The DB and NDCP Funding Conundrum**

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A particularly perplexing piece of the Pension Protection Act of 2006 (PPA), Internal Revenue Code section 409A(b)(3) creates a mandatory funding connection between a plan sponsor's defined benefit (DB) plan and any nonqualified deferred compensation plan (NDCP) it maintains. Sponsors are prohibited from "funding" an NDCP for certain highly-paid employees if circumstances arise that either actually or potentially jeopardize their DB plan's funding status. The puzzle lies neither with the purpose of this new rule nor its desired effect. In keeping with PPA's overall goal of protecting qualified pension plans, the prohibition sends the message that DB plan funding must take priority over dedicating corporate assets to NDCPs. This will force sponsors to look closely at their DB plan funding before leaping into funding any NDCPs.

While the statute's intent seems clear enough, the dilemma is in the details or, in some cases, the lack thereof. As currently written and absent any clarifying guidance, the rule raises a host of questions, including:

- Which employees are actually affected by the restriction?
- What does "fund" mean in this context?
- How does the law affect a sponsor's ability to pay NDCP benefits?
- What are the ramifications for deferral-only plans?

This article will attempt to disentangle these and other critical issues, while encouraging sponsors to develop an action plan before their DB plans' at-risk status places their NDCPs at risk of 409A noncompliance. In addition, the article will also provide a brief summary of how even the recently enacted pension funding relief contains a provision that continues this legislative trend toward linking DB plan and NDCP funding.

WHEN DO RESTRICTIONS APPLY?

NDCP restrictions apply during the appropriately named "restricted period," which goes into effect:

- when the "employer" is a debtor in a federal or state bankruptcy proceeding (Note: throughout this article, "employer" means the NDCP sponsor *and any other employers in the same control group.*);
- six months before or after the date that an underfunded DB plan of the employer is terminated; or
- during any period when an employer's DB plan is "at-risk," which generally means the plan has more than 500 participants and the assets of the plan represent less than a certain per-

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centage of the value of the benefits under the plan (i.e., 65% for 2008, 70% for 2009, 75% for 2010, and 80% for 2011 and beyond).

ARE ALL NDCP PARTICIPANTS AFFECTED BY THE FUNDING RESTRAINTS?

The funding restraints only apply to an individual who is an "applicable covered employee" of the employer. This term includes not only presently "covered employees" of the employer but also captures any employees that were "covered employees" of the employer at the time of their termination of employment. The term "covered employee" has a two-pronged definition:

1. The principal executive officer (or an individual acting in that capacity during the last completed fiscal year) or an employee whose total compensation is required to be reported to shareholders under the Securities Exchange Act of 1934 by reason of the employee being among the three highest compensated officers for the taxable year (not counting the principal executive officer), as described in tax code section 162(m)(3) and clarified by IRS Notice 2007-49; or

2. An officer, director, or shareholder who owns 10% or more of a publicly traded company's equity (i.e., an individual subject to the requirements of section 16(a) of the Securities Exchange Act of 1934).

While the application of these definitions to NDCP sponsors that are publicly traded is clear cut; the extent, if any, of their applicability to private companies is the subject of debate. Some analysts have argued that private companies are completely exempt. Their rationale is that such companies generally would not be subject to the Securities Exchange Act of 1934, which would by definition exclude them from coverage under prong #2 of the above definition. In prong #1, they argue that the reference is to section 162(m)(3), which is part of section 162(m) and deals with the $1 million deduction limit for publicly traded companies. Accordingly, they ask, "How can this definition apply to private companies if it is from a code section governing publicly held entities?"

Getting a legal opinion before relying on that interpretation is advisable. If prong #1 applies to private companies, it may only apply on a limited basis, given that they have no employees "whose total compensation is required to be reported to shareholders under the Securities Exchange Act of 1934 by reason of the employee being among the three highest compensated officers." Thus, in a private company, if anyone is affected, it would only be the principal executive officer. The IRS has not confirmed or denied a total exemption for private companies and no timetable for clarifying guidance has been announced, so the conservative approach for such companies (absent the above-referenced legal opinion) may be to treat the principal executive officer as an "applicable covered employee."

WHAT CONSTITUTES NONCOMPLIANCE?

Once the NDCP sponsor has entered a "restricted period" and the "applicable covered employees" are identified, a final question remains that may be the most puzzling: "What funding produces noncompliance?" However, before examining possible solutions to this riddle, it is worth noting that NDCPs must consist solely of a "promise to pay" a future benefit and, thus, are technically "unfunded." Accordingly, amounts deferred by participants or future benefits provided by the sponsor cannot be formally segregated to guarantee the plan's future obligations. If the sponsor becomes insolvent, the deferred amounts are considered a part of the sponsor's assets and, therefore, subject to the claims of its creditors. This "unfunded" feature is a prerequisite for NDCPs to maintain their pre-tax and tax-deferred status. That being said, many NDCP sponsors do set aside dollars that provide liquidity for future nonqualified benefit obligations. However, this "informal funding" may only consist of placing assets in a separate corporate account or, if greater protection is desired, a rabbi trust, which prevents the plan sponsor from reassuming control over these assets. Whether held in trust or not, informally funded assets must remain general assets of the company and thus subject to the claims of creditors.

The restrictions create two noncompliance traps that can be tripped by such informal funding:

Trap #1: The Funding Prohibition

During the "restricted period," no assets may be set aside or reserved (directly or indirectly) in a trust (or other arrangement as determined by the Treasury Secretary) or transferred to such a trust or other arrangement for purposes of paying deferred compensation of an applicable covered employee. This applies equally to any NDCP plan of the employer. However, this trap does not apply to any assets that are "so set aside" before the restricted period.

Accordingly, once the NDCP sponsor has entered the restricted period, Trap #1 prohibits the sponsor from any further prefunding of NDCP obligations—whether through contributions to an actual trust (e.g., rabbi trust) or using a separate corporate account established for this purpose. Because any amounts that were contributed before the beginning of the "restricted period" are not affected, a typical rabbi trust, funded before a restricted period begins, should not be affected by this trap. This is the case as long as no additional funding is made during the restricted period, and the trust's provisions or operations do not set off Trap #2.

Trap #2: The "Restricted" Prohibition

The employer's NDCP may not provide that assets will become exclusively earmarked for the provision of NDCP benefits in connection with a DB plan restricted period (or other similar financial measure determined by the Treasury Secretary). Furthermore, plan sponsors may not take any action that results in assets being restricted in this manner.

This trap is even more inclusive than Trap #1 in its potential to snare the unwary as it does not limit its noncompliance target only to those individuals captured by the "applicable covered employee" definition. It thus creates potential penalties for all NDCP participants. In addition, Trap #2 does not contain an exemption for assets already transferred before the restricted period and therefore could also reach arrangements that were fully funded before the beginning of a restricted period.

While clarifying guidance is needed, one common interpretation of Trap #2 is that it is intended to prohibit such features as the "springing" funding of unfunded trusts (i.e., no assets or only a small amount of assets are deposited in the trust until a specified event or condition occurs). Another example would be a revocable rabbi trust that becomes irrevocable. In these cases, the change in status of the trust or other arrangement would be deemed to be "in connection with" a restricted period or some other financial event identified by the Treasury and IRS (e.g., the sponsor's financials declining to a certain level). NDCPs and trusts containing triggers that might not comply with these provisions should be reviewed promptly and amended as necessary, because the mere presence of such triggers (as well as their use) might be construed as running afoul of the statute.

Practitioners and NDCP sponsors alike are struggling to ascertain the reach of these restrictions. While it is clear that sponsors cannot make deposits to a rabbi trust or other similar arrangement on behalf of applicable covered employees during a restricted period, the wording of the statute leaves much open to interpretation regarding what other sponsor actions are prohibited. Are the rules limited strictly to such "prefunding"? What about a situation in which the NDCP sponsor does not set aside any funds but merely pays benefits as they become due? Are these plans prohibited from paying benefits during a restricted period? Unfortunately, the exact meaning of the terms "set aside," "transfer," "other arrangement," and "in connection with" have not been defined at this point and may not be defined by IRS guidance for another year or two (at the very least).

For example, does the "in connection with" in Trap #2 mean "as a result of" or will the IRS apply it broadly so as to have it mean "during"? Under the former interpretation, it would seem that the payment of NDCP benefits would spring the trap only if the payment was triggered by the occurrence of an event(s) connected to the restricted period (e.g., at-risk status, bankruptcy, etc.). The trap would not be sprung if the payment was made independently of these event(s). That is, the payment would be allowed during this period if it was made in accordance with the plan's provisions, due to the occurrence of a 409A permissible payment, such as a separation from service, death, or disability. All this uncertainty leaves open major questions, including whether NDCP accruals may or should continue during the restricted period and whether NDCP sponsors may or should pay benefits that were not fully funded prior to the restricted period.

Harsh Consequences of Noncompliance

If NDCPs fail to solve the compliance puzzle presented by the law's restrictions, affected participants will face severe penalties. The assets in question will be treated as transferred in connection with the performance of services (regardless of whether they are subject to the claims of the employer's creditors). They will thus be currently taxable for the affected employees to the extent the amounts are not subject to a substantial risk of forfeiture (i.e., the participants have vested rights to them).

The affected amounts are assessed interest at the underpayment rate plus one percentage point. This applies to taxes that would have been incurred had the amounts been included in income when first deferred, or if later, in the first taxable year the amounts were not subject to substantial risk of forfeiture. Also, an additional 20% penalty tax applies.

While the amounts remain invested, the participant's taxation woes will continue to mount, as any subsequent increases or earnings on the transferred amount(s) are treated as additional transfers subject to the same income inclusion and penalty taxes. Employers cannot turn to any tax gross-up payments for executives in an effort to counter these severe tax consequences, as such payments would also be subject to the same adverse tax treatment (i.e., immediate income inclusion, interest at an increased rate, and an additional 20% tax). Further blocking this particular rescue route, the rules provide that the employer would be denied a tax deduction for any gross-up payment.

NDCPS WITH EMPLOYEE DEFERRALS

As difficult as the funding restrictions may be for NDCP sponsors in general, they pose even greater problems for sponsors of plans that include employee deferrals. Given that the impetus behind creating the DB plan/NDCP funding link is to restrict sponsors from setting aside funds in an NDCP during periods when such funds are needed in their DB plan, sponsors may be inclined to indulge in the wishful thinking that this link only applies to *employer* funds. After all, they might argue, why should it apply to executive deferrals? Such deferrals are merely executive elected reductions in salary that, absent the deferral election, would have been paid to the executive in cash. There is no real option to divert these funds from the NDCP to the DB plan unless the executives' overall compensation is reduced (a direction in which the law may be slowly heading as evidenced by the "excessive payments" provision included in the pension relief rules discussed in the next section). Consequently, sponsors must be aware that the rules as currently structured do not contain any exceptions for such executive deferrals.

This may pose significant problems because arrangements of this type invariably are set up with a rabbi trust so that the employee's deferrals can be directly deposited into this trust, much as 401(k) deferrals go into a qualified trust. Having the deferrals deposited in a rabbi trust does not protect them against creditors of the sponsor in the event of insolvency. Doing so does protect them against a change in control (or change of heart of the plan sponsor) that could make it difficult to receive payment of NDCP benefits if the funds were not held by a third-party trustee. Many NDCP participants would not defer their compensation to the plan if not for the underlying rabbi trust.

In general, 409A requires participants to make their deferral elections prior to the beginning of the calendar year and for the elections to remain in place until the beginning of the next calendar year. Consequently, NDCP sponsors should closely monitor their risk of entering a "restricted period" and be sure to communicate the risk and its consequences to executives as soon as possible before the restrictions apply. This proactive approach will provide participants the advance notice they will need to make timely elections to reduce or discontinue their future deferrals (if they are wary of continuing to defer at the same rate without the same level of protection for deferrals). Similarly, a sponsor should promptly inform such participants if and when restrictions are expected to be lifted so they have sufficient time to increase or resume contributions once contributions can again be deposited directly into the rabbi trust.

PENSION RELIEF ACT CREATES ADDITIONAL LINK

President Obama signed into law the Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010 (the "Act") on June 25, 2010. A detailed description of the various intricacies surrounding all the complex funding relief rules included in the Act is beyond the scope of this article. However, the main thrust of the Act is to create a limited window (i.e., generally any two plan years between 2008 and 2011) during which certain plan sponsors may elect to have additional time to amortize pension funding shortfalls, which, before the Act, had to be amortized over seven years. As might be expected, since such relief seldom comes sans strings, there are various requirements and conditions that must be met in order to qualify for this "credit extension." Since the purpose of this article is to illustrate the government's continuing efforts to link DB plan and NDCP funding, the Act's "cash flow" rule must be examined.

This rule essentially provides for reductions in the DB plan sponsor's ability to take full advantage of the Act's amortization extensions if an employer makes "excessive employee or shareholder payments" (i.e. compensation over $1 million paid to any employer). For example, assume a sponsor otherwise would qualify for an extended amortization period but they make these excessive payments during a plan year. The smaller contributions they could have made in the absence of such payments must be increased to reflect the payments.

The NDCP funding link comes into play because the Act defines compensation to include not only nearly all taxable compensation (only commissions are specifically excluded), extraordinary dividends and stock redemptions but also nonqualified deferred compensation. Accordingly, if an employer funds its nonqualified deferred compensation plan through a rabbi trust or otherwise, the amount of assets set aside for the employee through the funding arrangement is considered includible compensation for the year, even though it may not be taxable. There is some grandfather relief as the Act excludes the following in determining excess employee compensation:

- restricted stock that is granted after February 28, 2010, and is subject to a substantial risk of forfeiture for at least five years from the date of grant;
- nonqualified deferred compensation, restricted stock, stock options, or stock appreciation rights payable or granted under a written binding contract that was in effect on March 1, 2010, and not materially modified.

AN ACTION PLAN FOR NDCP SPONSORS

Since NDCP funding restrictions depend on the DB plan's funding status, NDCP sponsors that may be subject to funding restrictions should discuss the DB plan's current funding status and future funding strategies with the qualified plan's actuary as soon as possible. "Applicable covered employees" will need to be identified for publicly traded companies. Private companies should either include their top executive officer or consult counsel for confirmation if they believe they are not affected by the restrictions. All NDCP documents and related trust agreements should be reviewed for any "springing provisions" that could result in full funding or distribution of benefits and that may be interpreted as occurring "in connection" with the restricted period.

Last but certainly not least, until clarifying guidance is available, NDCP sponsors need to settle on an interim solution to the funding question prior to entering a restricted period. Some sponsors may take the position that given the lack of specificity in the statute's language, they would still be acting in good-faith compliance with the rules as long as they did not make any transfers or deposits to a trust or other arrangement. In other words, accruals under the plan could continue and payments could be made when due, provided they were triggered by a 409A permissible payment event stated in the NDCP and not by the restricted period or some other financial measure, such as some designated decline in the sponsor's stock price, gross revenues, or annual profits. The rationale here would be that even if later guidance tightened the wording to prohibit this interpretation, the later guidance would only apply prospectively.

The more conservative approach would be to amend the NDCP to freeze NDCP accruals/contributions on the day before the restricted period begins and provide that no payments be made from the NDCP during the restricted period other than those attributable to amounts that were funded prior to the freeze date. Then, if a participant is due to receive a distribution in accordance with a 409A permissible payment event under the terms of the plan, only the portion of the benefit that is supported by funds that were set aside prior to the restricted period would be paid. If the NDCP sponsor had already set aside sufficient amounts to meet the benefit obligations as of the freeze date, it should be able to distribute 100% of the benefit if a 409A permissible payment event occurs during the restricted period. If any portion of such otherwise payable benefit is not supported by pre-restricted period funding, then that portion would be withheld until the restricted period ends, at which time the plan can also be amended to restart accruals/contributions (and even restore lost accruals/contributions if desired).

Plan sponsors should consult legal counsel before making a final decision, regardless of which approach is taken. For example, even if the conservative approach is adopted, the sponsor could still face a legal challenge if the plan benefits were not fully funded prior to the freeze date. The source of the challenge would not be the IRS but rather participants who are denied full or partial payments and argue that the sponsor is incorrectly withholding such payments due to its overzealous interpretation of the law (and thus reneging on its contractual obligation under the NDCP). In an attempt to ward off such challenges, sponsors who opt for this approach should communicate the changes to the affected participants in advance and obtain their consent to the amendment if possible.

The inclusion of the "cash flow" and "excessive employee or shareholder payments" provisions in the recently enacted Pension Relief Act clearly demonstrates an ongoing legislative effort to firmly link the rules governing DB plan funding to the employer's ability to fund NDCP plans. If employers have sufficient cash flow to fund NDCPs, the expectation is that they should also be able to adequately fund their DB plans. Consequently, if employers are considering seeking funding relief for their DB plans, they must first assess their executive compensation levels (including NDCP plans) to ascertain whether or not they will actually receive significant pension relief from making an election under the Act. Since there is a grandfather provisions for NDCP plans in effect on March 1, 2010 but only to the extent they are not "materially modified," sponsors of such plans who are electing pension relief should seek counsel before implementing any amendments in order to determine if any adverse consequences will result from the changes under consideration.

While all eagerly await further clues from the IRS, the one current certainty of the NDCP/DB connection is that this is indeed a many-sided compliance conundrum which must be examined from all actuarial and legal angles to keep puzzled participants and sponsors from becoming "at risk."