How Turbulent Times Might Impact Executive Contracts and Compensation

Jun 24, 2020

Categories:

Coronavirus Response Team
Tax Law Defined™ Blog

Authors:

Alison M. Stemler

Executive employment contracts and compensation have been more heavily scrutinized for the last couple of decades, especially for public companies. COVID-19 is shifting that focus in ways that require careful coordination of legal agreements with tax and other considerations. Many executives have voluntarily reduced or forgone pay in 2020 as a show of good faith or solidarity with employees, customers and shareholders. While some businesses have reduced pay for some or all employees, often only the executives have employment agreements that give them a contractual right to certain levels of pay.

Executives and businesses need to consider tax and legal aspects when making changes to compensation promised under an employment agreement. Employers should also evaluate equity and bonus compensation programs to ensure they remain aligned with the business's goals and to consider taking advantage of opportunities created by a significantly reduced equity value many businesses are experiencing.

Reductions in Base or Bonus Compensation. Employment agreements typically do not permit the employer to unilaterally reduce an executive's compensation, but that may be changing. New or amended agreements might now have a clause allowing the business to reduce an executive's base or even bonus compensation if there is an across the board reduction for all employees or perhaps just all management employees. This might be limited to a set percentage of pay or to extraordinary circumstances such as a national disaster or emergency.

Internal Revenue Code 409A restricts changes in the timing of payment of compensation. Sometimes a business and executive agree that the compensation will never be paid, but we also see businesses that can't pay when the compensation is due and the executive agrees that the compensation can be paid later when the

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

business is able to. An agreement to pay later can create "deferred compensation" that triggers a whole new set of tax issues under Code Section 409A. Section 409A generally imposes an excise tax on the executive on compensation that is not paid until after March 15 of the tax year in which the related services are rendered. There are detailed rules as to the timing of elections to defer, and requirements that a written document have concrete payment timing for anything that is deferred. Technical gaps in contract language or agreeing to defer pay later than allowed, or short delays in payment can create heavy additional tax burdens for the executive, and a reporting obligation on the employer.

Even if there is no agreement to pay later and it is intended that the compensation be permanently forgone, there is always a risk that the IRS (with the benefit of hindsight) could argue that some later-paid amount was paid under a tacit agreement to substitute current year pay for something to be paid later, a substitution that violates 409A . To avoid the potential 20% excise tax on the executive under 409A, any agreement to delay or forgo compensation should be formally documented in a 409A compliant manner before the compensation is earned. This should be signed by both the executive and the business unless an employment contract allows a unilateral reduction by the business.

Total Compensation Considerations. For public companies, there are several considerations in determining compensation levels. For these companies, no federal tax deduction is permitted for compensation paid to certain named executives in excess of $1 million. Beginning in 2018 the exemption from this limit for certain performance-based compensation was eliminated. Public companies must now report the multiple of the highest executive pay to the average employee's pay, and must obtain shareholder advisory votes on compensation. Institutional voting advisory firms recommend against tax-gross ups, spousal travel reimbursement and other less direct and observable forms of pay. Even for non-public companies, few perks and simpler compensation mechanisms is generally the trend.

While the pandemic has perhaps caused more executives to voluntarily reduce or delay their pay, COVID-19 might not have a

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

lasting impact on executive compensation levels. Commentators have noted that compensation has rebounded after recessions and financial crises in the last few decades. To recruit and retain top talent, companies will likely continue to focus on bonuses based on company and individual performance and on equity compensation. A bonus structure paying earned bonuses over three or four years and only if the executive remains employed until the payment date has the added advantage of being a strong retention tool.

Equity Compensation. Equity compensation often consists of restricted stock, stock appreciation rights or stock options. Stock options give the executive the right to purchase company stock (or equity in an LLC) for the value of the stock as of the date the option is granted. When the business has good results and the stock price rises, the executive can benefit by purchasing stock at the lower grant date value. In this time of declining stock value due to COVID-19, options may have an exercise price higher than the current value of the employer's stock and consequently may not be a source of motivation for executives. There may be a desire to replace under water options with options issued at the current, lower fair market value as the exercise price. Plan restrictions on "re-pricing" and accounting consequences should be carefully considered before any such replacements.

Restricted stock is a grant by the business of equity in the business, subject to forfeiture if time or performance-based vesting requirements are not met. The executive can make an election within 30 days of the grant date to take the value of the restricted stock into income when the grant is made under Section 83(b) of the Code. Unless a Section 83(b) election is made, the restricted stock is taxed at vesting based on the vesting date value. In this time of lower valuation, more executives may want to consider electing taxation at grant, avoiding a larger tax bill after the stock rebounds.

Of course, it is too late to elect current year taxation for older awards. Executives might be tempted, however, to ask for accelerated vesting to trigger tax while values are low. While that may theoretically eliminate retention and performance incentives, it might make sense as a non-cash step to engender loyalty. Care

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

needs to be taken to be sure the restricted stock is exempt from 409A and acceleration is timed so as not to be effectively deferring earlier unpaid cash wages, to avoid tax penalties.

The composition and terms of compensation vary widely from business to business. Some of these differences related to the industry involved, some to the executive's unique skills and experience, and always due to the Board or business owner's philosophy and business experience. There are no one-size-fits-all approaches. To be successful, compensation and other employment contract terms should be tailored to the executive and the business and carefully documented to ensure fairness to all stakeholders.

Please contact Alison Stemler or any attorney in Frost Brown Todd Employee Benefits & ERISA if you have questions about executive or equity compensation.

© 2026 FBT Gibbons LLP. May be considered attorney advertising in some jurisdictions.

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

FBT Gibbons