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Top Ten Tax Compliance Risks for 2016

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Agenda

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#1 – EMPLOYER SHARED RESPONSIBILITY

4980H
ESR Penalties

- Employers face two types of play-or-pay assessments

1. 4980H(a) – Excise tax for *failure to offer coverage*
   - aka The Really Big Penalty

2. 4980H(b) – Excise tax for *offering lousy coverage*

- Good news: No concurrent liability
- Bad news: No good faith or reasonable cause exception

4980H(a)
Failure to Offer Coverage

- aka The Really Big Penalty

- Excise tax imposed if two conditions are met:
  1. Employer fails to offer minimum essential coverage (MEC) to "substantially all" full-time employees (+ dependents)
     - 70% in 2015
     - 95% in 2016 and beyond
  2. At least one full-time employee receives a premium tax credit to buy insurance on a public health exchange

- Minimum essential coverage (MEC) = basic medical
  - Preventive care
  - No annual or lifetime limits on essential health benefits

- Penalty = $2,000 times **total** number of FT employees

4980H(b)
Offering Lousy Coverage

- Excise tax imposed if employer offers coverage that lacks "minimum value"
  - Minimum Value = Employer cost of coverage must be at least 60% of the total
    - Includes contributions to HSA or HRA, wellness incentives
    - Must cover physician services and in-patient hospitalization

- Excise tax imposed if employer offers coverage that is not "affordable"
  - Affordable = Employee cost of self-only coverage must not exceed 9.5% of income
    - Form W2 safe harbor – current year
    - Rate-of-pay safe harbor
    - Federal poverty level safe harbor – 9.5% of $11,670

- Penalty = $3,000 times number of FT employees who meet two conditions:
  1. They are not offered affordable employer-sponsored coverage with a minimum value of at least 60%
  2. They receive premium tax credits to buy insurance through a public health exchange

#2 - CLAWBACKS

Clawbacks: The Basics

- Proposed SEC rules require public companies to recover excess incentive-based compensation in the event of a material accounting restatement
  - Current and former executives
  - Regardless of fault
  - Limited discretion by issuer
  - Must file clawback policy as exhibit to SEC Form 10-K
- Affects all issuers with listed securities
  - Including foreign private issuers, emerging growth companies
- Failure to comply → delisting by stock exchange
- Effective date: Late 2016 at earliest

Clawbacks: The Details

- Executive Officers (current and former)
  - President, PFO, PAO
  - VP in charge of principal business unit, division, function
  - Any other person who performed similar policy making functions

- Incentive-Based Compensation: Any compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure
  - Not salary
  - Not bonuses unless tied to financial reporting measure
  - Not equity awards based solely on continued employment

- Time Period: Three completed fiscal years immediately preceding date you are required to prepare a restatement
  - Not 36 months preceding restatement
  - Deemed received in fiscal period during which financial reporting measure is attained, even if payment occurs later

Clawbacks: The Issues

- Easy things:
  - Determining who's an Executive Officer – same as Section 16 officer
    - 3-year history resides in public SEC filings
  - Determining what is incentive-based compensation
  - Recovering funds from active employees
- Hard things:
  - Deciding to do a restatement
    - Clawback requirements will likely figure into the analysis
  - Recovering funds from:
    - Former employees
    - Non-US active or former employees (many jurisdictions prohibit clawbacks)
    - Employees who had no involvement in financial matters, and who are blameless
    - Compare: Many employers already apply clawback clauses in cases of breach of contract or violation of non-compete agreements
  - Recovering funds from anyone for amounts paid in previous years

Clawbacks: Unintended Consequences

- Possibly fewer restatements
  - Although the number of restatements has dropped dramatically in the years since Dodd-Frank was first passed
- Bonus and incentive compensation arrangements may be revised to contain metrics other than financial statement metrics and TSR
  - Examples: customer satisfaction, employee engagement, quality assurance, diversity hiring, etc.
  - Metrics need to be objectively determinable to qualify for deductibility under Section 162(m)
- Pressure on companies to compensate executives (active employees, anyway) in other ways or in subsequent years for compensation clawed-back
- Development of tax-practice on taxation of clawbacks

#3 – PBGC REPORTABLE EVENTS

What Is A Reportable Event?

- Change in controlled group
- Active participant reduction
- Transfer of benefit liabilities
- Extraordinary dividend
- Distribution to substantial owner
- Missed required contribution
- Application for minimum funding waiver
- Inability to pay benefits when due
- Insolvency
- Loan default
- Liquidation

- Employers must notify PBGC of various events that may signal a financial problem or put a pension plan at risk
- Deadline: Generally 30 days after event
  - Advance reporting may be required for some privately-held companies

Reportable Event Waivers

- PBGC has added three new waivers for "blue" events
  1. Low-default risk waiver
     - Based on company financial metrics
  2. Well-funded plan waiver
  3. Public company waiver

- Original waivers still apply
  4. Small plan – blue events only
  5. De minimis segment
  6. Foreign entity

- Effective January 1, 2016

"Low Default Risk" Waiver

- Company can demonstrate adequate capacity to meet obligations in full and on time

- Both company <u>and</u> highest level parent must satisfy four of seven criteria (or just the first two) during annual financial reporting cycle:
  - Probability of default on financial obligations is no more than 4% over five years, or 0.4% over next year (credit score)
  - Secured debt does not exceed 10% of asset value
  - Ratio of total debt to EBITDA is 3.0 or less
  - Ratio of retained earnings to total assets is 0.25 or more
  - Positive net income for two most recent completed fiscal years
  - Not experienced any loan default event in past two years
  - Sponsor has not experienced a missed contribution in past two years unless reporting was waived (i.e., made up within 30 days)

Well-Funded Plan & Public Company Waivers

- Well-Funded Plan Waiver
  - The plan owes no variable rate premium for the plan year preceding the year in which the event occurred
  - e.g., If 2016 premium filing is due 10/15/16, then waiver would apply to all events occurring in 2017
- Public Company Waiver
  - Any contributing sponsor is a public company
  - Company has *previously disclosed the event* in a timely-filed SEC Form 8-K
    - Not counting disclosure under Item 2.02 (results of operations and financial conditions) or Item 9.01 (financial statements and exhibits)

#4 – 401(K) FEES

401(k) Fee Litigation

- Claims against plan sponsors for fiduciary breach
  - First generation cases claim that plan sponsors allowed service providers to receive revenue sharing payments, which caused participants to pay excessive fees
  - Newer cases involve challenges to:
    - Selection of more-expensive actively managed funds as plan investment options (versus index funds)
    - Use of retail share classes
    - Investment and transaction draft associated with unitized stock funds
    - Use of a bundled service provider
- Claims against service providers as functional fiduciaries due to authority over fund selection

401(k) Fee Litigation - Trends

- Recent survey reports that 401(k) plan fees have dropped over the past few years
  - Fee reductions attributed to:
    - Better awareness and negotiation on the part of employers
    - Providers subject to greater scrutiny, so now provide (somewhat) greater transparency
- Still difficult for small and mid-sized employers to have any bargaining power –
    - Still very little benchmark data – almost as bad as shopping for health care
    - RFPs are time-consuming and expensive
    - Some of the larger service-providers won't even bid on services to be provided to smaller plans
- U.S. Department of Labor (DOL) still is active in auditing plan expenses, especially for companies that perform administrative services in-house and charge the plans

#5 – DETERMINATION LETTERS

End of the DL Program

- IRS largely abandons DL program
  - IRS Ann. 2015-19
  - Effective January 1, 2017
    - Last filers: Cycle E (by 1/31/16) and Cycle A (by 1/31/17)
  - DLs available only for new plans or terminations

- Increase employer's risk of sanctions on audit or plan disqualification

- New challenges for verifying plans' tax-qualified status
  - Auditors
    - Will seek assurances from management
  - M&A counterparties
    - Will seek enhanced reps and warranties
    - Integration of acquired company plans may be an issue
  - Rollovers
    - Will need to check Form 5500 of distributing plan prior to accepting rollover
  - Investment managers
    - Will seek assurances from management
    - Eligibility for certain investment vehicles, such as group trusts

Alternatives to the DL Program

- Increased burden on employers
  - Employers must amend in timely manner
  - IRS will not review plan document
  - Employer assumes risk of deficient amendments
  - No penalty-free opportunity to fix problems during extended remedial amendment period
  - Greater risk of sanctions on audit
  - Stifle innovation in plan design
- Alternatives:
  - Opinion from legal counsel re tax-qualified status
  - Improve internal controls
  - IRS model amendments
  - Prototype plan documents

#6 – STOCK DROP LITIGATION

Stock Drop Litigation

- Stock Drop cases typically involve claims for breach of fiduciary duty in connection with a plan's investment in employer stock

- *Fifth Third Bancorp v. Dudenhoeffer*: Supreme Court rejects presumption of prudence, but holds that actions based on over- or undervaluing the stock are generally implausible, in the absence of special circumstances
  - Having Court strike down the presumption of prudence seems like a loss for employers, but the new standard might make these cases more difficult to win

- Similar claims dismissed
  - *Smith v. Delta Air Lines* (11th Cir. 2015)
  - *Taveras v. UBS* (2d Cir. 2015)
  - But see *Harris v. Amgen* (9th Cir. 2014) (reversing dismissal)

Stock Drop Litigation – What's Next for Employer Stock Funds

- Trend in employers imposing plan-based limits on % of assets that can be invested in employer stock
  - Most common percentage limit is 20%
  - This doesn't protect completely against stock-drop cases, but it is protective of employees, and does reduce total employer exposure in those cases
- Does <u>not</u> seem to be any trend toward elimination of employer stock funds entirely
  - Large provider of independent fiduciary services reports that only one of its 82 clients has eliminated its stock fund
  - Exception: Legacy employer stock funds (due to spin-off or other corporate transaction) are now typically terminated/sunset within a year

#7 – WELLNESS PROGRAMS

Wellness Programs

- New EEOC regulations address ADA
  - ADA bans disability-based discrimination, but allows voluntary inquiries
  - Not a safe harbor
- Less flexible than existing HIPAA guidance
  - HIPAA bans health plans from discriminating in eligibility, premiums or benefits on basis of "health factors"
    - Program incentives up to 30% ok
    - Program incentives up to 50% ok for smoking cessation
    - No limit if incentive is awarded regardless of outcome
    - Financial rewards include gift cards, premium discounts, employer contributions to HRA/HSA/FSA
- No guidance under GINA
  - GINA bans misuse of genetic information

Wellness Programs

- Disability-related inquiries or medical exams
  - Questionnaires as part of health risk assessment
  - Biomedical screenings (e.g., cholesterol or diabetes tests)
  - Employees must receive detailed notice
- EEOC standard for employer wellness programs
  - Must promote health or prevent disease
  - Must offer reasonable accommodations so individuals with disabilities can participate
  - Must be voluntary
  - Must share only aggregate data with employer
  - Must have reasonable design
- Incentives now limited to 30%

#8 – CODE SECTION 162(M) COMPLIANCE

Code Section 162(m)
The Basics

- Code section 162(m) generally disallows a deduction for annual compensation in excess of $1M to a covered employee
  - Principal executive officer (CEO)
  - Three highest paid executive officers (other than CFO)

- Two exceptions:
  - Qualified Performance-Based Compensation Exception
  - IPO Exception

Code Section 162(m)
Qualified Performance-Based Compensation Exception

- Qualified Performance-Based Comp is exempt from the $1M deduction limit
  - Stock options and SARs automatically qualify if:
    - Approved equity plan *must include a per-employee limit* on number of options or SARs that may be granted
    - Plan can specify an aggregate number of shares underlying all equity-based awards that may be granted to each individual employee during a specified period
    - IRS rejects the view that an *aggregate limit* of shares reserved for issuance will satisfy this condition
    - These are standard equity plan terms, and should always be part of any equity plan
  - Effective June 24, 2011 – not considered a change

Code Section 162(m) IPO Exception

- For newly-public companies, the $1M deduction limit does not apply to compensation "paid" under a plan that pre-dates the IPO
  - Prospectus accompanying IPO must disclose existing arrangements
  - Valid during transition period only, ending upon earliest of:
    - Expiration of plan
    - Material modification of plan
    - Issuance of all stock or other comp under the plan
    - First annual shareholders meeting to elect directors that occurs after close of third calendar year following IPO year
  - Stock options and SARs: Amounts will be treated as "paid" on grant date
    - Excluded if *granted* during transition period before IPO
  - RSUs and phantom stock arrangements: Amounts will be treated as "paid" when actually settled or paid
    - Excluded only if *paid* during transition period
    - Effective prospectively, for arrangements issued on or after April 1, 2015

Code Section 162(m)
IPO Exception – in Practice

- For most newly-public companies, 162(m) will begin to apply as of the first annual meeting to elect directors that occurs after close of third calendar year following IPO year
  - Example: Company with calendar year IPOs in March 2014
    - 162(m) will begin to apply in spring of 2017
  - Overwhelming majority of newly-public companies don't come close to hitting the 162(m) limit by the time it begins to apply anyway
- Standard proxy disclosure item:
  - Don't promise any element of compensation will be deductible
  - Only that Compensation Committee considers deductibility as part of its deliberations

Code Section 162(m)(6) – New Limit for Health Insurance Providers

- Goal: Prevent health insurers from getting a tax benefit from higher levels of executive pay that may arise due to increased revenues expected to result from minimum coverage requirements
  - Translated: Insurance companies will be receiving more revenue (and presumably, making more profit) due to Obama-care, but they shouldn't be getting a big tax break if they're paying their executives a lot of money
- Reduces deductible limit from $1M to $500K
- Applies to "covered health insurance providers," subject to controlled group aggregation rules
  - Exception for self-insured plans
  - 2% de minimis exception may cover captive insurers
  - Generally does not apply to reinsurers
- Applies to both public and private companies
- Applies to all employees and service providers, not just CEO + 3
- No "performance-based" pay exception, no exception for stock options
- Different timing rules for taking amounts into account
- "Revenue raiser" that could be applied more broadly as part of tax reform legislation

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#9 – LOCAL LODGING

Local Lodging

- Normally, lodging expenses incurred by employee while <u>not</u> traveling away from home are considered personal expenses under Code section 262(a)
  - Not deductible
- IRS final rules create new exception for local lodging
  - Deductible as ordinary and necessary business expense under Code section 162
  - Excludible as working condition fringe benefit under Code section 132
  - Reimbursement is excludible under accountable plan
  - Facts and circumstances test, or safe harbor

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Local Lodging
Facts & Circumstances Test

- Lodging must be for business purpose
  - Not primarily social or personal benefit
- Lodging must not be lavish or extravagant
- Lodging must be due to "bona fide condition or requirement of employment" imposed by employer
  - Examples:
    - Employees required to stay at local hotel during work-related training session
    - Professional athletes required to stay at local hotel before home game
    - Employee who is relocating for work and looking for a new home
    - Employee who has to stay at a hotel near the office while working long hours
    - Employees who are occasionally on call for night duty shift

Local Lodging Safe Harbor

- Under safe harbor, an employee's local lodging expenses will be treated as deductible ordinary and necessary business expenses if:
  - Lodging is necessary for employee to participate fully in or be available for bona fide business meeting, conference, training activity, or other business function
  - Lodging does not exceed five calendar days
  - Lodging does not recur more than once per calendar quarter
  - Employer requires employee to remain at the activity or function overnight
  - Lodging is not extravagant or lavish and does not provide a significant element of personal pleasure or recreation

#10 – 401(K) FUND MAPPING

401(k) Fund Mapping

- Mapping occurs when a participant's investment in a fund is transferred to a different investment option, absent direction from the participant
  - Examples: an investment option is removed from the plan, or two plans are merged together (a target's 401(k) plan is typically merged into the acquirer's plan following the target company's acquisition)
- Employers usually map "like-to-like" – or default to the plan's "qualified default investment account" fund ("QDIA")
  - Like-to-like is more employee-friendly and not terribly difficult now that many plans now have fairly similar line-ups
  - QDIA is the default option, and 404(c) regulations provide some protection for this alternative
  - Best practice: Send two notices before, and a reminder notice after transfer has occurred

401(k) Fund Mapping

- But see: *Tussey v. ABB*: Eighth Circuit held that plan fiduciaries abused their discretion when they mapped participant investments from a balanced fund to a managed allocation fund
  - Decision to map funds was motivated in large part to benefit the trustee and plan sponsor, rather than participants
    - Improper cross-subsidization agreement where trustee was overpaid for providing trust services to the plan, in exchange for providing administrative services to the plan sponsor at a loss
  - Court declined to award damages
    - Investment policy allowed managed allocation fund
    - Plaintiffs failed to present evidence regarding performance of similar funds
- Lesson to be learned: Evaluate fund costs as part of the fund mapping exercise
  - If the fund into which accounts are being mapped has higher costs than the fund from which the accounts are coming, ensure higher cost is justified by increased services, greater performance, etc.

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