

# **2017 TOP TAX COMPLIANCE RISKS AND PITFALLS: EXECUTIVE COMPENSATION AND BENEFIT PLANS**

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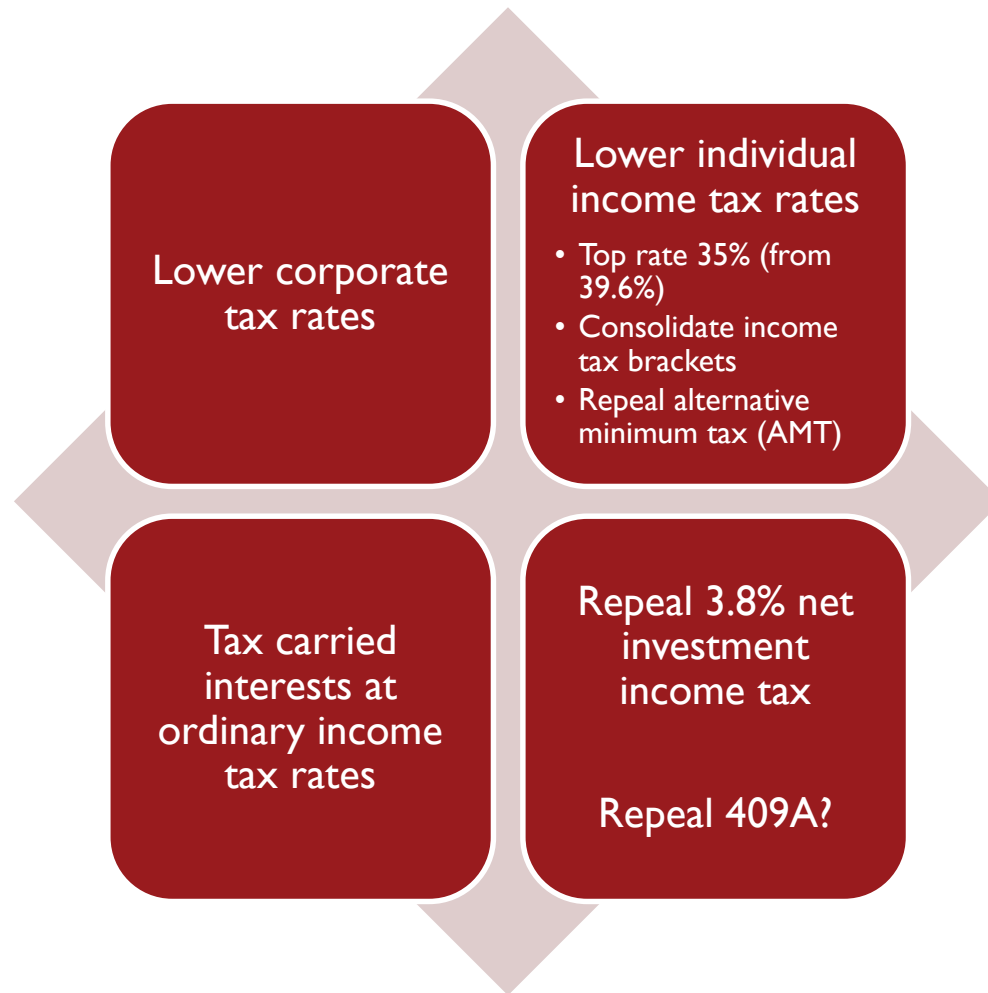
# Agenda

- 1 Tax Reform Proposals
- 2 Tax Compliance for Qualified Plans in a Post-DL World
- 3 Section 162(m) Compliance
- 4 New IRS Mortality Tables
- 5 Common Section 409A Failures



# **#1 – 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 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



## **#2 – Tax Compliance for Qualified Plans in A Post-DL World**

# WHY OFFER A TAX-QUALIFIED PLAN?

## Qualified Plans

- Advantages for Company:
  - Employer contributions are tax-deductible
  - Assets in trust grow tax-free
- Advantages for Individual:
  - Employee contributions can reduce current taxable income
  - Contributions and earnings are not taxed until distributed
- The catch: Qualified plans must satisfy the IRC in both *form* and *operation*
  - IRC rules as to eligibility, participation, vesting, nondiscrimination, reversion

## Determination Letters (DLs)

- Purpose is to obtain advance assurance from the IRS that the *form* of the plan document is tax-qualified



# IRS ABANDONS DL PROGRAM

## IRS largely abandons its Determination Letter program

- IRS Ann. 2015-19 (eff. 2017)
- DLs available only for new plans or plan terminations

## What, no DL?

- Auditors
  - Will seek assurances from management or opinion letter from counsel
- M&A counterparties
  - Will seek enhanced reps and warranties
  - Integration of acquired company plans may be an issue
- Rollovers
  - Will need to check Form 5500 of distributing plan prior to accepting rollover
- Investment managers
  - Will seek assurances from management
  - Plans may be ineligible for certain investment vehicles, such as group trusts

# POST-DL WORLD

## Tax Compliance risk → Employers

- Possibly greater risk of sanctions on IRS audit
  - Penalties can be in the millions
- Possibly greater risk of plan disqualification by IRS
  - Loss of deduction for employer contributions
  - Trust assets become immediately taxable
  - Employees taxed currently on value of accrued benefits
- IRS will not provide assurances on plan document
- Employer assumes risk of deficient or untimely amendments
- No “free pass” to fix problems during extended IRS remedial amendment period

## Alternatives

- Opinion from legal counsel re tax-qualified status
- **Rigorous internal process for amending and self-auditing plans**
- IRS model amendments
- Prototype plan documents



# **#3 – 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 million

- 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 Comp is exempt from the \$1M deduction limit

- Comp must be granted by Comp 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 \$1M 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 reapproval following material change





# **#4 – New IRS Mortality Table**

# NEW IRS MORTALITY TABLE – IMPACT ON PENSION PLANS

Mortality tables are used to calculate the present value of a stream of future benefit payments

- Required for minimum funding calculations
- Also relevant to calculating lump sum values

RP 2018 and projection scale MP-2018 “reflect longevity improvement”

- Companies have been anticipating the change for several years

Impact on pension plans

- Increases liabilities by ~5%
- Reduces funded status
- May increase PBGC premium liability

# NEW IRS MORTALITY TABLE – STRATEGIES TO CONSIDER

## Alternative plan funding strategies – instead of cash

- Contribute Treasury bills
- Contribute Company stock
- Contribute real property

## De-risking strategies

- Design Strategies: Freeze accruals or close the plan
- Portfolio Strategies:
  - Liability-driven investment
  - Annuity contracts as pension assets (buy-ins)
- Settlement Strategies:
  - Lump sum distributions
  - Annuity distributions (buy-outs)



# **#5 – 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 employee” 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

# TYPES OF DEFERRED COMPENSATION PLANS

Defined benefit plans

Defined contribution plans

Excess benefit plans

Top hat plans (e.g., deferral plans and SERPs)

But also-

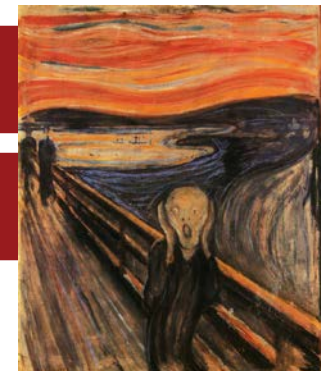
- Severance arrangements
- Equity compensation plans and awards
- Bonus plans
- Indemnity/reimbursement/gross-up agreements

# 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 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
    - Form W-2 and Form 1099
  - “Tax painful” for insiders – subject to 20% additional income tax
- No correction permitted after 2018

# SECTION 409A – COMMON PAYMENT ERRORS

## Early Payment

- Ex: 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

# BIOS



**Robin 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, where she will be teaching Retirement Plan Qualification Requirements this fall.



**Jodi Epstein** focuses on qualified plans, with particular expertise in benefit integration after acquisitions, setting up benefit platforms, and advising qualified plan committees regarding their fiduciary duties. Jodi's practice includes day-to-day compliance issues, such as assisting with implementation of new legislation and regulations, troubleshooting when glitches arise in plan operations, and helping qualified plan committees monitor plan investments and plan vendors. Jodi is well-versed in the complexity and challenges raised by large controlled groups. Jodi is a graduate of Stanford University and Harvard Law School.



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