Can nonqualified deferred compensation plans brave our new world?

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Given the current financial, legislative, and political climate, many employers may be questioning whether nonqualified deferred compensation plans (NDCPs) are still a viable means of attracting and rewarding key employees. Congress has already passed and continues to consider legislation that severely tightens the reins around NDCPs. With Section 409A finally in full swing, the IRS now has the power and procedures in place to effectively monitor and police these plans. The combination of the recent severe economic decline and the past and continuing discoveries of corporate abuses have placed all forms of executive compensation under increased scrutiny. What does all this mean for today's NDCPs?

In answering this question, this paper reviews the basic fundamentals of NDCPs for the corporate sector, describing their original appeal as well as their intrinsic limitations. The paper will also examine how the perpetual push to exceed these limitations led NDCPs to the precarious position in which they currently find themselves. However, the final analysis will reveal that while designing and maintaining NDCPs will certainly present much more of a challenge than in the past, the current climate may actually prove to make these arrangements a benefit option that employers should now embrace rather than abandon.

THE NDCP ATTRACTION

Before deciding whether NDCPs can endure the heat of the current political and economic climate, a review of what made them so appealing in the first place may be useful. Beginning with ERISA and continuing with all the subsequent qualified plan legislation that followed, employers found that providing their key employees with the desired level of benefits through their qualified plans (e.g., 401(k), profit-sharing, pension, etc.) increasingly difficult. In particular, limits on the amount of compensation that could be taken into account under qualified plans and the various nondiscrimination tests prevented employers from using these vehicles for a wide variety of strategic compensation purposes. These include, but are not limited to, providing:

- **Performance-based incentives** – While qualified plans generally only permit factors such as compensation and service to be considered in the determination of benefit amounts, NDCPs can be designed to condition the receipt of the benefits upon the completion of designated goals (whether individual or corporate) established by the employer or provide increasing benefits for reaching different levels of performance.

- **Deterrents to premature termination (the so-called *golden handcuff*)** – Although qualified plans have strict limits on how many years an employer can make participants wait before becoming vested in their benefits, no such limit applies to NDCPs. For example, if a sponsor decides it needs to retain a certain executive for at least the next 10 years, it could design the NDCP so that such benefit would be forfeited in its entirety if the executive terminated employment before 10 years had elapsed. In addition, NDCPs can include provisions that create a forfeiture if the participant's termination of employment is for *cause*, thereby protecting the employer in the event the executive works past the designated vesting date and then takes part in an egregious activity or conduct that results in the employee's termination.

- **Incentives for early retirement or postretirement services and deterrents to postretirement competition** – An employer may have cost or personnel reasons for wanting to terminate the employment of one or more executives; however, unless the employer also has sound grounds for the dismissal, it may face employee relations problems and perhaps even legal challenges. While early retirement windows may be offered under qualified plans, they must be made available on a nondiscriminatory basis and are limited in the amounts they can provide. In contrast, an NDCP can offer much more flexibility with respect to providing only the targeted executives an incentive to voluntarily leave of their own accord. Furthermore, NDCPs can be structured to include provisions: (a) requiring the executive to continue to provide postretirement services to the employer; or (b) restricting the executive from entering into direct competition with the employer (subject to applicable state laws).

- **A higher retirement-income-to-final-earnings ratio than would be possible (or economically feasible) in a nondiscriminatory qualified plan (or plans)** – Each year surveys are conducted trying to capture the percentage of working income that an individual needs to maintain the same standard of living in retirement. The ratio varies by location and typically ranges anywhere from 60% to 90%. Because the inherent limitations of Social Security and qualified plans typically prevent executives from meeting the desired replacement target from those sources, NDCPs can help bridge the gap.

- **Sufficient incentives to attract executives from competitors** – NDCPs can be designed to provide an employment incentive to a prospective employee who may be too close to retirement to accumulate sufficient service for a meaningful pension benefit from the recruiting employer's qualified plans. In addition, an NDCP can make up for benefits the executive would sacrifice in making the move. For example, the prior employer may have a qualified defined benefit plan while the recruiting firm only offers a 401(k) plan.

An NDCP could be designed to meet such objectives because it is not subject to any IRS nondiscrimination or coverage requirements (and generally has no or only limited ERISA applicability) as follows:

- **Participation (N/A)** – Qualified plans are subject to strict requirements regarding eligibility to participate and must satisfy coverage tests to ensure they are nondiscriminatory. NDCPs are not only exempt from these rules, but also must be careful to limit participation.

- **Vesting (N/A)** – As described earlier, qualified plans are limited in the length of service they can require a participant to complete before obtaining a nonforfeitable right to a benefit. Qualified plans also include joint-and-survivor annuity and spousal consent requirements, as well as rules limiting the employer's ability to force the participant's benefits out of the plan once the amount of the benefit exceeds a specified dollar amount. NDCPs do not have any limitations on vesting or any requirements to include joint-and-survivor annuities or spousal consent.

- **Funding (N/A)** – Qualified plans are required to establish qualified trust funds in which the plan assets must be invested and thus protected from the creditors of the employer. They also must be maintained for the exclusive benefit of the plan participants and are subject to ERISA's *prudent man standard* and proscription against prohibited transactions (i.e., transactions between the plan and parties-in-interest). NDCPs are not bound by these requirements.

- **Fiduciary standards (N/A)** – Although the ERISA fiduciary rules do not apply to NDCPs, sponsors should be aware that state fiduciary laws may apply.

- **Reporting and disclosure (Abbreviated applicability)** – While qualified plans are subject to annual Form 5500 reporting and must provide participants Summary Plan Descriptions and Summaries of Material Modifications, NDCPs can avoid these requirements if they file a simple one-page statement with the Department of Labor within a specified timeframe of their establishment.

- **ERISA enforcement provisions (Full applicability)** – NDCP sponsors need to be aware that participants are afforded the same ability to enforce their ERISA rights under NDCPs as they are under qualified plans. If the NDCP fails to pay benefits in accordance with its terms, participants may seek to recover benefits due and past due under the plan. In general, a participant who seeks to claim a benefit under an ERISA plan is required to exhaust the plan's claims procedure before bringing suit in state or federal court. Accordingly, the NDCP should include the required ERISA claims procedures.

WERE THERE TRADE-OFFS FOR ALL THESE FREE PASSES?

Because these plans were set free from so many of the qualified plan rules, it follows that they are also stripped of many of the qualified plan perks. The following are four of the most significant consequences that NDCP sponsors must accept in exchange for such freedom:

1. **Restricted participation**: NDCPs can only cover a select group of top management or highly compensated employees. To this day, the Department of Labor has never issued regulations providing specific guidelines regarding this definition, and while there have been several court rulings, their findings have varied. There have been some rulings that set the top-paid 5% as an acceptable cut-off; however, the ultimate determination really comes down to the facts and circumstances surrounding the workforce in question. This eligibility restriction would not seem to be a problem – isn't the whole purpose to create a plan for key employees? However, sometimes employers have reached too far down the corporate ladder and thus risk having the NDCP becoming subject to all the ERISA requirements from which it would otherwise be exempt. While these employers may believe they are being generous by such an expansion of coverage, the DOL's belief is that participation in these plans should be limited to only those employees whose position within the firm is high enough that they can accept the loss of the valuable ERISA rights and protections that are afforded qualified plan participants. Therefore, employers must take extreme care when deciding their NDCP eligibility and seek a legal opinion in the event they are in doubt.

2. **Unfunded status**: While a qualified plan's assets must be irrevocably transferred to a trust for the benefit of employees (i.e., beyond the reach of the employer and its creditors), NDCP sponsors are not required to set aside any assets to prefund their future obligations. While they are permitted to make financial arrangements in advance to ensure that there is sufficient funding when the benefit obligations become due, NDCPs must maintain an *unfunded* status. For this purpose, *unfunded* generally means that even if the employer decides to set money aside, such money is still considered to be a company asset and thus would be made available to the company's creditors in the event of corporate insolvency.

3. **Deferred corporate deduction**: Only qualified plans have the distinct advantage of permitting an employer to take an immediate tax deduction at the same time the participant enjoys a tax deferral. A properly designed NDCP will not create immediate income inclusion to the employee; however, it will also not generate an employer tax deduction until the employee actually receives or constructively receives the money.

4. **Constructive receipt doctrine**: Individual taxpayers must report as income amounts received during the year, including compensation paid to them during that time, as well as any other earnings that were realized. However, even income that was not actually paid to

or received by the taxpayers may still be taxable if it is deemed to be *constructively received*. Taxpayers are in constructive receipt of money or property even though they did not actually take possession of the money or property if at some point during the year their rights to it became such that they could have taken possession of it had they chosen to do so. An amount is not constructively received if it is available only in exchange for the surrender of some valuable right (e.g., the right to continue participating in a plan or program), if there are other limitations on the exercise of the option to take possession, or if there is a statutory exemption.

Qualified plans have such an exemption, which enables their participants to defer receipt or change the form of their benefits prior to commencement without being subject to immediate taxation. In contrast, NDCPs have no similar exemption and thus are generally subject to this doctrine. Consequently, the IRS originally took the position that any elections made by NDCP participants regarding the timing and/or form of distributions must be made when the participants first became eligible for the plan.

FROM PUSHING THE ENVELOPE TO RIPPING IT TO SHREDS

Even though they had a free pass from so many requirements, many NDCP sponsors and participants wanted more. No executive liked the idea of possibly losing his or her benefits in the event of the sponsor's insolvency. This led to such concepts as financial distribution triggers (paying out the money once the sponsor's fiscal health took a significant turn for the worse) and off-shore trusts (an attempt to frustrate creditors in the hopes that they would eventually give up their pursuit). Similarly, executives found being bound by constructive receipt way too restrictive and thus their NDCP sponsors sought ways to provide them with greater distribution flexibility. In the beginning, the IRS challenged these designs; however, the agency lost most of the tax court cases and with each loss, the designs became more and more aggressive. For example, the IRS's original position requiring preparticipation elections of timing and form of distribution was eventually ignored by most NDCPs as the common practice became a one-year advance notice for such elections. Several NDCPs permitted *haircut* withdrawals under which participants could make a withdrawal at any time provided that a designated percentage of their account would then be forfeited. Then there were those plans that even went so far as to allow withdrawals with no restrictions. Consequently, some of these arrangements became nothing more than personal piggy banks stuffed full by the employer while the executives held the hammer so that in the event the company suffered a sharp decline financially, they were ready to smash it open, clean out all the cash and then depart before the company completely collapsed.

During the more then 20 plus years that these trends were developing, the IRS and Treasury had been telling Congress that they needed some sort of statutory authority to police NDCPs. Enron and the other corporate scandals focused the attention of the press, the public and the politicians on this problem. This provided the IRS and Treasury an opportunity to convince Congress that the time had come to address the matter by snatching that hammer from the executives and using it to construct some very broad legislation – the sprawling Section 409A rules that now frame the NDCP landscape.

HOW MUCH OF A CHILLING EFFECT DOES SECTION 409A AND THE CURRENT CLIMATE CREATE?

Section 409A certainly does raise the compliance stakes for NDCPs. While the transition period to bring documents into compliance ended on Dec. 31, 2008, the same Section 409A issues with which NDCP sponsors and participants have been struggling extend into 2009 and will likely continue for many years to come. Therefore, deferred compensation plans must continue to comply with the onerous Section 409A requirements, in both form and operation, to avoid the tax and penalties associated with any violation. A failure to comply with Section 409A creates adverse implications for both the participant and sponsor:

For participants, a failure could result in the immediate recognition of income to the participant, a 20% excise tax penalty, and interest.

For sponsors, noncompliant employers have enhanced reporting and withholding responsibilities and may face legal battles with disgruntled employees who blame them for the 409A failure.

Perhaps the most difficult compliance challenge presented by section 409A is that it goes beyond what most employers consider an NDCP, covering a wide variety of deferred compensation arrangements, including severance pay agreements and employment agreements that provide for severance, salary continuation, separation pay, and even bonuses. Now, as many businesses are forced to consider workforce reductions in 2009, they must consider the far-reaching grasp of Section 409A. Employers must make sure they do not either alter any existing agreements so as to violate Section 409A or enter into any new contracts that fail to comply. While a complete review of the various 409A requirements is beyond the scope of this paper, the following are several common areas of potential non-compliance:

- **Six-month-delay rule** – Publicly traded companies either: (a) fail to have language in the plan prohibiting payments of deferred compensation to a *specified employee* during the first six months following termination; or (b) make payments in violation of this rule.

- **Short-term deferral exception** – Employers fail to pay a bonus or severance amount by March 15 of the year following the year in which it is *vested* (e.g., because a release needs to be negotiated) thereby removing the bonus or severance amount from the *short-term deferral* exclusion to 409A coverage.

- **Deferral elections** – With limited exceptions, NDCP participants fail to make deferral elections (other than with respect to certain performance-based compensation) before the beginning of the service year.

- **Distribution elections** – With limited exceptions, executives make a change to an existing distribution election that: (a) fails to be made at least one full year in advance of the commencement date and (b) requires the payments be delayed for at least five years.

- **Payment triggers** – An executive receives payments of deferred compensation upon the occurrence of an event other than one

of those specifically permitted and defined by Section 409A: (1) separation from service, (2) disability, (3) death, (4) at a specified time or pursuant to a fixed schedule, (5) a change in control, or (6) an unforeseeable emergency.

- **Anti-acceleration rule** – The NDCP permits an acceleration of payments to an executive and such acceleration does not meet one of the designated exceptions.

- **Certain funding prohibitions** – The NDCP sponsor formally sets aside funds for the NDCP with respect to certain participants during a period in which it maintains a qualified defined benefit plan that is not funded to the level specified under the law.

Not just NDCPs but all forms of executive compensation are now under increased scrutiny as a result of the media attention and the public backlash to a litany of corporate abuses. Corporate boards, executives, and shareholders are rethinking the value, security, and optimal execution of NDCPs in the face of market doldrums, higher plan liabilities, steeper security risks, and increasing demand for cost control and efficiency.

The IRS now has the authority, the support of the public and politicians, and mountains of motive to aggressively pursue NDCPs that violate tax code section 409A. With all the monies that the government is shelling out in bailout funds, however worthy doing so might be, some would argue that the government also should strongly encourage and support the IRS's audit efforts that could bring in additional tax revenues via imposition of the hefty 409A penalties for noncompliance. The rules are now completely in effect and once the annual W-2 reporting requirements are finalized, the IRS will be able to identify and target NDCPs on two fronts: the executive's individual returns and the sponsor's corporate returns.

WHY NDCPS MAY NOT ONLY SURVIVE BUT THRIVE

On the surface, the foregoing may seem to paint a grim picture for the future of NDCPs. However, upon closer examination, there are indicators that a properly designed, 409A-compliant NDCP actually may be the most appropriate compensation vehicle for these tough economic times, one that may finally enable employers to reconcile two objectives that have unfortunately grown more and more conflicting over the years: (1) attracting and retaining key executives and (2) serving the best interests of the company and shareholders. Here is a look at how some of the major negatives discussed earlier can either be turned into positives or at least successfully managed:

1. **Unfunded status**: Now that we are living in economic times so lean that even the bluest of blue chip companies does not seem safe from the threat of insolvency, this unfunded status requirement may seem to be a major disincentive for NDCPs. While that certainly is true for the participants, the opposite holds true for the sponsor, shareholders, and public. If we are indeed entering a new era of mandatory corporate consciousness and conscience, what better vehicle to ride than one that can truly create a long-term partnership between the executive and the company? The current climate suggests that executives will no longer be allowed to work their high-wire incentive-driven act where they were encouraged to take risks while knowing that should they fail, they had the safety net of a huge severance package and/or golden parachute. The well-designed NDCP works on several levels in this new economic environment as it eschews current compensation in favor of a deferred payout, the full receipt of which is conditioned on the company remaining solvent in the future.

With the credit crunch, a dim profit outlook, and cash in short demand, employers will want to minimize cash outlays for the foreseeable future as they seek to survive the economic downturn. Thus, for them to seek an arrangement that enables them to offer a future benefit while currently keeping the cash working within the business would make sense. With an NDCP, the cash outlay is not only deferred to the future but its eventual distribution is tied to the future solvency of the company, thus ensuring that the executive/participant focuses on the organization's long-term viability rather than short-term profits.

2. **Deferred corporate deduction**: During boom times, the mandatory deferral of the tax deduction for NDCP benefits may lead employers to think twice about the amount of compensation they are willing to defer on a participant's behalf in lieu of paying current compensation that can be deducted immediately. However, given the current economy, many employers may be a position in which they would rather defer the deduction to a future period, when they will have profits.

3. **Constructive receipt doctrine**: Now that 409A solidifies this doctrine in addition to establishing anti-acceleration rules, an NDCP sponsor can truthfully tell executives its hands are tied if and when it receives requests for early distributions of funds. This strengthening of the policy requires the sponsor to maintaining tight control over the NDCP provisions covering timing and form of distributions, and thus enables it to more accurately budget for future distribution streams.

4. **409A phobia**: While 409A compliance certainly creates the necessity for thorough and ongoing reviews of all NDCPs, this burden can be eased somewhat with a *409A-friendly* plan design. In addition, the IRS recently announced some good news, providing for a limited correction program for inadvertent and unintentional Section 409A operational failures. The correction program permits self-correction with reduced penalties for such operational failures as erroneous payments of deferred compensation and impermissible acceleration of payments. While not all failures may be corrected using this program, it remains a valuable option if and when Section 409A errors are discovered.

KEY QUESTIONS TO UNLOCK AN EFFECTIVE NDCP

Whether you have an existing NDCP or are considering establishing a new arrangement, there are several questions that sponsors should be able to answer. The following are four of the most significant:

1. What are the major corporate goals that we wish the NDCP to meet?

The answer(s) to this question will have a major impact on such plan provisions as plan eligibility, the determination and allocation of

the benefit amounts, the vesting schedule, and the timing and form of distributions.

2. Can we cope with 409A compliance?
While a serious challenge, 409A compliance can be managed. The process can be made easier by choosing a simpler plan design when establishing the plan; however, more complicated features are often desired, as they offer executives greater flexibility regarding the timing and form of their benefits. In either case, extreme care must be taken to ensure that the arrangement is: (a) covered by a plan document that satisfies 409A and (b) operated in accordance with its requirements. A system should be created to provide for regular self-audits to ensure that the NDCP will pass muster in the event of an actual IRS audit. Such a system will also enable the sponsor to catch any correctible errors that qualify for self-correction under the rules of IRS Notice 2008-113. These rules are detailed and, in some cases, administratively complex (e.g., requiring repayment of early distribution amounts and interest charges); however, they are a very valuable means of avoiding the severe 409A taxes and penalties.

3. How do we communicate the NDCP to maximize its effectiveness?
NDCP sponsors will want to make sure that the participating executives appreciate the value being provided as well as the inherent risks. The communications should stress the concept of a long-term partnership and explain that this is the most appropriate design given the current economic and legislative climate. In addition, for plan designs that permit participant elections (whether deferral or distribution choice), clear ongoing communications are essential to ensure 409A compliance and avoid misunderstandings with the participants in the future.

4. To fund or not to fund?
Given the current market conditions and the cash shortages faced by many employers, an NDCP sponsor may decide that retaining the assets within the company makes more sense than to invest them externally. In the event a sponsor decides to set aside funds and it maintains a qualified defined benefit plan, such plan's funding status would have to be reviewed before determining the extent to which, if any, NDCP benefits could be funded.

DO NDCPS PASS THE TESTS OF THESE TIMES?

There is no arguing the past appeal of NDCPs, as their vast flexibility of plan design and freedom from many of ERISA's restraints have long made them a staple of executive compensation programs. Now, however, employers cannot be blamed for questioning NDCPs' continuing viability in this new era of intense scrutiny and economic turmoil. Nevertheless, a closer look at the fundamentals of these plans reveals that if properly designed and communicated, NDCPs may actually prove to be the compensation vehicles best built to provide plenty of room for the interests of not only the executives, but also the employers and their shareholders.

Accordingly, if a company currently maintains or is considering implementing an NDCP, having qualified counsel to assist with the above questions will be prudent. Such expertise will be valuable with other issues that may arise, such as:

- searching for and finding the design solutions that prove most beneficial for both your company and your executives
- maintaining 409A compliance, whether in the design and/or amendment of the plan, establishing the necessary administrative procedures, or conducting a self-audit of the NDCP's operation
- if you also maintain a qualified defined benefit plan, reviewing its funding status to determine whether it will have any impact on your ability to fund your NDCP
- completing any complex calculations that may be required in the event the NDCP requires a self-correction to be made
- last but not least, effectively communicating the NDCP to the participating executives to foster maximum appreciation of the benefits, as well as an understanding of the inherent risks and why such risks are nonnegotiable in today's business environment

Disclaimer: This white paper is intended only to address NDCPs in the corporate (i.e., for-profit) sector and their limitations under Section 409A and in today's economy. It is not intended to address other current and more general executive compensation issues that are presently the focus of legislation such as the Troubled Asset Relief Program (TARP). Accordingly, please note that the any executive compensation issues, whether regarding current or deferred pay, that pertain specifically to TARP recipients or tax-exempt organizations are beyond the scope of this paper.

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