

# **2017 EXECUTIVE COMPENSATION AND EMPLOYMENT TAX UPDATE**

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**North Florida Compensation &  
Benefits Association**

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# Agenda

- 1 Common Section 409A Failures
- 2 Section 162(m) Compliance
- 3 Fringe Benefits: Personal Use of Aircraft
- 4 Fringe Benefits: Local Lodging
- 5 Employment Tax Traps: NQDC

# Appendix (Bonus Topics)

- 1 Tax Reform – Update from Washington, D.C.
- 2 Proxy Voting – Recent Developments
- 3 Director Pay – Litigation & Best Practices
- 4 Dodd-Frank – New Developments



# **#1 – Common Section 409A Failures**

# 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

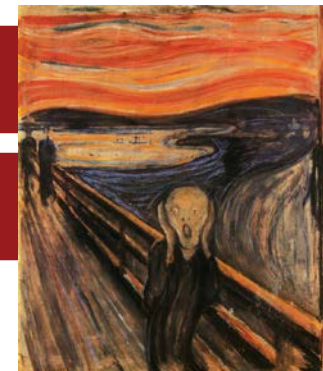
- Not limited to executives
- Includes directors & independent contractors
- Must assume that conditions on obtaining the amount (i.e. vesting conditions) are fulfilled
- Taxable payments for services
- So, excludes nontaxable welfare or fringe benefits, or founder's investments in company stock

# 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 31<sup>st</sup> 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 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



# **#2 – Section 162(m) Compliance**

# SECTION 162(M) – GENERAL RULE

Section 162(m) generally *disallows a deduction* for compensation paid to a “covered employee” in excess of \$1,000,000

- Certain types of comp are disregarded
- Does not affect employee’s tax treatment
- Applies only to public companies

## Who are Covered Employees?

- CEO and next three highest paid executive officers – but not CFO!
  - IRS Notice 2007-49 confirms this result
- IRC 162(m)(3) defines covered employee as CEO and **four** highest paid executive officers for SEC disclosure purposes
- SEC rules require disclosure for CEO, CFO, and next **three** highest paid

# SECTION 162(M) – PERFORMANCE PAY EXCEPTION

Qualified Performance-Based Compensation is exempt from the \$1 million deduction limit

- Comp must be granted by Compensation Committee
- Comp may be paid only upon attainment of pre-established, objective performance goals
- Award must preclude discretion to increase amount payable
- Committee must certify that goals have been satisfied



# SECTION 162(M) – SHAREHOLDER APPROVAL

Shareholders must approve the “material terms” of awards to covered employees

- Eligible employees or categories of employees
- Business criteria upon which the performance goal(s) may be based
- Maximum amount payable to any employee, or formula used
  - Special rule for equity awards

Mechanics of shareholder approval

- Separate shareholder vote
- No deduction if the awards would be paid anyway
- Re-approval required every five years if the Comp Committee has the authority to change the targets under a performance goal

# SECTION 162(M) – IPO EXCEPTION

For newly-public companies, the \$1 million 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

# SECTION 162(M) – COMMON FAILURES

Equity Plan

Failure to state individual share limits, for options or SARs

Performance goals

Adjusted to reflect changed circumstances, or waived altogether

Performance results

Committee fails to certify results

Shareholder approval

Failure to obtain shareholder approval, or shareholder re-approval following material change

# **#3 – Fringe Benefits – 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

# **#4 – Fringe Benefits – Local Lodging**

# LOCAL LODGING

## General Rule

- Employee local lodging expenses = Personal expenses
  - Section 262(a)
  - Not deductible

## IRS exception for local lodging

- Deductible by employer under Section 162
- Excludible as working condition fringe benefit under Section 132
- Reimbursement is excludible under accountable plan
- Safe harbor, or facts and circumstances test

# LOCAL LODGING – SAFE HARBOR

Employee must *participate fully in or be available for a* bona fide business meeting, conference, training activity, or other business function

Not fancy

## Limits!

- No more than 5 calendar days
- No more often than once per calendar quarter

Employer requires overnight stay

# LOCAL LODGING – FACTS & CIRCUMSTANCES

Business purpose  
(not primarily  
social or personal)

Not fancy

Bona fide condition  
or requirement of  
employment

## Good examples

- Employees required to stay at local hotel during work-related training session or conference
- Employees occasionally on call for night duty shift
- Professional athletes required to stay at local hotel before home game

## Bad examples:

- Employee relocating for work and looking for a new home
- Employee stays at hotel near the office while working long hours

# GRATUITOUS IMAGES OF LAVISH AND EXTRAVAGANT LODGING





# **#5 – Employment Tax Traps: Nonqualified Deferred Compensation (NQDC)**

# EMPLOYMENT TAX TRAPS – BASICS OF NONQUALIFIED DEFERRED COMPENSATION

## General Rule

- Compensation subject to FICA tax *when paid*

## Special Timing Rule

- Nonqualified deferred compensation subject to FICA tax on the *later of*:
  - The date the underlying services are performed, or
  - The date the compensation is no longer subject to a substantial risk of forfeiture.

Pro-taxpayer (and pro-employer) rule due to  
Social Security wage base



# EMPLOYMENT TAX TRAPS – EARNINGS

## Account Balance plans

- Earnings are not subject to FICA once the principal has been taken into account for FICA purposes, as long as:
  - Earnings are based on either a “reasonable rate of interest” or a “predetermined actual investment”

## Non-Account Balance plans

- Earnings are not subject to FICA, as long as:
  - the amount taken into account is determined using “reasonable actuarial assumptions”

Under the special timing rule, earnings in excess of these limits are subject to FICA tax as they accrue

# EMPLOYMENT TAX TRAPS – FAILURES



Special timing rule is mandatory



IRS may assess interest and penalties if rule is not followed and failure is not corrected



Alternatively, IRS may require taxation of benefits under the general timing rule

- Benefits (+ earnings) subject to FICA tax when paid
- Typically results in larger tax liability

# EMPLOYMENT TAX TRAPS – EXAMPLE # 1

## Account Balance Plan

- Employee defers \$10,000 in 2017, has total FICA wages of \$300,000
- Employee receives \$15,000 after retiring in 2022, has total FICA wages of \$100,000

### *General Timing Rule =*

\$1,147.50 of FICA tax in 2022

- $\$15,000 * 7.65\%$  (Social Security and Medicare)

### *Special Timing Rule =*

\$235 of FICA tax in 2017

- $\$10,000 * 2.35\%$  (Medicare + Plus Additional Medicare)
- Already exceeded Social Security wage base for 2017

# EMPLOYMENT TAX TRAPS – EXAMPLE #2

## Non-Account Balance Plan

- Employee retires in 2017 with a SERP benefit, has total other FICA wages of \$250,000
- Non-qualified benefit is not “reasonably ascertainable” until retirement
  - Present value of benefit at retirement is \$1,000,000
  - Annual benefit is \$80,000
  - Assume zero FICA wages in retirement

### *General Timing Rule =*

*\$6,120 of FICA tax each year for the remainder of the employee’s life*

- $\$80,000 * 7.65\%$  (Social Security and Medicare) every year in retirement

### *Special Timing Rule =*

*\$23,500 of FICA tax in 2017*

- Already exceeded Social Security wage base for 2017
- No FICA tax in retirement

# EMPLOYMENT TAX TRAPS – COMMON ERRORS



“Unreasonable” fixed interest rates



Failure to take employer contributions into account



Failure to tax earnings generated before benefits are “taken into account” for FICA purposes



Failure to tax retirement-age vesting of RSUs

# EMPLOYMENT TAX TRAPS – THE HENKEL CASE

*Davidson v. Henkel Corp.*  
(E.D. Mich., 1/6/15)

- Held that Henkel company violated ERISA by failing to withhold FICA taxes in accordance with the special timing rule
- Court granted summary judgment for the class
- Court held the company liable for the resulting reduction in the net benefits payable to participants

Under the special timing rule, FICA taxes should have been withheld at the time participants retired and started their benefits

- Instead, Henkel withheld taxes from all future payments under the general timing rule.
- Henkel also reduced monthly benefit payments for 12-18 months to recover taxes payable under the general timing rule for prior open years.

Fairly standard plan language

# EMPLOYMENT TAX TRAPS – KEY TAKEAWAYS & BEST PRACTICES

Follow the special timing rule!

Plan drafting tips

- Do not commit to withholding taxes at any specific time, or in accordance with any specific rule
- Specifically state that there is no guarantee the plan will be administered in a manner that complies with tax Code Section 409A or Section 3121(v), or any other tax rules
- Disclaim responsibility for any reduction in net payments to employees resulting from the application of any tax

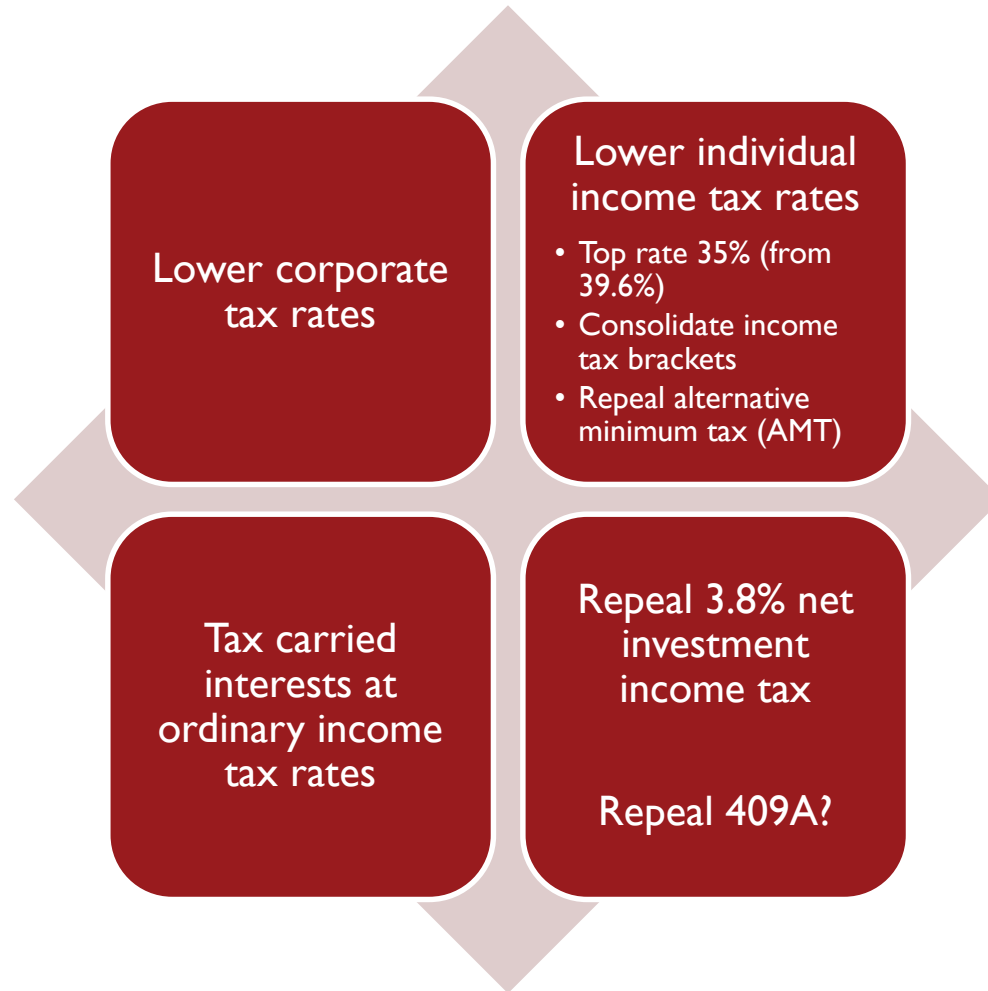
# Appendix





# **Tax Reform Proposals**

# TAX REFORM – PROPOSED CHANGES



# TAX REFORM – IMPACT ON EXEC COMP

## Impact on corporation

- Loss of tax deductions becomes less significant
  - 162(m) plans – more flexibility to reduce 2017 payments?
- Company may want to accelerate compensation tax deductions to earlier year (2017), when rates are still high

## Impact on individual

- Deferred comp plans become less attractive
- Incentive stock options become more attractive
- Employee may want to delay compensation to later year (2018) when rates are lower
  - Beware Section 409A elections

## Impact on private equity and hedge funds

- Equity awards become more attractive
- Eliminates advantage of compensating employees with profit interests

# TAX REFORM – IMPACT ON EMPLOYEE BENEFITS

## Impact on 401(k) Plans

- Cost of tax deferral for contributions and earnings to DC and DB plans - \$1.5 trillion (OMB)
- Proposals
  - Disallow pretax contributions
  - Limit pretax contributions
  - Mandate 50/50 split between pretax and Roth contributions

## Impact on Health Plans

- Cost of exclusion for employer-provided health insurance premiums and medical care costs - \$2.7 trillion (OMB)
- Proposals
  - Capping exclusion



# Proxy Voting Update

# ISS AND GLASS LEWIS UPDATES

## Institutional Shareholder Services (ISS) updates

- Equity Plan Scorecard changes
  - Adds new dividend factor to the plan feature pillar
  - Modifies minimum vesting factor to apply to all awards
  - Updates burn rate benchmarks
- New Metrics for Pay-for-Performance Analysis
  - Return on equity
  - Return on assets
  - Return on invested capital
  - Revenue growth
  - Growth in cash flow from operations
  - Growth in EBITDA

## Glass Lewis pay-related updates

- Equity Plan proposals
  - Adds overhang and grant history to provide more balanced approach in measuring dilution and cost
  - Incorporates longer-term assessment of company's granting history
- Gender Pay Equity
- Nonemployee Director Pay – increased focus

## Director Overboarding

- ISS and Glass Lewis generally recommend against a director who serves on more than five boards
  - ISS – public company CEOs can only serve on two other boards
  - Glass Lewis – executive officer can only serve on two boards in total



# **Director Pay: Litigation & Best Practices**

# DIRECTOR PAY – LITIGATION

## Risk of Litigation on Director Pay

- More likely to succeed due to director's self-interest in their own pay, unless shareholders approve pay formula or specific awards

## High profile settlements

- Facebook and Citrix
  - Amend equity plans to include dollar limits
  - Submit changes to shareholders for approval
  - Annually review director cash and equity-based compensation
  - Engage independent compensation consultant to assess director pay

## Director pay practices are evolving

- Enhanced disclosures in proxy statement
  - Pay limits
  - Process that the board follows in setting compensation levels, including independent review or analysis of market data



# DIRECTOR PAY – BEST PRACTICES

## Action Item #1: Review any limits that apply to director compensation

- Both cash and noncash programs
- Benchmark director pay to peer companies
- If no meaningful limits exist, consider adding them

## Action Item #2: Seek shareholder approval

- Grant limits or formula
- Can take position that shareholders ratified pay practices
- If shareholder approval is not feasible, conduct peer group analysis to support scrutiny

## Action Item #3: Disclose director pay-setting process

- Proxy disclosure should be clear
- Expand as needed to provide thorough description of director pay



# **Dodd-Frank Developments**

# FINANCIAL CHOICE ACT (PROPOSED)

## Trump has repeatedly criticized Dodd-Frank

- Wants to eliminate
- Rules that have been proposed but not implemented are first to be derailed

## Financial CHOICE Act (H.R. 10)

- Introduced by Chair Jeb Hensarling (R-TX)
- Passed by House Financial Services Committee on May 4, 2017
- Updated version of 2016 legislation (H.R. 5983), which passed the House but not Senate

## Proposed Legislative Changes

- **Repeal** pay ratio disclosure
- **Repeal** hedging policy disclosure
- **Limit** say-on-pay vote
- **Limit** clawback policy
- **Repeal** bank incentive pay rule
- Prohibits financial services companies from paying compensation that encourages inappropriate risk-taking

# DODD FRANK— BEST PRACTICES

## Action Item #1: Prepare to comply with pay ratio rule despite uncertainty

- Dodd-Frank Act requires public companies to disclose ratio of CEO total pay to total pay of median worldwide employees (eff. 2017)
  - Considerable **compliance cost**, especially for global workforce and multiple HRIS
  - Anticipate **potential backlash** from employees who discover that they are paid less than the median
- On Feb. 6, 2017, SEC Chair Michael Piwowar reopened public comment on “any unexpected challenges” and directed agency staff to reconsider implementation. Most comments (3,000) favor implementation without delay.
- Financial Choice Act would repeal pay ratio rule altogether

## Action Item #2: Determine frequency of say on pay vote

- Dodd-Frank Act requires public companies to obtain shareholder approval of executive pay at least once every 3 years
  - Can be more often; most companies (90%) vote annually
  - If Say-on-Pay (SOP) vote will not be held annually, **engage with shareholders**
- Financial Choice Act would require SOP vote only when exec comp materially changes

## Action Item #3: Revisit clawback policy

- SEC rules require public companies to recover excess incentive-based comp upon a material accounting restatement
  - No policy? If you have been waiting for final rules under Dodd-Frank, **consider adopting a clawback policy now**
  - Perform **compensation risk analysis** to ensure that programs don't encourage excessive risk-taking
- Financial Choice Act would limit clawbacks to executive officers who had “control or authority” over the financial reporting

# BIOS



**Robin M. Solomon**'s practice covers a wide range of federal tax and ERISA issues, including plan design, operational corrections, lump sum windows, plan terminations, and fiduciary liability. She frequently counsels clients on executive compensation arrangements and qualified benefit plans. Robin's client base covers many different industries, including aerospace and defense, automotive, food service, healthcare, manufacturing, oil and gas, retail and technology. Robin holds degrees from Stanford University and Harvard Law School. She is an adjunct professor at Georgetown University Law Center's L.L.M program, where she will be teaching Retirement Plan Qualification Requirements this fall.



**Benjamin L. Grosz** advises clients on a broad range of employee benefits and federal tax planning issues. He regularly advises clients regarding their fiduciary duties and handles day-to-day compliance issues, such as trouble-shooting when glitches arise in plan operations, and helping benefit committees monitor plan investments and vendors. He has handled a variety of benefits issues that arise in transactions, negotiated investor management agreements and other benefits vendor service agreements, and represented clients in IRS and DOL audits. Ben graduated from the University of Virginia, *magna cum laude*, and the University of Virginia School of Law, where he was a Senior Editor of the Virginia Tax Review.



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