

# COMPENSATION AND BENEFITS NEWSLETTER



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## FICA TAXATION OF NONQUALIFIED DEFERRED COMPENSATION PLANS

As payroll departments prepare for year-end reporting, it may be useful to review two IRS memos released in 2017 concerning FICA (social security and Medicare) taxes imposed on nonqualified deferred compensation ("NQDC"). The first memo released in January addresses the IRS' unwillingness to enter into closing agreements to protect employers who mishandled the FICA "special timing" rule. The second memo released in June addresses the application of the special timing rule for nonaccount balance NQDC plans. We summarize both guidance in a two-part article below.

## PART I - IRS DECLINES ENTERING INTO CLOSING AGREEMENT TO PROTECT FICA SPECIAL TIMING RULE

In a memo released in January 2017 (AM2017-001), the IRS National Office was asked whether the IRS should enter into closing agreements with employers that had not timely included NQDC as wages in the year of vesting for FICA purposes, and are willing to pay the tax due (along with interest and penalties) even though the year is closed for assessment under the period of limitations. The memorandum concludes that IRS agents should not enter into closing agreements with these employers since the regulations already provided three years for them to correct the taxes that were due in the year of vesting.

### Consequences of non-compliance with FICA special timing rule; motivation to enter into a closing agreement

Amounts deferred under a NQDC plan are subject to both a "special timing" rule and a "non-duplication" rule for FICA purposes. Under the special timing rule, deferred amounts are generally treated as wages for purposes of FICA taxes when the deferred compensation is no longer subject to a substantial risk of forfeiture (i.e., upon vesting). Under the non-duplication rule, once an amount is taken into account as wages for FICA purposes, neither that amount nor any subsequent earnings is treated as wages for purposes of FICA tax in any future year.

These rules generally result in less total FICA tax being paid than if the FICA taxes were paid under the "general timing" rule at the time the benefits were distributed. The social security portion of FICA tax is only imposed on wages up to the social security wage base. The employee often has other wages in the vesting year that equal or exceed the social security wage base, thereby making Medicare tax (and possibly the Additional Medicare tax) the only tax liability for such year. Also, less FICA tax is imposed because the future earnings on the amounts deferred avoid FICA tax pursuant to the non-duplication rule.

In contrast, paying FICA tax at the time of distribution under the "general timing" rule, rather than the year vested under the special timing rule, often results in more FICA tax being paid. To the extent the employees are retired at distribution, they are less likely to have other wages equal to or greater than the social security wage base for that year; thereby subjecting all or a portion of the distribution to social security tax as well as Medicare tax. This adverse tax consequence is amplified for employees who receive their deferred compensation in annual installments since the social security wage base must be satisfied multiple times, often resulting in the entire balance being subjected to social security taxes. Further, more FICA tax

is imposed because all earnings on the amounts deferred are also subject to FICA tax.

In addition, the case of *Davidson v. Henkel Corporation (2015)* highlights potential employer liability under ERISA to NQDC plan participants if benefits are not taxed in the most favorable manner. In *Davidson*, the employer maintained a NQDC plan, but did not follow the special timing rule. As a result, plan participants experienced a reduction in net benefits due to the increased FICA taxes they incurred with respect to those benefits. The participants brought a successful class action suit under ERISA seeking to recover the benefits they lost as a result of the employer's failure to withhold FICA tax pursuant to the special timing rule.

### IRS memo advising agents to decline requests for closing agreements

The tax regulations describe the steps to be taken if an employer fails to use the special timing rule under a NQDC plan. The employer may adjust its employment tax returns for any year for which the period of limitations has not expired to report and pay the additional FICA taxes attributable to the amounts deferred and required to be included under the special timing rule. For closed years, however, the general timing rule will apply.

To reinforce the importance of adhering to the special timing rule and its correction methods, the IRS National Office advised that it is not appropriate for the IRS to enter into a closing agreement in situations where employers did not timely take NQDC into account for FICA purposes and the period of limitations has closed.

### Action Items

To avoid paying significantly higher FICA taxes and potential employer liability under ERISA for not taxing the participants' benefits in the most favorable manner, employers should ensure that account balances under NQDC plans are subject to FICA taxes at vesting. Upon any failure to timely include the deferred compensation in income for FICA purposes, remedial action should be taken immediately before the 3-year period of limitations closes.

While the point of FICA taxation (i.e., the vesting date) on most deferred compensation may be readily determinable (e.g., a specified date or event), the vesting date of some provisions may not be as apparent (e.g., a "Rule of 60" provision where vesting occurs on the date in which the participant's age plus years of service equals 60). The plan administration and payroll systems should be customized to recognize the vest date and trigger the FICA tax liability.

## PART II - APPLYING THE FICA SPECIAL TIMING RULE TO NONACCOUNT BALANCE PLANS

In a memo released in June 2017 (AM2017-0012), the taxpayer questioned why his employer paid FICA taxes on the present value of the annuity payments in the year he began receiving distributions under the NQDC plan. The IRS National Office confirmed the employer's method of withholding and paying FICA taxes on amounts deferred under the NQDC arrangement was proper.

The NQDC arrangement addressed in the memo was a nonaccount balance plan, which does not credit deferred amounts to a particular participant's individual account. Under a special rule for nonaccount balance plans, an employer is permitted to delay subjecting the deferred compensation to FICA taxes until the amount is considered "reasonably ascertainable." Reasonably ascertainable is defined as the first date on which the amount, form, and commencement date of the benefit are known, so that its present value can be computed. When the present value of a benefit becomes reasonably ascertainable, such amount is subject to FICA tax.

The IRS National Office confirmed the employer's method of withholding and paying FICA taxes on the present value of the payments upon the first distribution amounts deferred under the NQDC arrangement was proper.

### Action Items

Employers should determine when nonaccount balance plans become reasonably ascertainable for purposes determining the present value of a participant's benefits and withholding and paying FICA taxes on the amount at such time. Under some nonaccount balance plans, retirement benefits become reasonably ascertainable at the time of retirement. Notably, the present value calculation does not consider the probability that an employer will not make payments because of the unfunded status of the plan. Nor does it consider the risk associated with any deemed or actual investment of the amounts deferred under the plan, or similar risks or contingencies.



# IRS CLARIFIES RULES ON EMPLOYEE DISCOUNTS OFFERED TO FRIENDS AND FAMILY

In a Field Attorney Advice Memorandum released by the IRS on March 24, 2017, the IRS addressed the tax consequences of a fringe benefit program where a company allowed its employees to designate a limited number of individuals, without regard to their relationship to the employee, to rent property at a discount. While your facts may differ from these, this guidance helps clarify how the employee discount rules should be applied.

## QUALIFIED DISCOUNTS IN GENERAL

Under Section 132(a)(2) of the Code, gross income does not include the value of a “qualified employee discount.” A qualified employee discount is a discount provided to an employee on qualified services or property that does not exceed a threshold amount. The threshold amount for property is determined by the employer’s profit. For services, the threshold amount equals 20% of the price at which the services are offered by the employer to its customers. Any discount exceeding the threshold is taxable income to the employee. To be qualified, the services or property (excluding real estate or investment property) must be offered for sale to customers in the ordinary course of the employer’s business in which the employee normally works. The definition of “employee” for this purpose includes: (i) current and retired employees; (ii) employees who separated from service due to a disability, (iii) widows, and (iv) spouses and dependent children.

## IRS MEMO CLARIFYING QUALIFIED EMPLOYEE DISCOUNT RULES

The IRS memo addresses three issues:

### 1. Whether the discount is on services or property for purposes of determining the applicable threshold in which employee discounts are taxable?

While the heavily redacted memo does not reveal the nature of the employer’s business, one can glean that the employer is in the business of renting property. Based on the facts, the IRS concluded that the rentals should be characterized as the sale of a service and the qualified employee discount could not exceed 20% of the rental price offered to the employer’s customers. Accordingly, the employer is not treated as selling property, in which the qualified employee discount would be measured by its profits.

## 2. Whether the entire program is tainted by the inclusion of non-employees or whether the qualifying discounts provided to "employees" (as defined by the statute) continue to be excludible under Section 132(a)(2)?

The IRS concluded that the nontaxable benefit only applies to persons who fall within the definition of "employee" (e.g., current and retired employees, spouses and dependent children). However, the value of any discount provided to an individual who does not fit within the definition of "employee" for this purpose is taxable income to the employee who designated such individual. Accordingly, extending the discount to nonemployees does not adversely affect the discounts available to employees.

## 3. Which offering price should be used to measure the employee discount – the employer's published rate or the discounted price provided to discrete customers or consumer groups?

Nontaxable qualified employee discounts on services cannot exceed 20 percent of the price at which services are offered by the employer to the employer's customers at the time of the employee's purchase. The offering price used to determine the 20 percent limit can take into account discounts offered to discrete customers or to consumer groups, provided the sales at such discounted prices comprise at least 35 percent of the employer's gross sales for a representative period. Since the employer failed to provide sufficient information to determine whether the 35 percent standard was satisfied, the memo concludes that the employer's published rates must be used as the basis for determining the taxable excess discount.

Notably, the discounted price could have resulted in less taxable income. Assume, for example, an employer sells services to an employee for \$70 that is ordinarily sold to its customers for \$100 (a 30 percent discount). The employer would report \$10 taxable income to the employee (\$30 discount less the \$20 limit). Assume further, that the employer sells its services to discrete customers for \$90 (a 10 percent discount), which represents more than 35 percent of its gross sales. The employer would report \$2 taxable income to the employee (\$20 discount less the \$18 limit).

Presumably, this method may also be used to determine the amount to include in an employee's income for discounts provided to the employee's friends.

## ACTION ITEMS

While it is favorable that the extension of discounts to the employees' friends as well as their family members does not make all discounts taxable, such a design diminishes the value of the program to the employees and complicates plan administration for the employer.

From an employee's perspective, the value of the discounts provided to the employee's friends will be treated as additional wages in which taxes on such benefits must be withheld from the employee's paycheck; while the friends enjoy the fringe benefits without incurring any tax liability. If an employer extends its "qualified employee discount" program to non-employees, it should notify the employees about the tax consequences of designating such individuals to participate in the program.

From the employer's perspective, additional employment taxes attributable to the discounts provided to the employees' friends will be incurred by the employer. Plan administration also becomes more burdensome since an employee's relationship with each person designated to participate in the discount program must be tracked so that the employee's taxable income can be properly calculated, reported and withheld upon.

For administrative simplification, employers may wish to limit their "qualified employee discount" programs to active employees, retirees, and their spouses and dependent children to avoid having to identify nonemployees participating in the program and imputing income to the employees for their use.

Further, if the employee's discount is based on a discounted price provided to discrete customers or consumer groups, rather than the published rates, the employer should maintain records that (i) establish that 35 percent of the employer's sales are comprised of discounted rates given to such customers, and (ii) show each group's discount and the percentage of sales that each group contributes to the total sales. Absent such showing in an audit, the IRS agents are instructed to base the employee's discount off of the published rates, which may result in higher income inclusion for the employee.

# AVOIDING ACA EMPLOYER AND INDIVIDUAL PENALTIES FOR EXPATRIATES

The Affordable Care Act (“ACA”) requires individuals to have qualifying healthcare coverage (“minimum essential coverage”) for each month, qualify for an exemption from coverage for the month, or pay a penalty when filing their federal income tax return.

By a letter released June 30, 2017 (AM 2017-0011), the IRS addressed the application of this individual mandate where an individual moved from Germany to Florida in 1998 for reasons unrelated to work, and has since continued her health insurance coverage solely under the German healthcare system. The IRS concluded that the German healthcare system does not constitute an expatriate health plan that is deemed to satisfy minimum essential coverage and the individual does not qualify as an expatriate. Accordingly, the individual is subject to ACA penalties for failure to maintain minimum essential coverage, unless another exemption applies.

The IRS findings bear a review of the proposed regulations issued in June 2016 regarding the elements necessary for an individual to qualify as an expatriate and an employer’s plan to qualify as an expatriate health plan for purposes of avoiding ACA penalties for both employers and their employees.

## QUALIFIED EXPATRIATE HEALTH PLANS

The Expatriate Health Coverage Clarification Act of 2014 exempts expatriate health plans from complying with many healthcare reform requirements, provided several conditions are met. In particular, expatriate health plans must provide coverage that meets certain standards:

- ▶ Provide “minimum value”;
- ▶ Cover inpatient hospital services, outpatient facility services, physician services, and emergency services in the US and the countries where the individual is transferred;
- ▶ Offer coverage to dependent children until age 26; and
- ▶ Satisfy other standards to ensure that coverage is administered by an expatriate health insurance carrier or expatriate health plan administrator with international operations.

To qualify as an expatriate health plan, substantially all of the primary enrollees (e.g., employees of the plan sponsor) must

be “qualified expatriates.” A plan satisfies this requirement only if, on the first day of the plan year, at least 95% of the primary enrollees are qualified expatriates.

## QUALIFIED EXPATRIATES

Generally, qualified expatriates must fit into one of the following categories:

- ▶ Workers in the US (“Inpats”): Individuals (i) whose skills, qualifications, job duties or expertise caused the employer to temporarily transfer the individual to the US; (ii) who are reasonably determined to require access to health insurance coverage in multiple countries; and (iii) to whom the employer periodically offers other multinational benefits (e.g., tax equalization and compensation for cross-border moving expenses).
- ▶ Workers outside the US (“Expats”): Nationals of the US who work outside the US for at least 180 days in a consecutive 12-month period that spans across two consecutive plan years.

## EXPATRIATE PLAN RELIEF AND COMPLIANCE

Coverage under an expatriate health plan counts as minimum essential coverage for both the individual mandate to maintain minimum essential coverage and the employer mandate to offer the requisite coverage to substantially all of its full-time employees. The proposed regulations also relieve expatriate health plans from compliance with the healthcare reform mandates (e.g., no lifetime or annual limits, no preexisting condition exclusions, limited waiting periods before commencing coverage, coverage of preventive health services). In addition, expatriate health plans are exempt from the Patient Centered Outcome Research Institute (“PCORI”) fee and the transitional reinsurance fee.

Notably, the Affordable Care Act information reporting (Form 1095 series) is required; although to facilitate furnishing statements to individuals covered by an expatriate plan, such recipients are treated as having consented to electronic statements unless they explicitly refuse.

The proposed regulations may be relied upon for plan years beginning on or after January 1, 2017.

# IRS RELEASED 2017 ACA INFORMATION RETURNS

Notwithstanding executive orders signed by the President and ongoing efforts to repeal and replace the Affordable Care Act (ACA), the reporting requirements still apply for 2017 with the first due date on January 31, 2018. Coverage providers and applicable large employers (ALEs) should continue their efforts to prepare the filings for the 2017 year (due in early 2018).

Providers of healthcare coverage, including employers with self-insured health care plans that are not ALEs must report the individuals (and their spouses and dependents) covered under the plan on Form 1095-B with transmittal Form 1094-B (B Forms), which are used to enforce the individual mandate. ALEs must use Form 1095-C and transmittal Form 1094-C (C Forms) to report information relevant to the employer shared responsibility penalties and the premium tax credits, as well as to report employees (and their spouses and dependents) covered under the employer's self-insured health care plan.

The IRS released the 2017 B Forms and C Forms, which seem to have little to no changes from the 2016 forms, as summarized below:



Form	Purpose	Change
1094-B	Transmittal for Form 1095-B	Unchanged
1095-B	Health coverage information	Unchanged
1094-C	Transmittal for Form 1095-C	"4980H Transition Relief" removed from Line 22. This expired provision temporarily granted ALEs with fewer than 100 full-time employees and equivalents penalty relief.
1095-C	Employer-provided health insurance offer and coverage	Unchanged

The first penalty notification will begin late in 2017 based on the 2015 Forms 1094-C, 1095-C and premium tax credit information. ALEs will be notified of their potential liability for an employer shared responsibility payment in Letter 226J. If you receive a Letter 226J, the information should be reconciled to the employer's records to determine if the proposed penalty is correct.



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