METROPOLITAN CORPORATE COUNSEL®

OCTOBER 2016

WWW.METROCORPCOUNSEL.COM

**MCC INTERVIEW: Charles A. Bruder / Norris, McLaughlin & Marcus, P.A.**

# Big Changes Loom for Executive Compensation

## *Employers should not defer action on amendments with major implications for deferred payment plans*

*Although longstanding guidance under Section 409A of the Internal Revenue Code governs the use of deferred compensation to incentivize executives, proposed amendments are raising significant issues. Below, **Charles A. Bruder**, an executive compensation expert, discusses the changes and what they mean for employers and employees. His remarks have been edited for length and style.*

***MCC: What are some of the current issues facing employers in the area of executive compensation?***

***Bruder:*** One of the biggest issues is how to incentivize and compensate executives. Typically, there's only so much that an employer can do to incentivize a newly hired employee with respect to base salary or bonus arrangements. Potential employees are savvy enough to understand that the benefit of a financial arrangement compensating them for services is to provide them with some future upside based upon the performance of the company. Historically, employers have offered equity in the company in the form of stock, a partnership interest or a membership in an LLC. The problem is that once equity-based compensation is provided, the executive becomes an owner. While employers may want individuals to have a longstanding and fulfilling employment relationship, they may not necessarily want employees to become owners given the rights and opportunities that executives would have.

***Longstanding rules dictate what employers can and cannot do with deferred compensation***

Typically, what happens is that employers look to provide some type of future incentive compensation. By definition, under the Internal Revenue Code (IRC), that future right to receive compensation is deferred compensation. There are longstanding IRC rules with respect to what employers can and cannot do with deferred compensation. The most significant guidance has been issued by the IRS under Section 409A, which has been in place for a number of years. To properly incentivize an executive, however, and ensure that he or she receives the full benefit of incentive compensation deferred until a future date, the employer needs to ensure that the executive is going to receive those payments in accordance with Section 409A. Otherwise, the income deferral can be lost, and the employee – not the employer – could be subject to a 20 percent excise tax for failure to satisfy the requirements of Section 409A.

***MCC: The IRS recently issued proposed regulations concerning deferred compensation. Is this newly released guidance significant?***

***Bruder:*** Yes. The IRS intended for the proposed regulations to clarify certain provisions of Section 409A because when that section was issued in 2007, there were a number of questions as to how it applied to deferred compensation. It was a sea change with respect to deferred compensation. Prior to that, deferred compensation could generally be structured in whatever manner the employer desired. Given some of the financial disasters of the early 2000s, Congress decided to revise the IRC to give more structure to deferred compensation arrangements for executives. Hence, Section 409A was born.

A number of questions were raised by employers and practitioners concerning this code section. As such, the IRS issued fairly voluminous proposed regulations, which after comment and revision, became final regulations. In place for a number of years now, those have provided a general blueprint of what employers can and cannot do with deferred compensation. There have been a number of issues, however, that have been left to interpretation. Employers and practitioners have been concerned with these open issues,

**Charles A. Bruder**

*A member of Norris, McLaughlin & Marcus, P.A. He focuses his practice in the areas of ERISA, executive compensation and taxation.*

**cabruder@nmmlaw.com**

Norris McLaughlin & Marcus, P.A.
Attorneys At Law

which the proposed regulations are intended to address. That's why they're significant.

For example, there's a separate set of rules that are applicable to deferred compensation arrangements sponsored by not-for-profits or tax-exempt organizations. There has always been a question as to whether the provisions of Section 409A apply, or whether they are subject to IRC Section 457. In June, the IRS indicated that deferred compensation arrangements sponsored by tax-exempt organizations may be subject to both rules.

***MCC: What are some of the other key revisions under the proposed regulations?***

***Bruder:*** Section 409A includes the concept of a short-term deferral, which basically means that if an employee is eligible for deferred compensation, and payment will be made within the year in which the employee first becomes entitled to receive it – in other words, in the calendar year in which the payment is no longer subject to a substantial risk of forfeiture – that payment will not be subject to the strictures of Section 409A as long as it is made no later than 75 days after the last day of the year in which the employee becomes entitled to receive it. In concept, that rule is fairly straightforward. In practice, however, certain issues arise with respect to the employee's eligibility. Employers often hesitate to make a payment of incentive or deferred compensation because of the possibility that it might violate some other provision of the law. The proposed regulations clarify that if the payment is likely to violate federal securities or any other applicable law, and the employer has a good-faith belief that will occur, the employer can delay payment until the issue has been resolved. That provision gives employers specific authority for payments to be made after that 75-day period while still relying on the exclusion for the short-term exemption.

Similarly, employers will often provide for incentive compensation of different amounts based on future circumstances. For example, it's not unusual for an employer to provide that if an employee's employment is terminated for cause, the employee will not receive incentive compensation. Alternatively, however, if the employee's employment is terminated involuntarily but for other than cause, often the agreement will provide that the employee will get something less than the full amount of the incentive compensation payment. This ambiguity has caused consternation with practitioners. Under the provisions of the final regulations, there was some question as to whether this reduced payment amount would fall squarely within those provisions. The proposed regulations clarify the matter by indicating that as long as the payment reduction is based upon a future event, such as termination for other than cause or violation of a noncompete or other restrictive covenant, the reduction of the payment is generally permissible under Section 409A.

Another ambiguous area concerned the provision of incentive or deferred compensation to an individual prior to commencing their employment relationship. Often, when a company seeks to hire an executive, they'll offer him or her a form of incentive or deferred compensation. Technically, however, under Section 409A deferred compensation can be provided only to an individual who is in a service provider relationship, such as employee. The proposed regulations provide that an employer in that circumstance can enter into a deferred compensation agreement with the executive as long as it is reasonably intended that the executive will commence providing services within a 12-month period after the date on which the agreement is entered into, and in fact the individual does provide those services. This clarity allows employers some flexibility with respect to the structuring of deferred compensation arrangements for would-be employees.

On the flip side, there's a provision under Section 409A that effectively allows for the exclusion of separation pay from many of the rules. In general terms, this provision allows for separation pay to be excluded provided that the amount of the separation pay does not exceed the greater of two times the average salary of the individual during the prior year or two times the compensation limit under a tax-qualified plan. A question has arisen over the years as to how employers can structure a separation pay arrangement to meet this exclusion when the individual was hired and terminated within the same calendar year as there is no prior year's compensation to be averaged. In that circumstance, the proposed regulations indicate that employers can annualize the compensation the individual received during the period of their employment and use that for the purposes of determining where the outer markers are with respect to separation pay and structure a separation pay arrangement that otherwise would be compliant with Section 409A.

One final, potentially significant arrangement has to do with payments upon debt. Under Section 409A, payments of deferred compensation can only be made upon certain triggers, such as specified dates in the future or specified events, one of which is the death of the individual. Under the general rules, if an individual dies, the short-term exclusion rules apply. If payment was made to the individual's estate or named beneficiaries, that payment would be excluded from Section 409A if it was made within 75 days of the last day of the calendar year in which the individual was entitled to the payment. In this case, that would be the year in which the individual died. Under the proposed regulations, the IRS recognized that it may be difficult for payment to be made, particularly if an individual dies toward the end of a calendar year. The proposed regulations provide that death payments will be deemed to fall within the short-term deferral exception if they are made within the 75 days of the calendar year following the calendar year in which the individual is entitled to the payment. So the IRS added structure that provides some flexibility to the employer to get their affairs in order, since with respect to death benefits, sometimes these amounts are significant, and therefore require employers to marshal their assets in order to make those payments.

***MCC: Do these provisions apply to employees only?***

***Bruder:*** No. The provisions of Section 409A apply to independent contractors. The IRS doesn't necessarily distinguish between employers and independent contractors but categorizes all such individuals as service providers. However, it is not unusual for an executive whose employment is terminated to have a period of time during which they continue to provide services to the company. In prior years, it wasn't unusual for an employer to ask an employee to terminate his or her employment with the company as an independent contractor. The proposed regulations clarify that, in fact, if an individual enters into an independent contractor relationship and works more than 20 percent of the time, on average, for the employer, based upon the prior services that were provided, then payment can be delayed until the independent contractor severs that contractual relationship with the employer.

***MCC: What about employers whose agreements do not meet these new requirements? Is there relief available for them?***

***Bruder:*** Thankfully, consistent with prior practice, the proposed regulations provide for certain amendment rights to employers based upon the new provisions. Several years ago, the IRS issued guidance that allowed employers to amend their arrangements if they were not in compliance with Section 409A.

METROPOLITAN CORPORATE COUNSEL®



However, those provisions were narrowly tailored. They generally provided for penalties to employers who had arrangements that were not compliant, notwithstanding the fact that the IRS was allowing them to amend those arrangements to become compliant. Under the new regulations, the IRS has in some respects expanded those amendment rules, but in some respects it also has narrowed them. An employer can typically amend its arrangement to allow it to become Section 409A compliant so long as the employee doesn't have a right to receive payment and as long as the payment remains subject to a substantial risk of forfeiture. In supplementing the prior rule, which was referred to as an anti-abuse rule, the IRS indicated that under certain conditions it will allow the employer to amend its arrangement without triggering penalties under Section 409A. The IRS did note, however, that there must be a reasonable basis for concluding that the original provision was noncompliant. Employers can't just use these amendments to change arrangements they don't like or to provide for more beneficial terms to the employees.

***MCC: What should plan sponsors do in light of these proposed regulations?***

***Bruder:*** First and foremost, they should be familiar with them. While they are subject to change, in the preamble the IRS noted that employers may rely on them as if they were final. That said, employers have an opportunity to review their arrangements to determine whether, in fact, in light of these new regulations those arrangements continue to be compliant with Section 409A. As I mentioned earlier, the failure to be compliant has significant consequences for the employee, who will have income accelerated and recognized as taxable, and may be subject to potential interest and penalties for failure to report.

The bigger issue is the IRS's 20 percent excise tax if there's a violation of Section 409A. It's incumbent upon plan sponsors to review any form of deferred compensation that otherwise may be sponsored by the employer. Many employers have arrangements that are characterized as deferred compensation plans. However, deferred compensation arrangements also may be located in termination agreements, separation agreements, employment contracts and arrangements that provide for payment in the future based upon continued service by the employee. Employers and plan sponsors need to review all of their documents to determine whether amendments are needed to remain compliant with Section 409A. As I mentioned, the IRS allows for a limited amendment process to bring these arrangements into compliance. It's likely, however, that the longer an arrangement is out of compliance, the less likely the IRS will be to accept future amendments as timely.