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Executive Compensation: 409A Practical Tips and Current Plan Design Issues

Western Pension & Benefits Conference

Retirement Plan Symposium

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What We'll Cover

- Pointers on dealing with 409A
- Trends in executive compensation
- Phantom stock plans

Part 1—409A Pointers

Why The Fuss Over 409A?

- Internal Revenue Code § 409A—
  - Has a broad range
  - Packs a big sting
- There is no parallel ERISA provision
  - This is a Tax Code rule only
- "Top Hat" plan exemption takes most 409A plans outside of most of ERISA

409A's Broad Reach

General Rule

- Applies to any nonqualified deferred compensation plan
- "Deferred compensation"

  = Legally binding promise made in one year to pay in a later tax year
- "Plan" is any
  - Agreement
  - Method
  - Program
  - "Other arrangement"

409A's Broad Reach

Examples of Plans Covered

- Traditional deferred comp plans
- § 457(f) plans (for tax-exempts)
- Bonus deferral arrangements
- Incentive pay plans
- Employment agreements
- Expense reimbursement agreements
- SERPs
- Excess benefit plans
- Split-dollar insurance arrangements
- Discounted stock options
- Restricted stock units (RSUs)
- Phantom stock plans
- Change-in-control agreements
- Severance pay arrangements
- Salary continuation agreements
- Post-employment "consulting" agreements
- Retirement "stipends"
- Sabbatical programs

409A's Broad Reach
Plans Not Covered

- Qualified retirement plans (also 403(b) and 457(b) plans)
- Certain foreign plans
- Certain welfare plans (bona fide vacation, sick leave, comp time, disability pay and death benefit plans)
- Certain independent contractor arrangements
- Restricted stock
- Full-value stock options
- Short-term deferrals
- Safe harbor severance pay arrangements

409A's Big Sting
General Rules

- Immediate income tax recognition
  - On all vested amounts on date of breach
- 20% additional income tax
- "Stinger" penalty interest rate (underpayment rate + 1%)

→ Note: California has its own mini-409A which applies in addition to the federal taxes

409A's Big Sting
Tax Calculation Illustration

Example: Executive has $100,000 vested account balance in a plan that pays him $10,000 at a time not permitted under 409A

- Incorrect tax calculation #1
  - Immediate income recognition on $10,000 at 35% = $3,500
  - 20% additional tax = $2,000
  - Total = $5,500

409A's Big Sting

Tax Calculation Illustration (continued)

- Incorrect tax calculation #2
  - Immediate income recognition on $100,000 at 35% = $35,000
  - Plus 20% on the tax = $7,000
  - Total = $42,000
- <u>Correct</u> tax calculation
  - Immediate income recognition on $100,000 at 35% = $35,000
  - 20% additional tax = $20,000
  - Total = $55,000

What Does 409A Require?

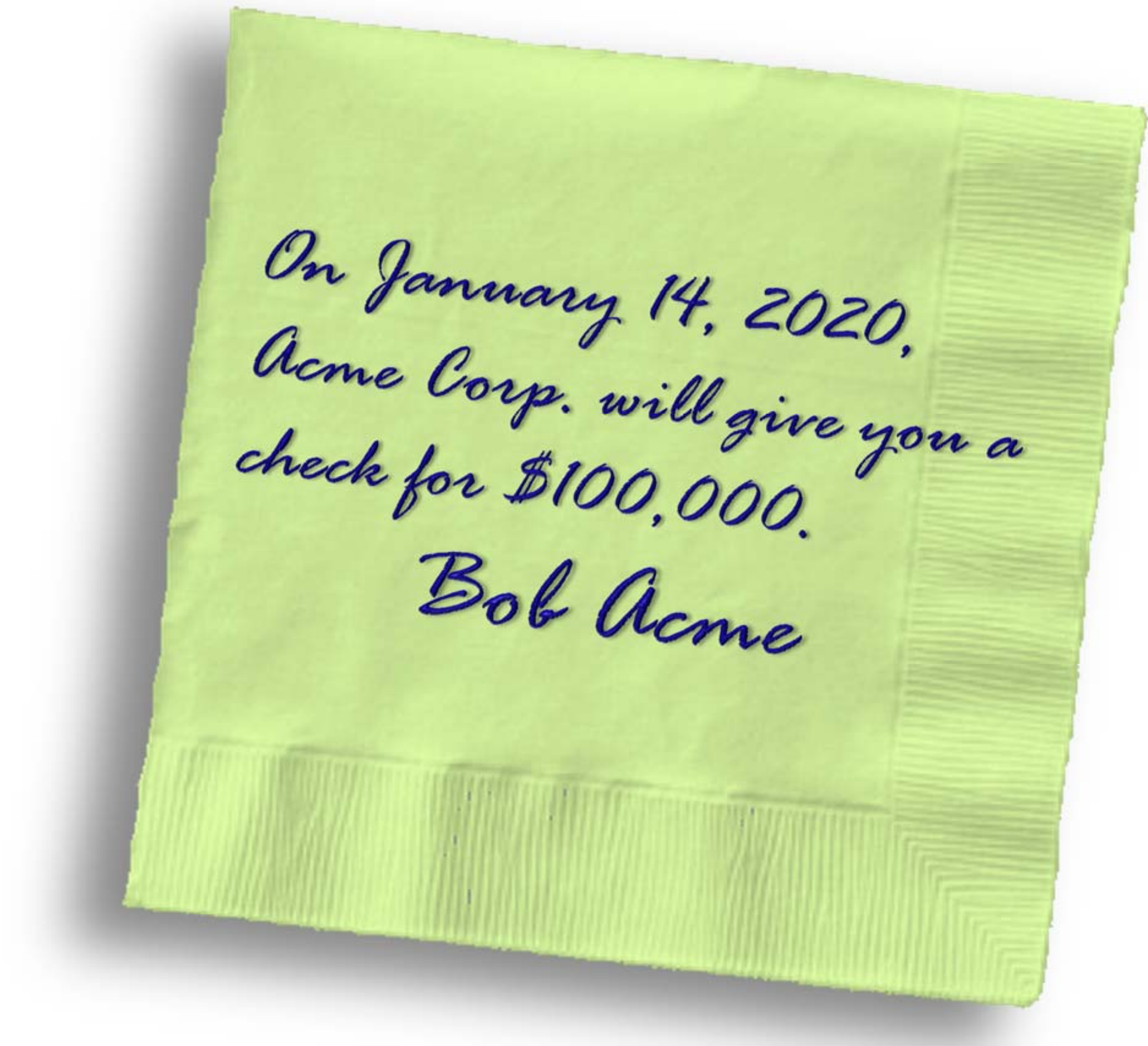
- Sets strict deadlines for deferral elections
- Requires time and form of payment to be elected at time of deferral
- Allows for payment only upon certain distribution events
- Delays severance payments to top executives of public companies for 6 months
- Prohibits acceleration of payments (other than for limited exceptions)
- Restricts ability to change form of payment or postpone time of payment
- Aggregates similar plans for compliance testing
- Restricts ability to terminate a NQDCP

409A Permissible Payment Events

1. Separation from service
2. A date certain or a fixed schedule
3. Change in control
4. Death
5. Disability
6. Unforeseeable emergency

➔ All these terms (except death) are specifically defined in the 409A final regulations

➔ Death is defined in *faux* Notice 2007-90 (attached) as "separation from life"


On January 14, 2020,
Acme Corp. will give you a
check for $100,000.
Bob Acme

Does it Comply with 409A?

- ✓ It's in writing
- ✓ Specifies time of payment
- ✓ Specifies form of payment
- ✓ Doesn't allow for acceleration of payment
- ✓ Doesn't allow for deferral of payment
- ✓ Doesn't allow for change in payment method

Problems with this "Napkin Plan"

- Failure to address withholding
- Failure to prohibit payment acceleration
- Failure to restrict change in date of payment
- Failure to restrict change in form of payment
- Failure to address termination of employment

My Pet 409A Peeve

Overuse/Misuse of 3/15 Payment Date

- Short-term deferrals are exempt from 409A
- “Short-term” if paid within 2½ months after the year in which the payment vests

Case Study #1—The Issue

A company's written 2015 bonus plan says that bonuses earned in 2015 will be paid on March 15, 2016.

Through an administrative oversight, the bonuses are not paid until April 15, 2016.

Q: 409A compliance problem?

Case Study #1—The Answer

No. Since the plan was written and specified a payment date (March 15, 2016), the company could delay payment until as late as December 31, 2016 without violating 409A, since the payment will be made in the same taxable year.

(But just because there isn't a 409A violation doesn't mean employees may not have a contract breach claim for the delayed payment.)

Case Study #2—The Issue

A company does not have a written bonus plan for 2015 or, if it does, the plan does not specify a date on which the 2015 bonuses will be paid. In either case, the company has a practice of paying bonuses by the following March 15.

However, through an administrative error, the 2015 bonuses are not paid until April 15, 2016.

Q: 409A compliance problem?

Case Study #2—The Answer

Yes. Since the payment was not made by March 15, the short-term deferral rule is not available.

If bonus plan is unwritten, that's an automatic 409A failure.

If it's written, it didn't specify a payment date, so the "later payment in the same tax year" exception that was used in Case Study #1 is unavailable.

Case Study #3—The Issue

A company's Employee Manual says that bonuses for a particular year will be paid after the financial statements for that year have been prepared and that employees must still be employed on the date the bonus is paid to receive payment.

The financials for 2015 aren't finished until June 2016 and, because of cash flow reasons, the company doesn't get around to paying the 2015 bonuses until March 16, 2017.

Q: 409A compliance problem?

Case Study #3—The Answer

No. The Employee Manual didn't specify a payment date or even a payment year, so the company has to rely on the short-term deferral exception to comply with 409A.

The 2015 bonus wasn't paid by March 15, 2016, but that doesn't matter. Why? Because employees have to be employed on the bonus payment date to be entitled to payment. In other words, they're not vested until the payment date. That is, this is a "pay-on-vesting" plan.

Part 2— Trends in Executive Comp

Pay-for-Performance

- *THIS* is a big concern for public companies
- Driven by—
  - Dodd Frank Wall Street Reform and Consumer Protection Act
  - "Say On Pay" votes
  - Proxy Advisory Firms (primarily ISS)
  - SEC compensation disclosure requirement
- Trickle down to private companies

What’s Happening—

- Move away from time-based compensation arrangements (e.g., stock awards or options)
- Move towards performance-based arrangements (e.g., performance unit plans and long-term incentive plans (LTIPs))
- Move away from time-based vesting to performance-based vesting
- Move away from discretionary bonuses to those based on attainment of target goals

Ways of Measuring Performance

- Total Shareholder Return
  - Stock price; stock price appreciation (w/ or w/o dividends)
- Income
  - EPS; EBITDA; operating income; pre-tax income
- Capital Efficiency
  - ROE; ROA; ROI; ROC; EVA (Economic Value Added)
- Revenue
  - Revenue; revenue growth

The Overriding Objectives

- Link pay to performance
- Align financial interests of executives with those of the shareholders

Part 3—Phantom Stock Plans

What is a Phantom Stock Plan?

- Gives key executives the economic benefits of being a shareholder without actually issuing them stock
- Executives receive the right to a future cash bonus based upon the growth of the company
- Can create opportunity for meaningful wealth accumulation (i.e., sale of company or IPO)
- Gets executives to think and act like owners

Applicability of Phantom Stock Plans

Note: Although this presentation will refer to "stock" and "shareholders," the phantom stock approach can be applied to LLCs and partnerships as well

So, What's Wrong with Just Issuing Stock?

- Plenty!
  - Corporate governance problems
  - Securities law issues
  - Unfavorable tax consequences

Downside of Issuing Stock
Corporate Governance Problems

- Issuing real stock gives executives—
  - Voting rights
  - Access to company books and records
  - Ability to sue for oppression of their minority shareholder rights

Downside of Issuing Stock
Securities Law Issues

- Allowing executives to buy stock triggers federal and state securities law requirements
- Registration exemptions are available
- But no exemption from anti-fraud rules
  - Requires a mini-Offering Memorandum
  - Disclosure of company's finances, business plans and risks of the investment
- Compliance costs and disclosure requirements are usually a deal-breaker

Downside of Issuing Stock

Unfavorable Tax Consequences

- If you simply give stock to executives, they have tax liability when their stock vests
- If you sell the stock to executives, they have to use after-tax dollars to purchase stock or exercise a stock option
- Your company gets no tax deduction when it redeems the stock upon executive's death or termination of employment—i.e., it's using after-tax dollars

Phantom Stock Plans

Two Basic Types

- Full-value plans
  - Pay a cash bonus equal to the value of the original shares plus the appreciation on those shares

    Example: Executive receives 100 shares of phantom stock valued at $10/share. If value at payment date is $20/share, executive receives $2,000.
- Appreciation-only plans
  - Pay a bonus equal to the difference between the issue and "redemption" price

    Example: Same facts as above, but payment will be $1,000 ($20 – $10 ✕ 100).

Phantom Stock Plans

Design Flexibility

- Since not subject to IRC/ERISA nondiscrimination or vesting rules, phantom stock plans can have—
  - Performance-based grants
  - Performance-based vesting
  - "Bad boy" forfeiture clauses
  - Clawbacks
- No need to have uniform grant, vesting or forfeiture provisions
  - Can be done by pay grades or even on individual basis

Phantom Stock Plans

Variation: Elective Phantom Stock Plan

- Executives can defer salary and/or bonuses
- Deferrals used to purchase phantom stock
  - Either full-value or appreciation only
- Earnings on deferrals based on growth in the phantom stock vs a credited interest rate or other notional investment
- Like a stock option plan, executives have to buy in
- Unlike a stock option plan–
  - Executives can't choose redemption date (must be 409A permissible payment event)
  - Don't have 409A worry as to whether the phantom stock is issued at a discount

Phantom Stock Plans
Variation: Performance Unit Plan

- Future cash bonus payable to executive is not tied to value of company stock
- Instead, it's tied to the growth in value of "units" awarded
- Units are defined by one or more financial metrics applicable to the executive or the executive's division, department, etc.

Questions?

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Appendix
(faux) IRS Notice 2007-90

Part III – Administrative, Procedural, and Miscellaneous
2008 Application Death Under § 409A to Nonqualified Deferred Compensation Plans

Notice 2007-90

I. PURPOSE

This notice provides additional guidance on the application of a service recipient's death under § 409A of the Internal Revenue Code to nonqualified deferred compensation plans. This guidance includes:

- A more precise definition of death (also known as "separation from life").
- Presumptions the Service will apply in determining if a service recipient has experienced a separation from life under § 409A.
- Examples detailing situations that the help illustrate the Treasury's position on separation from life.

II. BACKGROUND

Section 409A provides certain requirements applicable to nonqualified deferred compensation plans. If a plan does not meet those requirements, participants in the plan are required to immediately include amounts deferred under the plan in income and pay additional taxes on such income.

The Treasury Department and the IRS issued final regulations under § 409A in April 2007 (72 Fed. Reg. 19234 (April 17, 2007)). The final regulations apply to taxable years beginning on or after January 1, 2008. In general, the final regulations provide that payment may be made under a nonqualified deferred compensation plan upon a service provider's death. Commentators stated that taxpayers anticipate difficulties in formally determining if a service provider is dead. In addition, a number of commentators have raised questions regarding the application of the final regulations to certain types of deaths. This notice is issued in response to these comments and questions.

III. DEATH

A. In General

For purposes of determining if a service provider (or a service provider's beneficiary or estate) is entitled to a payment under a nonqualified deferred compensation plan on account of the service provider's death, the Treasury will consider a service provider to be dead if the service provider's death meets the criteria necessary for a separation from life.

B. Separation from Life

1. In General

A service provider separates from life with the service recipient if the service provider has a termination of all mental and bodily functions. However, the service provider's life is treated as continuing intact while the individual is temporarily unconscious, having an out of body experience, cryogenically frozen or experiencing another bona fide leave of absence from the individual's conscious state, if the period of such leave does not exceed ten minutes, or if longer, so long as the individual retains a right to regain life and/or reanimation under an applicable contract (with the devil or otherwise) or other arrangement.

If the period of leave exceeds ten minutes and the individual does not retain a right to regain life and/or reanimation under an applicable contract or other arrangement, the death is deemed to occur on the first minute immediately following such ten-minute period. Notwithstanding the foregoing, where a leave is due to any medically determinable physical or mental impairment that can be expected to result in death, where such impairment causes the service provider to be unable to perform the essential functions of life without mechanical support, a 525,600 minute period of absence may be substituted for such ten minute period.

2. Termination of Life

A service provider will be deemed to have experienced a separation from life if he or she experiences a termination of life. Whether a termination of life has occurred is determined based on whether the facts and circumstances indicate that the service provider reasonably anticipated (or would have reasonably anticipated) that no further mental and bodily functions would be performed after a certain date or that the level of bona fide mental and bodily functions the service provider would perform after such date (whether with or without mechanical assistance) would permanently decrease to no more than 20 percent of the average level of bona fide mental and bodily functions performed (whether with or without mechanical assistance) over the immediately preceding 36-month period (or the full period of life if the service provider has been living less than 36 months). Facts and circumstances to be considered in making this determination include, but are not limited to, whether the service provider continues to be treated as living for other purposes (such as whether or not he or she continues to receive a paycheck from the service recipient), whether similarly situated service providers have been treated consistently by the service recipient, and whether the service provider is permitted, and realistically available, to perform services for other service recipients. A service provider is presumed to have separated from life where the level of bona fide mental and bodily functions performed decreases to a level equal to 20 percent or less of the average level of mental and bodily functions performed by the service provider during the immediately preceding 36-month period. A service provider will be presumed not to have separated from service where the level of bona fide mental and bodily functions performed continues at a level that is 50 percent or more of the average level of mental and bodily functions performed by the service provider during the immediately preceding 36-month period. No presumption applies to a decrease in the level of bona fide mental and bodily functions performed to a level that is more than 20 percent and less than 50 percent of the average level of bona fide mental and bodily functions performed during the immediately preceding 36-month period. The presumption is rebuttable by demonstrating that the service provider reasonably anticipated that as of a certain date the level of bona fide mental and bodily functions would be reduced permanently to a level less than or equal to 20 percent of the average level of bona fide mental and bodily functions provided during the immediately preceding 36-month period or full period of life if the service provider has been alive for a period of less than 36 months (or that the level of bona fide mental and bodily functions would not be so reduced). For example, an service provider may demonstrate that the service provider reasonably anticipated that the service provider would cease mental and bodily functions, but that, after the original cessation of mental and bodily functions, a deal made with God (such as in the movie "Heaven Can Wait") caused the service provider to return to life. Although the service provider's return to life may cause the service provider to be presumed to have continued to live because the service provider is performing mental and bodily functions at a rate equal to the rate at which the service provider was performing mental and bodily functions before the termination of life, the facts and circumstances in this case would demonstrate that at the time the service provider originally ceased to perform mental and bodily functions, the service provider reasonably anticipated that the service provider would not perform mental and bodily functions in the future.

Notwithstanding the foregoing paragraph, a plan may treat another level of reasonably anticipated permanent reduction in the level of bona fide mental and bodily functions as a separation from life, provided that the level of reduction required must be designated in writing as a specific percentage, and the reasonably anticipated reduced level of bona fide mental and bodily functions must be greater than 20 percent but less than 50 percent of the average level of bona fide mental and bodily functions provided in the immediately preceding 36 months. The plan must specify the definition of separation from life on or before the date on which a separation from life is designated as a time of payment of the applicable amount deferred, and once designated, any change to the definition of separation from life with respect to such amount deferred will be subject to the rules regarding subsequent deferrals and the acceleration of payments. For purposes of this paragraph, for periods during which a service provider is experiencing a bona fide absence (as described in section III(B)(2)) and has not otherwise terminated life pursuant to this paragraph, the service provider is treated as performing bona fide mental and bodily functions at a level equal to the level of mental and bodily functions that the service provider would have been required to perform to receive the compensation. In this regard, the Service recognizes that not all jobs require the same level of mental and/or bodily functions.

3. Examples

Example 1 – Joanna uses 10% of her brain and 90% of her body on a daily basis. Joanna gets hit by a truck such that she can only use 2% of her brain and 18% of her body. If Joanna's nonqualified deferred compensation plan provides for payments on separation from life, Joanna is entitled to payment under her nonqualified deferred compensation plan because she is only providing mental and bodily functions equal to 20% of the bona fide mental and bodily functions she was performing before she was hit by a truck.

Example 2 – Pete uses 5% of his brain and 50% of his body on a daily basis. Pete has struck a deal with the devil such that, in exchange for his soul, Pete retains the right to regain life after the first two times that he would otherwise separate from life. Pete gets mauled by a cougar and is not performing any mental and bodily functions for more than 10 minutes. However, because Pete retains the right to regain life, he has not experienced a separation from life.

Example 3 – The same facts as Example 2 except that the devil realizes he got a raw deal because Pete does not have a soul. Because the contract providing Pete the right to regain life is not valid, even under the laws of hell, Pete no longer has the right to regain life pursuant to a contract or other arrangement, and therefore experiences a separation from life at the expiration of the 10-minute period.

VII. DRAFTING INFORMATION

The principal author of this notice is B. L. Zebub of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the Treasury Department and the IRS participated in its development. For further information regarding this notice, contact B.L. Zebub at (666) 911-4355 (not a toll-free call).