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Executive Compensation

Attorney Says IRS Clarifies Deduction Issues, Benefits Reduction Cases Raise Concerns

Three recent executive compensation developments of interest are the issuance of Internal Revenue Service guidance on the deductibility of annual bonuses, the final regulations under tax code Section 83 and litigation involving withholding on deferred compensation, a speaker told a conference session.

Pamela Baker, a partner in the Chicago office of Dentons, said during the April 2 session that last October, the Internal Revenue Service released field attorney advice memorandum 20134301F, which further clarified the ''all events test'' for determining the employer's year of deduction.

Earlier guidance in Revenue Ruling 2011-29 expanded on the rule (219 PBD, 11/14/11), and chief counsel memorandum CCA 201246029 clarified that an annual bonus pool isn't deductible in the performance year if forfeitures are permitted without reallocation.

The field attorney advice memorandum ''beats on the same drum'' as earlier guidance, but adds a few more clarifications, she said.

''It confirms the prior guidance that if you have a pool established in year one, you really have to pay out the entire pool in year two in order to be able to deduct it in year one,'' Baker said.

If the employer retains the discretion to adjust the individual bonus or the size of the pool up or down, ''you have to wait until the payment year to deduct it,'' she said.

If the employer or compensation committee has to certify the level of performance that occurred in year 1, ''and that certification doesn't occur until year 2, you can't deduct it until year 2,'' she said.

''We know that for public companies under [tax code Section] 162(m) you are going to use the performance-based exception to the million-dollar limit on payment of compensation to the top people,'' and the committee does have to certify performance, Baker said. It has been her experience that this ''certification is done early the subsequent year so that it postpones the deduction to year 2,'' she said.

Section 162(m) Umbrella Plans. Umbrella plans provide ways to take advantage of the ''truck-size loophole in 162(m)'' permitting plans that set a maximum amount of compensation that can be paid to an individual to retain discretion, typically through the compensation committee, to reduce that amount ''and still get the [employer] deduction'' in year 2 for performance-based compensation, Baker said.

Baker said that in establishing umbrella plans, it is important to make sure the plan includes the right group of employees. Covered employee status for 162(m) purposes is determined at fiscal year-end, but plans are set up at the beginning of the fiscal year, Baker said. ''When setting up an umbrella plan in January or February, you need to anticipate as best you can that it's going to cover all the relevant people or the company will lose out on some of the deductions,'' she said.

Put appropriate language in the plan allows the employer to cover the right number of people, and not just last year's named executive officers, she said. Baker's tips for covering the right group include a choice of designating all Section 16 officers, or all members of the company's executive committee or executive leadership team, or last year's next three to six most highly compensated executives.

Another umbrella plan issue is that companies have to disclose a list of performance criteria that might apply to earning the bonus, and shareholders have to approve that list and reapprove it every five years, Baker said. One tip is to draft the plan so that any performance-based awards granted after the lapse of the five-year interval are contingent on shareholder reapproval, she said.

If a company loses its exception for performance-based compensation and is subject to the $1 million deduction limit under 162(m), both 162(m) and Section 409A permit companies to postpone payment until 162(m) no longer applies, normally when a person leaves the company, Baker said.

''But you've got to provide for it in the plan,'' she said.

Some companies automatically provide for deferral, which is necessary not to violate 409A. Others prefer to add it occasionally as they foresee the need, she said.

The next question, Baker said, is ''what do you do if you have to get employee consent to an adverse amendment?''

People will argue that having to wait for the money until they leave the company is adverse, she said.

''Stay tuned for the answer to that,'' Baker said.

In the conference materials, Baker provided sample language that gives companies flexibility to accelerate or defer payment under 162(m) and avoid the need for consent.

Risk of Forfeiture Defined. With respect to the second development—final regulations on substantial risk of forfeiture under Section 83—the regulatory clarification ''doesn't change what the IRS has been saying all along,'' Baker said. The final regulations, effective Feb.

26, clarify that there are only two bases for a substantial risk of forfeiture, she said.

The final regulations provide that a substantial risk of forfeiture may be established ''*only* through a service condition or a condition related to the purpose of the transfer, and in determining whether a substantial risk of forfeiture exists based on a condition related to the purpose of the transfer, both the likelihood that the forfeiture event will occur and the likelihood that the forfeiture will be enforced must be considered'' (38 PBD, 2/26/14; 41 BPR 457, 3/4/14).

What that means, using noncompete agreements as an example, is that ''not only does the noncompete have to be there to begin to take the position'' that it is a substantial risk of forfeiture, ''but you have to demonstrate enforcement,'' she said.

A noncompete isn't going to hold up below the higher echelons and it isn't going to hold up if the employee is 65 years old and talking about retirement, Baker said.

FICA Withholding Disputed. The third recent development is a case in which the plaintiff claimed the employer illegally reduced his benefits by failing to observe the Federal Income Contributions Act special withholding rule applicable to nonqualified deferred compensation, Baker said. The case also raises questions whether this kind of illegal benefit reduction claim could apply in other instances of ''employer goof-ups like Section 280G golden parachute taxes and 409A mess-ups,'' Baker said.

In *Davidson v. Henkel Corp.*, No. 4:12-cv-14103-GAD-DRG, 2013 BL 196500 (E.D. Mich., July 24, 2013), the court allowed a case to proceed on a claim that the employer failed to withhold FICA taxes all at once as permitted under the special timing rule, Baker said (144 PBD, 7/26/13; 40 BPR 1856, 7/30/13).

The effect of the special timing rule is that if all benefits are fully accrued and vested and FICA is withheld at that time, the applicable cap on compensation for FICA purposes will apply only once and will possibly limit total FICA withholding, Baker said. If the special timing rule isn't applied, FICA is withheld on ''a pay-as-you-go basis and every payout will be subject to FICA,'' which will increase the total FICA liability for employer and employee, she said.

Although an employee can't sue for failure to withhold, the plaintiff in *Davidson* sued under the Employee Retirement Income Security Act, claiming that the employer had illegally reduced his benefits and was grossly negligent in failing to apply the special timing rule, Baker said.

She said the case ''is in a lower court in Michigan, so don't read too much into it.'' Nevertheless, employers should review their FICA withholding procedures, she said. They may want to draft into their plans language stating that the employee is responsible for taxes, as illustrated in drafting tips in the conference materials, she said.

Baker's presentation, titled ''Executive Compensation Drafting Tips 94133,'' was one of the sessions of a conference, Pension, Profit-Sharing, Welfare, and Other Compensation Plans, held in San Francisco and offered by live webcast. It was sponsored by American Law Institute Continuing Legal Education.

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