



# Bank and Capital Markets Tax Institute

## Session C3: Compensation and Benefits

Presented by:

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# Agenda

- Recent changes in executive and incentive compensation;
- Dodd-Frank Act;
- Sound Incentive Compensation Policies;
- Mortgage Originator Rules;
- Forgivable Loans;
- IRC Section 162(m) guidance and clarification;
- Cash bonus tax deduction;
- Restricted Stock vs. RSUs, and
- NQDC issues.

# Landscape of Legal and Regulatory Changes Driving Compensation and Enterprise Risk

- Based on recent history, three key regulatory changes serve as a platform for analyzing how regulators view compensation and risk:
  - SEC amendments to proxy disclosure rules relating to compensation and corporate governance adopted in December 2009;
  - Federal regulators of financial institutions “Guidance on Sound Incentive Compensation Policies”; and
  - The Dodd-Frank Wall Street Reform and Consumer Protection Act.
- Our discussion will incorporate the chronology of executive compensation changes beginning with the Sarbanes-Oxley Act of 2002 and continuing with the Emergency Economic Stability Act, the American Recovery and Reinvestment Act and leading to the most recent enactment of Dodd-Frank.
- The seeds of most of the current and likely the future executive compensation and corporate governance changes will be revealed through the lens of this historical perspective .

# Key Topics for Understanding the Changes

- Many of the following topics have emerged and/or been addressed repeatedly in the progression of legal and regulatory requirements imposed on public companies and financial service institutions:
  - Pay for Performance;
  - Say on Pay;
  - Clawbacks;
  - Compensation and risk management;
  - Compensation consultant independence;
  - Compensation Committee independence;
  - Hedging policy;
  - “Golden parachutes”;
  - Pay disparity; and
  - Compensation structure.



# 2009 SEC Disclosure Changes

- On December 16, 2009 the SEC approved amendments to the proxy disclosure rules to address certain executive compensation and corporate governance issues.
- Many of these changes grew from the EESA and ARRA legislation and regulations that imposed restrictions on banks and financial institutions that received government assistance through programs such as TARP.
- Generally, these amendments addressed the following:
  - Compensation and risk management;
  - Summary compensation table-equity compensation;
  - Enhanced director and nominee disclosure;
  - Board leadership structure;
  - Board oversight role and risk management
  - Compensation consultant disclosures

# FRB Guidance and Principles on Incentive-based Compensation and Risk Management

- On June 21, 2010, the FRB, OCC, OTS, and FDIC adopted final guidance on safety and soundness for incentive compensation. The guidance focused on three principles:
  - Balanced risk-taking incentives;
  - Compatibility with effective controls and risk management; and
  - Strong corporate governance.
- Within its guidance and principles, the agencies identified the following incentive compensation strategies to ensure a balance of risk and reward:
  - Adjusted awards to reflect the following risks: credit, market, liquidity, operational, legal, compliance, and operational;
  - Positional and functional risks tied to employee incentives;
  - Use of multi-year deferrals to tie payment to the risk time horizon;
  - Risk-taking behavior linked to golden parachute and deferred compensation payments.

# FRB Guidance and Principles on Incentive-based Compensation and Risk Management

- The following planning tips reflect an appropriate application of these principles:
  - Risk and size adjust awards based on the control that individuals may have to impact a broad segment of the company's earnings or exposure to potential future losses;
  - Provide delayed payment schemes linked to the time horizon of the risk, especially if the executive has the ability to affect the near-term outcome;
  - Use of stock-based compensation, stock holding period requirements, and share ownership guidelines may improve the link between executive behavior and long term shareholder value;
  - Monitor performance to ensure that paid compensation is not later subject to revisions or restatements of financial information that would reduce the initial value of these payments;
  - Engage internal audit, the compensation committee, and management in the development, approval and tracking of incentive compensation plans.

# Dodd-Frank Wall Street Reform and Consumer Protection Act

- In response to the collapse of the financial markets and drawing from their executive compensation and corporate governance tool kit developed in framing the EESA and ARRA legislation, the Dodd-Frank legislation will require public companies, broker/dealers, stock exchanges, and, on an enhanced basis, financial institutions to comply with many new compensation rules.
- The following topics are addressed in the Act and provide direction for the future of compensation planning and design:
  - Clawbacks
  - Say on Pay
  - Compensation Committee Independence
  - Compensation Consultant/Legal Advisor Independence
  - Hedging Policy
  - Pay for Performance
  - Compensation Committee Structures

# Timing on Implementation of the Corporate Governance and Compensation Rules under the Dodd-Frank Act

- The table below identifies the implementation plan for the executive compensation and corporate governance regulations under the Act.:

Provision	Description	Status
971 — Proxy access authority	The SEC has been granted authority to adopt rules for including the names of shareholder board nominees in proxy solicitation materials.	Proposed rules due date undetermined
951 — Say-on-pay	The Dodd-Frank Act mandates a say-on-pay vote for shareholders on the compensation of the issuer's named executive officers.	Final rules issued January 25, 2011
957 — Broker discretionary voting	Stock exchanges must prohibit brokers from voting customer shares without receiving voting instructions.	No date set for issuance of regulations.
952 — Compensation committee and adviser independence	The SEC must direct national securities exchanges to require member companies to satisfy heightened independence standards similar to those that apply to audit committees.	Regulations due between August and December 2011.
972 — Disclosure of board leadership	The SEC must issue rules for filers to disclose the reasoning behind establishing the same or different roles for the chairman and the CEO.	No date set for issuance of regulations.

# Timing on Implementation of Dodd-Frank (continued)

- The table below identifies the implementation plan for the executive compensation and corporate governance regulations under the Act.:

Provision	Description	Status
953 — Additional executive compensation disclosures	This is a requirement for public companies to explain the pay-for-performance relationship and to disclose the ratio of CEO pay to the median compensation for all employees.	Regulations due between August and December 2011.
954 — Clawback of incentive compensation	This provision requires all public companies to establish and enforce an incentive compensation clawback requirement for current and former employees.	Regulations due between August and December 2011.
955 — Hedging by employees and directors	The SEC is directed to issue rules requiring companies to disclose policies on whether employees or directors are permitted to hedge their stock-based compensation.	Regulations due between August and December 2011.
956 — Compensation structures of financial institutions	Financial institutions with assets of \$1 billion or more must disclose the structure of all incentive compensation arrangements.	Regulations due between August and December 2011.

# Section 956- New Rules on Incentive-Based Compensation

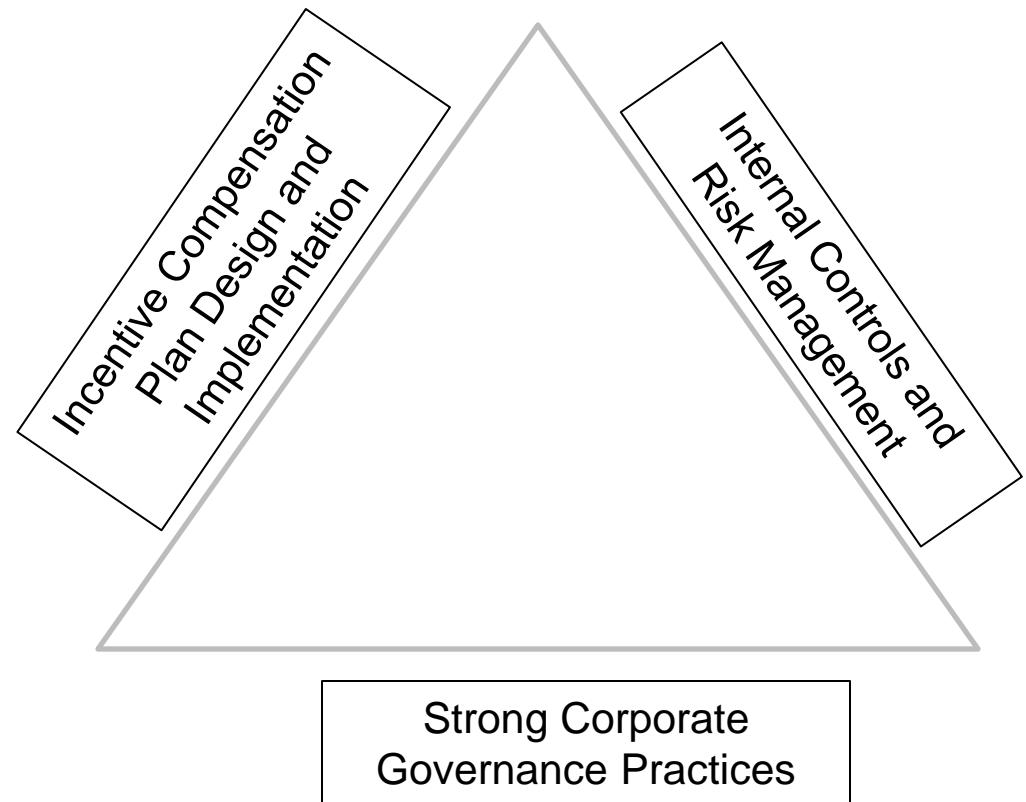
- On February 7, 2011 federal banking and securities regulators published notice of proposed rulemaking for standards on incentive compensation;
- On April 14, 2011, the proposed regulations were published in the Federal Register and comment period expired May 31,2011;
- Six months after the final rule is published in the Federal Register, the regulations will become effective.
- Prohibitions on excessive compensation;
  - Covered financial institutions
  - Covered persons
  - Incentive-based compensation
- Special rules for institutions of \$50.0 bill or greater;
- Prohibitions on incentive compensation that encourages inappropriate risks;
- Establish and maintain compensation policies and procedures;
- Reporting requirements on compensation structures;

# What are the principal compliance requirements?

- The three (3) compliance requirements of incentive-based compensation are as follows:
  - Balance of risk and financial rewards by: risk-based adjustment of awards, deferral of payment, use of longer performance periods, and reduced sensitivity to short-term performance;
  - Compatibility with effective controls and risk management by strong board oversight of compensation design and monitoring, integration with internal audit and risk management, and regular review of program effectiveness; and
  - Supported by strong corporate governance to include oversight of plan design, regular reporting of actual plan results, assurance of clawback actions in the case of restatement of financial data, access to special areas of expertise such and risk management and compensation advisors.

# Developing an Integrated Solution

- The major theme of compliance with the Dodd-Frank Act is to develop a multi-disciplinary approach to regulatory compliance. This applies especially to designing and implementing incentive compensation arrangements.
- Integrating incentive, risk management, effective corporate governance requires a management team approach with the independent directors acting in a broad-oversight capacity.



# Federal Reserve Board's Final Rule on Loan Originator Compensation and Steering (Regulation Z)

- Reg. Z prohibits a creditor or any other person from paying compensation to a mortgage originator or broker based on mortgage loan terms or provisions other than the amount of the loan.
- Basing the compensation on a fixed percentage of the loan will not be considered a term or condition.
- Creditor may pay the originator on an hourly rate or on loan volume within a given time period.
- The Final Rule permits the lender to pay a maximum or minimum amount as a way to address compensation for smaller loans.

# Mortgage Originator Rules 2

- Mortgage originators can't get pay from both creditor and consumer;
- Definition of compensation is very broad;
- Important to differentiate between compensation based on loan terms and compensation not based on loan terms;
- Steering is prohibited; unless you meet the safe harbor test.

# Mortgage Originator Rules 3

- Most lenders have already restructured their mortgage loan portfolios:
  - To eliminate prohibited compensation features such as commission based on interest rates or other terms and conditions;
  - Some lenders have shifted from 100 % commission plans to salary plus bonuses;
  - Regulators are also looking for provisions to clawback compensation in mortgage lending.

# Mortgage Originator Rules 4

- Recordkeeping will be a heavier burden in the future and critical to demonstrate compliance;
- Some regulators have extended the compensation prohibitions to include bonus plans for bank senior management;
- Future Dodd-Frank Act regulations may conflict with the Reg. Z;
- Rules will impact ability to attract and retain top mortgage originators.

# Forgivable Loans

- Financial institutions employ a practice of providing loans to employees to induce employment and to retain key talent;
  - Only applies to institutions not subject to Reg. O;
  - Loans prohibited to certain public company officers under SOX § 402;
- Typical features may include upfront cash outlay governed by a promissory note and executed in tandem with a bonus/forgiveness plan.
- Loans may have scheduled P&I payments or demand loan agreement with lump sum settlement.

# Forgivable Loans - Accounting

- Company books loan as an asset; recognizes interest income and asset reduction as normal payments made; or
- If loan payment becomes due and is forgiven based on continuous employment or the attainment of a performance objective, then;
- Company reduces principal and records compensation expense for loan forgiveness bonus;
- If employee terminates employment prior to full loan repayment, employee must pay loan in full at time of termination.

# Forgivable Loans- Tax Issues

Is the loan another form of compensation?

- TAM 2000400004 addresses the up-front payments to new employees and concludes:
  - Up-front payments are advance payments for employee services and not loans
  - Company gets a tax deduction ratable over the repayment period (all events test issue);
  - TAM doesn't address timing of employee compensation.

# Forgivable Loans – Best Practices

- Rethinking and confirming the business purpose of providing employee loans is a key first step;
- Is the purpose is to attract and retain key talent?
  - Yes, then consider using sign-on a bonus arrangement with a clawback provision; or
  - Consider awarding a retention bonuses linked to a fixed period of employee service.
- Because of the potential governance issues and the uncertain tax issues, substituting a retention bonus for a loan may be a wise decision.

# Code Section 162(m)

- Proposed Rule (REG-137125-08) clarifies 2 issues
  - Requirements for Stock options and SARs to meet the definition of performance-based compensation;
  - Clarification concerning transitional relief for certain stock-based compensation for companies that become public via an IPO or otherwise.

# Code Section 162(m) and REG-137125-08

- Code Section 162(m) places a \$1.0 mill. cap on deductible compensation for certain proxy officers of public companies.
- Exceptions include performance-based compensation and stock options and SARs are considered performance-based pay.
- This notice of proposed rule making clarifies the issue stating that plan documents must specify both the aggregate and per person maximums for stock options and SARs

# Code Section 162(m) and REG-137125-08

- Additional clarification of the tax deductible cap relates to the grandfathering of compensation paid pursuant to a plan existing during the period when the company was private.
- Compensation paid from an existing plan (see below) is exempted from inclusion in compensation used to calculate the \$1.0 mill cap.
- This transitional relief expires when (1) the plan or agreement expires; (2) a material modification of the plan or agreement; (3) all stock authorize has been issued; and (4) the 1<sup>st</sup> shareholder meeting three years following the IPO.
- The proposed rule making states that this transitional relief for stock-based compensation applies only to options, SARs and restricted stock;
- The relief DOES NOT apply to RSUs, phantom stock or other forms of equity-based compensation.

# Section 162(m)

- Compensation deduction for top executives limited to \$1,000,000 per year
- Including short taxable years (limit not prorated, see PLR 9810024)
- Exception for performance-based compensation

# Section 162(m)

## Case Study #1: ABC Bancorp

- Public company pays CFO Base salary of \$2,000,000.
- No other compensation is considered (stock, options, etc.)

**How much of the \$2,000,000 is deductible?**

# Section 162(m) Case Study #1

## How much is deductible?



**Answer:**

**\$2,000,000, assuming it is reasonable compensation.**

**Why?**

- CFO not subject to § 162(m) \$1,000,000 deduction limit.
- Current regulations under Notice 2007-49 clarified the covered officers subsequent to the new proxy rules which changed the reporting language.

# Section 162(m) Case Study #2

## How much is deductible?

CEO of World Financial Corp.

- Base salary = \$2,000,000
- No other compensation is provided.

**How much is deductible?**

# Section 162(m) Case Study #2

## How much is deductible?



### **\$1,000,000, assuming it is reasonable**

- CEO is subject to § 162(m) \$1,000,000 deduction limit;
- Others for whom the deduction limit (Notice 2007-49) include the three highest compensated officers for the taxable year (other than PEO or PFO)

## Section 162(m) Case Study #3

- COO of World Financial Corp. paid base salary of \$25.00
- Annual Bonus plan:
  - \$3,000,000 if company's EBITDA doubles, and
  - Overall performance rating of 5 for the year, at the discretion of the CEO

**How much is deductible?**

# Section 162(m) Case Study #3



## How much is deductible?

Deductible amount:

\$25 base salary (assuming it is reasonable)

+ \$975,000 bonus (also assuming it is reasonable)

**\$1,000,000**

**Why not the entire \$3,000,025?**

# Section 162(m) Case Study #3

## Why not the entire \$3,000,025?



- Performance criteria must be completely objective
  - Third party having knowledge of relevant performance results must be able to calculate amount to be paid.  
Reg. Sec. 1.162-27(e)(2)(ii).
- Other requirements for performance-based compensation
  - Pre-established – In writing no later than 90 days after commencement of period of service to which performance goal relates, and within the first 25 percent of the period of service;
  - Outcome must be substantially uncertain at time goal is established.

# Bonus Deduction Case #1

## § 404(a)(5) - Deductions for deferred compensation

- **General rule:** Deductible for the employer's taxable year with which or within which ends the taxable year of the employee in which includible in employee's income.
- **Exception to general rule:** Accrual basis employer can take deduction if paid within 2½ months after end of taxable year in which services are performed.
  - See Reg. Sec. 1.404(b)-1T, Q&A-2(b)(1).
  - But all events test must be satisfied as of the last day of the employer's taxable year.

# Bonus Deduction Case #1

International Finance Group (IFG) is an accrual basis and calendar year taxpayer;

- 2010 IFC met annual bonus targets:
  - Paid bonuses on March 1, 2011
  - Employee must be present on payment date to receive bonus
  - Forfeited bonuses not allocated to other employees

**When is the bonus deductible?**

# Bonus Deduction Case #1

## When is the bonus deductible?



Components of the all events test:

All events have occurred that:

- 1) Fix the fact of the liability;
- 2) Amount of the liability can be determined with reasonable accuracy
- 3) Economic performance has occurred

**How could the plan have been changed to get the deduction in 2010?**

# Bonus Deduction Case #1

How could the plan have been changed to get the deduction in 2010?



## Redesign plan so that all events test is met

- Employee receives payment if still employed on December 31, 2010 (or an earlier date)
- or**
- Bonuses forfeited by employees who aren't still at Fowler on the payment date are allocated and paid to other employees

## Bonus Deduction Case #2



- IFG's CFO, doesn't like this either solution
- CFO proposes giving all forfeited bonuses to his favorite charity;

**Does this meet the all events test?**

# Bonus Deduction Case #2

## Does this meet the all events test?



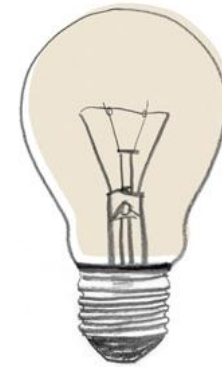
- CCA 200949040 – forfeited bonuses paid to a charity within 2½ months after end of year;
- Taxpayer's position
  - Section 170(a)(2) has same 2½-month rule as under Section 404(a)(5)
  - Thus, all amounts paid within 2½ months are deductible, regardless of whether a bonus or charitable contribution
- CCA position
  - Code Sections must be evaluated independently
  - All events test not satisfied for bonus, so not deductible on accrual basis

## Bonus Deduction Case #3

# IFG's CFO has a great idea to improve Fowler's cash flow

Example – 2011 annual bonus

- Vests on December 31, 2011
- Paid on March 1, 2013



**When does Fowler get the deduction?**

2011?    2012?    2013?

# Bonus Deduction Case #3

## When does Fowler get the deduction?



### 2013

- Services were performed in 2011
- 2½-month period starts running at end of year in which services are performed
  - Services performed in 2011
  - Not paid by March 15, 2012
  - Therefore, no accrued deduction
  - Not deductible until taxable year "with which or within which ends" the employee's year ends – 2013

**Any ideas for obtaining the deduction in 2012?**

# Bonus Deduction Case #3

## Obtaining the deduction in 2012



- Pay the bonus in 2012
  - If paid by March 15, 2012, would be deductible for 2011
  - If paid later in 2012, would be deductible in 2012
- Postpone vesting date from December 31, 2011 to sometime in 2012
  - Services deemed performed in year of vesting (TAM 199923045)
  - Causes 2½-month period to start running on December 31, 2012
  - If paid by March 15, 2013, deductible for 2012

# Other topics

- Additional topics may be added if new issues emerge before the November presentations.
- What are your questions?



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