Employee Benefits Update

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Tax Cuts and Jobs Act gives — and takes away

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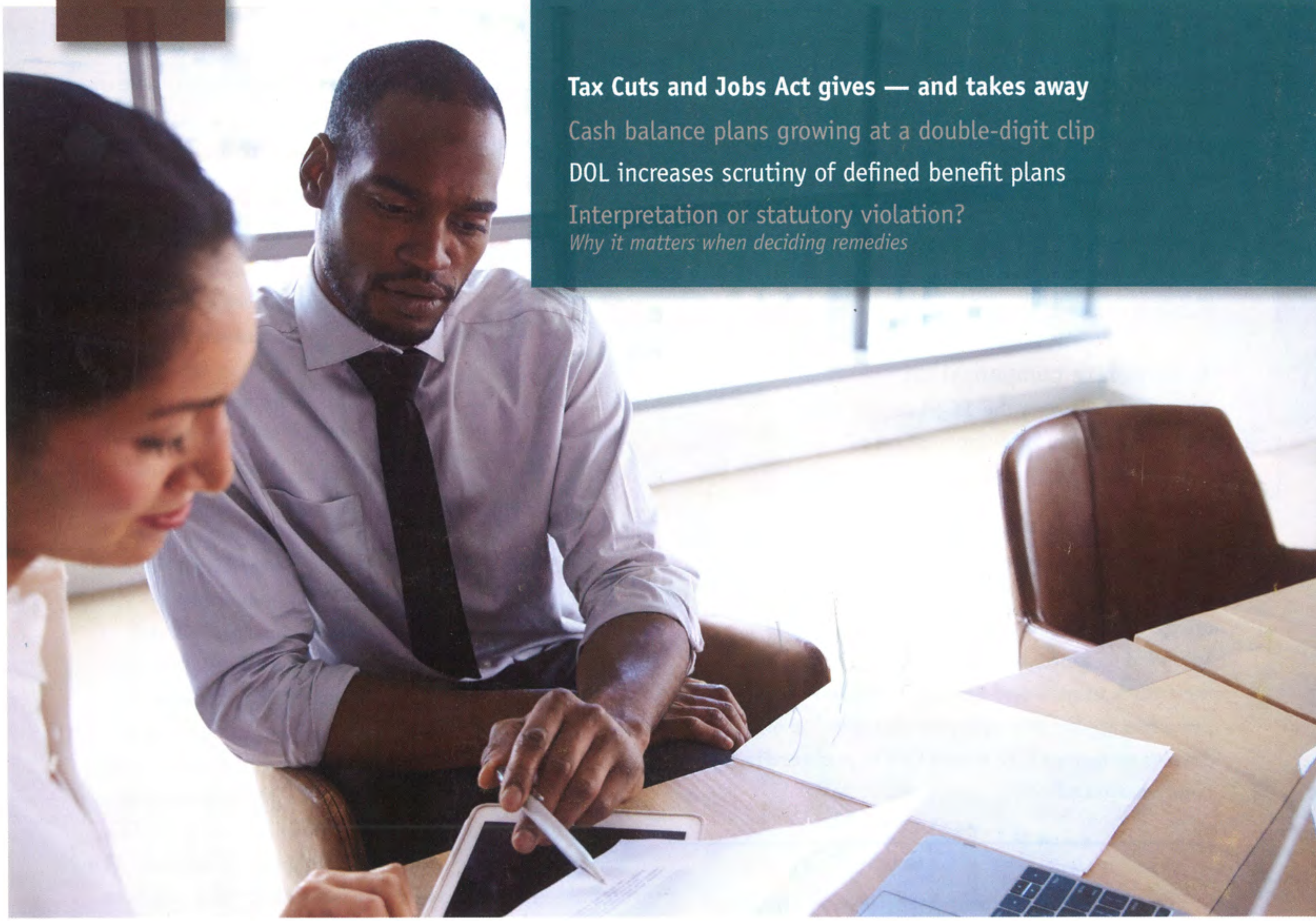

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Tax Cuts and Jobs Act gives — and takes away

While early drafts of the Tax Cuts and Jobs Act (TCJA) proposed significant changes to qualified retirement plans, the version that passed has minimal impact on them. However, the TCJA did make some notable adjustments to the tax treatment of other types of employee compensation and benefits, for both employers and employees. Here's a closer look at two affected areas.

1. Corporate compensation

Among the changes the TCJA makes to the tax treatment of compensation of corporate executives and employees are:

Enhancements to rules for qualified equity grants. Grants of stock options and restricted stock units (RSUs) are generally offered only to executives. Intended to spur employers to grant some of their stock to rank-and-file employees, the new provision applies to employees *other than* 1% owners, current or former CEOs and CFOs, and certain highly compensated officers.

To receive the new family and medical leave tax credit (available only in 2018 and 2019), employers must grant full-time employees at least two weeks of annual family and medical leave during which they receive at least half of their normal wages.

Specifically, the provision gives eligible employees who receive compensatory stock options or RSUs a five-year reprieve on the income tax liability incurred when they gain unencumbered access to that economic benefit.

The provision generally applies to stock attributable to options exercised or RSUs settled after December 31, 2017. But an important stipulation is that at least 80% of employees must be covered under the stock grant program for this provision to apply.

Tighter limits on excessive employee remuneration. The new tax law expands limits on publicly held corporations' ability to deduct the cost of certain executives' pay exceeding $1 million (not counting performance-based compensation). The cap applies to "covered employees," which, based on pre-TCJA IRS guidance, included the CEO and the other three highest paid officers. Under the TCJA, beginning in 2018, the definition has changed to include the CEO, the CFO and the other three highest-paid officers. The definition now also includes individuals who had been a covered employee in any tax year beginning after December 31, 2016, but no longer are. In addition, in general, performance-based compensation is now included under the $1 million cap on deductibility.

2. Family and medical leave tax incentives

One noteworthy TCJA provision provides tax incentives for employers to provide paid sick and family medical leave to employees. Five states (California, Connecticut, Massachusetts, Oregon and Vermont) already have mandatory sick leave requirements for private employers. Paid sick leave advocates have been lobbying for

Some other benefits affected by the TCJA

Some Tax Cuts and Jobs Act (TCJA) provisions remove or diminish tax benefits previously available to employers or employees. They include:

Employee achievement awards. Beginning in 2018, the law restricts the definition of employee achievement awards eligible for a tax deduction by the employer and exclusion from income taxation for the employee. "Tangible" achievement awards still qualify, but the following award categories are no longer considered tangible: cash, cash equivalents, gift cards, gift coupons, gift certificates, vacations, meals, lodging, tickets to theater or sporting events, stocks, and bonds.

Moving expense reimbursements. For 2018 through 2025, employees' ability to exclude from their income the value of employer-provided reimbursements for moving expenses has been removed, with an exception for active-duty military personnel in certain circumstances.

Transportation fringe benefits. Beginning in 2018, employers can no longer deduct the cost of qualified transportation benefits granted to employees, such as qualified parking, transit passes, vanpool benefits and qualified bicycle commuting reimbursements. However, these transportation benefits generally are still excludable from employee income. Exception: The exclusion for bicycle commuting reimbursements is suspended for 2018 through 2026.

Also, beginning in 2018, any expense incurred for providing transportation (or any payment or reimbursement) for commuting between the employee's residence and place of employment isn't deductible except if the transportation is necessary for ensuring the safety of the employee.

years to expand mandatory paid leave nationwide, but the new tax law just takes a carrot approach.

Here's how it works: To receive a tax credit (available only in 2018 and 2019), employers must grant full-time employees at least two weeks of annual family and medical leave during which they receive at least half of their normal wages. In addition, all less-than-full-time qualifying employees must receive a commensurate amount of leave on a pro rata basis. (Ordinary paid leave that employees are already entitled to doesn't qualify for the tax incentive.)

Employees whose paid family and medical leave is covered by this provision must have worked for the employer for at least one year, and not had pay in the preceding year exceeding 60% of the highly compensated employee threshold.

The credit is equal to 12.5% of the employee's wages paid during that leave. That credit amount increases to the extent that employees are paid more than the minimum 50% of their normal compensation, to a maximum of 25% of wages paid. The maximum amount of paid family and medical leave that can be eligible for the tax credit is 12 days per year.

The road ahead

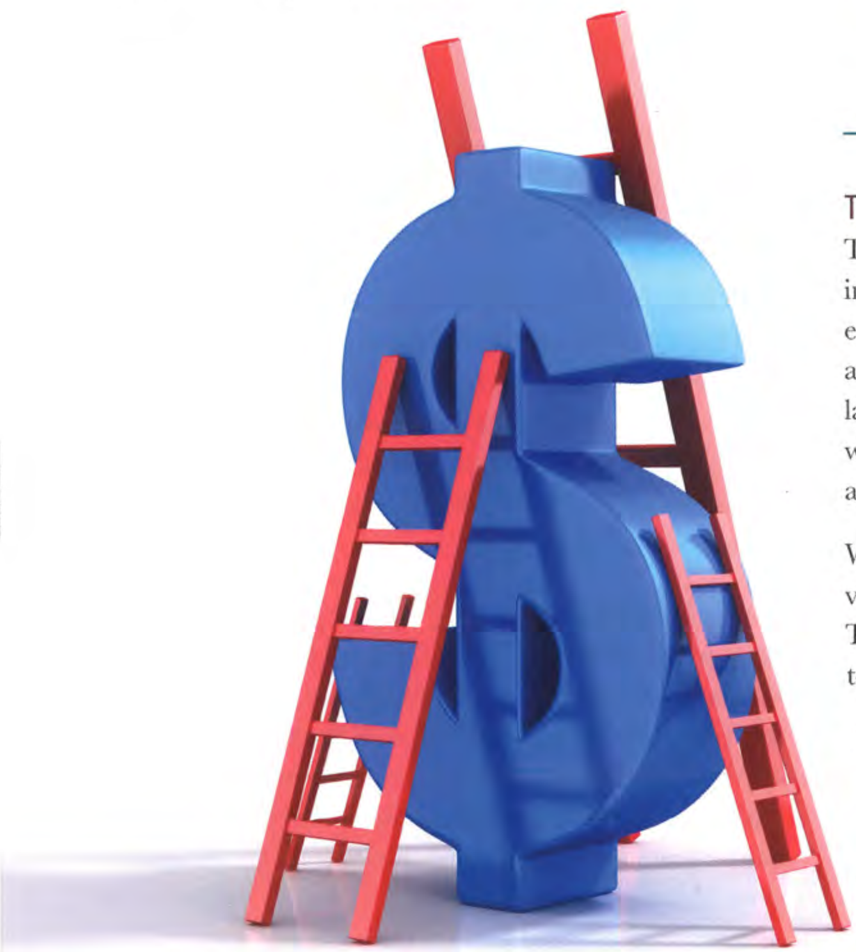
Keep in mind that additional rules and limits apply to the provisions discussed here. Also, don't forget about the TCJA changes to plan loans and Roth IRA recharacterizations. While employee benefits weren't largely affected by the TCJA, proposals in both the House and Senate that didn't make it into the law may be an indicator of things to come. ◻

Cash balance plans growing at a double-digit clip

The hybrid pension design known as the cash balance plan is on a roll. An analysis of the most recent IRS Form 5500 filings available reveals a 17% jump in the number of cash balance plans in 2015, while 401(k) plan formation growth was a meager 3%. Is this type of plan right for your business?

Looking at the numbers

Nearly all (92%) of cash balance plans are sponsored by employers with fewer than 100 employees, according to Kravitz, Inc., a cash balance plan administrator. However, some of the country's largest corporations, including IBM, AT&T, Boeing, and FedEx, sponsor them. Overall, nearly 13 million people are covered by cash balance plans, the firm estimates.



Although there's no expectation that cash balance plans will overtake defined contribution (DC) plans in popularity, their growth is noteworthy. Cash balance plans are, technically, defined benefit (DB) plans, and represent about one-third of the DB universe. As with standard DB plans, they're covered by the Pension Benefit Guaranty Corporation (PBGC), and subject to PBGC premiums. However, if the company is a professional services firm with fewer than 26 active participants, the plan is not covered by the PBGC.

Cash balance plans appeal to sponsors in that they give them a clearer view of the liabilities they're accruing over a standard defined benefit plan.

Tying in to 401(k) plans

The estimated number of cash balance plans in place in 2016 was 20,484, up from just 1,337 in 2001. Most employers offer cash balance plans in conjunction with a 401(k) plan, and not on a stand-alone basis. Many large company cash balance plans came into existence when they were converted from a standard final average pay pension.

What distinguishes them from standard DB plans is the variability of the ultimate benefit employees receive. The theoretical "account" feature resembles — but isn't technically the same — as a DC plan account.

With a cash balance plan, the employer commits to adding a fixed percentage of participants' compensation to an "account" that's, strictly speaking, more of an accounting device than an actual account as used in 401(k) plans. In addition, the sponsor credits earnings to those accounts. The interest crediting formula can be fixed, linked to an index or a combination of the two.

In recent years, regulations have given sponsors more flexibility with respect to interest crediting rates. Previously, most plans pegged their rate to rates on long-term Treasury bonds. Today, nearly as many sponsors use an "actual rate of return" crediting formula (subject to certain floors) as use the 30-year Treasury bond rate (39% vs. 44%, respectively).

Benefiting participants and sponsors

When cash benefit plan participants retire, the plan must offer them a lifetime annuity whose monthly benefits are determined by the size of the "account" balance. But vested participants also have the option of taking a lump sum distribution or IRA rollover of the accumulated "account" balance, even before retirement. Many participants see the portability feature as a big plus.

Another plus for participants is the ability to more easily understand the accrued value of their benefit, compared to a standard DB plan. Cash balance plans appeal to sponsors in that they give them a clearer view of the liabilities they're accruing over a standard DB plan. Although cash balance plan sponsors cannot back away from setting aside funds on behalf of participants as set by the plan formula, they have two fewer areas of exposure than traditional DB plan sponsors:

1. Less vulnerable to market swings. By linking the crediting rate on the account balance to an index, sponsors become less vulnerable to market swings. This assumes the sponsor invests plan assets consistently with the chosen index.

2. Monthly payment set. The size of the monthly lifetime payments at retirement is determined when the participant retires. This means, for example, that, if the cost of an annuity has risen sharply at the time a participant retires (such as because of a drop in interest rates), the sponsor isn't obliged to cover the difference between the monthly benefit that a participant might have received when annuity costs were lower, and the higher cost at the participant's retirement age. That risk is borne by the plan participant.

Looking ahead

Because you can design cash balance plans with different pay credits for distinct groups, these plans are ideal for owners wanting to make significantly higher contributions for their key executives as compared to the rest of the staff. Be sure to consult your employee benefits specialist, as the IRS rules allowing this disparity are complex. □

Compliance Alert

Upcoming compliance deadlines:

4/1* Initial required minimum distribution for participants who attained age 70½ in 2017 (applies to qualified plans where the participant is at least a 5% owner and to IRA accounts)

4/15* Deadline for corrective distribution of 2017 excess deferral failures

4/17** Deadline for filing of 2017 individual tax returns and making contributions eligible for deductibility

5/15 Deadline for filing 2017 Form 990, "Return of Organization Exempt From Income Tax"

** These due dates fall on a Sunday. The IRS historically hasn't extended due dates for required disclosures, contributions or distributions.*

*** This date reflects an extension of the normal deadline, which falls on a Sunday this year. In addition, Washington, D.C., celebrates Emancipation Day on Monday, April 16, 2018. Therefore, Tax Day is Tuesday, April 17, 2018.*

DOL increases scrutiny of defined benefit plans

Defined benefit (DB) plan sponsors might be facing tighter scrutiny from the U.S. Department of Labor (DOL). Last year the DOL's Employee Benefits Security Administration (EBSA) ramped up pension audit operations in its Philadelphia office, and later decided to do so elsewhere, the agency announced at an ERISA Advisory Council meeting.

Required statement

The focus of the audits is on DB sponsors' efforts to deliver benefits to terminated vested participants. According to EBSA's *Reporting and Disclosure Guide for Employee Benefit Plans*, plan administrators must provide a "Statement of Accrued and Nonforfeitable Benefits" to participants:

- On request,
- On termination of service with the employer, or
- After the participant has a one-year break in service.

However, only one statement is required in any 12-month period for statements provided on request.

Best practices

Timothy Hauser, EBSA's Deputy Assistant Secretary for Program Operations, offered some basic best practices for satisfying the agency's notification requirements:

- Send participants a certified letter using the participant's last known address.
- Keep good records on how to reach plan participants and relay those records to other corporate entities in a merger or acquisition.
- If mail is returned from the former employee's last known address, try calling. It's possible the phone number on record is a mobile phone that wouldn't be pinned to a previous mailing address.
- When other methods fail, reach out to former co-workers of the separated participant who might have remained in contact.

With so much information available through social media, employers should also consider using this method to find terminated missing participants.

In October 2017, the American Benefits Council submitted a letter to EBSA, requesting more detailed guidance as a result of some of its members having been harshly penalized for failure to do everything possible to find missing participants. From the DOL's perspective, a plan sponsor's failure to aggressively track down separated vested participants represents a fiduciary breach — not an accusation that any plan's sponsor would want to face in an audit.

Deficient audits

In addition, EBSA continues to focus attention on the quality of audits of benefit plans' financial records by "independent qualified public accountants." This is in response to an EBSA 2015 report after "auditing" a sampling of plan audits.

The review found "major deficiencies" with 39% of the audits it reviewed. Deficient audits were predominantly conducted by accounting firms with limited experience with this kind of audit. The takeaway from the report is that plan sponsors should carefully research an auditor's experience auditing benefit plans. ◻

Interpretation or statutory violation?

Why it matters when deciding remedies

Do ERISA plan participants who believe a plan has treated them unjustly have to exhaust their administrative remedies before filing an action in court? Last year, the U.S. Sixth Circuit Court of Appeals joined all but two other circuits in finding that plan participants don't have to do so. This may tip the scales before the remaining two federal circuits fall into line or the U.S. Supreme Court settles the matter once and for all.

Fateful plan amendment

Since 2009, the Cumberland University plan had matched employee contributions up to 5% of employee salaries. But a plan amendment in 2014 backed off that commitment, giving its trustees discretion whether to provide any matching contributions. Most notably, the amendment was retroactive to 2013.

The university emailed plan participants, telling them that its discretionary match would be zero for the 2013–2014 and 2014–2015 plan years. (It hadn't yet paid out its matching contributions for the 2013–2014 plan year at that time.) Employees responded with a class action lawsuit.

ERISA rule in question

ERISA Section 1132 governs administrative remedies. It says that employee benefit plans must "provide adequate notice in writing to any participant or beneficiary whose claim for benefits under the plan has been denied, setting forth the specific reasons" for the change. The law also requires the plan to provide an opportunity for review of that decision by a plan fiduciary.

The university asserted at the trial court level that the employee's complaint was a dispute over the denial of benefits, and covered under ERISA Sec. 1132. Thus, according to the university, the plaintiffs had failed to exhaust their administrative remedies, requiring the court to dismiss the action and require the employees to proceed administratively.

The participants, however, argued that the university's action was a statutory violation of ERISA, which didn't require administrative exhaustion. The trial court agreed with the university, and the employees appealed.

The court decides

According to the appeals court, the issue was the legality of the plan provision, not whether the plan's trustees had accurately interpreted plan provisions. In this case, there was no argument about whether trustees, in withdrawing the match, had acted consistently with the newly amended plan document.

The employees argued that the plan amendment violated ERISA's "anticutback" provision. This section gives employees the right to receive accrued benefits that cannot be decreased by an illegal plan amendment. The participants also asserted that the plan trustees had violated their ERISA fiduciary duties to safeguard participants' interests.

The appeals court found their argument convincing and concluded that participants need not exhaust administrative remedies before proceeding to federal court when they assert statutory violations under ERISA. Thus, it reversed the lower court's decision and sent it back to that court for further proceedings.

The future

What does this mean for other plan trustees and fiduciaries? Be sure to consider whether any contemplated changes to your plan are substantive enough to be challenged as an ERISA violation, rather than on grounds of plan document interpretation. Chances are, had Cumberland University's trustees not made their plan amendment retroactive, they could have avoided this dispute. ☐

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Our Story

We are committed to the success of our clients. As one of the largest California-based accounting and consulting firms, we have worked with plan sponsors and other fiduciaries to ensure their plans are fully compliant, for over 30 years.

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