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Top Five Executive Compensation Tips and Traps

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Executive compensation is fraught with complicated regulatory and tax issues that can surprise even seasoned executives. This article summarizes five frequently encountered traps and discusses some ways to avoid them altogether, and, when stuck in the hazard, some solutions for getting out.

1. Failure to Monitor Equity Plan's Authorized Share Award Limits and Expiration Dates

Both federal income tax rules and stock exchange rules require equity plans to have a cap on the number of shares that can be awarded under the plan, as well as defined lifespan. Equity plans typically then provide that no new awards may be granted after a specified date (typically ten years after adoption). Unfortunately, it is not uncommon for an employer to issue equity awards only to realize belatedly that the awards either exceeded the number of authorized shares or were issued after the expiration of the plan. This can result in the awards being void (or at best, voidable) and/or violations of securities' exchange rules. Below are some suggestions to minimize the risk of these events occurring:

- At least annually, employers should review their equity plan documents to confirm the number of authorized shares and compare that to the number outstanding;
- Consider the plan's provisions on recycling awards and whether change is needed. Some plans permit recycling of shares; however, the plan must specify how and to what extent previously awarded shares can be reissued upon forfeiture or exercise. Publicly traded employers should take care that the recycling of shares does not adversely affect the company's rating by proxy / shareholder advisory services. If the recycle policy is too liberal, companies may receive negative ratings. The current trend is to recycle only those shares that are forfeited and none that have been exchanged for value.
- If companies want to grant "qualified options," or an incentive stock option (ISO), they have to comply with a number of rules. One is that the options can't have more than a ten-year life. If an employee reaches the ten-year expiration date and they have yet to exercise their vested stock options, they forfeit those options which get absorbed back into the company. And a company can't just extend that period for another ten years without resetting the exercise price to the current "fair market value," which is an unattractive alternative in most cases.
- Start early to prepare new documents for shareholder approval when nearing the limit of authorized shares and/or the expiration date the plan. The process can be lengthy and for public companies can require advance disclosure. This can impede a company's ability to make equity awards.

2. Employment Agreements – Accidentally Creating Deferred Compensation

Deferred compensation rules under Internal Revenue Code (IRC) Section 409A cover a broad range of post-employment payment arrangements. These rules apply to compensation which is paid in a year later than the year in which the compensation is both earned and vested. While there are several exceptions to this general rule, if documents are not properly drafted, the result can be deferred compensation that it not 409A-compliant, subjecting the executive to a 20 percent excise tax on the deferred amounts plus acceleration of income tax. Here are some examples of provisions in employment agreements that can cause the amounts to be "deferred compensation":

- "*Bonus will be paid as soon as practical after end of calendar year performance period*." Because the bonus is earned and vested in one year and paid in the next, it is deferred compensation as presently drafted. However, 409A exempts compensation that is paid within 2 1/2 months of the end of the year in which earned and vested, so long as there is written agreement so providing. Further, if the payment is delayed beyond the 2 1/2 month deadline, it is still exempt so long as paid by the last day of the year. By including language that utilizes the 409A "short-term deferral" exemption, the amount will be exempt from Code Section 409A, provided it is paid no later than December 31 of the year following the performance year.
- *"Upon Executive's termination, Executive will be paid two times Base Salary."* While 409A exempts certain "separation pay" from being treated as deferred compensation, that exemption is only applicable to payments upon involuntary termination. The agreement would need to make certain that the severance pay is conditioned on involuntary termination by the company or by the Executive for "good reason."
- "*Upon termination, payments will be made for twelve months."* This provision contemplates payments beyond the year of termination and potentially for a period beyond 2 1/2 months after the year in which termination occurs. Thus, the agreement will need to include either 409A-compliant language or provisions to satisfy the separation pay exemption.
- *"Executive is awarded XXX units of phantom stock."* Phantom stock is considered deferred compensation subject to 409A. So, unless the award is drafted to comply with the 409A deferred compensation rules or to take advantage of an exemption such as the short-term deferral exemption, the award could subject the executive to punitive taxes.

3. Why Having IRC § 280G Parachute Payment Provisions Matters

Internal Revenue Code Section 280G imposes punitive excise taxes on certain "golden parachutes" that are triggered by a change in control of both public and privately held corporations. Disqualified individuals must pay a 20 percent excise tax on all "excess parachute payments" they receive in addition to the ordinary income taxes owed on those excess payments. Further, employers are prohibited from taking tax deduction for the excess parachute payments. With such adverse tax consequences, it is preferable at the outset of an agreement for the parties to address how potential golden parachute payments will be treated upon a change in control. Three options to consider are:

- Agreeing to "gross up" the executive by any excise tax. While this allows the executive to maximize his or her payment amounts while avoiding excise taxes, gross ups are expensive, and the corporation will end up with additional non-deductible expenses. As a result, this option is disfavored, especially by proxy advisory firms;
- Agree to reduce change in control payments to amounts below excess payment threshold. This cutback provision generally provides that if the IRC Section 280G excise tax and loss of deductibility under are triggered, then the payments and benefits will be reduced to the maximum amount that does not trigger the excise tax and loss of deductibility. While this certainly benefits the corporation by assuring that it does not risk losing the tax deduction for compensatory payments, executives tend to disfavor this option as promised payments may be significantly reduced; or
- Agree to implement a better-off cutback / valley provision. The better-off cutback has become the more favored option and provides for the executive's payments and benefits to be reduced to the maximum amount that does not trigger the excise tax unless the executive would be better off (on an after-tax basis) receiving all payments and benefits and paying all excise and income taxes.

4. Outliving Life Expectancy Under Split Dollar Policy

The problem: Many employers finance deferred compensation benefits with the use of split dollar policies. These arrangements are often designed under a "loan regime" whereby the employer "loans" the insured executive (who is the policy owner) amounts to pay the policy premiums and the executive secures the loan by assigning a portion of the death benefit proceeds to repay the employer's outlay for the premiums. Upon the executive's death, the employer recoups its premium outlay. Employers typically book these assignments on their balance sheets as assets. Problems arise, however, when the premiums have been paid up, the executive retires, and then outlives his or her life expectancy and suddenly premiums are again due under the policy. If the parties do nothing, the policy's cash value will be reduced each year by the value of the death benefit premium until the entire cash value is used up and the policy lapses (or requires the insured to pay out of pocket the annual premium). If the policy lapses, the executive and the employer both lose. The executive's beneficiaries receive no death benefit and the employer forfeits its account receivable, adversely affecting its balance sheet.

What to do? Employers and their executives would be wise to monitor annual policy illustrations so that when an insured is reaching his or her projected life expectancy under the policy and before cash value is used to pay for additional premiums, consideration can be given to terminating the policy for cash value and allocating the proceeds proportionately between the employer and insured.

5. Protecting Grandfathered Status 162(m) – Do We Care If Compensation is Performance Based Anymore?

Before Tax Reform was signed into in late 2017, publicly traded companies were able to deduct annual performance-based compensation (e.g., stock options, performance shares) in excess of $1 million for the CEO and next three highest-paid employees (other than CFO) serving on the last day of year. In other words, performance-based compensation was excluded from the $1 million limit imposed by IRC Section 162(m) on publicly-traded company tax deductions for most compensation payments made by the company to its "covered employees" in a particular fiscal year. That exemption was eliminated except for "grandfathered" arrangements. Performance-based compensation arrangements that were effective on or before November 2, 2017 (and not materially modified since), may still be able to take advantage of the performance-based compensation exception. However, it appears not all plans in effect on November 2, 2017, will meet the narrow requirements of the grandfather rule. In particular, the grandfather rule does not apply to:

- plans or agreements that permit an employer to retain discretion to reduce or eliminate the amount of compensation payable pursuant to an award, even if the employer never actually reduces or eliminates the amount of the award; or
- plans or agreements that require the employer to exercise discretion to renew or extend the agreement, for the period after such renewal or extension.

Since the pool of grandfathered arrangement is relatively small to begin with and will shrink as such arrangements come up for renewal or require modification, does the loss of grandfathered status really matter? At first blush, it would seem so as the corporation will lose the tax deduction for the heretofore "performance-based compensation." However, when considering the reduction in the corporate tax rate to 21% and the alternatives available for compensating executives, the loss of grandfathered status may not be that problematic. Some alternatives are:

- Incentive Stock Options (ISOs). ISOs are not deductible anyway (the tax effect is less as the corporate tax rate goes down to 21 percent from 35 percent). This will allow recipients to get capital gains tax treatment if they hold onto the stock for at least one year. In addition, the Tax Act reduces the effect of the Alternative Minimum Tax (AMT) on individual tax payers, which was another impediment to using ISOs before 2018.
- Stock option programs can be redesigned to adapt to the new changes in compensation. For example, the terms of stock options may be extended with limits on the amount of stock options that can be exercised (similar to ISOs), which will allow for more of the stock option proceeds to become tax deductible.

- Compensation portfolios may be rebalanced to emphasize fixed pay (salary and time vested restricted stock or units) as no compensation will be deductible over $1 million.
- Supplemental Executive Retirement Plans (SERPs) and other nonqualified deferral programs with their associated trust and funding techniques will make a comeback. Since any amounts paid to the top Named Executive Officers (NEOs) will not be deductible over $1 million, amounts may be deferred as a supplemental post-employment payment (although this payment will be capped at $1 million, even in death, as well in order to receive the full deductibility).

For assistance with your organization's compensation strategy, please contact the author, Andrea Powers, or any member of Baker Donelson's Employee Benefits and Executive Compensation practice.

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