Taxation of Executive Compensation and Retirement

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INCENTIVES AND BENEFITS

beware the United States golden parachute excise tax

Laurence Wagman and **Sandra Cohen** discuss the United States golden parachute excise tax rules, which are complicated, and expensive, and are important for Canadian companies who have operations in the United States or U.S. taxpayers working in Canada to be aware when structuring employment arrangements or undergoing a change in ownership or control. When a Canadian company engages in merger and acquisition activity, unforeseen tax issues may add unexpected expenses to the transaction. One example of a potentially expensive (and obscure) tax, which affects both executives and shareholders is the golden parachute excise tax that may be imposed on change in control payments that might routinely be awarded in connection with a transaction. Golden parachute payments typically comprise a package of cash bonuses or severance that will be paid, stock rights that will vest, and other benefits that will be delivered in the event that a corporation undergoes a sale, merger, initial public offering, or other change in ownership or control. In this case, it is not just the cost of executive golden parachutes that can affect the business case for a transaction, even though such costs can be significant, but also the costs to the company and to the executives of the tax and loss of deductions under the U.S. golden parachute rules. In a cross-border acquisition, such as the acquisition of a U.S. target or a Canadian target with U.S. operations, the acquiring company should plan for the application of the U.S. golden parachute tax under Section 280G of the Internal Revenue Code as part of its financial model for the transaction. The authors also examine the two practical alternatives for avoiding the golden parachute tax.

PENSIONS

B.C. unveils new Pension Benefits Standards Act

British Columbia's new *Pension Benefits Standards Act* (the "PBSA" or the "Act") recently received Royal Assent. While this new Act will eventually repeal and replace the existing PBSA, it will not come into force until the underlying regulations are developed and finalized, likely in 2013 or later. As the new Act is the final product of the November 2008 Joint Expert Panel on Pension Standards ("JEPPS") report and subsequent work by the B.C. and Alberta governments, it is anticipated that Alberta will introduce a substantially identical bill later this year. As **Kenneth Burns** and **Megan Kaneen** explain, one of the most important features of the new Act is that it provides for new plan designs. The Act also requires the introduction of a new compliance and assessment regime, and gives the Superintendent a variety of enhanced regulatory powers.

Taxation of Executive Compensation and Retirement

Topical Summary

Incentives and Benefits

This regular feature is edited by Dov B. Begun, of Osler, Hoskin & Harcourt LLP. It examines major trends and tax planning issues pertaining to executive incentive and benefit plans and arrangements.

GOLDEN PARACHUTE EXCISE TAX RULES

Canadian Employers – Beware the United States Golden Parachute Excise Tax as Not Just a U.S. Problem

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When a Canadian company engages in merger and acquisition activity, unforeseen tax issues may add unexpected expenses to the transaction. One example of a potentially expensive (and obscure) tax, which affects both executives and shareholders is the golden parachute excise tax that may be imposed on change in control payments that might routinely be awarded in connection with a transaction. Golden parachute payments typically comprise a package of cash bonuses or severance that will be paid, stock rights that will vest, and other benefits that will be delivered in the event that a corporation undergoes a sale, merger, initial public offering, or other change in ownership or control (a "change in control" or "CIC" transaction). In this case, it is not just the cost of executive golden parachutes that can affect the business case for a transaction, even though such costs can be significant, but also the costs to the company and to the executives of the tax and loss of deductions under the United States' golden parachute rules. In a cross-border acquisition, such as the acquisition of a U.S. target or a Canadian target with U.S. operations, the acquiring company should understand and plan for the application of the U.S. golden parachute tax under Section 280G of the Internal Revenue Code ("Section 280G") as part of its financial model for the transaction. Even a Canadian domestic acquisition, with no U.S.-based acquirer or target, may be caught by these expensive tax rules, if there are U.S. taxpayers working in Canada.

Part I: Basic Golden Parachute Excise Tax Rules

The golden parachute excise tax is covered by U.S. Internal Revenue Code ("IRC") Sections 280G and 4999. These two mirror provisions impose an excise tax on the U.S. taxpayer and deny a U.S. corporate tax deduction to the employer. The rules impose a golden parachute excise tax if the present value of CIC payments and benefits received or to be received by a disqualified individual are equal to or greater than three times the individual's base amount.[1] The "base amount" is the Executive's average taxable company compensation for the five years preceding the year of the CIC.[2] The amount which is $1 under three times the Executive's "base amount" is referred to as the golden parachute or 280G safe harbor amount. The safe harbor amount is the maximum amount of parachute

[1] In this article, the term "executive," instead of disqualified individual, is used for ease of reading, although directors, certain shareholders and officers can also be disqualified individuals. Where we use the term "Executive," we are referring to any individual who is a disqualified individual for purposes of IRC Section 280G. A disqualified individual is generally a 1% shareholder, an officer (in rare cases, a non-employee officer) or a Highly Compensated Executive (top 1%). For more information regarding who is a disqualified individual, see Treasury Regulations 1.280G-1 Q/A 15-20.

[2] In general, where an individual works less than five years, the average gross income over the number of years preceding the year of the CIC in which the executive has rendered services. Detailed directions on precisely how to calculate an executive's "base amount" can be found in Treasury Regulations 1.280G-1 Q/A 34-36.

payments that an Executive may receive and not be subject to a golden parachute excise tax.

When an Executive receives CIC benefit(s) which exceed his or her golden parachute safe harbor amount, the Executive will incur a 20% excise tax on the portion of total parachute payments which exceed one times the individual's base amount. One of the more draconian aspects of the golden parachute excise tax is the unique way the tax is imposed. Although the safe harbor allows an Executive to receive CIC payments of up to three times his or her base amount, such CIC payments can be as little as $1 over the golden parachute threshold amount, yet become subject to a significant excise tax. The reason for this punitive result is that the excise tax is imposed not only on the portion of CIC payments that exceed the threshold amount, but rather on all CIC payments that exceed one times the Executive's base amount. Lastly, the portion of the total parachute payment that is subject to the excise tax becomes a non-deductible payment for corporate income tax purposes. This can result in an expensive surprise to an acquirer who did not plan for the impact of the U.S. golden parachute taxes in its financial model for the transaction.

One of the more complicated parts of the 280G computations is how to value unvested property which becomes vested as a result of the CIC. Typically, unvested property will be a stock option, restricted stock, performance award, or benefits under a supplemental executive retirement plan ("SERP"). In general, the golden parachute regulations provide for two ways to value equity that receives accelerated vesting upon a CIC. If the equity vests solely on the performance of services over time, Treasury Regulations Section 1.280G-1 Q/A 24(c) provides that the parachute value of unvested equity is equal to the present value of the unvested equity plus the face value of the unvested equity benefit times 1%, which is then multiplied by the number of full months that the vesting is accelerated. However, if the unvested equity is accelerated upon the change in control, rather than upon achievement of performance measures that would otherwise be applied, then the entire value of unvested equity must be included as a parachute payment. To further complicate the issue, if the vesting hurdle is based on attaining a certain stock price, and the stock price hurdle is achieved after the announcement of, and within one year before a CIC, Treasury Regulations 1.280G-1 Q/A 22(b)(2) provides that a substantial increase in the market price of a company's stock is an event that would be considered contingent upon a CIC. Thus, even if the performance hurdle is reached prior to the CIC, the full amount of the equity could still be subject to the 280G excise tax.[3] The basic rules and the extensive costs caused by 280G rules are illustrated by the following examples.

**Example A –
Excise Tax Costs With No Gross-up**

Executive A (a disqualified individual for purposes of the application of Sections 280G and 4999) receives CIC benefits equal to US$4 million, has a "base amount" of $1,000,000, and works for a company with a combined U.S. marginal corporate income tax rate of 40%. In this example, the benefits Executive A receives exceeds three times his or her average base compensation (e.g., $4 million is greater than [$1,000,000 x 3] - $1), resulting in the executive having a golden parachute excise tax liability of $600,000 (e.g., [$3,000,000 x 20%]). Moreover, the company will lose a $3,000,000 deduction, which is equal to $1,200,000 on an after tax basis (e.g., $3,000,000 x 40%). Thus, the combined IRC Section 280G related costs are $1,800,000 - $600,000 for the excise tax (executive's responsibility), and $1,200,000 attributed to the economic cost of losing the corporate deduction (corporate cost).

**Example B –
Excise Tax Costs With Gross-up**

Same as the above example, except the Executive is eligible for a gross-up payment so that the Executive is made whole for any 280G excise tax. Assume the Executive is in a combined 40% marginal income tax bracket. Under the above example, the company would be required to pay a gross-up of $1,500,000 [$600,000/(1 - 60%)] (60% is derived from

[3] Laurence Wagman, "Structuring CIC Arrangements in the Current Financial Environment," *Journal of Compensation and Benefits* (September/October 2009): 5-19.

the 40% marginal income tax rate and the 20% excise tax; $600,000 represents the pre-gross-up excise tax due). Thus, total payments that would have been $4,000,000 (which, on an after tax basis, would have cost the company $2,400,000) without considering IRC Section 280G, increase to an after tax cost of $5,100,000 ($5,500,000 payment of which only $1,000,000 is deductible to the corporation). In this relatively typical example, the company's net cost more than doubles!

The above examples demonstrate the magnitude of an IRC Section 280G golden parachute issue and thus, the importance of proper planning. The combined excise tax to the executive and the loss of the U.S. corporate tax deduction to the employer create an economic drain on the business model for an M&A transaction, where the value is diverted to the IRS. When an executive has a contractual right to a tax gross-up, the losses attributable to Section 280G are magnified, as shown in the above examples. Acquirers who investigate the golden parachute tax traps as part of the due diligence for the transaction avoid such unpleasant economic surprises in the business model for the deal.

Part II: How the Golden Parachute Excise Tax Rules May Affect Canadian Companies

The first step to planning is to determine whether a Canadian company or its executives are subject to the golden parachute excise tax rules. There are two primary ways in which a Canadian company or its executives may be affected:

1. A Canadian employer with U.S. operations (or vice versa) undergoes a change in control.
2. An Employee of a Canadian company undergoing a CIC is subject to U.S. Taxation.

In the first scenario, a CIC occurs under Section 280G, even if the target organization is not subject to U.S. tax.[4] Section 280G would capture payments to disqualified individuals that would have been deductible on the corporation's consolidated U.S. tax return, whether such payments are to U.S. or Canadian residents. However, if the target corporation that undergoes a CIC is not subject to, or does not pay, U.S. corporate income taxes, then the loss of deduction under Section 280G is of no practical impact to the employer.

The second scenario involves U.S. taxpayers who may be subject to an excise tax on payments from a Canadian employer, even if the employer has no U.S. operations. U.S. citizens and permanent residents are subject to U.S. taxation on their worldwide income regardless of where they reside. In addition, Canadian residents who provided services directly to the U.S. operations of a Canadian employer may be deemed to have U.S. source income, unless the Canada-U.S. tax treaty exceptions are applicable. These employees could still be subject to the excise tax imposed by Section 4999, and the employer may suffer from the loss of the U.S. corporate income tax deduction for those payments.

When calculating the golden parachute tax impact with respect to globally mobile executives, there are special rules. Where a foreign Executive becomes a U.S. taxpayer during his or her "base period," such as during an expatriate assignment to perform work in the U.S., Treasury Regulations 1.280G-1 Q/A 34 provides that for purposes of computing the base amount discussed previously, the Executive includes in his or her base amount all income "which would have been includible in such gross income if such person had been a United States citizen or resident." This rule may have the effect of increasing the individual's base amount, which would be helpful in reducing the tax impact.

Part III: Eliminating Golden Parachute Taxes

In general, there are two practical alternatives for avoiding the golden parachute tax. First, private companies can avail themselves of several exemptions, including shareholder approval, to exempt the payments. The second method, discussed in Part IV, is to keep the total parachute payments from exceeding the safe harbor threshold, either by capping the amount of payments, or applying an exception such as for payments of reasonable compensation for services or for non-competes.

[4] U.S. Treasury Regulations Section 1.280G-1 Q/A 45 provides in part that for purposes of IRC Section 280G, the definition of corporation includes a foreign corporation as defined by IRC Section 7701(a)(32).

Private Company Exceptions

Although the golden parachute problem can be very expensive for both the disqualified individuals and their respective companies, most private employers may be eligible for an exception. If a company is a 501(c)(3) charitable organization, a partnership (not taxed as a corporation), LLC or an "S-Corporation," the company is not subject to IRC Section 280G. Moreover, if the company is a corporation that is not publicly traded, all golden parachute excise tax costs may be eliminated if an IRC Section 280G compliant shareholder approval is obtained.[5]

Shareholder Approval

Where a non-publicly traded corporation seeks shareholder approval, the corporation is not subject to the excise tax and lost deduction if sufficient amount of payments/benefits (i.e., an amount which if excluded would put the Executive under his or her 280G threshold) are approved by shareholders representing more than 75% of the voting power immediately before the CIC. Although this may sound straightforward, there are a number of intricate rules which must be followed.

Adequate Disclosure. Per the 280G regulations, adequate disclosure consists of disclosure of "all material facts concerning all material payments which would be parachute payments with respect to a disqualified individual."[6] The regulations provide that "material facts" are: the event triggering the payment or payments, the total amount of the payments that would be parachute payments if the shareholder approval requirements are not met, and a brief description of all payments being made (e.g., accelerated vesting of options, bonus, or salary).

Right to Receive Payment. The shareholder vote must determine the right of the Executive to receive such payment(s). In other words, if the vote fails, the Executive must not be entitled to receive such payment. Where an Executive is entitled to a payment under a prior agreement, he or she must waive the right to such payment(s) or benefit(s) if he or she does not receive the vote of more than 75% of the shareholders, which would enable him or her to receive the payment or benefit. The necessary shareholder approval documents will include a parachute payment waiver agreement to ensure the Executive has waived his or her right to payments subject to the shareholder approval vote.

Voting Requirements. The regulations provide that a shareholder approval vote can be on less than the full amount of payments, although as described above, the disclosure must describe all payments even if the vote will determine the right to receive only a part of those payments. Shareholder approval can be a single vote on all payments to any one Executive, or on all payments to more than one Executive. However, the total payment(s) submitted for shareholder approval must be approved by shareholders separately from the vote on the CIC transaction.[7] The change in control transaction cannot be contingent on the outcome of the parachute payment vote. In determining the shareholders entitled to vote, the vote can be based on the shareholders of record as of any day within the six-month period immediately prior to and ending on the date of the change in ownership or control.[8] Lastly, a disqualified individual who receives parachute payments is prohibited from voting on his or her or anyone else's parachute payments. In order to compute whether the more than 75% voting threshold has been reached, the disqualified individuals' voting shares are disregarded.[9]

Part IV: Valuations and the Golden Parachute Excise Tax Rules

One of the more unique aspects of the golden parachute excise tax rules is the heavy emphasis on valuations for purposes of calculating the tax or determining safe harbor exempt amounts. There are three primary

[5] This exception is available only to private companies. Foreign corporations whose stock trades on a non-U.S. exchange are treated like public companies and cannot use the "shareholder approval" exception.

[6] Treasury Regulations Section 1.280G-1 Q/A 7(a)(2).

[7] Treasury Regulations Section 1.280G-1 Q/A 7(b)(1).

[8] Treasury Regulations Section 1.280G-1 Q/A 7(b)(2).

[9] Where an Executive receiving parachute payments owns voting shares, the total voting shares outstanding are reduced by his or her respective shares. For example, if Private Company X has 125,000 outstanding shares, and DI owns 25,000 in order for there to be a successful 280G shareholder vote, remaining voting shareholders holding more than 75,000 shares must approve such parachute payments.

areas in which valuations may become necessary; reasonable compensation, stock option valuations, and supplemental retirement plan valuations.

Reasonable Compensation

The Golden Parachute Tax rules provide that if an Executive receives compensation for the performance of services rendered after a CIC, and such compensation is determined to be reasonable, the amount paid for such services are not considered contingent upon a CIC, and thus, not included for purposes of determining whether an Executive exceeds his or her 280G threshold amount.[10] Lastly, the regulations specifically state that reasonable compensation paid in exchange for withholding services (e.g., a *bona fide* non-competition arrangement) may be excluded under this section.[11]

Compensation in Exchange for Active Services

In practice, it is common to see situations where an Executive will either be retained by the acquiring company or be provided benefits subject to a non-competition arrangement. Where an Executive is retained by the acquiring company and such arrangements are negotiated prior to the CIC, to the extent the taxpayer cannot demonstrate by clear and convincing evidence that such payments are reasonable compensation for the services to be rendered, such services will be considered payments contingent upon a CIC.

The IRS Regulations and related case law[12] provide that "post-CIC compensation should not be significantly greater than the annual compensation customarily paid by the employer or by comparable employers to persons performing comparable services."[13] In general, this means that both market and historical compensation should be taken into account when determining what constitutes reasonable compensation.

Compensation in Exchange for Inactive Services – Valuing the Non-compete Covenant

The services performed in connection with entering into and satisfying a non-compete condition are better described as "refraining from performing services." The golden parachute regulations provide that:

> An agreement under which the Executive must refrain from performing services is an agreement for the performance of personal services to the extent that it is demonstrated by clear and convincing evidence that the agreement substantially constrains the individual's ability to perform services and there is a reasonable likelihood that the agreement will be enforced against the individual.[14]

Reasonable compensation paid to an employee for such non-compete services are not parachute payments.

The first two steps in valuing a non-compete are to determine the enforceability of the covenant in the governing jurisdiction and to demonstrate the likelihood that the employer will take actions to enforce the agreement against the individual. If a covenant is not enforceable, it would not meet the Section 280G standard that the agreement must "substantially constrain" the individual. Accordingly, it would not be reasonable to place any value on a non-enforceable restrictive covenant to minimize golden parachute taxes.

In the United States, whether a non-compete is legally enforceable is a state-law matter. Many state courts will enforce a non-compete covenant that is narrowly tailored to protect legitimate business interests of the employer. However, some states have statutes prohibiting non-competition covenants for public policy purposes. Most notably in the State of California, non-competition arrangements are generally not enforceable, other than in connection with the sale of a business by a shareholder.[15] In Canada, the law concerning

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[10] Treasury Regulations Section 1.280G-1 Q/A9.

[11] Treasury Regulations 1.280G-1 Q/A 11(a) and 40(b).

[12] See *Square D Company and Subsidiaries v. Commissioner*, 121 TC 168 (2003).

[13] Treasury Regulations 1.280G-1 Q/A 42(a)(2).

[14] Treasury Regulations 1.280G-1 Q/A 42(b).

[15] In *Vacco Industries, Inc. v. Van Den Berg* (1992) 5 Cal. App. 4th 34, the Court upheld the enforceability of a non-compete agreement against a prior employee who was a three-percent shareholder who sold shares to the buyer in connection with the sale of the business.

these kinds of restrictive covenants has been the subject of substantial judicial refinement and also some inconsistency in the last several years. Canadian courts, like many U.S. state courts, will not enforce agreements that prevent competition by a former key employee, unless an employer can establish that the covenant is reasonable. A reasonable covenant, in general, is one that goes no further than is necessary to protect the employer's legitimate business interests because it is reasonable in duration, geographic scope and all other aspects (such as scope of activity covered). It should not unduly restrain the key employee from making use of their skills and talent. Unlike in the U.S., a Canadian court will not revise a non-compete covenant to be enforceable to the extent permitted (known as "blue penciling") even if the parties agree to allow a court to do so. As a result, employers tend to draft modest and conservative non-competes that do not overreach in the hopes of ensuring that they will not be overturned entirely in court.

If the non-compete is both enforceable under applicable law and likely to be enforced by the employer, the next step is to ascribe value on the covenant in order to reduce the excess parachute payments by the "reasonable" amount. When valuing a non-compete, valuators are generally required to look to Revenue Ruling 77-403, which addresses three qualitative issues. In this ruling, the IRS specifically provides for the following relevant factors:

1. in the absence of the covenant, the covenantor would desire to compete;
2. the ability of the covenantor to compete effectively with the covenantee in the activity in question; and
3. the feasibility, in the view of the activity and market in question, of effective competition by the covenantor within the time and area specified by the covenant.

Typically, in connection with an acquisition, non-competition valuation reports are prepared as part of the purchase price allocation (for accounting purposes). In these types of valuations, the calculation of fair value is based upon the product of (1) the present value of the economic attrition which could have otherwise been caused by the disqualified assuming he or she were not constrained by the non-compete, and (2) the effective probability of competition. This type of valuation reflects the product of the hypothetical "business loss" that would be incurred if the executive were permitted and did actually compete with the former employer and a probability that the executive would effectively be able to compete.

In ascribing value for purposes of IRC Section 280G, there is a differing of opinion among golden parachute excise tax professionals as to whether a company may apply the business loss computation, specifically where the value exceeds what the Executive could have earned had he or she been able to provide services to a competitor. The more conservative viewpoint is that because the regulations specifically provide that the value ascribed has to be "reasonable compensation for holding oneself out as available to perform services,"[16] the business attrition valuation should be capped by what would otherwise constitute reasonable compensation for active services. On the other hand, certain valuators have argued that reasonable compensation is reflected by the "business value" of a non-compete covenant, and thus, should be evaluated in the context of its probable economic value to the payor (the employer seeking to enforce it).

Reasonable Compensation for Services Rendered Prior to a CIC

One of the more unusual provisions provided within the golden parachute tax rules is the treatment of reasonable compensation attributed to services rendered before a CIC. Unlike services rendered after a CIC, CIC benefits conveyed which are reasonable compensation for services rendered prior to a CIC are not excluded for purposes of determining whether an Executive exceeds his or her golden parachute threshold. However, if the Executive does exceed his or her threshold, such benefits may be excluded for purposes of calculating the 280G excise tax.[17] It is important to recall that if an Executive exceeds his or her threshold by $1, the excise tax will essentially be 20% multiplied by two times the Executive's base amount. Typically, reasonable compensation for services rendered

[16] Treasury Regulations 1.280G-1 Q/A 40(b).

[17] Treasury Regulations 1.280G-1 Q/A 39.

prior to a CIC is considered with respect to unvested equity, a *pro rata* bonus, or a deal retention bonus. The application of reasonable compensation for services rendered prior to the CIC is illustrated by the following example.

Example C – Reasonable Compensation

Assume the same facts in Example A. In addition, assume that $1,200,000 of the $4,000,000 payment is a portion of performance-based equity which was vested on the CIC, but also considered reasonable compensation for services rendered prior to the CIC. Under this example, the Executive still exceeds his or her threshold by $3,000,000, however, because $1,200,000 of the payments are considered reasonable compensation prior to the CIC, and the Executive is able to reduce that amount for the purpose of computing the excise tax. Unfortunately, the calculation also requires that we exclude a ratio of the reasonable compensation for pre-CIC services over the total payments (e.g., $1,200,000/$4,000,000) multiplied by the deductible one times the base amount. Thus, in this example, 30% of the base amount ($1,000,000 in this example) or $300,000, must be subtracted from the amount of the deductible base. So in this case, the total amount of payments subject to the excise tax is $2,100,000 ($4,000,000 - $1,200,000 - $1,000,000 + 300,000) and the total excise tax due is $420,000 (20% of $2,100,000). The total non-deductible payment to the corporation is $2,100,000.

Stock Option Valuations

The value of accelerating the vesting of an option to purchase stock must also be included in the calculation of parachute payments to determine if the threshold is met and whether the golden parachute tax applies. In attributing value to an option, the regulations provide that if an option is transferred upon the CIC, then the value of the option is determined "under all the facts and circumstances" in the particular case. Factors relevant include but are not limited to: the difference between the option's exercise price and the value of the property subject to the option at the time of vesting; the probability of the value of such property increasing or decreasing; and the length of the period during which the option can be exercised."[18] Revenue Procedure 2003-68 provides further guidance, which states that a taxpayer may value a stock option, without regard to whether the option is on publicly or non-publicly traded stock, using any valuation method that is consistent with generally accepted accounting principles ("GAAP") (such as FAS 123 or a successor standard). The intrinsic value (spread) of an option alone is not sufficient to properly determine the value of an accelerated option.

Because of the administrative task of rolling over stock options and for other reasons, many acquirors seek to "cash out" all stock options upon the CIC. Where a company does not cash out stock options upon a CIC, Executives may be faced with paying excise tax on value, which has not yet been realized on such equity. On the other hand, where Executives own underwater options, they are generally not willing to forfeit such property for no payment, if the strike price is relatively close to the transaction price. One of the mitigating strategies which may be considered is examining different GAAP valuation calculation methods to see which method produces a lower value for the options. While most valuation methods return similar values (as the inputs are similar), there is nothing in the 280G rules which would prohibit an Executive from utilizing any specific valuation method as long as it considers all the relevant factors. Another strategy companies may consider is paying cash in exchange for unexercised equity. Because of the uncertainty surrounding stock valuations in general, Executives are often willing to accept in cash an amount which is less than what is determined by an approved GAAP option valuation model.

Supplemental Retirement ("SERP") Plans

Although less prevalent in recent years, sometimes an Executive who is a participant in a SERP plan, and, on account of the CIC, receives additional SERP credits and/or the ability to receive the cash value of the SERP upon the CIC. Actuarial calculations are necessary to calculate the portion of value which is contingent upon the CIC. This valuation often requires an actuary and 280G expert to work together in order differentiate

[18] Treasury Regulations 1.280G-1 Q/A 13.

the portion of the SERP benefits. For example, an actuary would need to compute the difference between the portion of SERP payments enhanced as if the executive continued to perform services for a specified period of time (e.g., additional SERP credits)[19] and the portion which represents the present value of the SERP payment if the executive terminated employment on the CIC and began receiving payments upon normal/early retirement without enhancement. Moreover, where an executive was not fully or partially vested in his or her SERP, the actuary needs to provide a valuation with respect to the portion of the SERP the executive would have earned had he or she not been terminated. Once the various SERP components are computed by the actuary, a 280G expert will determine to what extent such components are parachute payments based on the application of the golden parachute excise tax rules discussed in Part I.

It is an understatement to say that valuing a SERP for 280G purposes is one of the most challenging valuations within the 280G rules.

Conclusion

The U.S. golden parachute excise tax rules are complicated, expensive and should not be ignored. A typical executive compensation package can inadvertently include parachute payments that exceed the safe harbor threshold; the resulting tax expense can be acute, to the point of affecting the financial model for a deal, and potentially even prohibiting a transaction entirely. It is important for Canadian companies who have operations in the United States or U.S. taxpayers working in Canada to be aware of these rules when structuring employment arrangements or undergoing a CIC.

[19] In the past, the treatment of additional SERP credit was controversial, as 280G experts assumed that additional SERP credit services would have been earned solely based on the executive performing services. The Final Regulation 1.280G-1 Q/A 24(f)(v) specifically provides that additional SERP credits do not fall under this exception, and the full value be included as contingent upon a CIC.

Pensions

This regular feature is edited by Elizabeth H. Boyd of Blake, Cassels & Graydon LLP. It reviews current developments pertaining to pensions and other deferred plans.

LEGISLATION

British Columbia's New Pension Benefits Standards Act – Key Changes

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British Columbia's new *Pension Benefits Standards Act* (the "PBSA" or the "Act") received Royal Assent on May 31, 2012. While this new Act will eventually repeal and replace the existing PBSA, it will not come into force until the underlying regulations are developed and finalized, likely in 2013 or later. As the new Act is the final product of the November 2008 Joint Expert Panel on Pension Standards ("JEPPS") report and subsequent work by the B.C. and Alberta governments, it is anticipated that Alberta will introduce a substantially identical bill later this year.

New Plan Designs

One of the most important features of the new Act is that it provides for new plan designs. The new Act sets out five basic plan structures: single employer plans, collectively bargained multi-employer plans, non-collectively bargained multi-employer plans, jointly sponsored plans and negotiated cost plans, on top of which may be overlaid one or more categories of benefit provisions, including defined benefit, target benefit and defined contribution provisions. Interestingly, not all of the plan structures appear to be mutually exclusive. For example, while these combinations may well be limited by the regulations, it would seem at present that a jointly sponsored plan could also be a single employer plan, a non-collectively bargained multi-employer plan, a collectively bargained multi-employer plan or a negotiated cost plan.

What follows are some of the basic rules in the new Act distinguishing these new plan and benefit structures.

Non-collectively Bargained Multi-Employer Plans

The new Act requires that each employer of a non-collectively bargained multi-employer plan enter into a participation agreement with the administrator. It also provides special rules for employer withdrawal that are analogous to partial wind-up rules, whereby the employer remains liable for a portion of the solvency deficiency. This is the closest the new PBSA comes to the "partial termination" concept, which has been eliminated generally from the new Act.

Collectively Bargained Multi-Employer Plans

A collectively bargained multi-employer plan, on the other hand, is defined to be established through a collective agreement and no participation agreement is required as a rule. In addition, employer withdrawal is to be dealt with in the plan text rather than through the partial termination-like provisions noted above.

Negotiated Cost Plans

A negotiated cost plan can be structured as either a single employer plan or a collectively bargained multi-employer plan. The definition of negotiated cost plan is much clearer in the new Act than in the existing PBSA, setting out that the plan must be established under a collective agreement and that the contributions (and in turn employer and active member liability) are determined and limited by the collective agreement. Importantly, as in the existing PBSA, accrued benefits can be reduced with the consent of the Superintendent of Pensions (the "Superintendent") and employers are not liable for solvency deficiencies on termination.

Jointly Sponsored Plans

Jointly sponsored plans can be either single employer or multi-employer plans, but must have defined benefit or target benefit provisions. While we do know that both employers and active members will have to contribute to the plan and share the plan's governance, it is not yet clear how to become a jointly sponsored plan. The Act sets out that a jointly sponsored plan must meet the criteria to be prescribed in the regulations. Like a negotiated cost plan, a jointly sponsored plan will be subject to solvency funding rules, but will be able to reduce accrued benefits with the Superintendent's consent. Similarly, the employer(s) is/are not liable for solvency deficiencies.

Target Benefit Provisions

A target benefit provision looks like a defined benefit provision, but benefits can be reduced without the Superintendent's consent. Under a target benefit provision, an employer is liable only for the amount it is contractually required to contribute to the plan and is not liable for solvency deficiency on termination. Further, a target benefit provision can be contained in any plan structure, including in a single employer plan where the employer retains sole control of governance.

This new benefit structure should be attractive to employers that want both cost containment and the efficiencies of a defined benefit-like arrangement and, accordingly, has the potential to buck the trend towards defined contribution plan conversion. Unfortunately, although the new Act states that plans will be able to switch from a defined benefit to a target benefit design, we do not yet know how this will occur as the process remains to be prescribed in the regulations.

Governance

The Administrator

Like the existing PBSA, the Act draws a distinction between the governance roles of the "administrator" and the "participating employer" ("employer" under the current PBSA). The characterization of these roles has, however, shifted somewhat. Under the existing PBSA, the administrator is defined by who has that role, whether it be the employer, a board of trustees or another person appointed by the Superintendent. The Act, on the other hand, defines the administrator more broadly as the person responsible for administering the plan; however, as it elaborates only to the extent it specifies a pension plan must have an administrator who meets the prescribed criteria, we will not know until the regulations are published who precisely will fit the role of administrator.

Interestingly, while the administrator is still permitted to employ an agent (provided that it carries out reasonable and prudent supervision), the provision in the existing PBSA imposing on the agent fiduciary obligations to plan members has been eliminated.

The Participating Employer

As for the other "hat," while the term participating employer is used in the current PBSA only in relation to multi-employer plans, the term will now be defined as "an employer that is required to make contributions to the Plan." Thus, the language will shift such that we will refer to a participating employer even in the context of a single employer plan.

Governance Policy

The Act requires the introduction of a new compliance and assessment regime. The rationale behind this development is that by setting out governance, funding and investment standards, it is easier for stakeholders and others to monitor performance and challenge the administrator's actions.

Under this new regime, all plans will be required to have a written governance policy established in respect of the structures and processes overseeing, maintaining and administering the plan, the elements of which will be set out in the regulations. While the new Act does not provide any guidance as to what those elements will be, the elements noted in both CAPSA Guideline No. 4 and the JEPPS Report provide a good indication. The Act does not require the administrator to write the policy, but does require the administrator to comply with the governance policy.

Funding Policy

All plans with a benefit formula provision are also going to have to create a written funding policy respecting funding objectives and the intended method for achieving the objectives, the elements of which will also be prescribed. Again, a good indicator of what these elements will be is CAPSA Guideline No. 7 and the JEPPS Report. As with the governance policy, the new PBSA does not require the funding policy to be written by the administrator. Further, unlike the governance policy, the new PBSA does not require the plan to be administered in accordance with the funding policy.

Governance and Compliance Assessment

Finally, in terms of governance and compliance assessment, the new PBSA states simply that the administrator must, at the times and in a manner required by the regulations, assess in writing the administration of the plan, including compliance with the Act and regulations, plan governance, plan funding, plan investments, performance of trustees (if any) and performance of administrative staff and agents. Of course, we will not know until the regulations are published such details as whether this will be an annual assessment, whether there will be requirements for reporting non-compliance or taking remedial action for non-compliance, or what the standard of care will be for this function. In addition, while the new Act provides that the assessment must be available to the Superintendent as requested, it is at present unclear as to what confidentiality standards will apply, including whether the report will have to be transparent to all stakeholders.

Core Versus Ancillary Benefits

The existing PBSA defines "benefit" broadly as a pension or any other benefit under a pension plan. As the power to amend and restrictions on amendments that reduce benefits do not differentiate between types of benefits, there have been recurring questions as to whether entitlement to certain types of benefits, such as indexing and bridging benefits, can be amended as well as when the right to those benefits vests.

The Act now draws a distinction between core and ancillary benefits, providing that ancillary benefits include disability benefits, bridging benefits, cost of living adjustments (indexing), pre-retirement and early retirement benefits, joint survivor pension benefits that exceed statutory minimums and any other prescribed ancillary benefits. The Act also provides guidance as to when ancillary benefits vest, setting out that an amendment cannot reduce ancillary benefits if a person has met all requirements necessary to exercise the right to receive the benefits.

The Act sets out a procedure for reducing benefits under a target benefit provision, which contains as its first step the reduction or elimination of ancillary benefits.

Plan Funding Rules

Many of the detailed funding rules under the Act will not be known until the regulations are released, including whether the JEPPS recommendation for "going concern plus" will be introduced for target benefit provisions. However, the new Act does state that in a negotiated cost plan or under a target benefit provision, the liability for funding the benefits is limited by the amount the employer/members are contractually required to contribute. The Act also provides that where a plan contains a benefit formula provision other than a target benefit provision, the plan may have a solvency reserve into which solvency deficiency payments can be deposited (prescribed actuarial excess may be withdrawn from that account despite the language of the plan text).

The Act crystallizes what the case law has provided in respect of contribution holidays. First, in general, a plan's actuarial excess can be used to reduce the contribution paid by employers, or by employers and members. Second, where a plan has both a benefit formula provision and a defined contribution provision, the excess can be used to reduce employer contributions for the defined contribution benefit.

Administrative Expenses

Finally, also crystallizing the case law as to when plan administration expenses may be paid from plan funds, the Act states that the administration and investment expenses of the plan may be paid from the plan's pension fund unless the plan documents specifically provide otherwise. This reduces the likelihood of litigation about administrative expenses.

Benefit Rules

The Act amends many of the detailed rules in the existing PBSA that must be followed by plan administrators when paying out benefits under their plans.

Immediate Vesting

The Act has amended a number of the general plan rules respecting benefit payments, the most talked about of which is probably the switch to immediate vesting. A plan member will now be eligible for benefits in respect of the active period of active membership while employed in B.C. in provincially regulated employment. However, it will still be open to a plan administrator to impose a waiting period of up to two years before an employee is eligible for plan membership as the eligibility rules remain in place.

Pre-retirement Death Benefits

The pre-retirement death benefit formulas hinging on vesting and the pre/post January 1993 distinction have been removed, streamlining the section significantly. The most noticeable change, however, is the amount of the benefit, which will be the "pension to which the member was entitled." In other words, there will be no more permitted reduction to 60% of commuted value, meaning that the pre-retirement death benefit will be 100% of commuted value.

Interestingly, the Act provides in respect of a pre-retirement death benefit that "in no case is the surviving spouse entitled to receive any benefit as [the member's] designated beneficiary or from the [member's] estate." Presumably, this language is designed to prevent circumvention of the locking-in rules by ensuring that a member cannot have his or her spouse sign a waiver then subsequently designate the spouse as beneficiary (either on the designated beneficiary form or through a Will as will be permitted once the British Columbia *Wills, Estates and Succession Act* is in force) such that the spouse would receive the benefit on a non-locked in rather than a locked-in basis.

Post-retirement Death Benefits

The minimum amount of the joint and survivor pension will remain as 60% of the amount of pension that would have been payable to the member had the death not occurred. What is new, however, is a double waiver procedure that will now be required for a spouse to fully waive his or her right to such benefit. The first waiver will be the same as exists under the current PBSA in that the spouse must sign a prescribed form stating he or she is aware of the entitlement and waiving the right to that entitlement. Under the Act, however, even if the spouse has signed that waiver, he or she will still explicitly be deemed to be the member's sole designated beneficiary, despite any actual beneficiary designation. In order to avoid this deemed designation, the spouse will have to sign a second waiver, also in a prescribed form, explicitly acknowledging his or her entitlement to the death benefit and waiving that entitlement.

Unlocking

There will be two shifts to unlocking under the Act. First, unlocking on shortened life expectancy will be a mandatory rather than optional plan provision. Second, and more significant, hardship unlocking is introduced, which will apply to former members who have transferred their funds out of a pension plan and into a locked-in retirement account or retirement income arrangement. The process will require a spousal waiver. However, we know very little about the details of such financial hardship unlocking as they remain to be prescribed in the regulations.

Temporary Suspension of Membership

Although financial hardship unlocking will not apply to funds held in a pension plan, under the Act, a plan text will be permitted to provide that an active member may suspend their plan membership in the plan while continuing to work. The Plan may also set out that the member does not accrue benefits during the suspension period, and the suspended member must be allowed to lift the suspension at any time prescribed in the regulation. Notably, the member will not be able to receive or transfer any of his or her benefit entitlement until actual termination of membership.

Small Benefit Force-out

The current PBSA provides that benefits under a defined benefit provision may be forced out of a plan where a member terminates and is entitled to a benefit that is less than a prescribed amount. While the current Act provides that the small benefit threshold may be calculated in two ways, based either on commuted value or the value of future pension payments, the Act refers only to commuted value, indicating that the regulations will likely provide for a single calculation based on commuted value.

Superintendent's Powers

The Act gives the Superintendent a variety of enhanced regulatory powers. For example, the Superintendent will be able to impose conditions on any approval, authorization, extension or consent, will be able to sever part of an amendment submitted for registration and will be able to direct the plan administrator to terminate if the plan documents do not comply with the Act or the administrator has not complied with the Act. In addition, during the life of the plan, the Superintendent will be empowered to remove the administrator and appoint a temporary administrator if either (i) the administrator is unable/unwilling to act, insolvent or can not be located; or (ii) the plan or its administrator fails in a substantial manner to comply with the Act.

While the Superintendent currently has the power to obtain a court order to compel compliance with the PBSA, he or she will now have enhanced power under the Act to take preventative action by issuing a direction where someone has not yet but is about to do something that is contrary to safe and sound pension practices. As of yet, there is no guidance as to the meaning of "safe and sound pension practices."

A further interesting addition to the Superintendent's powers is that the Superintendent will be able to designate an actuary to prepare an actuarial or termination report if in his or her opinion, the methods or assumptions used by the plan's actuary were inappropriate in the circumstances, even if these methods or assumptions were consistent with actuarial practice. The designated actuary will have broad powers to obtain information needed and will file a report in the normal course, upon which the plan must be funded in accordance with the new report.

Under the Act, the Superintendent will be able to impose administrative penalties if a person breaches prescribed provisions of the Act, fails to file records within the time required, fails to provide information or records required or fails to make contributions. Such penalties may be disputed within certain time limits and the Superintendent has a three-year limitation period from knowledge of the breach to impose a penalty in respect of it. If the Superintendent takes certain actions (such as issuing a direction for compliance, ordering a date for termination, ordering payment of expenses of an investigation, refusing to register an amendment, etc.), he or she must give notice of the decision. That notice triggers a 30-day limitation period of serving a notice of objection, which notice of objection in turn acts as a stay of the Superintendent's decisions or directions or order, as the case may be. In addition, if an administrative penalty is imposed in respect of a corporation's breach, the penalty can be imposed on an officer/ director who directed or participated in the breach.

Noticeable Absences From the New Act

The provisions in the current PBSA respecting required arbitration of certain disputes will be eliminated, as will the concept of partial termination and the provision setting out that all pension plan documents filed with the Superintendent are on the public record. There will not be a requirement to establish a pension advisory committee at the request of members, nor a provision for the Pension Benefits Standards Advisory Council. Finally, the language used throughout the Act has shifted from "members" and "former members" to the new terms of "active members," "deferred members" and "retired members."

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