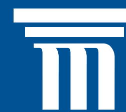
Matters of Interest

Executive and Director Benefits and COLI



M Benefit Solutions®

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An Overview of IRS Notices and Regulations Issued under the TCJA

On December 22, 2017, Donald Trump signed the Tax Cuts and Jobs Act (TCJA) into law. The IRS has since elaborated on aspects of the bill that may impact M Benefit Solutions' clients.

Initial IRS Guidance on Expansion of Section 162(m) Deduction Limitations

Internal Revenue Code ("Code") Section 162(m) limits deductions for certain compensation over $1 million paid by publicly held companies to covered employees. TCJA expanded the deduction limitations under Section 162(m). Specifically, it:

- Expanded the definition of compensation subject to the limitations ("applicable employee remuneration") to include commissions and performance-based pay, which had been exempt;
- Expanded the definition of "publicly held corporation;"
- Expanded the definition of "covered employee;" and
- Provided a grandfathering rule that exempts certain remuneration from the application of the new rules

The IRS issued Notice 2018-68 last year with initial guidance on the amendments to Section 162(m), including the expanded definition of "covered employees" and the operation of TCJA's grandfathering rule for compensation provided under written binding contracts in effect on November 2, 2017.

Application of Section 162(m) to Deferred Compensation

TCJA amended Section 162(m) to provide that once an individual is considered a "covered employee" that individual continues to be a "covered employee" for all future years, including post-termination, and even after death. As such, more payments of deferred compensation will be subject to the deduction limitations of Section 162(m).

Covered Employees

The expanded definition of "covered employee" includes the following employees of a public company:

- Any employee who was the principal executive officer or principal financial officer of the employer, or acted in such capacity, at any time during the taxable year;
- Employees who were required to be reported for the taxable year to shareholders under the Securities Exchange Act of 1934 because such employees were among the three highest compensated officers for the taxable

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year (excepting any individual described in the bullet above); and

- Covered employees of the taxpayer (or any predecessor) for any prior taxable year beginning after December 31, 2016.

Grandfathering Rule—Payment of Deferred Compensation

The grandfathering provision of the TCJA exempts compensation payable under a written binding contract that was in effect on November 2, 2017, and which has not subsequently been modified in any material respect. The Notice provides details and explains what this means in practice.

The grandfathering rule protects:

- Compensation subject to a written binding contract on November 2, 2017, which compensation was not previously subject to Section 162(m), and
- All compensation subject to a written binding contract on November 2, 2017, when a covered employee would not have been a covered employee under pre-TCJA rules.

Pre-TCJA, most deferred compensation escaped the restrictions of Section 162(m) because it was paid after the employee had terminated employment and was no longer a covered employee. Thus, most nonqualified deferred compensation plan (NDCP) payments will rely on the second bullet for grandfathering.

Determination of Grandfathered Amount

Under the Notice:

> *"... [T]he amendments to section 162(m) made by the Act apply to any amount of remuneration that exceeds the amount of remuneration that applicable law obligates the corporation to pay under a written binding contract that was in effect on November 2, 2017, if the employee performs services or satisfies the applicable vesting conditions."*

This amount would include the amount owed on November 2, 2017. The question is whether any amounts paid or credited after November 2, 2017, would also be grandfathered.

Under the Notice, once a contract is "renewed" the contract becomes subject to post-TCJA Section 162(m). Additionally, a "written binding contract that is terminable or cancelable by the corporation without the employee's consent after November 2, 2017, is treated as renewed as of the date that any such termination or cancellation, if made, would be effective."

Most NDCPs are terminable by employers at any time. Thus, under the Notice, most NDCPs will be considered renewed as of November 3, 2017 as the employer could have terminated them. Under the terms of the Notice, for most NDCPs, vested amounts owed to participants as of November 2, 2017 should be grandfathered, but earnings and non-vested amounts would not be.

A number of lawyers, however, have taken issue with the Notice's conclusion that earnings on grandfathered amounts in such circumstances will not be grandfathered. They have suggested that the right to have earnings credited to grandfathered amounts is part of a binding contract regardless of whether the employer could terminated the plan at any time. Counsel should be consulted with respect to this issue.

For NDCPs or other deferred compensation agreements which cannot be terminated either by the employer or the employee except by termination of employment (assuming the agreement has not been materially modified), all amounts under the NDCP or agreement including earnings should be grandfathered.

Material Modifications

The grandfathering provisions become inapplicable if the parties materially modify the contract after November 2, 2017. A material modification is an amendment to increase the amount of compensation payable to the employee. A materially modified written binding contract is treated as a new contract entered into on the date of the material modification. A modification that accelerates payment

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of compensation is a material modification unless the modification discounts the amount of compensation paid to reasonably reflect the time value of money. To avoid a material modification of the contract, it is necessary to base any additional compensation on either a reasonable rate of interest or a predetermined actual investment.

Changes to Pass-Through Taxation

Last year, the IRS proposed regulations to implement new Code Section 199A as added by TCJA. In January of this year, the IRS issued final regulations under Section 199A.

Background

Under Section 199A, pass-through entities, such as subchapter S corporations and partnerships, may claim a deduction for up to 20 percent of "qualified business income" from pass-through entities and up to 20 percent of real estate investment trust (REIT) dividends and publicly traded partnership income. Pass-through entities are taxed at the individual level, with a top marginal rate of 37%, compared to C Corporations' flat rate of 21%. The new deduction is intended to put both entity types on an equal tax footing.

The deduction has limits based on W-2 wages and property basis, and is unavailable for specified service trades or businesses (SSTBs) if taxpayers receive taxable income exceeding $207,500 ($415,000 for joint filers). These limitations phase in for taxpayers with taxable income exceeding $157,500 ($315,000 for joint filers).

For purposes of Section 199A, SSTBs include the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing and investment management, trading or dealing in securities, or any trade or business where the reputation or skill of one or more of its employees or owners is its principle asset. Engineering and architecture services are exempt from this list, and are fully eligible for the deduction.

Qualified Business Income

"Qualified business income" (QBI) generally means, for any taxable year, the net amount of qualified items of income, gain, deduction, and loss for any trade or business of the taxpayer, provided the other requirements of the regulation and section 199A are satisfied. Reg. § 1.199A-3(b)(1).

The term "qualified items of income, gain, deduction, and loss" means items of gross income, gain, deduction, and loss to the extent such items are effectively connected with the conduct of a trade or business within the United States that are included or allowed in determining taxable income for the taxable year. Reg. § 1.199A-3(b)(2)(i).

Some notable exclusions follow:

- Any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss, including any item treated as such under any other provision of the Code.
- Any dividend, income equivalent to a dividend, or payment in lieu of dividends described in section 954(c)(1)(G) (concerning foreign personal holding company income).
- Any interest income not properly allocable to a trade or business. For purposes of section 199A and this section, interest income attributable to an investment of working capital, reserves, or similar accounts is not properly allocable to a trade or business.

Reg. § 1.199A-3(b)(2)(ii).

W-2 Wages

As noted above, the deduction is not available for certain specified service trades or businesses (SSTBs) if taxpayers have taxable income exceeding $207,500 ($415,000 for joint filers).

The deductible amount for other businesses is limited based on W-2 wages and property basis. The limit is equal to the greater of the owner's allocable share of 50% of "W-2 wages" or 25% of "W-2 wages" and 2.5% of the UBIA of the pass-through entity's qualified business property.

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In Revenue Procedure 2019-11 the IRS provides three methods of calculating W-2 wages. The first method, the unmodified Box method, allows for a simplified calculation, while the second and third methods, the modified Box 1 method and the tracking wages method, provide greater accuracy. All of the methods are based on amounts reported on Form W-2.

After computing W-2 wages under one of these methods, the taxpayer must determine the extent to which the W-2 wages are properly allocable to QBI. Then, the W-2 wages limitation for that trade or business is determined using the properly allocable W-2 wages amount.

Summary

The regulations governing Section 199A are complex and results are highly dependent on the particular facts and circumstances of each pass-through entity and each owner of the pass-through entity. Many pass-through entities will need to do a substantial analysis to determine how best to structure itself to maximize the availability of the Section 199A deduction.

Litigation Spotlight for Q2 2019

Late in 2018, four lawsuits were filed alleging that large corporate plan sponsors of qualified defined benefit plans (DB Plans) had failed to use "reasonable actuarial assumptions" in calculating alternative annuity forms. These lawsuits highlight the fact that while DB Plans are well established, stable, and trusted vehicles for providing retirement benefits, they are long-term commitments, deserving careful periodic review to ensure that plan sponsors provide the retirement benefits they intend and to minimize their litigation risk.

What Are Reasonable Actuarial Assumptions?

DB Plan benefits often come in multiple forms. For example, a plan might offer an employee the right to receive their benefit as a lump sum or as various types of annuity, including single life and joint and survivor annuities. The DB Plan may also offer early retirement benefits. ERISA imposes upon plan sponsors the requirement that when comparing benefits between forms, the forms must be "actuarially equivalent." To calculate "actuarial equivalence," it is necessary to compare the present value of future payments under different payment forms based on both interest rate and participant mortality assumptions. ERISA has requirements for the assumptions used to generate actuarially equivalent lump sum payments, but there are no specified assumptions when converting between different types of annuity payments.

The Lawsuits

The lawsuits were filed against four plan sponsors, Metropolitan Life Insurance Company, American Airlines, PepsiCo, and U.S. Bancorp, as well as related benefit committees and the individuals serving on those committees.

The lawsuits argue that the actuarial equivalence factors used by the DB Plans were inherently unreasonable and that, as a consequence, the annuity benefits provided for certain participants violated ERISA's anti-forfeiture provisions. They also allege breaches of ERISA fiduciary duty provisions.

Some of the relief requested includes a redetermination of benefits, make-up payments for past underpayments, and revision of plan provisions.

What do the Cases Allege with respect to Actuarial Equivalence?

The four cases rely on two related theories of failure to calculate "actuarially equivalent" benefits. Two cases allege that plan sponsors used outdated mortality tables when determining benefits and that these outdated tables resulted in lower payments for participants who elected to receive joint and survivor annuities than they would otherwise have received.

The other two cases allege that plan sponsors used conversion factors that are lower than reasonable actuarial assumptions would have generated. The conversion factors incorporated interest and mortality

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assumptions without identifying the underlying assumptions. The plaintiffs argue that calculating the benefits in these plans using reasonable actuarial assumptions results in a significant increase in benefits over what many participants are currently due, implying that the actuarial assumptions used by the plan sponsor, though not known, must, therefore, have been unreasonable.

What Should Plan Sponsors Do?

For plan sponsors of qualified DB Plans, now might be a good time to review the actuarial assumptions used in their plans to determine whether any updates, especially to older mortality tables or conversion factors based on outdated mortality and interest assumptions, are warranted.

For plan sponsors of nonqualified defined benefit plans, the issue is not quite as important because these plans do not fall under the ERISA rules that underpin these lawsuits. However, there are situations in which the issue could arise:

- Some qualified DB Plan benefits are used to offset a nonqualified plan benefit. However, in most cases, the normal form of benefit is used as an offset, so assumptions for equivalent forms will generally not be a factor.
- The issue may also arise when there is a participant election to change an annuity payment form with the intention of avoiding the otherwise applicable 5-year payment delay requirement. Before any such change in form is made, therefore, it should be confirmed that the reasonableness of the assumptions has been considered.
- A third possible situation is if a participant were to sue on the theory that the nonqualified plan assumptions are not reasonable, even if such reasonability is not legally required. The risk here would appear to be minimal but any M Benefit client may contact their plan administrator if there is any concern about the assumptions used in your plan.

M Benefit Solutions Security Part 2: Client-Facing Systems

This article is the latest in our series about data security at M Benefit Solutions. In the previous article, we discussed the human element of our security procedures. In this article, we discuss the security measures we have in place to keep our client-facing data safe and accessible.

Good security begins with the basics. At M Benefit Solutions, our websites make secure connections using the Hypertext Transfer Protocol Secure (HTTPS) transfer protocol. HTTPS creates a secure channel over an insecure network. This ensures adequate protection from eavesdroppers and secures the privacy and integrity of the exchanged data while in transit. HTTPS is an industry standard and increasingly represents a baseline level of security that all web sites should provide.

In recent years, it has become all too common for distributed denial of service attacks (DDoS) to impact web services for minutes, hours, or in extreme cases multiple days. If the target of the DDoS is a datacenter or other major service provider, the potential for collateral impact to unintended targets is significant. To safeguard against collateral impacts, we work with an ISP that provides DDoS prevention capabilities.

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With the continuous emergence of new threats, we also work with a managed security service provider. This firm tracks ingress into and egress out of our network and notifies us of questionable activity. Our MSSP provides comprehensive visibility into the security activity on our network and is able to proactively mitigate real time events.

Our systems undergo annual penetration testing. The results of this testing allow us to prioritize security risks based on their criticality, probability, and impact. A third party performs these tests, and results are reported directly to our Board of Directors as part of our internal auditing process.

In addition to our internal audits, M Benefit Solutions participates in the SSAE 18 audit process. The audit assesses the adequacy of our processes and considers whether we are acting as good stewards of the data entrusted to us. The change in the industry standard from SSAE 16 to SSAE 18 represents a shift to a more extensive and holistic assessment of our processes.

We engage in all these processes because we care about the safety of our client's data. Plan participants make sensitive financial decisions while using our systems. We want those plan participants to feel comfortable and secure when they entrust that information to us. That means making sure that our websites are secure and available whenever a user needs them.

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