

# MATTERS OF INTEREST

EXECUTIVE AND DIRECTOR BENEFITS AND COLI



M Benefit Solutions®

FIRST QUARTER 2013

## HIGHLIGHTS OF THIS ISSUE

- **SUTARDJA V. UNITED STATES INDICATES IRS WILL SEEK PENALTIES UNDER CODE SECTION 409A EVEN IN CASES WHERE THERE HAS BEEN A GOOD FAITH EFFORT TO COMPLY WITH SECTION 409A**
- **SUTARDJA UPHOLDS NOTICE 2005-1 AND REGULATIONS THAT SUBJECT DISCOUNTED STOCK OPTIONS TO CODE SECTION 409A**
- **TAXATION OF CURRENT COLI POLICIES IS STABLE BUT M BENEFIT SOLUTIONS IS MONITORING PROPOSALS THAT COULD AFFECT THE TAXATION OF COLI PURCHASED IN THE FUTURE**
- **LIFE INSURANCE INDUSTRY IS STABLE BUT CURRENT LOW INTEREST RATE ENVIRONMENT IS PUTTING PRESSURE ON CARRIER EARNINGS**
- **M BENEFIT SOLUTIONS RECEIVED FAVORABLE SSAE 16 AUDIT REPORT IN DECEMBER 2012**

## IRS AGGRESSIVELY SEEKS PENALTY TAXES UNDER SECTION 409A

The U.S. Court of Federal Claims in *Sutardja v. United States*, No. 11-724T (Fed. Cl. Feb 27, 2013) held that Internal Revenue Code Section 409A permits the taxation of discounted stock options. The result is consistent with IRS Notices and regulations under Code Section 409A but the case, more importantly, demonstrates that the IRS intends to aggressively enforce Code Section 409A penalties.

## The Facts

- On December 26, 2003, the Executive Compensation Committee of the Board of Directors approved a grant to Mr. Sutardja of stock options for 1.5 million shares of Marvell stock at an option price of \$36.50 per share. The options were to vest in segments at predetermined dates.
- The grant was “ratified” on January 16, 2004 by the Committee. The price of the stock on January 16, 2004, was \$43.64/share.
- In January 2006, Mr. Sutardja exercised options for 399,606 shares at a split price of \$18.25 per share, which was the stock price on December 26, 2003, the date of the original grant approval.
- In May 2006, the Board began a review of past stock option granting practices and determined that the option price should have been the price of the stock on January 16, 2004 rather than December 26, 2003. Mr. Sutardja then paid an additional \$5.3 million for the exercise of stock options. This amount represented the difference in exercise price both for the 2006 exercise and option exercises before 2006.
- Mr. Sutardja and his wife filed a joint tax return for 2006. In 2010, the Internal Revenue Service issued a notice of deficiency for 2006 in which it determined that the exercise of the stock options was from a non-qualified deferred compensation plan subject to Code Section 409A(d).

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- The IRS assessed a tax liability for an additional 20 percent of the tax in the amount of \$3.1 million, and a second addition to tax of \$304,456. Sutardja paid the amount in the notice, a late-filing penalty, and requested a refund.

## Application of Section 409A

In 2004, Congress enacted Section 409A to provide that if deferred compensation fell within certain parameters it was subject to immediate taxation, plus an additional 20-percent tax, and interest for late payment at a premium rate. In 2005, IRS issued Notice 2005-1 to provide that if an option agreement allows the grantee to purchase stock at a discounted price it is deferred compensation under Code Section 409A and subject to Code Section 409A penalties.

The court rejected Mr. Sutardja's arguments that Code Section 409A could not apply to stock options in general and, in particular, this stock option exercise. The court found that:

- A grant of stock options could be a taxable event,
- Treasury regulations applying FICA tax to deferred compensation that exclude stock options from its operation does not preclude the IRS from treating stock option discounts as deferred compensation under Code Section 409A,
- Mr. Sutardja had a legally binding right to purchase shares at the time the shares vested, and
- The short-term deferral rule of Section 409A did not exclude treatment of the discounted stock option price as Code Section 409A deferred compensation.

Thus, the court determined that the case must go to trial to determine whether in fact the options in questions were discounted and whether there was deferred compensation to which Code Section 409A penalties might be applied.

The court's legal findings appear noncontroversial. However, the IRS's application of Code Section 409A penalties to pre-Code Section 409A option grants when the company and optionee attempted to fix the

pre-Code Section 409A defective stock option granting procedure appears very aggressive and does not bode well for a sensible application of Section 409A penalties to inadvertent mistakes.



## STATUS OF CORPORATE-OWNED LIFE INSURANCE TAXATION

The tax treatment of corporate-owned life insurance (COLI) is currently stable. No important legislative changes have been introduced in Congress. However, with government revenue needs and continued talk of tax reform, changes to the tax treatment of COLI cannot be ruled out during the current Congressional session.

The proposal most often made in recent years, appearing in several of the President's recent annual budget proposals, would deny company interest deductions allocated to life insurance policies unless the contract is on a person who owns at least 20 percent of the company.

Current law provides that the interest deductions of a business other than an insurance company are reduced to the extent the interest is allocable to unborrowed policy cash values based on a statutory formula. However, there is an exception to the pro rata interest disallowance with respect to contracts that cover individuals who are officers, directors, employees, or 20-percent owners of the taxpayer. The proposal would eliminate the exception for contracts that cover officers, directors, and employees.

The interest deduction disallowance proposal generally would be effective for purchases of life insurance contracts made after the enactment of any change in the law.

In addition to this specific proposal, a recent Congressional Research Service report on revenue raising options for tax reform addressed life insurance products as a potential source of revenue.

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While we do not expect any proposal to affect current COLI policies, M Benefit Solutions will continue to monitor developments on the legislative front that may impact COLI.



## FINANCIAL OUTLOOK FOR THE LIFE INSURANCE INDUSTRY

For 2013, the industry's ratings outlook generally remains stable though one rating agency revised its outlook for the industry last year from stable to negative based on the persistent low interest rate environment that is putting pressure on life insurer earnings.

### Recent History of the Life Insurance Industry

During 2009 and 2010, when all the ratings agencies rated the industry outlook as negative, there were many life insurers that had their financial strength ratings downgraded. Nevertheless, throughout this difficult economic time, the life insurance industry continued to maintain high financial strength ratings supported by good capitalization and liquidity. The pace of the financial downgrades slowed significantly during 2011 and 2012 with a slowly strengthening economy.

### Latest Ratings Agency Reports on the Life Insurance Industry

The most recent outlook from the ratings agencies generally calls for ratings stability during 2013 given the industry's generally strong regulatory capital position, favorable operating earnings levels, and ongoing efforts to improve balance sheets through liquidity and capital management steps.

In December 2012, Fitch Ratings stated in its U.S. Life Insurance Outlook for 2013 that the credit outlook for the industry remains stable. The stable outlook for U.S. life insurance reflects the industry's strong balance sheet fundamentals and improved liquidity profile, which helps to mitigate ongoing concerns over challenging macroeconomic conditions which continue to pressure industry operating fundamentals. While Fitch believes that the industry is well positioned to withstand macroeconomic challenges over the coming year, they cautioned that the outlook is vulnerable to, as are most industries, shocks in a severe, albeit unexpected, scenario.

In November 2012, S&P reported that while life insurers remain well-capitalized, their credit outlook for the North American life insurance industry is cautious. S&P expects a weak global economy, persistent low interest rates, and intense competition will continue to dampen insurers' revenue growth and limit the potential for higher operating margins. S&P believes these factors could cut into insurers' net interest margins (the return on an insurer's investments relative to its interest credited to policyholders) because many blocks of business are already at or near their guaranteed minimum interest rates.

In October 2012, A.M. Best reaffirmed its stable outlook for the U.S. life and annuity sector, noting it continues to monitor the macroeconomic environment and life insurance company initiatives to strengthen earnings and their affect on the life and annuity sector's absolute and risk-adjusted capitalization.

In September 2012, Moody's changed its outlook for the US life insurance industry to negative based on its view that low interest rates, in particular, will continue to depress companies' earnings over the next 12 to 18 months. Moody's Vice President, Laura Bazer stated: "We believe that low rates, along with below-trend economic growth and prolonged volatility in the equity markets, will continue to erode insurers' earnings and revenues, gradually weakening their financial flexibility."

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## Summary

M Benefit Solutions will continue to monitor developments that may impact the financial health of the life insurance industry in general, as well as our clients' particular life insurance carriers.



## M BENEFIT SOLUTIONS' MOST RECENT SSAE 16 REPORT

In order to maintain its first-rate service to our clients, M Benefit Solutions made a corporate commitment in 2003 to undergo annual external audits to ensure we examine our internal structure on a regular basis to improve upon our existing practices. As a consequence, we underwent an annual SAS 70 audit through 2010.

Thereafter, the Statement on Standards for Attestation Engagements ("SSAE") No. 16 Reporting on Controls at a Service Organization was adopted and replaced SAS 70 as the authoritative guidance for reporting on service organizations.

The SSAE 16 report represents that a service organization has been through an in-depth audit of their control activities which generally include controls over information technology and processes which relate to the data belonging to their clients.

M Benefit Solutions received a "clean opinion" Type II report for 2012, an indication of our ongoing success in this area.



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