both of which would result in significant, absolute tax cuts for high income households.
- There are other legislative initiatives important to Republicans that will take time to work through, such as the effort to repeal and potentially replace the Affordable Care Act. As well, there will be initiatives dealing with immigration and infrastructure. International trade may also need to be addressed. In addition to legislative initiatives, there are cabinet nominations and a Supreme Court justice nomination to be dealt with in the Senate, all of which will take time out of a limited legislative calendar. The timing and scope of tax reform will ultimately depend on where the issue falls within this list of competing priorities.

M Benefit Solutions will be following tax legislation closely and will keep our clients informed, especially as they might impact our clients' deferred compensation plans and life insurance funding.

M Benefit Solutions Welcomes David Watros as the New President

In August 2016, David Watros was named President of M Benefit Solutions. David joined M Financial in 1991 and has more than 30 years of experience in the financial services industry. He has extensive experience working with M Member Firms, distributors, insurance carriers, and service providers on behalf of corporate and professional clients in the design and implementation of customized income continuation and retirement planning solutions. As President, David is responsible for strategic and operational aspects of the company.

Updates to Section 409A Regulations

Earlier this year, the IRS released updated, proposed rules under Internal Revenue Code Section 409A. These rules largely clarify and formalize existing IRS policy under Section 409A with the goal of helping taxpayers comply with the Code section's requirements. Though the regulations provide few surprises, they do provide some useful certainty to those implementing and administering plans subject to Section 409A.

Below is a discussion of some of the more notable proposals from the full list of nineteen.

Modification of Short-Term Deferral Rule

Ordinarily, a delay in payment of income no longer subject to a substantial risk of forfeiture beyond 2½ months following the later of the end of the employee's or the employer's taxable year in which the income vests results in the deferral of income becoming subject to the requirements of Section 409A. A small number of exemptions to this rule allow delays beyond the 2½ month period. In light of concerns that the strict application of the short-term deferral rule could lead to a violation of Federal securities laws, the list of exemptions is expanded to include delays that avoid a reasonably anticipated violation of Federal securities laws.

When Payment Has Been Made

The final regulations did not include a generally applicable rule to determine when a payment was made for Section 409A purposes. The proposed regulations create such a general rule. Specifically, "a payment is made, or the payment of an amount occurs, when any taxable benefit is actually or constructively received." This rule includes payments of cash, events that result in income under the economic benefit doctrine, transfers of property under Section 83, contributions to or the creation of certain trusts, and transfer, cancelation, or reduction of deferred compensation in return for a benefit. This does not include some transfers of substantially nonvested property to satisfy a nonqualified deferred compensation plan obligation, which will not be a payment under Section 409A unless the recipient makes a Section 83(b) election to include the fair market value of the property less any amount paid.

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An Employee's Continued Service as Independent Contractor

Confusion existed over a provision in the final Section 409A regulations that stated: "[i]f a service provider ceases providing services as an independent contractor and begins providing services as an employee, or ceases providing services as an employee and begins providing services as an independent contractor, the service provider will not be considered to have a separation from service until the service provider has ceased providing services in both capacities." There was concern that this meant that employees who had occupied both roles would not have a separation from service when transitioning to an independent contractor role and reduced their services to 20% or less of their prior service level. To eliminate the confusion, this sentence has been removed. An employee who occupies or has occupied both roles and becomes an independent contractor will have a separation from service as an employee when he/she provides less than 20% of their prior average level of services over the preceding 36 months.

Modification of Rules for Payment Following Death

Some commentators questioned whether rules regarding amounts payable upon the death of an employee applied upon the death of a beneficiary. The proposed regulations clarify that these rules do apply to beneficiaries.

In addition, to accommodate the practical issues that arise after death, the window for payment upon the death of an employee has been expanded to December 31 of the first calendar year following the year in which the death occurred. Plans with specified payment times that amend their timing provision to any other time within this period may do so without violating the provisions of regulation Sections 1.409A-2 or -3, which include the prohibition on acceleration of payments.

Payments to Beneficiaries Upon Death, Disability, or Unforeseeable Emergency

The final regulations provided an exception to the anti-acceleration rules in cases of death, disability, or unforeseeable emergency for the employee. The new regulations expand these exceptions to include beneficiaries entitled to payment due to the employee's death.

Plan Termination

The final regulations list nine categories of nonqualified deferred compensation plans. All plans of the same category that an employee participates in are considered a single plan. For an employer to accelerate a payment and terminate a plan, the employer must terminate all plans that are aggregated under these rules "if the same service provider had deferrals of compensation" under all those plans. Some practitioners asked whether this meant that only plans in which employees whose payments would be accelerated by the plan termination actually participate need to be terminated. The IRS feels the rule is clear as it currently reads, but states more clearly in its proposed regulations that the reference to the "same service provider" having deferrals of compensation under all plans of the same category refers to participation of a hypothetical employee in all such plans. The IRS reiterates its position that acceleration of payment through termination of a plan can only be achieved by terminating all plans of the same category that an employer sponsors at the time of acceleration. Such plans may include deferred compensation provisions in individual employment contracts. Thus, employers will need to make a careful inventory of its deferred compensation plans and contracts when terminating a deferred compensation plan.

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Acceleration and Debt Collection

Commentators expressed concern that Section 409A had conflicts with certain Federal debt collection laws by prohibiting certain payment accelerations that would be required to comply with such debt collection laws. In response, the list of exceptions to the prohibition on accelerated payments is expanded to "the extent reasonably necessary to comply with Federal laws regarding debt collection."

Effective Dates

The provisions of the proposed regulations are proposed to be applicable on or after the date on which they are published as final regulations in the Federal Register. For periods before this date, the existing final regulations and other applicable guidance apply (without regard to these proposed regulations). Taxpayers may, however, rely on the proposed regulations before they are published as final regulations, and until final regulations are published the IRS will not assert positions that are contrary to the positions set forth in the proposed regulations.

Note, however, certain provisions of the proposed amendments are intended solely as clarifications and not as substantive changes to the current requirements under Section 409A, such as the plan termination rule discussed above.

Update to Section 457 Regulations

Earlier this year, the IRS published proposed regulations that updated regulations under section 457 of the Internal Revenue Code. These regulations govern deferred compensation plans put in place by government entities and nontaxable entities. The proposed regulations have two purposes, to address changes in the law that have occurred since the original Section 457 regulations were promulgated and to expand on the definition of "substantial risk of forfeiture."

Harmonizing Regulations

Numerous bills relating to employee compensation have been enacted since Section 457's regulations were finalized in 2003. Several of those bills affected benefit plans under Section 457. These regulations formalize the IRS's thinking on these changes and address commentator concerns on specific issues. The most consequential alteration to the Code since 2003 was the enactment of Section 409A and issuance of final regulations under Section 409A. Important clarifications in the Section 457 regulations include:

- Section 457(f) plans, as nonqualified plans, will be subject to both regulations under Section 457 and Section 409A.
- Short-term deferrals as defined under Section 409A do not qualify as a deferral of compensation for the purposes of Section 409A or Section 457 and, consequently, are not subject to the restrictions of these sections. Additionally, bonus payments for a calendar year made after March 15 of the following year may still qualify as short-term deferrals if they meet the exceptions outlined in Section 409A's regulations.
- The rules outline the IRS's interpretation of "reasonable actuarial assumptions" for Section 457 plans.

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- A safe harbor is created for payment upon voluntary severance from employment when certain conditions, such as the reduction of the participant's compensation, are met.
- Reaffirmation that earnings on unpaid Section 457(f) compensation that have been included in gross income are taxable.

In addition to these clarifications, the IRS has provided two important ways employers and employees may be able to provide more flexible deferred compensation plan designs for plans regulated under Section 457(f). The first is a set of rules allowing a delay in the vesting and, consequently, taxation of a participant's deferred compensation. The second is a set of rules that permit a noncompete agreement to provide for a substantial risk of forfeiture. Both of discussed below.

Extending the Risk of Forfeiture

Unlike deferred compensation governed only by Section 409A, compensation deferred under a Section 457(f) plan is taxed in the year that it is no longer subject to a "substantial risk of forfeiture." Historically, there has been little that an employer can do to extend this risk of forfeiture. The new regulations provide a set of rules that create an opportunity for limited extensions to the deferral of income. These rules apply to both so-called rolling risks of forfeiture and for deferrals of a participant's current compensation.

Under the proposed regulations, four key factors determine whether substantial risk of forfeiture may be extended:

- The value of the benefit subject to additional risk must substantially increase. The regulations require the present value of the new amount to be paid upon the lapse of the substantial risk of forfeiture must be more than 125% of the amount the participant would have been paid in the absence of the extension;
- The employee must continue to perform substantial services for the employer or be bound by a noncompete agreement for a minimum of two years after the date that the employee could have otherwise received the compensation (a plan may provide that the substantial future service condition will lapse upon death, disability, or involuntary severance from employment without cause);
- The payment of the benefit is delayed by a minimum of two years; and
- A written agreement to subject the compensation to a substantial risk of forfeiture must be entered into prior to the calendar year in which any services giving rise to the compensation are performed in the case of initial deferrals of current compensation or at least 90 days before lapse of risk would otherwise occur.

These rules present the employer with the ability to spread benefit accrual over more years and to further delay payment of compensation. It also provides an opportunity for employee tax planning. If an employer wishes to retain an employee who might otherwise retire, employer and employee can enter into an agreement to extend the risk of forfeiture. Prior to the proposed regulations, this employee would have been paid and taxed on their benefit income in the year of their expected retirement. Then any additional benefit accrued during their extended service would be paid and taxed when they actually retire. Now, under the proposed regulations, employer and employee can agree to extend the risk of forfeiture, if they meet the requirements above, and then the employee can delay taxation on the entire benefit payment until they are paid at retirement, allowing the full tax benefit of deferral to remain in place for the entirety of the employee's work life.

Noncompete Agreements

As mentioned above, an employee who is not providing substantial services may still extend the substantial risk of forfeiture through the use of a noncompete agreement in which the payment of the benefit is conditioned on the employee refraining from performing certain services for a competitor.

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To extend the risk of forfeiture:

- The written agreement must expressly condition the employee's compensation upon refraining from performance of services and the agreement must be enforceable under applicable law;
- The employer must consistently make reasonable, ongoing efforts to verify compliance with the agreement and any other noncompete agreements it may have in force;
- Facts and circumstances must demonstrate:
  - The employer has a bona fide interest in preventing the employee's performance of services; and
  - The employee has a bona fide interest in and ability to engage in the competition prohibited.

In assessing whether these bona fide interests exist, the IRS will consider the risk of adverse economic consequences to the employer from a violation of the agreement, the marketability of employee's skills, and the employee's interest, financial need, and ability to engage in the prohibited services.

These proposed rules aid an employer that is concerned a key employee will depart for a competitor with the ability to enter into a noncompete agreement that provides a forfeitable benefit that will not be paid or included in taxable income until the noncompete agreement has expired. However, plan designers should be cautious with this new structure. Noncompete agreements will be governed by state law. Some states have significant restrictions on noncompetes. For example, noncompete agreements generally are unenforceable in California. Working closely with local counsel on a plan that relies upon a noncompete is necessary.

General Applicability Dates

Generally, these regulations are proposed to apply to compensation deferred under a plan for calendar years beginning after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register, including deferred amounts to which the legally binding right arose during prior calendar years that were not previously included in income during one or more prior calendar years.

The IRS states that no implication is intended regarding application of the law before these proposed regulations become applicable. However, taxpayers may rely on these proposed regulations until the prescribed applicability date.

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