Matters of Interest

Executive and Director Benefits and COLI

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The "Clawback" of Erroneously Awarded Executive Compensation and Section 409A

Last summer, the SEC proposed rules that would direct national securities exchanges and associations to establish listing standards requiring companies to develop and implement policies to recover incentive-based executive compensation that later is shown to have been awarded in error. The proposed rules were issued under Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. No final rules have yet been issued.

Below we briefly summarize the proposed rules and then discuss the issues involved in the recovery of incentive compensation from nonqualified plans with respect to the application of Internal Revenue Code Section 409A to the recovery.

Highlights of Proposed SEC Rule 10D-1

Overview

- Listed companies would be required to adopt a compensation recovery policy.
- Compensation recovery ("clawback") would be required from current and former executive officers who received incentive-based compensation during the three fiscal years preceding the date on which the company is required to prepare an accounting restatement to correct a material error. The recovery would be required regardless of whether there was any misconduct by an executive officer.
- The amount of incentive-based compensation clawed back from an executive officer would be the amount in excess of the amount the executive officer would have received had the compensation been determined based on the accounting restatement.
- Companies would have discretion not to recover the excess compensation if the direct expense of enforcing recovery would exceed the amount to be recovered or, for foreign private issuers in specified circumstances, where recovery would violate home country law.
- Under the proposed rules, a company would be subject to delisting if it does not adopt a compensation recovery policy that complies with the applicable standard, disclose the policy in accordance with Commission rules, or comply with the policy's recovery provisions.

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Definition of Executive Officers

The proposed rules include a definition of an "executive officer" that is modeled on the definition of "officer" under Section 16 under the Exchange Act. The definition includes the company's president, principal financial officer, principal accounting officer, any vice-president in charge of a principal business unit, division or function, and any other person who performs policy-making functions for the company.

Incentive-Based Compensation Subject to Recovery

Under the proposal, incentive-based compensation that is granted, earned or vested based wholly or in part on the attainment of any financial reporting measure would be subject to recovery. Financial reporting measures are those based on the accounting principles used in preparing the company's financial statements, any measures derived wholly or in part from such financial information, and stock price and total shareholder return.

Proposed Disclosure

Each listed company would be required to file its compensation recovery policy as an exhibit to its annual report.

In addition, if during its last completed fiscal year the company either prepared a restatement that required recovery of excess incentive-based compensation, or there was an outstanding balance of excess incentive-based compensation relating to a prior restatement, a listed company would be required to disclose, among other things, the aggregate dollar amount of excess incentive-based compensation attributable to the restatement, the names of persons subject to a clawback from whom the company decided not to pursue recovery and why the company is not pursuing recovery, the amounts due from each such person, and a brief description of the reason the company decided not to pursue recovery, and, if amounts of excess compensation to be clawed back remain outstanding for more than 180 days, the name of, and amount due from, each person at the end of the company's last completed fiscal year.

Covered Companies

The proposed rules would apply to all listed companies except for certain registered investment companies to the extent they do not provide incentive-based compensation to their employees.

Transition Period

The proposal requires an exchange's listing rules become effective no later than one year following the publication date of the final rule.

Each listed company would be required to adopt its recovery policy no later than 60 days following the date on which the listing exchange's listing rule becomes effective. Each listed company would be required to recover all excess incentive-based compensation received by current and former executive officers on or after the effective date of Rule 10D-1 that results from attaining a financial reporting measure based on financial information for any fiscal period ending on or after the effective date of Rule 10D-1.

Listed companies would be required to comply with the new disclosures in proxy or information statements and Exchange Act annual reports filed on or after the effective date of the listing exchange's rule.

Application to Nonqualified Deferred Compensation and the Effect of Code Section 409A

Incentive compensation otherwise subject to the clawback rules that is deferred into a nonqualified deferred compensation plan or which is taken into account under a nonqualified supplemental executive retirement plan is subject to clawback.

SEC View of Clawbacks from Nonqualified Plans

With respect to how deferred compensation should be clawed back, the SEC stated in a footnote in its discussion of the proposed regulations that:

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> Similarly, for nonqualified deferred compensation, the executive officer's account balance or distributions would be reduced by the excess incentive-based compensation contributed to the nonqualified deferred compensation plan and the interest or other earnings accrued thereon under the nonqualified deferred compensation plan. In addition, for retirement benefits under pension plans, the excess incentive-based compensation would be deducted from the benefit formula, and any related distributions would be recoverable.

The SEC did not consider potential tax issues of these reductions.

Code Section 409A Issues

Some commentators have questioned whether the SEC treatment would result in a violation of Section 409A, specifically whether the clawback would be considered an accelerated payment of deferred compensation under Section 409A.

If the clawback is considered a repayment of a debt owed to the employer by the executive officer, there is support in the Section 409A regulations that such a repayment would be an acceleration of payment, at least to the extent the repayment exceeds $5,000. See IRS Reg. § 1.409A-3(j)(4)(xiii) (a plan may provide for an acceleration of payment to satisfy a debt of the employee to the employer, but only to the extent the payment does not exceed $5,000; anything in excess of this amount would be an impermissible acceleration of payment and subject to Section 409A penalties).

There is also a question whether the mistaken addition to a participant's account itself would cause a violation of Section 409A. Mistaken additions to a deferral account in other circumstances can result in a Section 409A violation, which, according to the IRS, can only be corrected in certain prescribed ways within certain prescribed periods if Section 409A penalties are to be avoided. If the IRS applies these same standards to clawbacks, there may be 409A penalties to be paid with respect to the erroneous additions regardless of how such additions are paid back to the company.

Potential Solutions to Section 409A Issues

If clawbacks are looked at in another way, however, all Section 409A consequences and penalties could be avoided. Many nonqualified plans have forfeiture provisions and if a benefit is forfeited under these provisions, we are not aware of any IRS action or suggestion that such a forfeiture would cause a Section 409A violation, as long as there is no other benefit substituted for the forfeited benefit. This may suggest that nonqualified deferred compensation plans of listed companies should be amended to explicitly provide that any amounts that must be recovered under the SEC clawback rule (as well as any earnings on such amounts) should be considered forfeited under the plan.

This would seem a sensible way to treat clawbacks as the evils sought to be avoided by Section 409A are not implicated in the operation of the SEC clawback rule.

Another way the IRS could deal with the issue is to modify the 409A regulations to provide that to the extent a clawback results in an acceleration of payment, it is excepted from Section 409A consequences, in a manner similar to the current exception in the Section 409A regulations for acceleration of payments required to comply with conflict of interest laws.

In any case, we would suggest companies that have nonqualified deferred compensation benefits that could be impacted by the clawback rules to consult with their counsel about how to mitigate potential issues. In addition, we hope that the IRS will soon clarify its stance regarding clawbacks and Section 409A.

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Some Administration Tax Proposals from the 2017 Budget

The President has released his final budget proposal. Many of its tax provisions have been previously proposed and it is unlikely any of the provisions will pass through Congress this year. However, the budget provides insight into many Democratic priorities and it is likely that any subsequent Democratic administration would take up substantial portions of the President's budget as an initial set of policy positions.

Life Insurance Proposals

Expanded Interest Deduction Limits for COLI Policies

Current law limits corporate deductions of interest on loans to buy life insurance on individuals, with a de minimus key person exception. This is coupled with a separate pro-rata limit on all interest deductions based on the amount of interest expenses allocated to un-borrowed cash values in life insurance policies, with exceptions for policies on 20% owners, officers, directors, and employees. The budget, as it has in previous years, proposes to expand the limit on interest deductions to eliminate the exceptions it currently provides for officers, directors, and employees. This would reduce the tax effectiveness of new COLI policies purchased after the effective date of the law. The proposal would apply to policies entered into after December 31, 2016, but with retroactive effect on any policies that are materially modified after that date.

Limited Exceptions to Transfer for Value Rules

The budget would modify the transfer-for-value rule by eliminating the exceptions that currently apply if the buyer is a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer. Instead, under the proposal, the rule would not apply in the case of a transfer to the insured, or to a partnership or a corporation of which the insured is a 20% owner.

Reporting for Sales of Existing Life Insurance Contracts

The budget imposes new reporting requirements on purchasers of existing policies with death benefits exceeding $500,000. The purchaser would need to notify the IRS, the insurance company that issued the policy, and the seller of policy issuer and policy number, buyer and seller's identity, purchase price, and upon payment of death benefits the insurance company would be required to report gross benefit paid, the buyer's TIN, and estimated basis to the IRS and to the payee.

Income Tax Proposals

The 2017 budget re-proposes a variety of new tax rates and strategies that would significantly impact high net worth individuals. These proposals include:

- Increasing the capital gains tax rate to 24.2% (28% when including the net investment income tax)
- Impose capital gains tax upon gifts and bequests of appreciated assets by treating them as sales triggering gains on appreciated value
- Create a 30% "Fair Share Tax" on the adjusted gross income (AGI) of earners with over $1 million AGI (with a phase-in that begins at $1 million and with a full phase-in at $2 million)
- Reduce the value of some deductions in the 33% and greater tax brackets to 28%
- Consolidate charitable deductions while extending their carry-forward period to 15 years
- Tax carried interests as ordinary income instead of long-term capital gains

These tax changes generally narrow the gap in tax treatment between long-term capital gains and ordinary income, and limit the value of certain deductions in higher income brackets. Additionally, they incentivize charitable giving through an increased carry forward period and simplified compliance requirements.

Latest Ratings Agencies' Reports on Life Insurance Industry

The most recent outlooks from the ratings agencies call for ratings stability given the industry's generally strong regulatory capital position, strong equity markets, continuing economic improvement in the United States, and the forecast for slightly higher interest rates.

In December 2015, Fitch Ratings confirmed its stable U.S. Life Insurance Outlook. Fitch's outlook considers the industry's very strong balance sheet fundamentals, strong liquidity profile, and stable operating performance. These positive factors somewhat mitigate Fitch's ongoing concerns over persistent low interest rates that will pressure interest margins and reserve adequacy in 2016. Credit-related investment losses are expected to increase in 2016 under Fitch's base case scenario but remain somewhat below historical averages and pricing levels. Credit concerns that could lead to higher than expected losses include continued weak commodity prices, softening global demand, potential Fed rate hikes and increasing geopolitical risk.

In December 2015, A.M. Best maintained its stable outlook for the U.S. life and annuity sector, noting the benign credit and interest rate environments. Best noted that generally, the life/annuity industry has seen absolute and risk-based levels of capitalization improve. In addition, asset impairments remain low and operating performance was up modestly as compared with 2014. A.M. Best noted that the life/annuity industry continued to experience stability despite current economic and industry challenges, and that those challenges remain similar to those faced heading into 2015.

In November 2015, Moody's maintained its stable outlook on the U.S. life insurance industry due to strong asset values, strong U.S. employment levels, continuing economic growth, and an expectation of rising interest rates. Moody's said these factors support its expectation for moderate revenue and earnings growth in the industry over the next 12–18 months.

S&P reported that the 2016 outlook for U.S. life insurers remains stable. S&P said capitalization remains a key strength for credit quality in the industry, along with prudent risk management and improving operating efficiencies.

Failure to Properly Withhold Nonqualified Plan FICA Taxes—Case Settled in Favor of Participants

In *Matters of Interest*, First Quarter 2015, we discussed *Davidson v. Henkel*, 2015 U.S. Dist. LEXIS 722; 115 A.F.T.R.2d (RIA) 369 (E.D. Mich. 2015), in which the District Court held that a company was liable under ERISA for improper withholding of FICA tax. Under a supplemental retirement plan, rather than withholding FICA taxes at the time when benefits were reasonably ascertainable (generally at retirement) as provided under IRS regulations, the company paid such taxes at the time of each retirement benefit payment.

In December 2015, a settlement in this case was approved which provided a gross cash award to participants and attorneys of $3.35 million. Approximately, $1.3 million was allocated to attorneys' fees and the remainder was to go to participants to cover the amount of decreased benefits attributed to the company's failure to withhold FICA taxes in accordance with IRS regulations, plus 5% interest on past damages, plus a 40% tax gross up for payments to participants.

Section 409A Failure in Retention Agreement Results in Taxable Income

The Office of Chief Counsel for the IRS has taken the position in CCA 201518013 that the correction of a failure to comply with Section 409A(a) of the Internal Revenue Code (Code) in the year in which compensation subject to a substantial risk of forfeiture vests does not avoid income inclusion under section 409A even if the correction is made prior to the date the compensation vests.

Facts

On October 1 of Year 1, Employer entered into a retention agreement with Executive. The retention agreement provided that, if Executive remained continuously employed until the third anniversary of the execution date of the retention agreement (the "vesting date"), Executive would receive a retention bonus.

The retention agreement provided for payment of the retention bonus in equal installments on the first two anniversaries of the vesting date. However, the agreement also provided that Employer, in its sole discretion, could pay the retention bonus as a lump sum payment on the first anniversary of the vesting date. The retention agreement failed to meet the time and form of payment requirements of Section 409A(a) because it permitted the Employer to accelerate payment of the retention bonus

To correct the failure, Employer amended the retention agreement on June 6 of Year 3 to remove its discretion to accelerate payment. Executive continued providing services through October 1 of Year 3, and the substantial risk of forfeiture lapsed. Employer paid Executive the retention bonus in equal installments on October 1 of Year 4 and Year 5.

IRS Reasoning

Section 409A(a)(1)(A)(i) provides that, if a nonqualified deferred compensation plan fails to comply, or fails to be operated in accordance, with section 409A(a)(2), (3) and (4) "at any time during a taxable year," compensation deferred under the plan that is not subject to a substantial risk of forfeiture and that has not previously been included in income is includible in the service provider's gross income for the taxable year. Deferred compensation that is subject to a substantial risk of forfeiture is subject to the requirements of section 409A(a)(2), (3), and (4) at all times during a taxable year, though a deferred amount is not includible in income under section 409A if it is subject to a substantial risk of forfeiture at all times during the taxable year. In contrast, if the amount is not subject to a substantial risk of forfeiture at all times during the taxable year (generally meaning the amount is vested as of the end of the taxable year), the amount is includible in income.

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