M Benefit Solutions®
Bank Strategies
An M Financial Group Company

The Bottom Line

Executive and Director Benefits and BOLI

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Proposed Tax Reform Act of 2014

In February, Representative Dave Camp (R–MI), chairman of the House Ways and Means Committee released the Tax Reform Act of 2014, a comprehensive draft tax reform plan (Proposal). While the general consensus is that tax reform is highly unlikely to be enacted this year, the Proposal is significant in that it will likely serve as a basis for future tax reform, either by incorporation or purposeful exclusion of its provisions. In addition, because many provisions would raise revenue, these provisions may be picked out to offset future government spending or to effect deficit reduction in bills other than a bill to effect tax reform.

Highlights of the Proposal

New Individual Tax Rate Structure

There would be two individual income tax brackets (10% and 25% on taxable income, and a new 10% surtax on modified adjusted gross income (MAGI) above a 35% bracket threshold). The 35% bracket threshold would begin at the same income levels as the current 39.6% bracket ($400,000 for single filers and $450,000 for joint filers in 2013). MAGI for purposes of the 10% surtax would include, among other things, any annual addition to a defined contribution plan which is not includible in, or which is deductible from, the gross income of the individual and tax excludable contributions to health plans. In other words, 401(k) and matching contributions and the cost of employer-sponsored health plans, for example, would be subject to a 10% tax for those with MAGI above the 35% bracket.

Larger Standard Deduction

Inflation-adjusted standard deduction of $11,000 for individuals and $22,000 for married couples.

Capital Gains and Dividends

Long-term capital gains and dividends taxed as ordinary income, but exempts 40% of such income from tax.

Many Tax Credits and Deductions Would be Modified or Repealed

- Deduction for personal exemptions repealed.
- State and local income tax deductions repealed.
- Reduction of amount of mortgage indebtedness eligible for mortgage interest deduction from $1,000,000 to $500,000 phased in from 2015 to 2018.
- Exclusion of gain from sale of principal residence available once every five years (rather than every two years).

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AMT Repealed

The Alternative Minimum Tax would be repealed.

Executive Compensation

- The Proposal would modify the current rules under Code § 162(m) that limit the tax deduction for covered employees of a publicly traded corporation to no more than $1 million per year.
  - The definition of covered employee would be revised to include the CEO, CFO, and the three other highest paid officers (under current law the CEO and the three highest paid officers are covered employees), aligning it with SEC disclosure rules.
  - The Proposal would also repeal existing carve-outs from the deduction limitation for commissions and performance-based compensation, such as stock options.
- In addition, the Proposal would impose a 25% excise tax on compensation in excess of $1 million paid by a tax-exempt organization to any of its top five highest paid employees.
- The Proposal would repeal Code §§ 409A and 457A prospectively.
  - In place of these sections, the Proposal would add new Code § 409B to provide that compensation deferred through nonqualified deferred compensation plans would be taxed when the compensation is no longer subject to a substantial risk of forfeiture, eliminating the ability to defer compensation on the basis that the taxpayer does not have constructive receipt of the compensation. This is similar to the current rule applicable to tax-exempt employees under Code § 457(f).
  - Current-law rules would continue to apply to existing nonqualified deferred compensation arrangements until the last tax year beginning before 2023, when such arrangements would become subject to the new rule.

Pension and Retirement Provisions

- Elective salary deferrals to 401(k), 403(b), and governmental 457(b) plans on a pre-tax basis would be limited in the case of plans sponsored by large employers (employers with more than 100 employees).
  - Under present law, up to $17,500 generally may be deferred on a pre-tax basis. Under the reform proposal, only half of the contribution limit ($8,750 under current law) could be deferred on a pre-tax basis; the remaining amounts would be required to be deferred as Roth contributions.
  - The same rule would apply to catch-up contributions.
  - Roth contributions are included in taxable income in the year of deferral, but generally would not be taxable in later years.
  - Employers would be required to offer Roth accounts (or may choose to offer Roth accounts entirely with no pre-tax account at all).
  - Employer contributions would still receive pre-tax treatment.
- Contribution limits for tax-qualified retirement plans (such as the 415 limits, contribution limits on ROTH IRAs, and the limit on elective salary contributions and catch-up contributions) would be frozen at 2014 levels until 2024.
- Income eligibility limits for contributing to Roth IRAs would be eliminated.
- New contributions to traditional IRAs would be prohibited.
- Employers would not be permitted to establish new SEPs or SIMPLE 401(k) plans after 2014.
  - Employers would be permitted to continue making contributions to existing SEPs and SIMPLE 401(k) plans.
  - SIMPLE IRAs would continue to be available.
- Numerous other changes.

COLI/BOLI Reforms

Under current law, business interest deductions are reduced to the extent the interest is allocable to insurance policy cash values based on a pro rata formula, unless the insurance policy insures the lives of officers, directors, employees, or 20% owners of the business.

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Because most corporate-owned life insurance (COLI) and bank-owned life insurance (BOLI) are on officers, directors, and employees, this rule generally does not affect COLI/BOLI.

Under the Proposal, the exception to the pro rata interest expense disallowance rule would not apply to officers, directors, or employees, and thus only would apply to 20% owners of the business that holds the insurance contract. The provision would be effective for insurance contracts issued after 2014 with any material increase in the death benefit or other material changes to existing contracts being treated as new contracts. The Proposal would affect the efficiency of COLI/BOLI contracts purchased after the effective date. This proposal has been in President Obama's budget for many years.

Health Care

No major modifications. It would not modify the tax exclusion for employer-provided health coverage, nor would it alter the deduction for health coverage available to the self-employed. However, both of these would be a tax-preference item for purposes of the MAGI definition of income subject to the 10% surtax.

Limit on reimbursements of expenses for over-the-counter medications would be removed for flexible spending accounts, health savings accounts, and Archer MSA's.

Certain Areas of Agreement Between the Proposal and the President's Budget

In March, the Obama administration revealed its Fiscal Year 2015 Revenue Proposals (President's Budget). Though the President's Budget and the Proposal come from Democrats and the Republicans, respectively, and significant differences would be expected, there are areas of agreement, two of which are discussed briefly below.

Expand Deduction Limits Related to COLI/BOLI Policies

As noted above, the Proposal and the President's Budget both contain the proposal to apply the pro-rata interest disallowance provision under Code § 264(f) for most COLI/BOLI policies. This provision was designed to deter financial intermediaries Fannie Mae and Freddie Mac from using COLI/BOLI policies to insure the lives of mortgagees, and not to deter the use of COLI/BOLI by corporations and financial institutions, which is why the exceptions for policies on officers, directors, and employees was included as a feature of Code § 264(f).

This provision would increase the costs of COLI/BOLI policies purchased after the effective date of any enacted proposal. It would not affect previously purchased policies.

Example: Cost of Proposal with respect to new COLI/BOLI Policies.

X Corp has the following:

Interest Deductions	$400,000
Average unborrowed cash values in COLI/BOLI policies subject to disallowance provision	$500,000
Total average assets	$10,000,000

Under the proposal, X Corp would lose 5% ($500,000/$10,000,000) of their $400,000 interest deduction or $20,000 in lost deductions.

Reducing/Eliminating Certain Deductions and Tax Expenditures

Individual taxpayers reduce their taxable income by excluding certain types or amounts of income, claiming certain deductions in the computation of adjusted gross income ("AGI"), and claiming either itemized deductions or a standard deduction. Both the Proposal and the President's Budget would reduce the value of certain tax preferences and deductions, including, among others:

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- Itemized deductions (excluding charitable deductions under the Proposal).
- Certain excludable employer/employee contributions to health and retirement plans.
- Tax-exempt interest.

The effect of this is to tax the value of the affected items. As noted above, employee contributions to a qualified plan would be taxed at a 10% rate for those in the 35%-tax bracket under the Proposal. Under the President's Budget, these same employee contributions would be taxed at a rate equal to the taxpayer's marginal tax rate (39.6%, 35%, or 33%) less 28%, or at a rate equal to 11.6%, 7%, or 5%, dependent upon which tax bracket the employee is in.

Differences Between the Proposal and the Budget

Individual Income Tax Rates

The President's Budget retains the current seven bracket structure with a top rate of 39.6%. In addition, the Budget proposes a 30% "Fair Share Tax" on taxpayers with adjusted gross income beginning at $1 million. The Proposal would compress the seven brackets essentially to three (10%, 25%, and 35%).

Estate, Gift and GST Taxes

The Proposal, other than a basis reporting consistency provision and a proposal to address the present interest requirement for annual exclusion gifts, does not make changes to the estate and gift tax structure. The President's Budget, however, would make various changes, among them:

- Reinstatement of 45% top transfer tax rate with $3.5 million estate and GST tax exemptions, $1 million gift tax exemption.
- Coordination of income and estate tax rules applicable to grantor trusts.
- 10-year minimum term GRATs.

Comments

- Neither the Proposal nor the President's Budget have been introduced as bills. Both parties have indicated it is unlikely there will be tax reform enacted this year.
- The Proposal, while not introduced, has been prepared with legislative text, making readily available language for insertion into future bills, whether part of a tax reform effort or to raise revenue.
- Senate Finance Committee Chairman Ron Wyden (D–Ore.) said April 3 that the effort underway to renew dozens of expired tax breaks will be the last the committee takes up as long as he's chairman. After the two-year extensions to tax breaks such as the deduction for state and local taxes and the research tax credit is complete, Wyden said the committee would take up a broader overhaul of the tax code, holding a hearing in the spring.

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

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), a Michigan district court rejected a motion to dismiss a claim under ERISA made by a former employee whose retirement benefit payments were reduced as a result of the employer's failure to properly withhold FICA tax at the time of the employee's retirement.

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FICA Taxes and Nonqualified Deferred Compensation Plans

The general rule of Code § 3102(a) requires that employers deduct FICA taxes from an employee's wages when they are actually or constructively paid. However, Treasury Regulations under Code § 3121 provide a "special timing rule" applicable to FICA taxes on contributions to nonqualified deferred compensation plans. In general, for an individual account type of 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.

For certain defined benefit types of deferred compensation plans, FICA tax will be due when amounts are "reasonably ascertainable." Most often this occurs when the participant retires or terminates. In addition, once a benefit is taxed, a "non-duplication rule" eliminates additional FICA tax when benefit payments are made under the plan.

Thus, when the special timing and non-duplication 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 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) 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 twelve to eighteen month period. Effective January of 2012, the Company began adjusting participants' monthly payments under the Plan.

Court Holding

The court held that the Company may be 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 Plaintiff's benefits, which they purportedly admitted to mishandling in an October 14, 2011 letter that stated:

"Yes, at the time you commenced receipt of this benefit, Henkel should have applied FICA tax to the present value of your nonqualified pension benefit."

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In addition, the court held that the Plaintiff properly asserted an ERISA equitable estoppel claim. The court found that the Plaintiff alleged the Plan Administrator discussed and provided Plaintiff with calculations of his benefits and tax liabilities at the time he was deciding whether to retire. He further alleged that the Company was aware or should have been aware of the devastating tax consequences if Plaintiff's FICA taxes were not withheld pursuant to the special timing rule and that Plaintiff relied to his detriment upon the erroneous representations. Lastly, Plaintiff alleged special circumstances warranting the application of estoppel by setting forth facts detailing Company's grossly negligent management of the Plan, negotiated resolution with the IRS without prior notice to Plaintiff, and subsequent reduction to Plaintiff's benefits.

The court dismissed Plaintiff's state law claims but held that the case could go to trial to determine whether the Plaintiff could recover damages under these ERISA claims.

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. Plan sponsors need to review their participant communications and payroll withholding procedures to ensure that the special FICA timing rule is being administered properly.

Just the FAQs

Why does an employer have to book a liability for providing a post separation split-dollar life insurance benefit when no booked expense is required for providing the benefit during working years?

On September 20, 2006, the Financial Accounting Standards Board (FASB) ratified Emerging Issues Task Force (EITF) Issue No. 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements." EITF Issue No. 06-4 was written to eliminate divergent accounting practices that had developed over the years for post-separation death benefits provided through endorsement split-dollar life insurance. It was effective for fiscal years beginning after December 15, 2007.

Prior to EITF Issue No. 06-4, some employers recognized the cost of the post-separation insurance benefit or future premiums as a liability. Others did not recognize any liability for the insurance benefit or premiums paid for the insurance policy because they viewed the purchase of the insurance as effectively settling the obligation.

EITF Issue No. 06-4 requires employers to recognize an ongoing expense for post-separation death benefits provided under endorsement split-dollar arrangements. If the employer has agreed to maintain the underlying insurance policy that provides the death benefit, the accrual will be based on the expected post-separation cost of maintaining the insurance policy.

BOLIPRO™

New on BOLIPRO™

M Benefit Solutions - Bank Strategies is committed to delivering leading edge service and support to our clients. We are pleased to announce the following enhancements to BOLIPRO™:

- Three client access levels are now available—full access, benefits only access, and insurance only access. Please contact your M Benefit Solutions Client Administration Associate if you would like to take advantage of these different access levels.
- IRS Form 8925 and the supporting data are now available on BOLIPRO™ under Financials.
- In addition to the current Annual Review, historical Annual Reviews are now available on BOLIPRO™.

Insurance Industry Updates

Fitch Ratings Issues Stable Outlook for U.S. Life Insurance Industry in 2014

Fitch Ratings said its outlook for the U.S. life industry in 2014 is stable, reflecting the industry's very strong balance sheet fundamentals, solid liquidity profile, and improved operating performance. Fitch said it believes the industry is well positioned to address macroeconomic challenges over the coming year.

While low interest rates and macroeconomic uncertainly continue to loom over the industry, asset quality and capitalization remain stronger than pre-financial crisis levels. In addition, improved financial markets have enhanced earnings levels of most companies. Fitch said its outlook assumes continued, but weak, improvement in the economy along with relatively high levels of unemployment over the near term.

A.M. Best Says U.S. Life/ Annuity Sector Holds Gains As Economy Continues to Strengthen

In a report on ratings trends for the U.S. life/annuity industry published by A.M. Best, the ratings agency said that the sector has maintained strong risk-adjusted capital, generated steady operating earnings, and improved balance sheet fundamentals. As a result of the continued favorable performance of the life/annuity industry, A.M. Best's rating outlook for the sector remains stable.

In reviewing its rating actions in 2013, A.M. Best noted that upgrades outpaced downgrades by a 2.5 to 1 margin. As of December 31, 2013, more than 60% of the rated life groups had an A.M. Best rating described by A.M. Best as "Excellent" or better. Only 4.8% of rated life groups had a rating described as "Fair" or worse.

FASB Abandons Plan to Converge Insurance Accounting with IASB Standards

In late February, the U.S. Financial Accounting Standards Board (FASB) announced it was abandoning plans to achieve a convergence of accounting standards for insurance contracts with the model proposed by the International Accounting Standards Board (IASB). The FASB said it will instead focus its efforts on making targeted improvements to the existing U.S. GAAP model. According to the FASB, the decision was based on the likelihood that the FASB and IASB would be unable to agree on a unified accounting model as well as the cost of implementation for insurance companies.

Fitch Ratings said the development was a win for most U.S. insurers as it reduces uncertainty and potential volatility in financial statements. However, Moody's Investors Service said the decision was a negative for global investors because of the difficulty of comparing insurers across borders with differing accounting regimes. Moody's also noted that the decision removes the downside risk for U.S. insurers of diminished investor interest because of the significant opposition to the proposal previously expressed by investors of U.S. insurers.

Upcoming Events

The Bank Holding Company Association (BHCA) Spring Seminar

May 5–6; Minneapolis Airport Marriott Hotel Bloomington, MN

Thomas V. Lynch of ECI Companies, an Advisor Firm of M Benefit Solutions, will be in attendance at the BHCA Spring Seminar.

2014 North Dakota Bankers Association/South Dakota Bankers Association (NDBA/SDBA) Annual Convention

June 8–10; Ramada Plaza & Suites Fargo, ND

Mark Boomgaarden, an Advisor of M Benefit Solutions, will be in attendance at this event.

2014 FMS Accounting & Finance Forum

June 22–24; Hyatt Regency Grand Cypress Orlando, FL

M Benefit Solutions - Bank Strategies is proud to exhibit. Join us at Booth 504 for your bank's customized BOLI Empowerment Page and enter to win a GoPro Hero3 camera.

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Community Bankers of Iowa (CBI) Management Conference and Convention

July 16–18; Arrowwood Resort Okoboji, IA

Thomas V. Lynch of ECI Companies, an Advisor Firm of M Benefit Solutions, will be in attendance at this event.

2014 ABA Annual Convention

October 19–21; Hyatt Regency Dallas Dallas, TX

M Benefit Solutions - Bank Strategies is proud to exhibit. Join us at Booth 208 for your bank's customized BOLI Empowerment Page and enter to win a GoPro Hero3 camera.

Advisor Firms

M Benefit Solutions - Bank Strategies is structured to provide our clients with consistent nationwide coverage. We have identified several Advisors with extensive experience in bank executive and director benefits and BOLI to provide consulting services to clients nationwide.*

Distributed throughout the country, these Advisors work with M Benefit Solutions and bank clients to design programs which meet each bank's specific needs and to ensure high quality administrative and compliance services.

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About M Benefit Solutions - Bank Strategies

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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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