

American Benefits Council BENEFITS BRIEFING

Executive Compensation: Section 409A and TARP

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Speakers

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Topics

- Overview of 409A Guidance
 - Proposed calculation regulations
 - Discussion of common 409A errors
 - Notice on corrections procedures
- Specific 409A problems (examples)
 - Possible approaches
- Update on TARP and stimulus bill
 - Latest guidance
 - Expectations for future changes



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409A – Proposed Calculation Regulations

Definition of “Amount Deferred”

- Plan aggregation
- Departure from 3121(v) concepts
- “Last day” rule
- Application to “formula” plans
- Required amended returns
- No future “taint”
- Implications for unvested plans
- Future deductions for “losses” by employee limited to 2% miscellaneous itemized deduction



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409A Errors

- Operational vs. documentary errors
- Operational errors generally take the form of either “paying too early” or “paying too late”
- Employer risks:
 - Code Z reporting
 - Timing of employment tax withholding
 - Timing of employer’s deduction
- Employers may also have non-tax risks to the extent that errors result in any gross up obligations to affected employees



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409A Errors

Three-step analysis:

- May the “error” be resolved under general tax principles or administrative rules in the Regulations?
- If not, may the error be corrected via Notice 2008-113?
- If not, what is the tax owed and for what years must amended returns be filed?



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409A Errors

Possible methods of resolving errors:

- General tax principles, i.e., rescission in same calendar year
- Regulatory “grace periods”
 - End of the calendar year
 - 2-1/2 month period for short term deferrals
 - Delays in calculations
 - 162(m)
 - Violations of “other laws”
 - “Refusal to pay”

 Plan interpretation

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IRS Notice 2008-113

- Limited opportunity to correct specified operational failures
- Does not expressly address “form” or documentary failures
- Relief only available if reasonable steps are taken to avoid recurrence of failure
- Relief for erroneous payment may not be available where service recipient is subject to substantial financial downturn



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General Considerations

- All corrections under the Notice entail some form of disclosure to the IRS
- Availability of correction or terms of correction may be limited if affected service provider is an “insider”
- For this purpose, insiders generally include directors and senior management, determined under Securities Exchange Act rules (without regard to whether the company is public)



Correction of Failure in Same Taxable Year

- Failure to defer or incorrect payment (other than a 6-month delay violation) of amount otherwise due in a later year
- Repay in same taxable year to correct
- Extended repayment (up to 24 months, with interest) permitted for non-insiders
- If subject amounts are in excess of section 402(g) limit, interest must be added to repayment amount for insiders



Correction of Failure in Same Taxable Year

(continued)

- Early payment of amount scheduled for same taxable year or ahead of the six-month delay date
- Amount must be repaid in same taxable year and held for later payment based on number of days necessary to eliminate benefit of earlier erroneous payment
- Adjustments may not be made for earnings but may be made for losses



Excess Deferral Corrected in Same Taxable Year

- Repay excess deferral in same taxable year
- Adjustment for earnings required for insiders but permissible for non-insiders



Stock Rights – Correction of Exercise Price

- Prior to the end of the year of grant (and prior to exercise of the stock right), the exercise price can be reset (i.e., increased) to an amount not less than the fair market value of the underlying stock on the date of grant.



Correction in Next Following Taxable Year

- Not available for insiders
- Failure to defer or incorrect payment scheduled for later year corrected with repayment with interest; adjustments for earnings may be made
- Payment in violation of six-month delay requirement or ahead of scheduled payment date in same year may be corrected by repayment held for the number of days of acceleration



Correction in Next Following Taxable Year (continued)

- Excess deferrals can be paid out without interest
- Stock right exercise price may be corrected
(reminder – this relief does not apply for insiders)



Correction Involving Limited Amounts

- Failures involving amounts not greater than 402(g) limit
- Requires Code Z reporting and payment of 20% tax on affected amount



Correction by End of Second Year Following Year of Failure

- Failures to defer, certain erroneous payments, excess deferred amounts
- Repayment, 20% tax and Code Z reporting required
- Special transition rule for non-insiders allows non-Code Z (no 20% tax) correction by end of 2009



Examples

Premature payments

- Failure to give effect to a deferral election
 - Pure administrative error
 - Payroll “coding” issues
- Failure to correctly determine separation from service date
- Plan interpretation questions: does the plan require deferral of all “bonus” or “salary”?



Examples

“Late” Payments

- Administrative errors in calculating amount to be paid
- Failure to “start” payments due to administrative error
 - Separation from service definitions
 - “Coding” errors for accounts
- How broadly may we interpret the “failure to pay” rule?
 - What level of knowledge is imputed to the employee?
 - Must the employee make a claim for benefits if the employee has no actual knowledge of the error?



Examples

- Incorrect application of the 6-month delay for key employees
 - Mistake in categorizing short term deferrals or separation pay
 - If the result is a “late” payment, is there any protection in a “conservative” application of the 6-month delay?
- If early payments are discovered in the same year, may the concept of rescission apply?
- Is the correction method in Notice 2008-113 the sole method for correcting or is it a “safe harbor”?



TARP Executive Compensation Rules

- EESA enacted in original financial bailout bill signed October 3, 2008
- Generally addressed --
 - Limits on excessive risk taking
 - Clawbacks of incentive comp based on bad financials
 - Severance limits
 - Revised \$1 million deduction limit
- Statutory rules depend on whether direct purchases or auction purchases over \$300 million
- Restrictions apply to top 5 in proxy (SEOs), and non-public counterparts
- Potential effect on best practices, expansion outside TARP



Initial Treasury Guidance Under TARP

- Various programs with different exec comp rules
- Generally follow EESA requirements
- Capital Purchase Program (CPP) for most
 - Interim final rules provide guidance
- Some thought rules not tough enough



Restrictions Announced by Obama Administration

- February 4 White House and Treasury press release with tougher rules
- Generally prospective only
- Distinguishes between institutions receiving "exceptional assistance" and those in "generally available" program
- Imposes \$500,000 limit on amounts of annual comp paid to CEOs (with exception for certain long-term incentive comp)
- Adds "Say on Pay" requirements under exceptional assistance program
- Adds luxury expenditure policy
- Toughens prior rules and expands some restrictions beyond CEOs



Economic Stimulus Act (ARRA)

- Signed Feb 17
- Generally, effective immediately
- Applies to all past and future TARP recipients
- Amends large part of the EESA rules
 - Limits on incentive compensation
 - Tougher severance prohibitions
- Keeps requirements to date and adds new requirements



Economic Stimulus Act (ARRA)

(continued)

- Treasury directed to create rules, authorized to provide additional restrictions
- Treasury working on guidance
- Feb. 4 press release rules likely will be revised based on Stimulus Act
- Rules apply until TARP recipient repays the government the amounts received
- Treasury recently announced their Capital Assistance Program ("CAP")
- Participants will be subject to requirements in line with Stimulus Act amendments



Limits on Incentive Compensation

- Prohibition on payment or accrual of "any bonus, retention award, or incentive compensation" for certain executives
- Applies to certain number of highest paid employees varying from 1 – 25 based on level of assistance company received
 - Unclear how to determine most highly compensated employees outside CEOs
 - Possibilities – proxy rules, key employee rules
 - Types of compensation? Lookback?
- Contains an exception for "long-term" restricted stock if –
 - Does not fully vest before Treasury paid back,
 - Value does not exceed 1/3 of annual compensation, and
 - Subject to any other terms Treasury imposes
- Exception for bonuses under written, valid employment agreements as of Feb. 11, 2009



Other Restrictions in Stimulus Act

- No severance for CEOs or any of the next 5 highest-paid employees
- Modified §162(m) \$500,000 deduction limit applies to all TARP recipients
 - No performance based comp exception
 - Not limited to public companies
 - No deferring amounts over \$500,000 and deducting in future
- Mandatory, non-binding "Say on Pay" votes required in public company annual proxy statement
 - Act instructs the SEC to issue final rules within one year
 - SEC staff release says effective immediately



Other Restrictions in Stimulus Act

(continued)

- Board must adopt policy regarding "excessive or luxury expenditures"
 - entertainment or events,
 - office and facility renovations,
 - aviation or other transportation service, or
 - certain other activities and events
- Treasury to review bonuses, retention awards and other comp paid before enactment to CEOs and next top 20 highest paid employees
 - Treasury to determine whether payments inconsistent with ARRA executive compensation restrictions, TARP, or public interest
 - If so, enter negotiations with institution for federal government to be repaid appropriate amounts



Other Restrictions in Stimulus Act

(continued)

- Clawback of bonus or incentive compensation paid to CEOs and next top 20 highest paid employees based on inaccurate financial statements
- Limits on arrangements that cause CEOs to take unnecessary and excessive risks that threaten value of institution
- Prohibitions on compensation plan that would encourage manipulation of company earnings to enhance compensation of any employee
- CEO and CFO to provide certification of compliance
- Need to have Board Compensation Committee comprised of independent directors



Possible Expansion of TARP Proposals

- White House press release that Administration plans to engage in long-term efforts to examine compensation structures at financial institutions
 - How compensation policies encouraged excessive risk-taking that contributed to financial crisis
 - Develop model compensation policies
 - Host White House-Treasury conference with stakeholders
- Likely that long-term efforts could result in changes for all companies



Other Executive Compensation Proposals Likely

- Say on Pay rules
- Expansion and tightening of § 162(m) deduction limit
- § 409A cap on annual deferrals
- Broader limitations on performance-based compensation
- Restrictions on QSERPs
- Expansion of PPA NQDC funding restrictions
- Other

