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HOT TOPICS IN EXECUTIVE COMPENSATION AND EMPLOYMENT TAX

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Agenda

- Correcting common Section 409A failures
  - Audits on the horizon
- FICA taxation of nonqualified deferred compensation
  - Recent court decision raises red flags for employers
- Fringe benefits
  - Local lodging
  - Corporate aircraft
- Section 162(m)

COMMON SECTION 409A FAILURES

Section 409A: What is Deferred Compensation?

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

service provider has a	• Not limited to executives • Includes directors & independent contractors
legally binding right to	• Must assume that conditions on obtaining the amount (i.e. vesting conditions) are fulfilled
compensation to be paid in a later year	• 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
- Top hat plans (e.g., deferral plans and SERPs)
- Excess benefit plans
- But also-
  - Severance arrangements
  - Equity compensation plans and awards
  - Bonus plans
  - Indemnity/reimbursement/gross-up agreements

Section 409A: Consequences of a Violation

- Consequences to employee
  - Current-year income taxation of all vested benefits
  - Additional 20% penalty tax
  - Premium interest tax equal to federal underpayment rate plus 1% retro to vesting date, for all vested benefits
  - Same penalties for benefits earned in any "aggregated" plan
- Consequences to employer
  - 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

- Deferral elections generally must be made no later than December 31 of the year preceding the year in which the compensation is earned.
- Bonus deferral elections may be made mid-year for certain bonuses
- 30-day election window for mid-year hires
- Re-deferral permitted if the election is made at least one year prior to payment and pushes out the initial payment by at least five years

Section 409A: 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 Errors

- Definition of compensation not administered correctly
- Mid-year enrollment for newly eligible participants
- Application of bonus deferral elections
- Identifying separations from service
  - Reduction in hours
  - Leave of absence
  - Transfer to an affiliate on a different payroll system
  - Ongoing consulting work after termination of employment
  - Rehire following termination
  - Acquisitions & dispositions

Section 409A: Error Correction

- Operational errors may be corrected in accordance with IRS Notices 2008-113, 2010-6, and 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

Section 409A: Late Payment

- Employee separates from service in 2015, but cannot be located; error is discovered in 2016.
- Payment must be made, without interest, in 2016
- Payment is taxable in 2016
- If employee is an "insider," amount subject to the failure is subject to 20% additional income tax

Section 409A: Early Payment

- Employee transfers to a foreign affiliate in 2015, mistakenly receives lump sum payment; error is discovered in 2016
- Employee must repay the plan, with interest, in 2016
- No refund or credit on 2015 return
- Deduction for repayment on 2016 return
- If employee is an "insider," amount subject to the failure is subject to 20% additional income tax

FICA TAXATION OF NONQUALIFIED DEFERRED COMPENSATION

Section 3121(v)(2): FICA Treatment of Nonqualified Deferred Compensation

- Compensation generally subject to FICA tax when paid
- Special Timing Rule: Nonqualified deferred compensation is 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.
    - For non-account balance plans, FICA taxation may be further delayed until the amount deferred is "reasonably ascertainable"; alternatively, earlier inclusion is permitted, with a subsequent true-up
- Pro-taxpayer (and pro-employer) rule because of Social Security wage base
- Non-duplication rule shields earnings from FICA tax

Section 3121(v)(2): Special Timing Rule

- For account balance plans, earnings attributable to an amount that has been taken into account for FICA purposes are not subject to FICA tax, as long as earnings are based on either
  - A "reasonable rate of interest" or
  - A "predetermined actual investment"
- For 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
- If the employer fails to take the excess earnings into account, all benefits attributable to earnings in excess of AFR are subject to FICA tax in the year of accrual

Section 3121(v)(2): Special Timing Rule

- 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 (including earnings) subject to FICA tax when paid
  - Typically results in larger tax liability
  - Especially valuable for IRS when limitations period for the special timing rule has expired

Section 3121(v)(2): Example #1

- Account Balance Plan
  - Employee defers $10,000 in 2016, has total FICA wages of $300,000
  - Employee receives $15,000 after retiring in 2021, has total FICA wages of $100,000
  - Special Timing Rule: $235 of FICA tax in 2016
    - $10,000 * 2.35% (Medicare + Plus Additional Medicare)
  - General Timing Rule: $1,147.50 of FICA tax in 2021
    - $15,000 * 7.65% (Social Security and Medicare)

Section 3121(v)(2): Example #2

- Non-account Balance Plan
  - Employee retires in 2016 with a SERP benefit, total other FICA wages of $250,000
  - 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
  - Special Timing Rule: $23,500 of FICA tax, only in 2016
  - General Timing Rule: $6,120 of FICA tax each year for the remainder of the employee's life

Section 3121(v)(2): Common Errors

- "Unreasonable" fixed interest rates
  - This is fairly typical for older account balance plans
- Failure to take employer contributions into account
  - Unlike company contributions to 401(k) plans, company contributions to nonqualified plans are FICA wages
- Failure to tax earnings generated before benefits are "taken into account" for FICA purposes
  - E.g., contributions are credited/taken into account at year-end, but earnings are calculated as if contributions were made ratably throughout the year
- Failure to tax retirement-age vesting of RSUs

The Henkel Case

- In *Davidson v. Henkel Corp.* (E.D. Mich., 1/6/15), a federal district court ruled that Henkel violated ERISA by failing to withhold FICA taxes in accordance with the special timing rule
- As a result, the court granted summary judgment for the 49 class action members, and held the company liable for the resulting reduction in the net benefits payable to participants

The Henkel Case

- Under the special timing rule, FICA taxes should have been withheld at the time participants retired and started their benefits
- For Davidson and other participants, the limitations period for the year of retirement had already expired
- Henkel reached an agreement with the IRS under which Henkel would withhold 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

The Henkel Case

- The court based its ruling on fairly innocuous plan language:
  - "The Company … ***shall have the right to withhold*** any and all local, state, and federal taxes…in accordance with applicable law." [Emphasis added]
  - "For each Plan Year in which a Deferral is being withheld or a Match is credited to a Participant's Account, the company shall ratably withhold … the Participant's share of all applicable Federal, state or local taxes."
  - The purpose of the plan was to provide tax benefits to participants

The Henkel Case

- The opinion is confusing in several respects:
  - Was the plan an account balance plan or a non-account balance plan?
  - Why did the court determine that the special timing rule is optional, despite citing regulatory provisions indicating that the rule is mandatory?
  - Did the court understand the non-duplication rule?

Big Question

- Could the reasoning in the Henkel case be applied against an employer that inadvertently administers its plan in a manner that violates Code section 409A?

Key Takeaways

- Plan drafting
  - 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 Code section 409A or 3121(v), or any other tax rules
  - Disclaim responsibility for any reduction in net payments to employees resulting from the application of any tax
- Self-audit plans annually for Section 409A compliance
- Follow the special timing rule!

FRINGE BENEFITS

Local Lodging

- Normally, lodging expenses incurred by employee while not traveling away from home are considered personal expenses under Code section 262(a)
  - Not deductible
- IRS final rules create new exception for local lodging
  - Deductible as ordinary and necessary business expense under Code section 162
  - Excludible as working condition fringe benefit under Code section 132
  - Reimbursement is excludible under accountable plan
  - Safe harbor, or facts and circumstances test

Local Lodging Safe Harbor

- Necessary for employee to participate fully in or be available for bona fide business meeting, conference, training activity, or other business function
- Stay does not exceed five calendar days
- No more than one stay per calendar quarter
- Employer requires employee to remain at the activity or function overnight
- Not extravagant or lavish and does not provide a significant element of personal pleasure or recreation

Local Lodging
Facts & Circumstances Test

- Business purpose (not primarily social or personal)
- Not lavish or extravagant
- Must be due to "bona fide condition or requirement of employment" imposed by employer
- "Good" examples:
  - Employees required to stay at local hotel during work-related training session or conference
  - Employees who are 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 who has to stay at a hotel near the office while working long hours

Personal Use of Corporate Aircraft

- Personal use of corporate aircraft has value to the employee and is provided in connection with employment. Therefore:
  - The "value" is includible in the employee's income as a taxable fringe benefit. Code Section 61(a)(1).
  - Under SEC rules, the "aggregate incremental cost" to the company must be disclosed to shareholders in the company's annual proxy for reportable executives (CEO, CFO +3 other highest-paid officers)
- IRS and SEC rules have different purposes – and so the calculations are different.
  - IRS rules look at the value provided to the employee
  - SEC rules want shareholders to know what it costs the company to provide that benefit
  - For example, the same cross-country flight might be treated as follows:
    - Employee is taxed on imputed income of $1,600.
    - Proxy could report that the employee received a perquisite with a value of approximately $30,000.

Personal Aircraft Use: Tax Rules

- Treas. Reg. 1.61-21(g): Noncommercial flight valuation
  - Companies can value personal usage of aircraft in two ways:
    - Comparable charter price on a comparable aircraft
    - SIFL method: "Standard industry fare level" valuation method
  - SIFL almost always produces a lower rate, and so is the more commonly used valuation method
- SIFL Method: Treas. Reg. 1.61-21(g)(5):
  - The value of noncommercial flights on employer-provided aircraft that is subject to taxation as a fringe benefit is determined by multiplying SIFL cents-per-mile rates applicable for the period during which the flight was taken by the appropriate aircraft multiple (1.61-21(g)(7)), and then adding the applicable terminal charge

Personal Aircraft Use: SIFL Rates

- SIFL rates are published semi-annually by the IRS (most recently Rev. Rul. 2016-10 (April 7, 2016))
  - For flights taken Jan. 1 – June 30:
    - 21.44 cents/mile up to 500 miles
    - 16.35 cents/mile from 501 to 1,500 miles
    - 15.72 cents/mile in excess of 1,500 miles
    - Terminal charge is $39.19
  - Aircraft multiples are based on "maximum certified take-off weight of the aircraft"
    - 6,000 lbs. or less: 62.5%
    - 6,001 – 10,000 lbs.: 125%
    - 10,001 – 25,000 lbs.: 300%
    - 25,001 lbs. or more: 400%
- Doing the math: 3,000 mile flight on aircraft weighing 20,000 lbs. results in imputed income to executive of ~$1,600.00
  - If the executive has family members or guests accompany her, the executive has the same amount of income ($1,600 in this example) imputed to her for each family member and guest (Employee + 3 guests = ($1,600 x 4))
  - Note: If 50% of seats are occupied by individuals who are primarily on the plane for business reasons, then there is no income imputed to the executive or the family members

Personal Aircraft Use: Proxy Disclosures

- SEC rules require disclosure of the value of any "perquisites" provided to executives
- Personal aircraft usage requires calculation of the "aggregate incremental cost"
- That is, what costs does the company incur in order to provide the flight to the employee (and his/her guests)?
  - Includes flight crew, fuel, allocable maintenance fees, catering etc.
  - Services produce an average hourly cost of operating each particular type of aircraft
  - ❖ Company cost typically runs between $4K to $6K/flight hour, depending on the aircraft

Personal Aircraft Use: Other differences in Tax v. SEC Rules

- Oddity #1: "Deadheading" is when a plane flies empty to a particular location to pick up an executive;
  - SEC counts deadhead flights; IRS does not
  - For example, plane is located in CA; executive wants plane to come to DC to pick him up and return home
    - IRS taxation: $1,600 under SIFL rules (deadhead leg is not included)
    - SEC disclosure: $55,000 = $5K/hour x 11 hours (deadhead leg is included)
- Oddity #2: Family member/guest going along with executive on business trip
  - 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)

Personal Aircraft Usage: Traps for the Unwary

- 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 proxy purposes (positioning leg from plane location to vacation home); possibly no imputed income
- Commuting
  - Traveling to or from your principal place of business is always personal
  - Tele-commuting makes this a more difficult analysis for some executives (i.e., is the principal place of business his/her home?), but not usually for the top 5 executives
- "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
  - For example, executive in DC taking vacation in SLC for five days; plane drops off family, then returns to HQ, flies back to SLC and returns again (4 flights in total for proxy purposes; 2 flights for tax purposes)

SECTION 162(M)

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
- Applies in the year in which the payment otherwise would be deductible
- Covered employees include the CEO, and the four highest paid officers for SEC disclosure purposes
  - Notice 2007-49: Does not include the CFO

Section 162(m): Performance Pay Exception

- Must be granted by a compensation committee consisting solely of two or more outside directors
- Compensation may be paid only upon the attainment of one or more pre-established, objective performance goals
  - Outcome of performance goals must be substantially uncertain at the time the award is issued
  - A performance goal is objective if a third party having knowledge of the relevant facts could determine whether the goal has been achieved
  - The performance goal must be established in writing no later than 90 days after the start of the performance period, and after no more than 25% of the performance period has elapsed
  - Compensation Committee may have discretion to decrease an award, but not to increase the award
- The award must preclude discretion to increase the amount payable following the 90-day and 25% deadlines set forth above
- Before any payment is made, the compensation committee must certify that the goals have been satisfied

Section 162(m): Performance Pay Exception

- Shareholders must approve the "material terms" of awards to covered employees. These include:
  - The employees or categories of employees that are eligible to receive the compensation;
  - The business criteria upon which the performance goal(s) may be based (but not specific targets); and
  - Maximum amount that could be paid to any employee, or the formula used to calculate compensation if the performance goal is reached. For equity awards, a share limit will suffice.
    - Per-person limits for stock options and SARs
- Mechanics of shareholder approval
  - Separate shareholder vote
  - No deduction if the awards would be paid anyway
  - Re-approval required every five years if the Compensation Committee has the authority to change the targets under a performance goal

Section 162(m): Common Failures

- Failure to specify individual share limits for options and SARs
- Performance requirements waived in the event of retirement, or involuntary or "good reason" termination
- Dividend rights not subject to performance metrics
- Use of performance metrics that were not approved by shareholders
- Performance goals adjusted to reflect changed circumstances without specific plan language that allows for the change
  - New FASB guidance may require new plan language
- Committee fails to certify performance results
- Failure to obtain shareholder re-approval of performance metrics

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