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BENEFITS BRIEF

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SEC's Proposed "Clawback" Rule Raises Section 409A and Other Tax Issues

On July 1, 2015, the Securities and Exchange Commission ("SEC") released a proposed rule that would require publicly-traded companies to adopt "clawback" policies for recovering erroneously awarded compensation from its executive officers. This long-awaited clawback rule is the third executive compensation rule proposed by the SEC this year under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). With this rule, the SEC has now proposed or finalized all of the executive compensation rules required by the Dodd Frank Act. The required clawback policies could give rise to significant tax issues, particularly if a clawback is applied to a covered executive's deferred compensation arrangements.

Overview

Under the proposed rule, if a company is required to prepare an accounting restatement to correct a material error, the company's clawback policy must require the company to recover certain amounts of "incentive-based compensation" paid to its executives in the prior three fiscal years. "Incentive-based compensation" includes compensation that is based, at least in part, on reaching a financial reporting measure (including stock price or total shareholder return ("TSR")). Executives covered by the measure generally include the company's president, principal financial and accounting officers, any vice president in charge of a principal business division or function, and any officer or other person who performs a policy-making function.

The amount subject to recovery would be the amount of incentive-based compensation actually received over what the executive would have otherwise received based on the accounting restatement, determined on a pre-tax basis. If the compensation is based on stock price or TSR, the proposed rule would require the company to make a reasonable estimate of the effect of the restatement on the stock price or TSR.

Recovery Should Comply with Section 409A

The proposed rule gives the company significant discretion over how it should recover erroneously-awarded compensation. In response to commenters, the SEC asked whether it should approve the use of a nonqualified deferred compensation plan to aid in recovering such compensation. However, companies should be aware of a potential pitfall for such a recovery created by Section 409A of the Internal Revenue Code (the "Code").

Section 409A contains strict rules regarding nonqualified plan documentation and operation and imposes severe tax penalties on employees for violations. Among many other restrictions, Section 409A generally prohibits the settlement of a current employee debt over $5,000 by reducing the amount of deferred compensation the employee is scheduled to be paid in the future, as such an arrangement would be an impermissible “acceleration” of the deferred amount.

Section 409A’s general prohibition on accelerations means a company should not satisfy its clawback obligation under the proposed rule by deducting the amount to be recovered from an executive’s nonqualified plan account (or any other amount subject to Section 409A), as such a practice would expose the executive to Section 409A’s tax penalties. There is also a potential problem if the documentation for an arrangement subject to Section 409A provides for recouping amounts owed by the employee, even if recoupment is to occur at the originally scheduled payment date. While there may be situations where a clawback could be made from deferred compensation amounts (e.g., forfeiture of grandfathered amounts exempt from Section 409A or excess incentive-based compensation amounts subject to a clawback policy), a company should consider these Section 409A implications both when drafting its clawback policy and when actually recovering compensation from the executive.

Executive’s Recovery of Taxes Paid

The proposed rule requires amounts to be recovered on a pre-tax basis, and requires a clawback policy to provide for a “lookback” period that extends into prior tax years. Thus, an executive impacted by the policy may be required to return to the company an amount received in a prior year on which he has already paid income tax. A practical consequence of the proposed rule is that an impacted executive will need to recover this income tax.

Since the executive had use of the amount during a prior tax year, he would not be entitled to recover this tax by filing an amended tax return for the year in which he received the amount. Instead, Code Section 1341 generally allows the executive to account for the repayment as a deduction (or in certain cases, a credit) on his tax return for the year in which the amount is repaid to the company.

Conclusion

The proposed rule would certainly impact the corporate governance and disclosure practices of publicly-traded companies, and of course could have significant financial implications for their executives. However, as companies and their executives work through the many potential ramifications of the proposed rule, they should keep these two significant tax issues in mind.