

# FocusOn Call: Benefits, Compensation, and Payroll Tax Aspects of the Proposed Tax Reform Act of 2014

The ERISA Industry Committee

April 24, 2014

# Presenters

---



**Anthony Provenzano**  
*Member*



**Garrett Fenton**  
*Member*



**S. Michael Chittenden**  
*Senior Associate*

# Agenda

---

- Retirement Plans
- Health Care
- Executive Compensation
- Fringe Benefits and Employment Tax

# Retirement Plans

---

- Section 1001
- New 401(k) Plan Requirements – § 1613
- Miscellaneous Retirement Plan Changes

# Rate Reduction Has Benefit Consequences (Section 1001)

---

## Good News/Bad News

- Good news is that Reform bill consolidates 7 tax brackets into 3 (15%, 25% and 35%) and reduces highest rate from 39.6% to 35%. Also, repeals the AMT
- Bad news is that numerous items currently excludable or deductible from gross income (e.g., the cost of employer-provided group health coverage and employer and employee pre-tax contributions to defined contribution plans) get hit with a 10% surcharge which kicks in when "modified" adjusted gross income exceeds \$400K for single filers (\$450K for joint filers)

# New 401(k) Plan Requirements (Section 1613)

---

- Section 402(g) limits on elective deferrals would be cut in half – no more than 50% of the limit may be contributed pre-tax. The rest must be contributed to a Roth account
- Plans must include a Roth feature
- Small employers (100 or less employees) would be excluded from these rules

# Miscellaneous Retirement Plan Changes

---

- Section 415 limits on contributions and benefits under qualified plans would be frozen at current levels through 2024
- Repeal of the net unrealized appreciation (NUA) exclusion for distributions of employer securities
- Curtail extended payout for non-spouse beneficiaries (with limited exceptions) under employer DC plan and IRA
- DB plans allowed to make in-service distributions to participants over 59-1/2

# Miscellaneous Retirement Plan Changes

---

- Allow participants taking hardship withdrawals to continue contributions to 401(k) plan without the 6-month holdout
- Extend rollover period for terminating participants with plan loan balance
- Repeal exception to the 10% early withdrawal penalty for higher education expenses
- Simplified minimum required distribution rules



# Health Care

---

- OTC Drugs Purchased with Tax-Free Funds
- Small Employer Tax Credit
- Medical Expense Deduction
- Archer MSA
- Special Tax Rules for certain BCBS Organizations

# Health Care

---

- Repeal prohibition against tax-free HSA, FSA, and Archer MSA dollars to buy OTC drugs without Rx, effective 1/1/2015
- Repeal ACA small employer tax credit (IRC § 45R), effective for taxable years beginning in 2015
- Repeal itemized deduction for medical expenses in excess of 10% of AGI, effective 1/1/15
  - Tax exclusion for employer coverage under IRC § 105/106 unchanged
  - But tax benefit is limited for employer health plan contributions (and deductions for HSA contributions) for high-income individuals in top (35%) tax bracket

## Health Care: Continued

---

- Eliminate deduction (and employee exclusion) for Archer MSA contributions, effective 1/1/2015, but existing Archer MSA balances can continue to be rolled over tax-free to HSA
- Modify special tax rules for certain Blue Cross Blue Shield organizations (IRC § 833)

# Executive Compensation

---

- Change in “Carried Interest” rules
- NQDC
- Section 162(m)
- Excise Tax on “Excess” Compensation for Tax Exempts
- Deduction of ISO or ESPP stock payment

# Change in “Carried Interest” Rules

---

- Current rule:
  - A “profits interest” in a partnership’s underlying holdings (a portfolio company) generally not taxable at the time of grant
  - When portfolio company is sold, the payment to the executive taxed at capital gain rates
  - Proposed rule: Generally converts a portion of any gain into ordinary income

# Executive Compensation – NQDC

---

## End of nonqualified deferred compensation?

- Good news – § 409A repealed!
- Bad news – Proposed new § 409B would tax compensation when right to amount no longer subject to a substantial risk of forfeiture
- Substantially tracks § 457A regime

# Executive Compensation – NQDC

---

- Very limited exceptions:
  - Short-term deferrals paid within six months of end of year
  - Exemptions include qualified plans, bona fide disability, vacation, and leave plans
  - SARs specifically covered by rule (as with § 457A)
- Important differences with arrangements under § 457(f):
  - Earnings taxed currently
  - SROF includes only future services?

# Executive Compensation – NQDC

---

- Effective date/transition issues:
  - Effective for compensation attributable to service after 2014
  - Pre-2015 deferrals taxed upon later of 2022 or vesting
  - Plans can be amended to provide payment upon inclusion



# Executive Compensation – Section 162(m)

---

Deduction of compensation for “covered employee” limited to \$1,000,000 in any one year

- Elimination of exceptions for performance-based compensation and commissions
- Identity of “covered employee”
  - Current rule: CEO & 3 highest paid (other than CEO and CFO) at the end of the year
  - Proposed rule: CEO, CFO & 3 highest paid (other than CEO and CFO)

# Executive Compensation – Section 162(m)

---

- Duration of Covered Employee status:
  - Now extends to anyone who was a covered employee during the year
  - Deduction limitation applies to anyone who ever had the status
  - No tracking rule similar to § 162(m)(6)
- Policy considerations:
  - No consideration for pay for performance or shareholder views
  - Driven towards revenue gain

# Executive Compensation – Excise Tax on “Excess” Compensation for Tax Exempts

---

Tax-exempt organization subject to 25% excise tax on compensation in excess of \$1 million paid to any “covered employee”

- Current rule generally requires “reasonable” compensation
- Tax-exempt organization: Code § 501(c) or 501(d) organization; certain farmers cooperatives
- Covered employee includes one of the 5 highest paid employees for the year starting in 2014
- Executive retains covered employee status for life

# Executive Compensation – Excise Tax on “Excess” Compensation for Tax Exempts

---

- Compensation taxed:
  - Annual remuneration
  - “Parachute payments:” Compensation contingent upon separation from service equal or exceeding 3 times “base amount”
    - ❖ No change in control necessary
    - ❖ Borrows heavily from § 280G rules

# Executive Compensation – Deduction of ISO or ESPP stock payment

---

- Current law prevents a deduction “under § 162” for stock transferred under an incentive stock option or employee stock purchase plan
- Given specific reference to § 162, potential for deduction under 174 as a research expenditure
- Amendment to § 421 would eliminate reference to § 162 and therefore expand deduction limitation to § 174

# Fringe Benefits and Employment Tax Proposals

---

- Perks
- Deduction disallowances
- Credits
- Miscellaneous employment tax proposals
- Worker classification safe harbor

# Perks

---

- Repeal of exclusions for qualified tuition reduction (§ 117(d) and educational assistance (§ 127)
- Repeal of exclusion for qualified moving expense (§§ 132(a)(6) and 132(g)), along with repeal of the moving expense deduction (§ 217)
- Repeal of the exclusion for qualified employee achievement awards (§ 74(c)) and related deduction provision (§ 274(j))
- Limitation of value excludable as lodging provided for employer's convenience under (§ 119), i.e., \$50,000

# Perks

---

- Repeal of the “Rostenkowski” rule, i.e., exclusion for space-available air travel by employee’s parent (§ 132(h)(3))
- Freezing of exclusions for qualified parking and mass transit benefits, with no parity and no inflation adjustment
  - parking → \$250
  - mass transit → \$130
  - bicycles → exclusion in § 132(f) entirely eliminated



# Deduction Disallowances

---

- Elimination of certain above-the-line employee unreimbursed business expenses (i.e., performing artists, state and local government officials, and school teachers)
  - Rules pertaining to employee business expense reimbursements by employers are left intact
- Overhaul of § 274 deduction disallowance rules for entertainment
  - 100% disallowance for fun activities, facilities and membership dues related to such activities
  - No deduction for qualified transportation benefits and amenities

# Credits

---

- Repeal of § 45B FICA tax tip credit for hospitality employers
- Repeal of § 51 Work Opportunity Tax Credit (WOTC)
- Repeal of § 45F credit for employer-provided child care

# Selected Employment Tax Proposals

---

- Elimination of two-tier supplemental wage withholding rate regime
  - Eliminates mandatory withholding at highest rate on aggregate supplemental wages in excess of \$1 million
  - If employer elects to apply a flat rate on supplemental wages, the rate is 35% for all payments
- Repeal of FICA tax exemption for certain foreign agricultural workers, foreign students and foreign participants in international cultural exchange programs

# Selected Employment Tax Proposals

---

- In the case of student services, the FICA tax exemption for the calendar years is limited to earnings that are less than amount needed to receive a quarter's worth of coverage (currently \$1,200)
- Total override of IRS guidance exempting certain SUB pay from FICA taxation—clarification that all severance pay is subject to payroll taxation
- Statutory structure for professional employer organizations—PEO will be able to step into the common law employer's shoes for liability purposes

# Worker Classification Safe Harbor

---

- New statutory safe harbor for determining whether a worker should be classified as an independent contractor
  - IRS is precluded from retroactive reclassification
  - Sales and service criteria apply, as well as a written agreement meeting certain requirements
  - Withholding of 5% on first \$10,000 of payments to worker
  - Common law factors and § 530 relief not overridden

# Contact Information

---

For additional information, please contact:

**Garrett A. Fenton**

gfenton@milchev.com

202-626-5562

**S. Michael Chittenden**

mchittenden@milchev.com

202-626-5814

**Anthony G. Provenzano**

aprovenzano@milchev.com

202-626-1463

This presentation was prepared in connection with the Miller & Chevalier Chartered webinar – Benefits, Compensation, and Payroll Tax Aspects of the Proposed Tax Reform Act of 2014 – held on March 6, 2014. It does not provide legal advice and is not intended to establish an attorney-client relationship.

Any tax and employee benefits advice in this webinar was not intended or written to be used, and cannot be used, for the purpose of avoiding penalties.