Sections 162(m) and 409A:
Developments and Audit Issues

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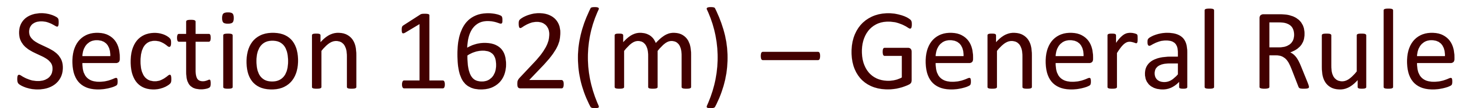
Agenda

- Section 162(m) Update
  - Exception for performance-based compensation
  - Recent legislation and guidance, including Section 162(m)(6)
  - Recent shareholder derivative lawsuits
- Section 409A
  - Brief reprise of rules and penalties for failure
  - What makes compliance so demanding?
  - Common failures and corrections inside and outside formal IRS corrections programs

Part I: Code Section 162(m) Update:
IRS Enforcement and Shareholder
Lawsuits



Section 162(m) – General Rule

- Compensation paid to a "covered employee" in excess of $1 million generally is not deductible by the corporation
  - Certain types of compensation are disregarded
  - Does not affect employee's tax treatment
- Applies only to public companies
- Covered employees include the CEO, and the four highest paid officers for SEC disclosure purposes
  - Notice 2007-49: Generally does not include the CFO

Performance-Based Compensation

- Four Basic Requirements
  - Must be granted by a compensation committee consisting of two or more outside directors
  - The "material terms" of the award, including the performance goals, must be disclosed to and approved by the shareholders
  - Performance goals must be "pre-determined" and "objective"
  - Before any payment is made, the compensation committee must certify that the goals have been satisfied

Shareholder Approval

- Material Terms
  - Performance goals
    - But not specific targets
    - Also may use an “umbrella” plan
  - Eligible employees
    - By category, but not necessarily by name
  - Maximum amount that could be paid to any employee, or the formula used to calculate compensation if the performance goal is reached.
    - Most plans list maximum amounts (e.g., dollars or shares)

Shareholder Approval, cont.

- Mechanics
  - Separate shareholder vote
  - No deduction if the awards would be paid anyway
  - Re-approval is required every five years if the Compensation Committee has the authority to change the targets under a performance goal after the plan is approved
    - Otherwise re-approval is not needed unless the material terms are changed

Performance Goals

- Must be established not later than 90 days/25% of the performance period
- Outcome must be substantially uncertain at the time the goal is established
- A third party with knowledge of the facts must be able to determine whether the goal has been met, and the amount payable to each recipient
- Not required to be based on positive results
  - May be based on maintenance of status quo, or limiting losses
- Compensation Committee may have discretion to decrease an award, but not to increase the award
  - Negative discretion is key to umbrella plan design
  - Use of qualitative or non-GAAP metrics may constitute impermissible discretion (e.g., recent Viacom, Caterpillar cases)

Recent Developments

- IRS Audit Guidelines – Common Failures
  - Mid-year changes to performance goals
  - Failure to properly document performance goals
  - Compensation committee includes non-outside directors
  - Failure to obtain shareholder re-approval
  - These are the simple rules, not the hard ones!

- Section 162(m)(6)
  - Reduces limit from $1M to $500K
  - Applies to “covered health insurance providers,” subject to controlled group aggregation rules
  - Generally applies to all service providers, including officers, employees and directors
  - No performance pay exception
  - Different timing rules for taking nonqualified deferred compensation into account
  - Takes effect in 2013

Recent Developments

- Revenue Ruling 2012-19
  - Dividends and dividend equivalents are separately subject to performance requirements
  - Good: Vest and become payable only if and when performance goals are satisfied for the underlying restricted stock/RSUs
  - No good: Paid at the same time dividends are paid, without regard to performance goals
  - Payment rule also must satisfy Section 409A, which can be tricky!

Recent Developments - Lawsuits

- Plaintiffs allege that plans failed to qualify for the performance-based exemption under Section 162(m)
- Suits allege breach of fiduciary duty, waste, and unjust enrichment
- Seek recovery of compensation, liability for directors and executives, and injunctions against future payments
- Several cases have (partially) survived motions to dismiss, resulting in significant settlements that include attorneys' fees
    - Courts dismissed direct claims because of the lack of direct economic harm, but allowed derivative claims to proceed.
- Small likelihood of success on the merits, but companies still face litigation costs and negative publicity

Seinfeld v. O'Connor – Good Result

- Proxy statement indicated that bonus plans were "intended" to comply with Section 162(m), but the company "may" issue non-deductible awards outside of the bonus plans
- Plaintiffs interpreted this to mean that awards would be granted even if the shareholders failed to approve them
  - Therefore, the vote was coercive, and the shareholder approval was meaningless.
- The court reviewed the plans' terms and found no 162(m) deficiencies
- Court dismissed all claims, relying in part on PLR 200617018

Resnik v. Woertz – Bad Result

- ADM's proxy statement indicated that shareholder approval would enable the company to issue awards that "will" be exempt from the Section 162(m) deduction limits
- However, the plan allegedly did not comply with Section 162(m)
  - Failed to obtain shareholder re-approval in 2007
  - Failed to sufficiently specify the performance goals, although the disclosures appeared to be compliant
- Derivative claims were allowed to proceed

Hoch v. Alexander – Bad Result

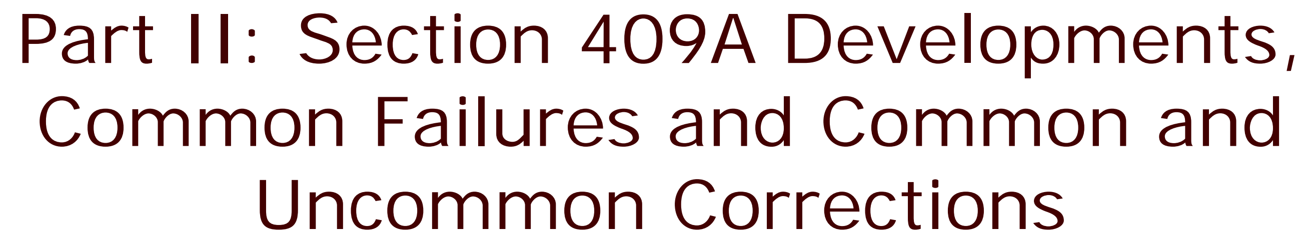
- Qualcomm's proxy statement indicated that the company's long-term incentive plan complied with Code section 162(m)
- Complaint alleged that the plan was not 162(m)-compliant because the company would pay larger awards even if the new plan was not approved by shareholders
- The court denied the motion to dismiss without considering the substantive allegations under Section 162(m)
- Derivative claims were allowed to proceed, and demand was excused because directors participated in the plan

Viacom & Caterpillar – Still Pending

- Complaints filed in August allege the following:
  - Companies impermissibly used qualitative and non-GAAP performance targets
  - SEC regulations require additional disclosures that are not required on the face of the Section 162(m) regulations
  - "Astronomical" maximum awards do not adequately communicate the true award limits

Recommendations

- Reserve the right to issue awards that are not deductible under Section 162(m)
- Make sure the plan complies with all requirements for performance-based compensation
- “Umbrella” plan design may facilitate Section 162(m) compliance and limit the need for re-approval, but large maximum awards may raise red flags for shareholders
- Separate bonus plan for directors


Part II: Section 409A Developments,
Common Failures and Common and
Uncommon Corrections

Section 409A Overview

- Section 409A requires that all nonqualified deferred compensation plans be in writing and comply in form and operation with strict rules governing:
  - Timing of deferral elections
  - Timing of payment
- Penalties apply for failures in operation or documents

What’s Covered

- Any right to receive compensation in a later taxable year **except**
  - Qualified plans (e.g., 401(k) & pension plans)
  - Vacation, medical, and disability plans
  - “Short-term deferrals”
  - Grandfathered arrangements
  - Non-discounted stock options or stock appreciation rights
  - Certain severance pay
  - Certain reimbursement rights
  - Certain foreign arrangements
- This means that all bonus programs, executive employment agreements, separation agreements, etc. must be checked for Section 409A compliance

Permitted Deferral Elections

- General Rule: Election to defer compensation must be made no later than last day of the year before the year in which the compensation is earned

- Special rules for new participants, performance based compensation and 401(k) linked elections

- Subsequent deferral elections - very limited

- Seven permissible payment “triggers”
  - Separation from service
  - Specified date
  - Change in control
  - Unforeseeable emergency
  - Disability
  - Death
  - Vesting (not an “official” trigger, but permitted nonetheless)

- 6-month delay for “specified employees”

- No accelerations!

Penalties for Failure

- Current taxation of vested deferred compensation under the plan
- 20% penalty tax – paid by employee (no withholding)
- Premium interest tax equal to federal underpayment rate plus 1% back to vesting date, on all vested amounts under plan – paid by employee (no withholding)
- The "plan" may include all arrangements of same type covering same employee
  - Example: Failure in "parachute" payment paid to executive may in some cases trigger 409A tax penalties for PV of that executive's SERP benefits

Why Is This So Ugly?

- IRS presumes collusion – no innocent mistakes
- Complex rules with many key terms ill-defined
- Policy mish-mash: no rule of thumb to decide uncertainties
  - Tax policy: deferral is bad
  - Corporate governance ("Enron") policy: acceleration is bad
- Plan aggregation ("bucket") rule – all plans in the same bucket are the same plan
  - Failure in one plan may taint all arrangements in same bucket
  - Rule for one plan may apply to all arrangements in the same bucket
    - Example: "De-risking" by terminating SERPs and cashing out benefits. This is an "acceleration." Under regulations, it is permitted only if all plans in the same bucket are terminated. This may include parachute plans, executive compensation agreements, etc.

Developments in Guidance

- Regulations on operational rules – Finalized 2007
- Proposed regulation on income inclusion. No final regulation in sight
- Notice guidance on “correction” programs
  - Notice 2008-113 – Correction of operational failures
  - Notice 2010-6 – Correction of document failures
  - Notice 2010-80 – Additional corrections of document failures
- Important December 31, 2012, deadline:
  - Correct “failed” release provisions. If any plan or agreement conditions a payment on employee’s execution of a release, this fails section 409A because it allows employee to choose taxable year of payment. Must correct under Notice 2010-80 by December 31, 2012, to avoid penalties.

Common Failures

- Delayed Payments
  - Scheduled payment date somehow overlooked
- "Separation from Service" not identified properly
  - There may not be a "separation" if employee
    - Terminates but has consulting agreement
    - Is employed by another member of the controlled group
  - There may be a separation if employee
    - Stops working but receives salary continuance
    - Cuts back hours
    - Terminates and returns to work after 6 months
- Deferral elections badly administered
  - Employee elects to defer $100, only $90 is taken from paychek
- Deferral elections apply to bonuses earned in deferral year, but paid in subsequent year
- Failed release provisions – fix these this year!

IRS Correction Programs

- Formal IRS correction programs
  - Notice 2008-113 – Correction of operational failures
  - Notice 2010-6 – Correction of document failures
  - Notice 2010-80 – Additional corrections of document failures

- Common features:
  - Correct or prevent all similar failures in controlled group
  - Partial penalties may apply in some instances
  - Must generally notify participant of failure
  - Company and affected employee (in most cases) must notify IRS on attachment to tax returns

Advantages of IRS Correction Programs

- Limits the violation to amounts directly involved in the failure
- No premium interest
- No other plans affected
- IRS claims that employers are not more likely to be audited for using the program
- Reasonable certainty of effective cure

Limitations of IRS Correction Programs

- Only specified types of failure can be corrected
- Can't correct operational failures more than 2 years old
- Operational failures not corrected unless employer takes commercially reasonable steps to prevent recurrence; plus good story for repeat offences
- Mistaken payment not correctible if made when employer in substantial financial downturn, or employer pays or provides benefit to substitute for returned payment.
- Detailed reporting on tax returns filed for correction year (exception for employee's tax return for operational failure corrected in failure year)
- Many document failures can be corrected only subject to "one year rule" – 50% of 409A tax penalty if bad payment trigger actually occurs within one year of correction
- Document failures not corrected unless employer takes commercially reasonable steps to identify and correct all substantially similar provisions in all of employer's other 409A-covered plans – where "employer" defined on controlled group basis

Example 1 – Delayed Payment Corrected Under Notice 2008-113

- Employee is owed $100K deferred compensation in 2012 upon separation from service. By mistake, $100K not paid in 2012
  - Failure discovered in 2013 – employee is not an "insider"
    - No 409A penalty
    - Account earnings zeroed out for period of improper deferral
    - Employer and Employee attach statement to tax return
  - Failure discovered in 2013 - employee an "insider"
    - 20% penalty tax but not premium interest tax on $100K
    - Penalty tax applied only to $100 K failure, not to all vested amounts in same bucket
    - Account earnings zeroed out for period of improper deferral
    - Employer and Employee attach statements to tax return
  - Failure discovered in 2015:
    - Correction under Notice 2008-113 not available more than 2 years after failure year

Example 1 (Cont.) – Delayed Payment Corrected Outside of Notice 2008-113

- Alternative Correction 1: No 409A failure occurred. Employee A was in constructive receipt of the payment in 2012. Appropriate correction is to issue an amended Form W-2 for 2012.

- Alternative Correction 2: Use failure-to-pay exception under Treas. Reg. Section 1.409A-3(g)
  - Applies to intentional and unintentional failures to pay
  - Employee must make "reasonable" and "prompt" efforts to collect
  - "Reasonable" collection requirement presumptively not met after 90 days after payment date. What overrides presumption?

- When might you want to use alternative correction approaches?
  - When Notice 2008-113 is unavailable
  - Other circumstances?

Example 2 – Accelerated Payment Corrected Under Notice 2008-113

- "Insider" Employee elects to defer $500K of June 2012 bonus, but plan administrator mistakenly defers only $400K of bonus

- $100K "acceleration" is discovered in same year - i.e., 2012
  - No 409A penalty
  - Employee repays $100 plus interest on "accelerated" payment
  - Employer attaches statement to tax return
- Discovered in 2013
  - 20% penalty on $100K acceleration
  - No premium interest tax and no penalty on plans in same bucket
  - Employee repays $100K plus interest on "accelerated" payment
  - Employer attaches statement to tax return
- Discovered in 2015
  - No correction available under Notice 2008-113

Example 2 (Cont.) – Accelerated Payment Corrected Outside of Notice 2008-113

- $100K acceleration is discovered in 2012 (year failure occurred)
  - Alternative correction:
    - Amount is returned in the same year as paid -- no failure, under doctrine of *Couch v Commissioner* and *Russel v. Commissioner*

- Discovered in 2015
  - Alternative correction is harder when payment made in earlier year. One approach to think about:
    - Employee returns payment
    - No receipt occurred for section 409A purposes under "unwilling payee" rule of *Illinois Power Co. v. Commissioner*
    - Approach is not free of problems

Example 3 – Option Grant Corrected Under Notice 2008-113

- Option granted in 2012 with strike price of $100, described as FMV of stock. It is determined that FMV of stock on grant date was $110. Stock vests in 2014

- FMV mistake discovered in 2013
  - For "insider" employees – it is too late to correct. Rescind option before vesting and taxation in 2014
  - For non-insider employees. Option price can be corrected before end of 2013.

Example 3 (Cont.) – Option Grant Corrected Outside of Notice 2008-113

- Correction before vesting: Revise option contract? IRS informally says this doesn't work. Better argument is that it does.

- Correction after vesting or exercise. More difficult. Possibilities:
  - Ignorant payee rule of *Roberts v. United States*, 734 F. Supp. 314 (N.D. Ill. 1990) (taxpayer doesn't have income that he doesn't know about)
  - unwilling payee rule of *Illinois Power* (taxpayer doesn't have income he is not entitled to keep)
  - *Couch/Russel* if increment returned in year of exercise.
  - Issues raised: Alternative correction implicitly bifurcates strike price into permissible and impermissible piece. IRS has rejected bifurcation analysis in 162(m) context. CCA 2009-06 (July 6, 2009).