

Playing by the rules

Code Sections 409A and 162(m) and executive compensation **Interviewed by Meredyth McKenzie**

Although the Internal Revenue Code Sections 409A and 162(m) rules are not new, they continue to raise important issues that companies and their employees must be aware of.

Section 409A imposes limits upon plans and agreements of public or private companies that include deferred compensation that ensure “participating employees do not have complete control over determining when income will be recognized for income tax purposes,” says Daniel N. Janich, an officer in the employee benefits practice group in the Chicago office of Greensfelder, Hemker & Gale, PC.

Section 162(m) limits the deductibility of compensation for a public company’s CEO or three other most highly compensated officers (other than the principal financial officer) for a given taxable year to \$1 million. Janich says that Section 162(m) “essentially caps the total amount of compensation guaranteed to be paid to the public company’s top executives.”

Recently, the IRS ruled that employment agreements, equity and other incentive plans that permit payments when such officers terminate “without cause” or “for good reason,” or who retire, may no longer be considered “performance-based compensation” that is excluded from Section 162(m)’s limitations.

Smart Business spoke with Janich about what you need to know about these rules and how to make sure your company is following them.

What key things do business owners need to understand about these rules?

With regard to Section 409A, business owners and employees must understand this rule applies in a broad set of factual circumstances. The penalties for a violation will impact the employee, not the company; therefore, it is the employee who must be certain that his or her deferred compensation benefit fully complies with 409A. A 409A violation results in tax penalties, accelerated recognition of income and interest charges.

Section 162(m) is more limited in scope than Section 409A, applying only to a handful of top paid executives of public companies. Unlike in the past, when terminating executives were permitted to waive their performance goals and still receive their incentive compensation benefit as performance-based compensation excluded from Section 162(m)’s deduction limits, the IRS has recently pronounced that such payments



Daniel N. Janich

Officer, employee benefits practice group
Greensfelder, Hemker & Gale, PC

will no longer be treated as performance-based compensation if triggered solely by an involuntary termination or retirement.

This position has caused many public companies to restructure their plans and agreements to comply with this interpretation of Section 162(m).

What are the risks and benefits of these rules?

The main risk is posed by a failure to understand how and when these rules apply, which will lead to costly violations. The principal benefit of Section 409A is that it provides a bright line on the operation of deferrals in such plans. The major benefit of the IRS position on Section 162(m)’s application to equity and incentive awards is greater clarity as to how and when such compensation will be deemed performance-based.

These benefits may be outweighed by the added layer of complexity and administrative expense associated with compliance with these rules.

How can a company make changes to comply with these rules?

Any company providing a form of deferred compensation or incentive plan benefit should work with competent legal counsel who is familiar with these rules

DANIEL N. JANICH is an officer in the employee benefits practice group in the Chicago office of Greensfelder, Hemker & Gale, PC. Reach him at (312) 419-9090 or djnj@greensfelder.com.

and their application. Experienced legal counsel should be routinely consulted before new deferred compensation plans or agreements are implemented to confirm compliance with these rules, insofar as the failure to comply will most certainly result in unhappy employees.

Although the consequences of violating Section 409A will generally be felt by the employee, the company may also be subject to a tax penalty arising from a failure to withhold income due to the acceleration of income recognition that a violation entails.

Under Section 162(m), the company is the one that would suffer the most significant consequences of a violation. The restructuring of plans and agreements to comply with Section 162(m) requirements may result in some loss of flexibility in fashioning a suitable payout arrangement for the top-paid executives.

How can you make sure you and your employees don’t overstep these rules?

The problem is that many employees and executives are not familiar with these rules, even though they are the recipients of significant amounts of income that are subject to them. Of course, this is less of a problem for Section 162(m) than it is for Section 409A.

For example, in the case for severance plans, an inadvertent 409A violation may occur simply because the length of the payment schedule causes the severance to be treated as deferred compensation. Many former employees signing off on separation packages without the benefit of competent legal advice on 409A issues may not realize the income tax ramifications until it is too late to do anything about it.

Employees and employers alike must become familiar with these rules. Employee benefits counsel can and should assist in the educational process through in-house seminars and other training programs for human resource personnel.

By becoming familiar with these rules, as well as with the common scenarios when they typically arise, human resource personnel can meaningfully assist employees. Although these tax rules may be complicated, a basic understanding of when and how they apply can be achieved with the right kind of program in place. <<

Insights Legal Affairs is brought to you by Greensfelder, Hemker & Gale, P.C.