FOR YOUR BENEFIT

A newsletter on current legal issues impacting employee benefits and executive compensation

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IRS Announces Benefits Relief for Hurricane Victims

By Susan Foreman Jordan, Esq.

In the wake of Hurricane Harvey, the IRS provided some employee benefits-related relief to plan sponsors and participants. That relief was then extended to the victims of Hurricane Irma.

Relief is provided, first, by relaxation of the rules governing participant loans and hardship withdrawals from qualified retirement plans to enable taxpayers to more readily access retirement funds to alleviate financial hardships caused by the devastation. As detailed in Announcement 2017-11 (related to victims of Hurricane Harvey) and Announcement 2017-13 (for victims of Hurricane Irma), a qualified retirement plan that does not currently permit hardship withdrawals or loans may make both available immediately and will not be treated as failing to satisfy any compliance requirement, provided that an appropriate amendment is adopted no later than the end of the first plan year beginning after December 31, 2017. Additionally, if the principal residence of the participant (or of the participant's lineals, dependents or spouse) was located in one of the counties identified for individual assistance by the Federal Emergency Management Agency (FEMA), the plan administrator may rely upon the representation made by that participant as to the need for, and amount of, a hardship distribution unless the plan administrator has actual knowledge to the contrary.

Normally, the right of the participant to make voluntary deferral contributions must be suspended for a period of six months following a hardship withdrawal.

Those who take withdrawals due to hardships arising from Hurricane Harvey or Hurricane Irma will not be subject to the six-month suspension.

However, it is important to note that no relief was provided from the 10% excise tax on early distribution.

In addition, the IRS has confirmed, in Notice 2017-48, favorable tax treatment of leave-based donation programs under which employees agree to forego vacation, sick or personal leave in exchange for contribution by their employers of the value of the unused leave to charitable organizations providing hurricane relief. As long as the contributions are made to those organizations before January 1, 2019, the employers may deduct the contributions as business expenses under Code Section 162. The employees who participate in the leave-sharing donation program may not claim a charitable deduction for the value the donated leave, but likewise will not be taxed on the value of the leave.

Finally, in recent days, both the IRS and PBGC have granted relief to hurricane affected sponsors of defined benefit pension plans, by extending the deadlines for minimum funding requirements, actuarial certifications and various notice requirements until January 31, 2018,. The deadline for applying for a funding waiver that otherwise would occur during the relief period also is extended until January 31, 2018.

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Leveraging – A Hidden Advantage of Roth 401(k) Accounts

By Harvey M. Katz, Esq.

There have been numerous articles published about the advantages of Roth IRAs and Roth 401(k) accounts. While no tax deduction is available for contributions to Roths, in general, distributions of both principal and earnings are tax-free. When combined with the ability for leveraging (subject to payment of unrelated business income tax (UBIT)), some interesting planning and tax saving opportunities arise. One such opportunity may be the ability to leverage a Roth account to enhance the deferral and tax-free distribution power of the Roth.

As a threshold matter, it is preferable to leverage a Roth 401(k) rather than a Roth IRA. While it may be possible to accomplish a similar result in a Roth IRA, Section 408(e)(4) of the Internal Revenue Code prohibits a pledge of IRA assets as security for a loan, which complicates the situation. While it is not clear whether the prohibition applies to IRA investments themselves (as opposed to security for third party loans), it is best to avoid leveraging in Roth IRAs. However, unlimited rollovers are permitted from IRAs to qualified plans such as a 401(k) plan, and there are not significant impediments to use of a Roth 401(k) for leveraging purposes. Undoubtedly, not every individual is able to dictate the provisions of the Roth 401(k) sponsored by their employer. However, business owners and those with independent consulting and/or directorship income have the ability to establish their own 401(k) plans with a Roth 401(k) feature.

Leveraging is permitted in 401(k) plans, but earnings derived as a result of the leveraging are taxed as UBIT. It is important that any individual engaged in leveraging be aware of the tax rules for computation of UBIT before engaging in any leveraging transaction. The specific issue is that the tax is computed based upon the total earnings of the account, including the non-leveraged assets. This rule is best illustrated by the following example:

	Initial Amount	Earnings	Borrowing Cost	Net Earnings	Taxable Percentage	Taxable Income
Amount of Borrowing	$1,000,000	$50,000	$30,000	$20,000	$1,000,000/ $10,000,000	
Non-leveraged assets	$9,000,000	$450,000	N/A	$450,000		
Total	$10,000,000	$500,000	$30,000	$470,000	10%	$47,000

The result in the forgoing example is somewhat counter-intuitive to this article's focus insofar that while only $30,000 was earned on the borrowed funds, the result is that $47,000 is taxed. It occurs because the UBIT is computed on a percentage of the total earnings of the fund. While it is common to borrow to make a specific investment, money is fungible and the taxable income is computed as if the borrowed funds were allocated to all of the investments on a proportionate basis. (Please note that this is a simplified illustration; the actual calculation of UBIT is more complex involving the calculation of "average acquisition indebtedness.")

However, the inverse of the forgoing rule is also true and can be used to the taxpayer's advantage in a situation where the borrowed funds significantly outperform the non-leveraged assets. This opportunity is illustrated in the following example.

	Initial Amount	Earnings	Borrowing Cost	Net Earnings	Taxable Percentage	Taxable Income
Amount of Borrowing	$1,000,000	$50,000	$30,000	$20,000	$1,000,000/ $10,000,000	
Non-leveraged assets	$9,000,000	$50,000	N/A	$50,000		
Total	$10,000,000	$100,000	$30,000	$70,000	10%	$7,000

As illustrated above, the opposite result occurs here. By pairing the "borrowing" with other assets that do not produce ordinary income (as opposed to capital gains) the amount upon which tax is paid is reduced from the $20,000, which is the net income that results from investment on the "borrowed" funds, to $7,000. (It should be noted that UBIT is also payable on capital gains producing property; however, if the "acquisition indebtedness" is eliminated more than one year before the sale, the gain is not subject to UBIT.)

While minimizing taxable income on borrowed funds is desirable, it is only a technique to maximize the real "hidden" benefit of leveraging in a Roth 401(k) – which is the tax-free earnings generated on borrowed funds.

In the last illustration, the net investment earnings on the "borrowed" funds was $20,000. Assuming that $3,000 in tax is paid on the $7,000 of UBIT generated, then the Roth 401(k) is net $17,000 "richer" than it otherwise would be without leveraging. All things being equal, all of the subsequent earnings produced by the additional $17,000 will never be taxed. If we assume that these "extra" dollars earn interest at 5 percent, compounded annually, after 20 years the $17,000 will have grown to more than $45,000. In other words, by borrowing a single $1,000,000 in one year, the Roth 401(k) can generate more than $45,000 in tax-free income by simply investing the resulting net income in conservative investments.

These results shown above can be dramatically improved by borrowing every year. In fact,

we estimate that almost an additional $600,000 in tax-free income could be generated over a 20-year period, by borrowing $1 millon each year under circumstances shown in the second illustration.

Undoubtedly, those results are a product of utilizing a somewhat optimal set of facts, particularly in connection with the "mix" of assets for leveraging purposes. In the first case, assets that produce capital gains, rather than ordinary income, may not be part of the underlying plan's overall investment portfolio. Even when such assets are part of the investment portfolio, the investment mix may not produce optimal tax results. However, with the use of multiple plans, each of which is its own taxpayer, a business owner will have greater flexibility to structure the optimal investment mix. Because a trustee-to-trustee transfer of assets among plans is generally permitted, it may be easier to achieve the desired combination of income and capital gains producing properties than you might otherwise think.

There are other challenges, however. One is the complexity of UBIT calculation. While the examples provided above are intentionally based on a simple, straightforward set of facts and assumptions, it is unlikely that the actual situation will be so straightforward. Another challenge is to properly isolate the leveraged and non-leveraged assets. While it is possible to write a plan to segregate Roth 401(k) assets from non-Roth assets for internal plan allocation purposes, it is unclear whether the asset segregation language will be respected by the IRS for purposes of UBIT calculations. This issue can likely be minimized by maintaining separate plans as noted above. If non-owner employees also participate in one of the plans, care must be taken to provide the same rights, benefits and features to rank and file participants as are available to those key participants desirous of leveraging.

Without question, the benefits of leveraging in a Roth account require complex planning and structuring. Implementing this type of planning should be performed with the assistance of an experienced pension and retirement planning professional.

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Responding to Mental Health Parity Model Disclosure Request Form

By Stephanie Moscetti, Esq.

In June 2017, the Departments of Labor, Health and Human Services and Treasury released a draft model form that participants may use to request mental health/substance use disorder (MH/SUD) limitation information from their health plan or issuer under the Mental Health Parity and Addiction Equity Act (MHPAEA). Participants are not required to use the "Mental Health and Substance Use Disorder Parity Disclosure Request" form when requesting information about MH/SUD benefits, but its availability increases the likelihood that plan sponsors will receive more detailed requests for information on MH/SUD benefits and parity requirements.

Mental Health and Substance Use Disorder Parity Disclosure Request Form

On the model form, participants, providers and authorized representatives (a "submitter") may make a general information request or a claim/denial information request. The form's general information request allows the submitter to request information on the plan's limitations on MH/SUD disorder benefits, *or* its limitations relating to a specific MH/SUD condition or disorder. The form's claim/denial information request allows the submitter to receive information about a claim that was or may be denied or restricted.

Regardless of whether the submitter indicates he or she is pursuing a general information request or claim information request, the request form asks the plan or issuer to provide the following information within thirty (30) calendar days of the date of the request:

- The specific plan language regarding the limitation and all of the medical/surgical and MH/SUD benefits to which it applies in the relevant benefit classification;
- The factors used in the development of the limitation and the evidentiary standards used to evaluate those factors;
- The methods and analysis used in the development of the limitation; and
- Any evidence to establish that the limitation is applied no more stringently, as written and in operation, to MH/SUD benefits than to medical/surgical benefits.

Responding to a Request

While intended to provide clarity, the model form leaves plan sponsors and third party administrators (TPAs) with plenty of questions. ERISA requires numerous disclosures around plan documentation and the claims procedures. MHPAEA adds additional requirements, but they generally run parallel to the claims procedures. Given all of the required disclosures, how should a plan sponsor respond to this type of request? Does a plan sponsor need to respond and, if so, how much information should it provide? Will TPAs cooperate with the plan sponsor to ensure the submitter receives the appropriate information?

Unfortunately, like most issues related to MHPAEA, the answer is complicated. The information requested is likely burdensome to prepare and not easily accessible for both the plan sponsor and TPA. For most self-insured plans, the TPA likely made the decision related to any limitations, such as prior authorization, and may consider it proprietary information and not want to provide it. Further, under ERISA, the plan may not even be under any obligation to provide the information.

Given the uncertainty around a response, the plan sponsor should first discuss with its TPA how it envisions handling requests. While the TPA may hold the requested information, the onus is on the plan to comply with ERISA. As such, the plan sponsor must be aware of any information requests and have control over the information provided to a submitter.

Second, a plan sponsor should discuss with its legal counsel a process for responding to a request and determine the type of information it will provide to a submitter. While intended to be a useful resource for participant and plans, the model form does not track the language of any regulation closely, leaving substantial ambiguity about what information must be disclosed.

Finally, after receiving a request, the plan sponsor should consider speaking with the submitter to better understand the reasoning behind the request. By doing so, the plan sponsor may be able to provide the submitter with the relevant information related to his or her concern without needing to prepare the burdensome and lengthy documents necessary to comply with the model form's request.

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Full Implementation of Fiduciary Rules Likely To Be Extended

By Susan Foreman Jordan, Esq.

In April 2016, the Department of Labor issued regulations to expand the definition of "fiduciary" under ERISA and the Internal Revenue Code as applied to those who render investment advice for a fee or other compensation with regard to the assets of a qualified retirement plan or an IRA. At the same time, the Department published two new exemptions from the prohibited transaction rules, namely, the Best Interest Contract (BIC) Exemption and the Principal Transactions Exemptions, as well as amendments to several existing prohibited transaction exemptions.

These regulations and prohibited transaction exemptions were to take effect April 10, 2017, but were delayed until June 9, 2017. In conjunction with the delay, the new and amended exemptions were modified to provide transitional relief through January 1, 2018, at which time, the fiduciary rules and exemptions will become fully applicable. During this transition period, impartial conduct standards apply, requiring that (1) advice be provided in the best interest of the plan participant or IRA owner; (2) that no more than reasonable compensation may be charged; and (3) that misleading statements be avoided.

Earlier this month, the Department of Labor proposed extending the transition period through July 1, 2019, and delaying, from January 1, 2018, to July 1, 2019, the full applicability dates for those exemptions. According to the Department, the primary purpose for the delay is to allow the time necessary for it to consider possible changes and alternatives.

The Office of Management and Budget now has approved that proposal, which means that the Department of Labor will move forward to collect comments and finalize the extension. It remains to be seen whether and to what extent the fiduciary rules will change prior to the final applicability date.

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