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COMPENSATION AND BENEFITS NEWSLETTER

457A: 2017 DEADLINE TO PAY TAX ON CERTAIN OFFSHORE DEFERRED COMPENSATION

If you have a deferred compensation arrangement with an offshore employer located in a tax haven jurisdiction, you should be aware of an upcoming deadline of December 31, 2017 for compensation earned during 2005-2008 but not yet paid to you.[1]

BACKGROUND

Employees of US companies who defer compensation outside of a tax-qualified plan (e.g., a 401(k) plan) enjoy the tax benefit at the expense of the employer, which must wait until the amounts are paid before claiming a corresponding deduction. By contrast, offshore employers located in non-tax jurisdictions can provide deferred compensation to their US employees and suffer no economic consequences, since the timing of the deduction for the related compensation is not relevant when the employer does not have any tax liability. In absence of the *quid pro quo* relationship among US employees and such tax-indifferent employers, Section 457A is intended to promote parity among US taxpayers by eliminating the ability to defer compensation from these offshore employers.

1 Deferred amounts that were earned and vested in a taxable year before 1/1/2005 are not subject to 457A under its grandfather provision and can be paid in accordance with the originally schedule date, provided the arrangement was not materially modified after 10/3/2004

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DEVELOPMENT

Pursuant to Section 457A, deferrals attributable to services performed after 12/31/2004 and before 1/1/2009 must be included in your US taxable income no later than 12/31/2017. Plans that initially provided for payment after 2017, should have been amended by 12/31/2011 to establish a new distribution date that conforms with Section 457A. If your plan was not timely amended by 12/31/2011 and distribution (or income inclusion) is still scheduled to be made after 2017, the deferred amount is in violation of Section 457A and subject to a 20% additional tax and premium interest charge. Upon any untimely attempt to comply with 457A by changing the distribution date to fall within this year, the same penalties would still apply, but under Section 409A instead – Section 457A's sibling that broadly governs all nonqualified deferred compensation arrangements. Section 409A generally prohibits accelerating distributions prior to the originally scheduled payment date.

After 2008, compensation earned from an offshore employer in a non-tax jurisdiction generally cannot be deferred beyond 12 months following the end of the taxable year in which vesting occurred, otherwise Section 457A requires income inclusion on the vesting date and imposes a 20% additional tax and premium interest charge (at the underpayment rate plus one percent). Whereas, compensation paid within 12 months after the end of the employer's taxable year in which such payment is vested is exempt from Section 457A under a short-term deferral exemption. For example, assuming the offshore entity has a fiscal year ending on December 31 and the 2016 incentive compensation was vested on 12/31/2016, such incentive compensation must be paid not later than 12/31/2017 to be exempt from Section 457A and avoid the additional 20% tax and premium interest charge. For purposes of Section 457A, vesting must be conditioned upon the future performance of substantial services only; an employee's compensation is treated as vested if such person's right to compensation is subject to a performance-based condition only.

ACTION ITEMS

The IRS provides complex guidance (Notice 2009-8) with respect to the application of Section 457A. Parties to deferred compensation arrangements should ensure that (i) the service provider's right to compensation is conditioned upon the future performance of substantial services (i.e., a service-based condition and not a performance-based condition); (ii) such compensation is paid within Section 457A's 12-month short-term deferral period; and (iii) any outstanding deferrals related to services performed prior to 2009 are to be distributed by end of this year in accordance with the plan amendment adopted by 12/31/2011 to conform with Section 457A (or, if grandfathered, in accordance with the originally scheduled payment date/event).

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PLAN SPONSORS SHOULD REVIEW PROCEDURES FOR HARDSHIP WITHDRAWALS

Plan sponsors should keep records that align with the IRS' expectations for hardship withdrawals from qualified plans as described in a February 23, 2017 IRS memorandum to its employee plan examiners. The memo provides instructions on the types of documentation that should be requested during an IRS audit to evaluate whether in-service distributions were allowed under the hardship withdrawal rules.

401(k) plans may allow participants to withdraw from their retirement accounts prior to separation of service because of a financial hardship. To qualify for a hardship withdrawal, a participant must show the withdrawal is "necessary" (a needs test) to meet an "immediate and heavy financial need" (an events test). While the regulations do not specify the substantiation requirements, the IRS' Employee Plans News previously provided informal guidance in 2009 and 2015.

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The 2009 guidance broadly requires a statement or verification of the employee's hardship. The 2015 guidance indicates that the plan sponsor or administrator must obtain and preserve financial information and documentation that substantiates the need for the hardship withdrawal. Further, the practice of self-certification, whereby administrators allow participants to self-certify that they satisfy the criteria to receive a hardship distribution, is only permitted to satisfy the needs test (i.e., the distribution was the sole method of alleviating the hardship). However, self-certification is not allowed to demonstrate satisfaction of the events test. Instead, the plan sponsor or administrator must obtain documentation to show the nature of the hardship. Notably, document retention is the responsibility of the plan sponsor.

The 2017 IRS memorandum indicates that plan sponsors and administrators should follow either of two substantiation procedures upon receiving a hardship withdrawal request: source documents or employee summary.

Source documents. The plan sponsor or administrator should request actual documents (such as estimates, contracts, bills or statements from their parties) and review those documents to verify that they support the requested hardship withdrawal.

Employee summary. If the plan relies on an employee's summary of the information contained in source documents, the plan sponsor or administrator must first issue a notice to the participant advising the following:

- The hardship distribution is taxable and additional taxes could apply.
- The amount of the distribution cannot exceed the immediate and heavy financial need.
- Hardship distributions cannot be made from earnings on elective contributions or from QNEC or QMAC accounts.
- The recipient agrees to preserve source documents and to make them available at any time, upon request, to the employer or administrator.

The plan sponsor or administrator must ask each participant requesting a hardship withdrawal to provide information specific to any of the six safe harbor hardship withdrawals sought (medical care, purchase of a principal residence, prevent eviction from or foreclosure of principal residence, repair of damages to principal residence, post-secondary education expenses, or burial and funeral expenses).

The 2017 IRS memorandum contains an attachment that lists the information requests for each hardship withdrawal event. The plan sponsor or administrator must ensure the summaries are complete and contain the relevant items listed in the IRS guidance, otherwise an IRS agent may request source documents to substantiate the hardship. Further, administrators should provide a report or other data to the plan sponsor, at least annually, describing the hardship withdrawals made during the plan year.

If an IRS agent determines that all applicable requirements of the "source documents" or "employee summary" substantiation methods are complete, then the plan should be treated as satisfying the substantiation requirement for making hardship distributions.

In-service distributions that fail to satisfy the hardship distribution rules violate the requirements for plan qualification. While the statutory penalty would be loss of tax-exempt status and immediate taxation to all plan participants, the IRS' Employee Plans Compliance Resolution System (EPCRS) would allow the sponsor who cannot produce the required documents to the IRS examiner to salvage the plan's tax-exempt status after paying a monetary sanction that could be substantial. EPCRS also allows plan sponsors to enter the voluntary correction program prior to notification by the IRS of an examination and pay significantly less in the form of an application fee. Therefore, it is advisable to consider a compliance review of hardship withdrawal procedures and documentation before notification of an IRS audit.

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QSEHRA

A New Way for Small Employers to Help Employees Purchase Health Care Insurance and Frequently Asked Questions

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Small employers with no group health plan should consider a new Qualified Small Employer Health Reimbursement Arrangement (QSEHRA) to help pay for individual health insurance policies on a tax free basis.

The Affordable Care Act (ACA) changed a long standing practice where employers reimbursed employees for premiums on their individual health care insurance coverage under an Employer Payment Plan (EPP). While this reimbursement remains nontaxable under IRC 105 and 106, the stand alone EPP is considered a health care plan that violates the ACA's prohibition on annual dollar limits and therefore is subject to a penalty of $100 per day for each instance. This penalty effectively eliminated the EPPs, thereby limiting the tax-favorable access to healthcare coverage by employees of small employers.

Prior to leaving office, President Obama signed the 21st Century Cures Act (the "Cures Act") that established the QSEHRA - a new type of health reimbursement account that can serve as a replacement for EPPs for years after 2016 .

1. How does the new QSEHRA differ from an HRA or EPP?

Health Reimbursement Arrangements (HRAs) and EPPs are mechanisms under which an employer reimburses medical expenses (whether in the form of direct payments or reimbursements for premiums or other medical costs) incurred by employees up to a certain amount. A "stand-alone" HRA or EPP (one that is not integrated with an employer's group health plan) is considered a group health plan that is subject to the group market reform provisions of the Affordable Care Act, including the prohibition on annual dollar limits and the requirement to provide certain preventive services without cost sharing. Stand-alone HRAs and EPPs fail to comply with these group market reform requirements because these arrangements, by their definition, reimburses or pays medical expenses on the employee's behalf only up to a certain dollar amount each year and may be subject penalties of $100/day per affected employee.

Similar to HRAs and EPPs, QSEHRAs are employer-funded account-based arrangements that can reimburse employees for certain medical care expenses (including healthcare premiums) incurred by employees and their spouses and dependents. Unlike HRAs and EPPs, however, QSEHRAs are not considered "group health plans" that are subject to the group market reform provisions of the Affordable Care Act.

2. What employers may offer QSEHRAs?

Employers that are not "applicable large employers" under the Affordable Care Act. Generally, these are employers with fewer than 50 full-time employees (including full-time equivalent employees) that do not offer group health plans.

3. What are the benefits of offering a QSEHRA?

- Employer perspective: Since QSEHRAs are not considered group health plans, these "stand-alone HRAs" can be used to purchase individual market coverage and reimburse qualified medical expenses without being subject to penalties imposed under the Affordable Care Act.
- Employee perspective: Employer reimbursements for individual health insurance policy premiums (and other qualified medical expenses) under a QSEHRA are excluded from an employee's income.

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4. What are the requirements for offering a QSEHRA?

- The employer cannot offer group health insurance coverage to any employee.
- The QSEHRA must be provided on the same terms to all eligible employees.
- Employer contributions only (no employee contributions or salary reductions permitted).
- Satisfy employee notice requirements.
- Satisfy reporting requirements.
- An employee must maintain minimum essential coverage in order to exclude the reimbursements from income.

5. What employees may be excluded from offering a QSEHRA?

For purposes of determining whether the employer offers the QSEHRA to all "eligible employees," the following employees may be excluded:

- Employees with less than 90 days of service
- Under age 25
- Part-time or seasonal employees
- Union employees
- Non-resident aliens

6. What are the QSEHRA limits?

The maximum reimbursement under a QSEHRA is $4,950 for employee-only coverage, and $10,000 for family coverage. The limits are prorated for a partial year of coverage and indexed for future years.

7. Can the amount of the reimbursements under the QSEHRA vary from employee-to-employee?

Generally, the employer must offer coverage on the same terms to all eligible employees. However, the arrangement will not fail to satisfy the "same terms" requirement if the reimbursement varies on account of the price of an insurance policy, which is based on the age of the employee or family members covered or the number of persons covered.

8. What information must be included in the QSEHRA notices issued to employees?

- Maximum amount of benefit for the year.
- Employee must inform the Marketplace to which employee applies for premium tax credit assistance of the maximum amount of benefit available to the employee under the QSEHRA (notably, an employee's eligibility for premium tax credits may be eliminated or reduced as a result of benefits available under the QSEHRA).
- Reimbursements under the QSEHRA will be taxable if the employee does not maintain minimum essential coverage.

9. When must QSEHRA notices be issued to employees?

Provide the notice not later than 90 days before the beginning of the year. Further guidance is expected to clarify if "year" refers to the calendar year or the plan year. For 2017, the 90-day notice was due March 13, 2017 (90 days after the enactment of the Cures Act). In the case of a new employee, provide the notice not later than the date the employee is eligible to participate in the QSEHRA.

Failure to timely provide the notice to employees can result in a penalty equal to $50 per affected employee (up to $2,500 per year).

10. What are the reporting requirements?

Employers must report the maximum amount available to the employee for the year in box 12 of the employee's W-2, using code "FF."

11. Are employers required to provide a COBRA notice to terminated employees?

No. QSEHRAs are not considered group health plans for purposes of COBRA continuation coverage.

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