

EXECUTIVE COMPENSATION: SELECTED TOPICS

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EXECUTIVE COMPENSATION PRESENTATION AGENDA

- Introduction & Overview
- Section 409A: Common Failures & Issues
- Incentive Compensation
- Fringe Benefits Overview
- Personal Use of Aircraft

INTRODUCTION & OVERVIEW

EXECUTIVE COMPENSATION PROGRAMS AND PLANS

- SERPs, Excess Plans, and Supplemental Pensions
- “Top Hat” Plans (i.e., Non-Qualified Deferred Comp)
- Incentive Stock Options & Non-Qualified Stock Options
- Restricted Stock, Phantom Stock, Stock Bonus
- Golden Parachutes – Change-in-Control and Severance Agreements
- Executive Perquisites
 - E.g., personal use of corporate jet

EXECUTIVE COMPENSATION LAW – NOT SO SIMPLE

- Tricky Tax Rules
 - Code § 409A – Nonqualified Deferred Comp Plan Rules
 - Code §§ 83, 421, 422 – Stock & Stock Options
 - Code § 162(m) – limits deductibility of certain exec comp
 - Code § 280G – Tax penalties for excessive golden parachute payments
- Top-Hat Plans subject to fewer ERISA requirements
- Securities Rules – SEC Disclosures

WHAT IS SECTION 409A?

Covers all forms of *deferred compensation* (unless specifically excluded)

Prescribes general rules for:

- Elections to defer compensation
- Payment of deferred compensation
- Reporting and withholding of deferred compensation
- Mandatory six-month payment delay for payments to “specified employees following termination



Even if plan documents are compliant, operational failures may result in additional taxes and interest

Calculating taxes and penalties is a mess

SECTION 409A – WHAT IS DEFERRED COMPENSATION?

Unless a specific exception applies, deferred compensation is when a–

service provider
has a

legally binding
right to

compensation
to be paid in
a later year

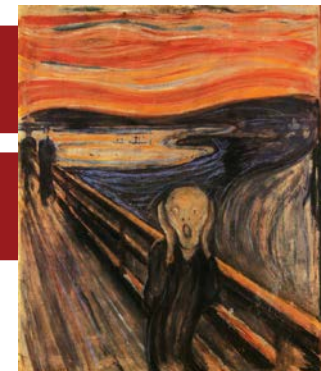
- Not limited to executives
- Includes directors & independent contractors
- Must assume that conditions on obtaining the amount (i.e. vesting conditions) are fulfilled
- Taxable payments for services
- So, excludes nontaxable welfare or fringe benefits, or founder's investments in company stock

SECTION 409A – CONSEQUENCES OF A VIOLATION

Errors occur all too frequently

Tax Consequences to Executive

- Current-year income taxation of all vested benefits
- Additional 20% penalty tax
- Premium interest tax equal to federal underpayment rate plus 1% back to vesting date, for all vested benefits
- Unfavorable plan aggregation rule



Tax Consequences to Company

- Under-withholding penalties for regular income taxes (additional Section 409A taxes not subject to withholding requirements)
- Failure to report violation on Form W-2 or 1099-MISC
- Gross-up commitment for violations caused by the employer?

SECTION 409A – DEFERRAL ELECTIONS AND PAYMENT

Deferral Elections

- Elections to defer salary must be made no later than December 31st of prior year
- Elections to defer bonus pay are tricky
- Special rule for new hires
- Generally, no acceleration and no deferral!

Payment Triggers

- Separation from Service
 - Six-month delay for “specified employees”
- Specified date
- Change in control
- Unforeseeable financial emergency
- Disability
- Death
- Vesting
- “Earlier of” or “later of” any of the above

SECTION 409A: COMMON FAILURES & ISSUES

SECTION 409A – COMMON DEFERRAL ERRORS



Definition of compensation not administered correctly



Mid-year enrollment for newly eligible participants



Application of bonus deferral elections



May be able to correct deferral before year-end without using the corrections program

SECTION 409A – COMMON PAYMENT ERRORS

Failure to Identify Section 409A Separation from Service

- Consulting arrangements following termination of employment; reduction in hours
- Leave of absence
- Transfer to affiliate, especially if affiliate is on a different payroll system
- Rehire following termination
- Acquisitions & dispositions

SECTION 409A – COMMON PAYMENT ERRORS

Late Payment

- Employee separates from service in 2016 but cannot be located; error is discovered in 2017
 - Payment must be made, without interest, in 2017
- Payment is taxable in 2017
 - “Tax painful” for insiders – subject to 20% additional income tax
- No correction permitted after 2018

SECTION 409A – COMMON PAYMENT ERRORS

Early Payment

- Example: Employee transfers to a foreign affiliate in 2016, mistakenly receives lump sum payment; error is discovered in 2017
 - Employee must repay the plan, with interest, in 2017
 - No refund or credit on 2016 return
 - Form W-2 and Form 1099
 - Deduction (above the line) for employee repayment on 2017 return
 - “Tax painful” for insiders – subject to 20% additional income tax

SECTION 409A – IRS CORRECTION PROGRAMS

Correction Opportunities (limited)

- Operational Failures → IRS Notice 2008-113, 2010-6, 2010-80
- Plan Document Failures → IRS Notices 2010-6 & 2010-80

Key variables

- How quickly error is corrected (must be within two years)
- Dollar amount involved
- Whether the employee is/was an “insider”

Errors corrected after the year in which the error occurred
must be reported to employee and IRS

INCENTIVE COMPENSATION

TYPES OF EQUITY COMPENSATION

	Recipient's Right	Economic Benefit
Stock Option	Option to buy stock based on price at grant date	Appreciation in stock between grant and exercise dates
Stock Appreciation Right	Payment (cash or stock) of increase in stock price since grant date	Appreciation in stock between grant and exercise dates
Restricted Stock	Stock, subject to specified restrictions	Entire value of stock on date becomes unrestricted
Restricted Stock Unit	Payment (cash or stock) of value of stock, subject to specified restrictions	Entire value of stock on date becomes unrestricted
Performance Shares	Payment (cash or stock) of value of "shares" based on specified metrics	Value specified by metrics

TAXATION OF OPTIONS

	Exercise	Disposition	FICA	Deduction
Non-qualified Stock Option (non-discounted)	Spread at exercise taxed as ordinary income	Appreciation after exercise taxed as capital gain	Spread at exercise subject to FICA	Employer deduction in year of exercise equal to spread at exercise
ISO (regular disposition)	Spread at exercise subject to AMT	Spread at disposition taxed as capital gain	None	None
ISO (disqualifying disposition)	Spread at exercise subject to AMT	Spread at exercise taxed as ordinary income, appreciation after exercise as capital gain	None	Employer deduction in year of disposition equal to the spread at exercise
SAR	Cash payment or spread at exercise taxed as ordinary income	(If stock-paid) Appreciation after exercise taxed as capital gain	Spread at exercise subject to FICA	Employer deduction in year of exercise equal to spread at exercise

STOCK OPTIONS

Incentive Stock Option (Section 422)

- Limited to \$100,000 at exercise
- Only for employees & non-transferable
- Exercise price must be at least 100% of the FMV as of grant (and thus will be exempt from Section 409A)
- Plan must be approved by shareholders and must state maximum ISOs to be granted and employees eligible
- Must be granted within 10 years of plan adoption
- 10-year limit on exercise period
- If qualifying disposition (at least 2 years after grant and 1 year after exercise), all appreciation from grant date is capital gain

Nonqualified Stock Option

EMPLOYEE STOCK PURCHASE PLAN

Section 423 ESPP

- \$25,000 purchase limit per year
- Only for employees & non-transferable
- Up to a 15% discount permitted
- Must be broad-based plan granted to generally all employees
- Plan must be approved by shareholders
- 27-month limit on exercise period
- If qualifying disposition (at least 2 years after grant and 1 year after exercise), discount taxed as ordinary income but excess beyond that is capital gain

Nonqualified ESPP

TAXATION OF RESTRICTED STOCK

	Grant/ Vesting	Disposition	FICA	Employer Deduction
Restricted Stock – 83(b) Election	FMV at grant taxed as ordinary income	Appreciation after grant taxed as capital gain	FMV subject to FICA at grant	Employer deduction equal to FMV at grant
Restricted Stock – no 83(b) Election	FMV taxed as ordinary income when becomes unrestricted	Appreciation after vesting taxed as capital gain	FMV subject to FICA when becomes unrestricted	Employer deduction equal to FMV when becomes unrestricted

SECTION 83

Section 83 covers–

Transfers of property

in connection with performance of services,

which are taxable under 83(a) when no longer subject to substantial risk of forfeiture

Unless the recipient elects under 83(b) to be taxed at transfer

- Including real or personal property, escrow accounts, stock, real estate, partnership interests
- Arises out of employment relationship
- Includes purchases at FMV
- Full enjoyment of property conditioned on future performance of substantial services – e.g., continued employment, perhaps a noncompete
- NOT time-based restriction, terminated for “cause,” risk of company’s failure
- Within 30 days of transfer
- Even if purchased at FMV, or if stock is worth \$0 (\$0 election)
- Subsequent loss is a capital loss (not offset against ordinary income)

TAXATION OF RSUs/PHANTOM STOCK

	Vesting	Disposition	FICA	Employer Deduction
RSUs Paid in Stock	FMV taxed as ordinary income	Appreciation after payment date taxed as capital gain	FMV subject to FICA at payment (or availability) date	Employer deduction equal to FMV at payment (or availability) date
RSUs Paid in Cash	Cash payment taxed as ordinary income	N/A	Cash payment subject to FICA at payment date	Employer deduction equal to cash payment at payment (or availability) date

- RSUs are not property under Section 83
- RSUs are subject to Section 409A unless an exception applies
- Be careful to separately analyze application of Section 409A to dividend payments/dividend equivalents

EQUITY COMPENSATION LESSONS

- Equity plan, besides meeting Section 422 requirements if applicable, should clearly identify Board's authority to modify and cash out awards in connection with change in control or other transaction – crucial in M&A context
- Equity award agreements also should be carefully drafted to—
 - Ensure compliance with 409A (RSUs and phantom stock) and 162(m)
 - Identify company's authority to withhold all reasonable taxes as determined by company in its sole discretion
 - Properly implement design features relevant to purpose of the compensation (for example, enforceable noncompetes or other restrictive covenants)

FRINGE BENEFITS OVERVIEW

FRINGE BENEFITS – COMMON ISSUES

- Taxes
 - Income Tax Treatment for Employees
 - Deduction Rules for Company
 - Employment (Payroll) Taxes
 - Employer Penalties for Errors
- Non-Discrimination Provisions
- Other “Special” Rules – can be tricky
- Record Retention

FRINGE BENEFITS – COMMON TYPES

- Adoption Assistance – Code § 137
- Dependent Care – Code § 129
- Educational Assistance (up to \$5,250) – Code § 127
- Group Term Life Insurance (up to \$50k) – Code § 79
- Moving Expenses – Code § 132(g)
- Transit & Parking Benefits – Code § 132(f)(4)
- Company Cafeteria – Code § 132(e)(2)
- Company Gym – Code § 132(j)(4)

FRINGE BENEFITS – COMMON TYPES

- Meals & Lodging “for convenience of the employer”
- “No Additional Cost Services” – Code § 132(b)
- “Qualified Employee Discounts” – Code § 132(c)
- “Working Condition Fringe” Benefit – Code § 132(d)
 - Company Cars?
 - Cell Phones
- “De Minimis” Fringe Benefits – Code § 132(e)
- Expense Reimbursements

PERSONAL USE OF AIRCRAFT

PERSONAL USE OF CORPORATE AIRCRAFT

IRS view

- Personal flights on company aircraft are a taxable fringe benefit
- Employee pays payroll tax and income tax on value of flight
- The personal use of corporate aircraft has value to the employee, and is provided in connection with employment

SEC view

- The “aggregate incremental cost” to the company must be disclosed to shareholders in the company’s annual proxy

IRS and SEC rules have different goals

- IRS wants to tax the value provided to the employee
- SEC wants to disclose what it costs the company
- Example, a single cross-country flight might be treated as follows:
 - Employee taxed on imputed income of \$1,600
 - Proxy disclosed employee perquisite valued at \$30,000

PERSONAL USE OF AIRCRAFT – VALUATION METHODS

Charter Rate (FMV)

- One rate, no matter how many people on board
- Keep a record
- Obtain a quote from a third party charter operator local to where flight originates
- Usually more expensive

Standard Industry Fare Level (SIFL)

- Designed to equate first class airfare
- Calculated per person
- Factors in miles flown, aircraft weight, employee status, etc.
- Usually cheaper, and thus the more commonly used valuation method
- SIFL Formula =
 - (Mileage x SIFL rate)
 - x (Aircraft multiplier)
 - + Terminal charge

PERSONAL USE OF AIRCRAFT – SIFL RATES

- **SIFL rates** for flights taken 1/1/17 to 6/30/17

Mileage Rates	Cents per Mile
0-500 miles	\$ 0.2125
501-1,500 miles	\$ 0.1620
over 1,501 miles	\$ 0.1558
Terminal charge	\$38.85

- **Aircraft Multiples Chart**

MCTOW	Control EE	Non-Control EE
6,000 lbs. or less	62.5%	15.6%
6,001 – 10,000 lbs.	125%	23.4%
10,001 – 25,000 lbs.	300%	31.3%
25,000 lbs. or more	400%	31.3%

PERSONAL USE OF AIRCRAFT – TRAPS FOR THE UNWARY

Guests

- For example, executive flies from CA to FL on business and back, with spouse
- IRS taxation: \$3,200 imputed to the executive (spouse's two flights – out and back)
- SEC disclosure: \$60 (additional catering costs for spouse on each flight)

Commuting

- Traveling to or from your principal place of business is always personal
- Telecommuting considerations
- Living near a branch office

Travel from a secondary residence to a business meeting

- If starting a business trip from a secondary residence or vacation location, then a portion of the trip is treated as personal for SEC purposes (proxy disclosure)
- Not necessarily personal for IRS purposes (i.e., no imputed income)

PERSONAL USE OF AIRCRAFT – TRAPS FOR THE UNWARY

“Dropping off” a guest in another location

- Example: NY to SFO via LAX
- Increases SIFL and incremental cost charged to the executive for self and all guests (even if you’re only dropping off one of several guests)

Overnight stays: If crew and aircraft return to HQ, additional deadhead and positioning legs are charged to the executive

- Example: Executive in DC takes vacation in FL for five days. Plane drops off family, then returns to HQ, flies back to FL and returns again
 - 4 flights in total for proxy purposes
 - 2 flights for tax purposes



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