VIEWS & VISIONS

A publication of Bowles Rice LLP

Spring 2016

Executive Compensation Needs Careful Consideration

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Bowles Rice attorney Lynn S. Clarke focuses her practice on advising employers on ERISA and tax compliance for employee benefit plans and executive compensation planning. She provides guidance on benefits matters and executive compensation to clients involved in mergers and acquisitions. Ms. Clarke has extensive experience with business succession planning involving employee stock ownership plans (ESOPs), insurance and other compensation planning methods.

She also provides fiduciary advisory services including consulting, training and educational seminars to help clients better understand and carry out fiduciary obligations and manage liability. With extensive experience in tax planning, Ms. Clarke provides advice to non-profit entities on governmental plan compliance and tax matters.

She received her law degree, *magna cum laude*, from Harvard Law School and her undergraduate degree, with honors, from the University of Chicago. She earned a master of studies degree in 2009 from the University of Cambridge (UK).

Melody A. Simpson focuses her practice at Bowles Rice in the areas of employee benefits, executive compensation and ERISA, with particular emphasis on qualified retirement plans (including governmental plans) and executive compensation, including 409A non-qualified deferred compensation issues.

Ms. Simpson represents both private and governmental employers and plan administrators, advising them on compliance issues related to their qualified retirement plans. She regularly assists clients with plan document review and analysis to ensure operational compliance, and prepares plan amendments to reflect updates in the law or client's desired changes. She has helped clients on numerous occasions with determination letter applications and voluntary correction filings with the Internal Revenue Service. Ms. Simpson has counseled clients when their qualified plans have been selected for audit by the Internal Revenue Service, interfacing with the IRS agent to negotiate and achieve audit closure.

She received her law degree, *cum laude*, from Harvard Law School and her undergraduate degree, *summa cum laude*, from the University of Vermont. Best Lawyers in America has recognized her as its 2016 Lawyer of the Year for Employee Benefits (ERISA) Law in southern West Virginia.

Attracting and retaining effective officers and other key management personnel is a vitally important task for the governing board of any organization. Knowledge about trends in executive compensation can help your organization accomplish this task, while avoiding potential problems with the IRS, DOL and other regulatory agencies.

Executive compensation packages, in both the for-profit and nonprofit arenas, often have a number of components. Here are a few of the more common elements of an executive pay package, and some tips for crafting a package that suits your company (keeping in mind that proxy disclosure rules include material details of executive compensation):

- **Cash Compensation** – Often called "base salary" and/or "Bonus," these amounts affect not only your executive's regular paycheck, but also deferrals and contribution limits for qualified plans such as a 401(k). Keeping salary and bonus in line with industry trends is important for regulatory and (for nonprofits especially) IRS compliance. For publicly traded companies, tying bonus payments to performance goals can be important with respect to the $1 million executive pay deductibility limit of IRC Section 162(m).
- **Equity Compensation** – Stock options, incentive grants of restricted shares and other forms of pay based upon company stock are important tools for linking company success to executive pay, planning for business succession and complying with the IRC Section 162(m) limit. Rules for timing of taxation and valuation of equity compensation can be complex, however, and care should be taken in crafting an equity compensation plan or "long-term incentive plan" that involves stock rights of any kind.
- **Deferred Compensation** – Compensation is often promised now, with payment deferred until a later date, usually for tax purposes. Post-Enron legislation, however, including IRC Section 409A, has restricted the use of deferred compensation plans. Failure to comply with 409A can result in income inclusion, with interest and a 20 percent penalty for the executive, and withholding and reporting problems for the employer. Also, for nonprofits, deferred compensation over the limits of a plan such as a 403(b) or 457(b) plan is generally taxed on vesting, rather than on distribution, so extra planning is needed to avoid unwanted surprises.

- **Retirement Packages** – In addition to 401(k)s and other qualified retirement plans, members of top management are often offered Supplemental Executive Retirement Plans (SERPs). These can pay out over a term of years or for life, and may involve a percentage of final salary or fixed lump sum payment amounts. SERPs also need to comply with the 409A rules. FICA taxes have to be withheld on "vesting" for SERPs, while income taxes are generally withheld at distribution, so extra care is needed to avoid costly errors in withholding and reporting.
- **Planning with Life Insurance** – Company- or bank-owned life insurance ("COLI" or "BOLI") is often used as an executive compensation tool. Recent changes in IRS regulations have made the tax rules for so-called "split dollar" arrangements much more complicated. Also, serious problems can occur when the internal rate of return on policies does not match projections, especially in early years. Careful long-term planning is essential when considering life insurance as an executive compensation tool.
- **Severance Packages** – A multiple of annual base salary is sometimes promised as severance to protect executives from certain terminations after a merger or sale of the company. If offered at all, such severance is generally limited to one to three years' pay. IRC Section 409A applies to many of these arrangements and IRC Section 280G can cause a 20 percent excise tax for the executive and loss of the deduction for many companies, when an executive receives more than three times pay (calculated under the 280G rules) contingent on a "change in control" of the company.
- **Executive Perks** – Where there is a demonstrated need, "fringe benefits" such as use of a company car, phone or computer, or company payment of professional licensing fees, continuing education costs and club memberships may still be fairly common. Payment of COBRA premiums as part of an executive severance package is becoming more problematic, however, as the IRS and DOL still decline to state whether this practice is discriminatory under the Affordable Care Act. Some employers instead offer additional taxable cash severance, which the executive can use to pay COBRA premiums.

As more mergers and acquisitions take place in the banking and financial services industries, companies should keep in mind that executive compensation arrangements, as well as more generally available retirement plans (e.g., 401(k) plans), can become problematic – and expensive – if they are not addressed. Many headaches can be avoided if possible future mergers or acquisitions are carefully considered when crafting executive compensation packages.

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