Matters of Interest

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Featured Articles

Wilson v. Safelite: A Call for Careful Administration of NDCPs

Excise Tax on Compensation of Highly Compensated Employees of Tax-Exempt Organizations

Meet a Managing Associate

Wilson v. Safelite: A Call for Careful Administration of NDCPs

A Sixth Circuit Appellate Court recently ruled on an appeal by Daniel H. Wilson regarding the application of Internal Revenue Code Section 409A ("409A") penalties to his nonqualified deferred compensation. *Wilson v. Safelite Grp., Inc.*, 930 F.3d 429 (6th Cir. 2019). Mr. Wilson, the former President and CEO of Safelite Group, Inc. ("Safelite"), argued that Safelite should be liable for part or all of the penalties applied to his deferred compensation as a result of 409A violations caused by Safelite. The court found against Mr. Wilson, but the case is a timely reminder of the need for careful administration, even if the employer will not, ultimately, be liable.

Wilson participated in the Safelite Plan and deferred sizable sums into it between 2006 and 2008. By 2014, he had approximately nine million dollars in deferred compensation owed to him under the Plan. Unfortunately, a federal tax audit found that some of his deferral elections violated 409A. The violations resulted in taxes and penalties of over four million dollars.

Wilson sued Safelite under a variety of state law theories involving negligence and breach of contract. Safelite successfully argued to the trial court that the Plan was a benefit plan under the meaning of ERISA, which resulted in the pre-emption by federal law of Wilson's claims. The trial court granted Wilson the opportunity to amend his complaint to include claims under ERISA's civil enforcement provision. Wilson did not amend his complaint, instead choosing to appeal the decision.

On appeal, Wilson argued that the Plan was not an ERISA Plan on the narrow technical grounds that it allowed participants to elect in-service distributions. Wilson's argument hinged on these in-service distributions preventing the Plan from resulting in "a deferral of income by employees for periods extending to the termination of covered employment or

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beyond" as described in 29 U.S.C. Section 1002(2)(A)(ii). Unfortunately for Mr. Wilson, ERISA is interpreted broadly when considering whether a plan falls within its scope. ERISA has repeatedly been found to cover plans that include in-service distributions. The judges of the Sixth Circuit Appeals court had no difficulty finding that ERISA applied, preempting any state law claims he made.

It is not clear why Wilson chose not to make an ERISA claim. He might have made the argument that the purpose of the Plan was to help him manage his taxes and that the violation by Safelite to comply with 409A caused the Plan to fail to fulfill its purpose under terms of the Plan. A similar claim was made by participants in *Davidson v. Henkel*, 2015 U.S. Dist. LEXIS 722; 115 A.F.T.R.2d (RIA) 369 (E.D. Mich. 2015) when their employer failed to properly withhold FICA from

their benefits causing the participants to pay more FICA than they otherwise would have. The participants were successful and recovered their tax losses from the employer. (*Henkel* is further described in *Matters of Interest*, First Quarter 2015, First Quarter 2016, and July 2017 (Vol. 36)). There may have been a reason why Wilson chose not to pursue the claim but on the face of the facts reported in the decided case, it would seem to have been a worthwhile argument.

Safelite reinforces the general concept that 409A penalties accrue to the employee rather than the employer. This is a result of Congress trying to solve a narrow problem with a very broad and punitive statute. The statute is a direct response to the Enron scandal. In 2001, Enron executives were able to get money out of their nonqualified deferred compensation plan from a rapidly failing company, preventing the funds from being dealt with in the bankruptcy of Enron. These actions resulted in far better financial outcomes for the executives than investors and rank and file employees. Section 409A aims to prevent executives from using their knowledge of a failing business to retain their retirement funds at the expense of others. The Congress' animosity toward these executives likely led them to place the penalties imposed under 409A on executives and other employees. However, the vast majority of 409A violations are not malicious or even intentional, but merely the result of administrative errors or other accidental violations, thereby placing tax penalties on employees who have no control over whether a plan is operated in compliance with 409A or not.

While some employers may seek to follow *Safelite* and transfer the liabilities for mistakes made by the employer or plan administrators to employees, employees do have arguments to employ against employers in litigation. See *Henkel*, above. Moreover, there are arguments against taking the *Safelite* approach and instead placing the onus of the liability on the employer or plan administrator when they make a mistake, including:

- Fairness to employees,
- Fostering trust from the employees for whom a plan is implemented and designed to reward, and
- Fostering employee retention.

Safelite won its legal battle but undoubtedly damaged its reputation with its employees.

M Benefit Solutions works closely with our clients to prevent 409A violations and avoid a *Safelite* situation, establishing procedures to help ensure a client's plan is operated in compliance with 409A. In addition to following these procedures, it is advisable that, before making changes to the operation of a Plan, what payouts are promised to a participant, or when that participant will be paid, you contact your organization's attorney to discuss whether these changes could present 409A issues. ■

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Excise Tax on Compensation of Highly Compensated Employees of Tax-Exempt Organizations

The TCJA created Section 4960, a 21% excise tax on compensation above $1 million for certain highly compensated employees ("covered employees") of tax-exempt organizations ("Compensation Tax") and certain payments contingent upon the covered employee's termination of employment ("Termination Tax"). The excise tax is an attempt to mimic the effects of Section 162(m)'s $1 million deduction limitation, applicable to public companies, and the Section 280G deduction disallowance for payments to covered employees contingent upon a change in control, for tax-exempt organizations.

The tax-exempt organization, not the employee, pays the excise tax.

The IRS recently issued Notice 2019-09 to provide interim guidance on how to apply Section 4960.

Covered Organizations

Notice 2019-09 outlines which tax-exempt organizations are "applicable tax-exempt organizations" (ATEOs) and, therefore, subject to the excise tax. ATEOs encompass all entities exempt from taxation under Code Section 501(a), including private foundations established by companies to direct their charitable contributions.

Additionally, for-profit corporations related to tax-exempt organizations may also be subject to the excise tax. See "Related Entities of ATEOs" below.

Covered Employees

Covered employees include any ATEO's five highest compensated employees in any taxable year and any covered employee of the organization (or predecessor) for any prior taxable year beginning after December 31, 2016. A covered employee need not be an officer. Covered employees remain covered employees in subsequent years, including years after terminating employment.

Compensation in Excess of $1,000,000

The Compensation Tax applies to any compensation paid to a covered employee above $1,000,000. Compensation for this purpose encompasses all wages, including deferred compensation when vested under Section 457(f). Compensation from "related persons and governmental entities" is included and may subject these related persons to the excise tax, even when from related for-profit entities (discussed below). Compensation, however, does not include the portion of any wages paid to a licensed medical professional (including nurses and veterinarians) which is for the professional's performance of medical or veterinary services.

It is important to note that compensation from related for-profit companies is deemed paid on the date it is no longer subject to a substantial risk of forfeiture within the meaning of Section 457(f)(3)(B) (regardless of whether Section 457(f) or Section 409A apply to the payment arrangement). Notice 2019-09, Q&A-13. Thus, when calculating the tax, all nonqualified deferred compensation is included upon vesting rather than upon payment.

Excess Parachute Payments

The Termination Tax applies to "excess parachute payments." A parachute payment is defined as a payment contingent on an employee's separation from employment with the employer, if the aggregate present value of the payments in the nature of compensation to (or for the benefit of) the employee which are contingent on such separation equals or exceeds an amount equal to three times the "base amount" (generally the average annual compensation of the individual for the five years prior to the year of separation). The amount subject to the tax is the amount of parachute payment in excess of the "base amount." Compensation paid to employees who are not highly compensated employees (within the meaning of Section 414(q)) is exempted from the definition of parachute payment, as is compensation attributable to medical or veterinary services of qualified medical professionals.

Note that under Notice 2019-09, Q&A-19, a payment qualifying as compensation for purposes of the

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Termination Tax is considered made in the taxable year in which it is includible in the covered employee's gross income and not in the year of vesting.

Observations on the Termination Tax:

- Even small organizations may be subject to the Termination Tax.
- Notice 2019-09 clarifies that a payment is contingent on an employee's separation from employment if the facts and circumstances indicate that the employer would not make the payment in the absence of an involuntary separation from employment. In other words, if the separation from employment is voluntary, there should be no Termination Tax.

Related Entities of ATEOs

A person or governmental entity is related to an ATEO if such person or governmental entity—

- Controls, or is controlled by, the ATEO;
- Is controlled by one or more persons who control the ATEO;
- Is a supported organization (as defined in Section 509(f)(3)) of the ATEO;
- Is a supporting organization (as defined in Section 509(a)(3)) of the ATEO; or
- In the case of an ATEO which is a voluntary employees' beneficiary association described in Section 501(c)(9), establishes, maintains, or makes contributions to such voluntary employees' beneficiary association.

Whether "Control" exists is determined under the following provisions:

- **Stock corporation.** In the case of a stock corporation, Control means ownership (by vote or value) of more than 50% of the stock in such corporation.
- **Partnership.** In the case of a partnership, Control means ownership of more than 50% of the profits interest or capital interest in such partnership.
- **Trust.** In the case of a trust with beneficial interests, Control means ownership of more than 50% of the beneficial interests in the trust.
- **Nonstock organization.** In the case of a nonprofit organization or other organization without owners or persons having beneficial interests (nonstock organization), including a governmental entity, Control means that:
  - More than 50% of the directors or trustees of the ATEO or nonstock organization are either representatives of, or directly or indirectly controlled by, the other entity; or
  - More than 50% of the directors or trustees of the nonstock organization are either representatives of, or are directly or indirectly controlled by, one or more persons that control the ATEO.

Note that under this framework, most, if not all, companies that establish private foundations control their private foundation and are, therefore, related to that foundation for purposes of the excise tax.

Allocations of the Excise Taxes among Related Entities

The Notice establishes the rules for allocating the excise taxes between an ATEO and related companies.

The general rule is each entity is allocated a proportionate share of the tax based on the specified remuneration paid to the covered employee of the ATEO.

This rule can get complicated when there are multiple ATEOs in a related group of entities because an entity can be subject to the tax as an ATEO or as a related entity of one or more ATEOs. In such a case, for each covered employee the entity will be liable for the greater of the excise tax it would owe as an ATEO or the excise tax it would owe as a related organization. This process requires multiple calculations of possible tax and coordination among related entities. This procedure may also result in a greater total excise tax payable with respect to a covered employee than would be owed by simply calculating the tax on the employee's excess remuneration prior to the allocation procedure.

Effective Date

The provision is effective for taxable years beginning after December 31, 2017. Unlike the changes to Section 162(m), there is no provision for grandfathering previously promised benefits. ■

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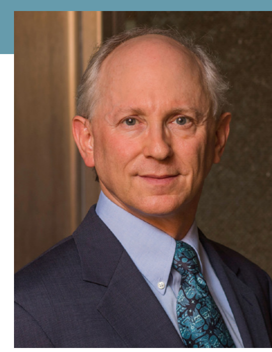
Meet a Managing Associate

M Benefit Solutions has been an innovator in the nonqualified plan space for over four decades. Over these decades, we have been privileged to employ extraordinary people, including our Managing Associates. Managing Associates oversee and partner with our staff of client associates to deliver the exceptional level of service and support our clients and Member Firms deserve. Our Managing Associates are industry experts and client-service leaders, but each brings something unique to our office. We want to introduce them to you here, and allow our clients and Member Firms the opportunity to learn more about the people that are differentiators in our office and industry.

Kevin Segal



Kevin has been with M Benefit Solutions for two years and arrived with over twenty-six years of industry experience. Years ago, Kevin challenged himself to master every facet of the industry, from plan design and technical consulting to client-service and plan administration. In addition to his uncanny memory for tax code and regulations, Kevin is a gifted parodist, penning songs about life insurance and nonqualified plans. His rendition of "COLI" set to "Lola" by The Kinks is an office favorite and a hit at conferences.

Kevin earned his B.A. and M.A. in mathematics from California State University, Fullerton, and went on to become an Associate of the Society of Actuaries. His wealth of experience and clear, cogent explanations had an immediate and immeasurable impact on our company and clients. Recently, Kevin created a series of life insurance and executive benefit training seminars for our associates and staff. In these courses, associates of all experience levels learn complex concepts and gain a better understanding of our industry, helping them provide exemplary service to our clients. As our resident professor, Kevin makes even the driest topics fun and understandable. If you want to see for yourself, pick up a copy of *101 Things Everyone Should Know About Math*, a book co-authored by—you guessed it—Mr. Segal!

Outside of the office, Kevin enjoys spending time in Portland with his wife and their two children. As recent transplants to Portland, the Segals try to visit a new restaurant whenever they go out to eat. Eat, sleep, but don't repeat the restaurant! Currently, their favorite is "a Cena," an Italian restaurant in the Sellwood neighborhood. Kevin also appreciates walking around the various farmer's markets scouring the produce, herbs, and spices for new home cooking adventures. After an adventure, Kevin enjoys walking off his meal in the Crystal Springs Rhododendron Garden, taking in the peaceful atmosphere and over 2,500 flowers and plants the garden has to offer. ■

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