New Legislation Complicates Nonqualified Deferred Compensation Plans

by Richard Sharpnack

Richard Sharpnack is president of Sharp Capital Consulting LLC in Denver, Colorado. He has been consulting in the areas of human and financial capital for over 15 years and is a recognized expert in the design and implementation of nonqualified deferred compensation plans, mergers, and acquisition consulting, and business continuity planning. He can be reached at rsharpnack@sharpcapitalconsulting.com or by phone at (303) 887-2951.

Executive Summary

- The American Jobs Creation Act of 2004, through the new Section 409A, has created additional complexity but also additional clarification in the design and administration of nonqualified deferred compensation plans.
- Companies have increased the use of NQDC plans in recent years, so financial planners need to become familiar with the new law and its planning implications.
- NQDC plans offer tremendous flexibility in the way plans can be design, and resulting in a variety of plans such as supplemental executive retirement plans, excess benefit plans, discounted stock option plans, and phantom stock plans.
- Noncompliance with the new rules will result not only in taxation of the deferred amount but also interest on the underpayment of taxes and a 20 percent penalty of the taxable amount.
- Among the new rules, participants must make voluntary deferral elections in the year before the year services are performed, though there are exceptions to this for new participants.
- The time and form of distributions must be specified and must be based on a specified time or fixed schedule.
- The new rules eliminate the "haircut" provisions, which allowed immediate distributions in exchange for a nominal reduction in total benefits.
- Distributions may no longer be accelerated faster than the time period specified in the plan, with certain exceptions such as for divorce payments.
- Extension of the deferral of distributions cannot take effect until 12 months after the original date of election and they must be deferred at least five years more. Consequently, it's often wise to choose shorter vesting schedules and deferral periods.

In recent years, companies in many industries have increased the use of nonqualified deferred compensation (NQDC) plans for select employees. According to WorldatWork (formerly the American Compensation Association), 91 percent of the Fortune 1000 companies reported having some type of NQDC plan. Among financial institutions, the percentage is as high as 94 percent.

While always a complex form of retirement plan, the design and administration of NQDC plans have been further complicated by new federal legislation: the American Jobs Creation Act of 2004. The act presents new rules affecting deferral election dates, the time and form of NQDC distributions including the elimination of the controversial "haircut" provision, and the deferral of distributions, among other changes. The new rules also clarify gray areas that have long existed for NQDC plans. This article will lay out some of these important legislative changes that should be closely reviewed by financial planners who have clients participating in or considering participation in a NQDC plan.

Why NQDC Plans Have Become So Popular

NQDC plans have become increasingly popular for numerous reasons. The classic reason to establish an NQDC plan is to create "golden handcuffs" for senior-level employees. NQDC plans have also become a proxy for traditional ownership plans such as stock options and restricted stock for privately held companies where owners are not interested in creating additional

stockholders. Companies use NQDC plans during internal ownership transfers to ensure that key employees—who will not participate in ownership—stay with their company during this time of leadership and ownership change. Finally, NQDC is an excellent vehicle to help key employees build additional wealth for retirement beyond what can be accumulated through traditional retirement plans.

NQDC plans are different from qualified retirement plans in just about every aspect. Qualified retirement plans have strict limits on the amounts that can be deferred each year. For example, the maximum elective deferral allowed in a 401(k) plan is $15,000 for 2006. The retirement plan contributions are transferred to a trust outside of the reach of company creditors, and the companies sponsoring the plans may take an immediate tax deduction for the amounts they match or otherwise contribute even though the deferred amounts will not be paid until sometime in the future. Qualified plans must meet strict requirements concerning maximum vesting periods, and the plans are nondiscriminatory—they must be offered to all employees who meet minimum participation rules.

NQDC plans—particularly "top-hat" plans, which limit participation to senior managers or other highly compensated employees—are subject to none of these requirements except for minimal reporting and disclosure requirements to participating employees. Companies may offer them to only a few employees and there are no limits on the amounts that can be deferred each year. Vesting periods may be any number of years; in fact, deferred amounts in some golden handcuff plans do not vest until retirement. The deferred amounts must be kept "at risk" to creditors to maintain their tax-deferred status; thus, they cannot be placed in a trust to keep them away from creditors after a bankruptcy filing. Finally, the sponsoring companies receive a tax deduction only in the year that they actually pay the deferred amounts to participating employees.

The relative lack of Internal Revenue Service and Department of Labor requirements for NQDC plans create tremendous flexibility in the way the plans may be designed. This flexibility has resulted in many different arrangements being used to calculate and pay deferred compensation benefits. Most NQDC plans are unfunded, meaning there are no formal funding mechanisms in place, and companies pay NQDC plan benefits out of general corporate assets. Plans may be categorized as *voluntary*, where an employee decides to voluntarily defer a portion of his or her salary or bonus, or *contributory*, where the company contributes certain amounts to the participant's accounts. A voluntary plan is often called a SERP, or supplemental executive retirement plan. Companies sometimes match voluntary deferrals with dollar-for-dollar or 50-cents-on-the-dollar contributions. Contributory plans may be called phantom stock, stock appreciation rights, performance unit, or deferred bonus plans. These are all performance-based NQDC arrangements where a company contribution is based on company (or company stock) performance. A contributory NQDC plan may be as simple as a written arrangement where a company contributes a certain amount in exchange for services, such as staying with a company for a certain number of years.

Plans and Penalties Under Section 409A

The American Jobs Creation Act of 2004 includes new Internal Revenue Code rules that affect NQDC plan design and administration. These IRC rules are contained in Section 409A and became effective for deferrals made after December 31, 2004. Deferrals earned and vested before the date are grandfathered under previous law. The new rules also apply to deferrals from previous NQDC plans (whether vested or unvested) made before January 1, 2005, if these plans were "materially modified" after October 3, 2004.

The net effect of all this is that any current plan that does not comply with the new rules must be terminated because any amendments to a nonconforming plan would trigger the material modification rule. Plan termination could trigger taxable distributions to a client much sooner than your client had planned, resulting in unexpected tax liabilities. Financial planners should carefully review an early distribution of deferred compensation to see if there will be an erosion of retirement funds for their client.

New Section 409A rules apply to many types of NQDC plans, including (but not limited to) the following:

- Traditional voluntary deferrals of base pay or bonuses, whether these deferrals are through employment agreements or NQDC plans.
- Excess benefit plans—a specific plan type that places company contributions in an NQDC plan equivalent to the amounts forfeited by the compensation limits of qualified retirement plans.
- SERPs.
- Discounted stock option plans—a plan that grants stock options at below-market value.
- Restricted stock and performance share plans—restricted stock tied to specific performance targets.
- Phantom stock and stock appreciation rights plans.
- Severance pay plans—except for vacation pay, death benefits, or disability benefits.
- Section 457(f) plans—nonqualified deferred compensation arrangements for certain governmental or tax-exempt organizations.

All contributions in a nonconforming NQDC plan that are deferred after December 31, 2004, and all amounts deferred but not vested before December 31, 2004, that do not meet all requirements of Section 409A will be includable in gross income for plan participants if such amounts are not subject to substantial risk of forfeiture. The penalties for noncompliance of IRC Section 409A are severe and include

- Immediate taxation of deferred

amounts defined above.

- Interest for underpayment of taxes at the IRS underpayment rates plus 1 percent calculated retroactively from the year in which the deferral occurred.
- 20 percent penalty of the taxable amount.

Summary of New Rules

The following is a summary of the new Section 409A rules.

Voluntary deferral elections. Participants generally must make their voluntary deferral elections—for example, in a SERP—in the year before the year in which they are to perform the services. For example, an election to defer a portion of one's salary for 2007 must be made before December 31, 2006.

Exceptions to this rule include new participants in an NQDC plan who have 30 days after becoming eligible to participate in the new plan to elect deferrals for performance pay based on an annualized formula. Participants in a performance pay plan must make their election to defer compensation, such as a bonus based on annualized company performance, no later than six months before the end of the performance year.

It is important for financial planners to be aware of the deferral election dates if a client is considering deferral of a portion of their compensation. Planners also need to assess the risks associated with these deferrals. To maintain tax-deferred status, NQDC plan contributions must remain at risk to creditors of the company in case of bankruptcy, though the risks associated with NQDC plan balances, such as in a SERP, may be mitigated somewhat (but not entirely) by using a rabbi trust (see below) to hold plan contributions.

Time and form of distributions. The time and form of distributions from an NQDC plan must be specified, either in the NQDC plan document or by the participant, at the time the deferral election is made. Under the new rules, distributions may commence because of separation from service, death, or total disability of a participant. The distributions must be made over a specified time or based on a fixed schedule, such as quarterly payments over five years. Distributions may also occur upon a change in ownership or in effective control of a company, or for an unforeseen emergency. An example of an unforeseen emergency is a major illness that creates a financial hardship for a client.

"Haircut" provisions. Section 409A rules eliminate the use of "haircut" provisions used in past plans where a participant may receive early distributions subject to a reduction of total benefits. This rule is largely a result of the Enron bankruptcy where many Enron executives elected to take NQDC plan distributions immediately in exchange for a relatively nominal reduction in total benefits when it became clear that the company was near bankruptcy.

Optional acceleration of distributions. Optional acceleration of distributions is no longer allowed except for divorce payments, distributions needed to comply with federal conflict-of-interest rules, and for required tax withholding from a participant's deferred account balance.

For example, when an NQDC plan specifies that a participant's deferred account balance be distributed over ten years, the participant may no longer accelerate that payout to a lump sum unless they meet one of the previously listed exceptions.

Extension of distribution deferrals. Changes to extend the deferral of distributions may only become effective 12 months after the date of election and must further defer the distributions for at least 5 years past the time when the distributions were originally scheduled to begin.

Because of the new restrictions in Section 409A, a favorite strategy of NQDC plan designers is to use shorter vesting schedules and shorter deferral periods with the knowledge that participants may elect to extend deferral of their deferred account balance. Financial planners must remember that an election to further defer a distribution (and the resulting taxes) must be made well in advance of the distribution date, and the election must be made for a specified number of years.

Rabbi trusts. NQDC plan assets may not be funded into offshore trusts (including offshore rabbi trusts). Rabbi trusts may no longer contain language that restricts assets in the trust only for the benefit of plan participants because of a change in the financial health of the company.

Rabbi trusts are a special type of trust used specifically for NQDC plans. Once deferred funds are place in a rabbi trust, the election is irrevocable and the company may not use the funds in the trust for other purposes. This provides limited protection for plan participants, in that the funds in the rabbi trust are still at risk to creditors of the company.

Reporting and taxes. Employers must report the amount of the deferral on the W-2 form or the 1099 form for the year of the deferral. The deferred amounts will need to be reported again when they are distributed from the plan and become includable as taxable income. Taxes on the deferred amounts must be withheld for that tax year. If the deferred amounts are included as income before they are actually paid to the participant, the company must determine a way to withhold the taxes required.

Effectiveness Not Diminished

The new rules have added a level of administrative complexity for companies, but have not diminished the effectiveness of nonqualified deferred compensation plans. NQDC plans remain one of the best tools to improve retention of senior-level employees and to help them build additional wealth for retirement.

The new rules clarify gray areas that have existed in the past for NQDC plans. For example, the "year before the year of performance" rule has long been identified as the best approach to guarantee tax deferral of voluntary NQDC plan contributions, but was never stipulated in IRS or Department of Labor requirements. The

new rules were also implemented to prevent abuse of NQDC plans—presumably a situation that occurred in the past as a result of high-profile bankruptcies. The IRS has added teeth to the new rules by potentially imposing the 20 percent additional penalty for noncompliance. In past years, the worst-case scenario for noncompliance was that taxes would be due on the deferred amounts. To pay these taxes, a plan participant would simply take distributions from the deferred amounts to meet the resulting tax liability.

Financial planning professionals should be aware of the Section 409A rules when advising clients regarding distributions, or continued deferrals in NQDC plans. Improper advice could potentially subject your client to immediate taxation of deferred amounts, plus interest and penalties. If a financial planner has any questions regarding a client's NQDC plan, he or she should contact the plan's administrator and then seek additional guidance from an expert in the design and implementation of these types of compensation plans.