

Legal Aspects of Nonqualified Deferred Compensation

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Robert L. Abramowitz

Morgan, Lewis & Bockius, LLP

1701 Market Street

Philadelphia, PA 19103

215.963.4811

r Abramowitz@morganlewis.com

Why Use Nonqualified Deferred Compensation?

- Code 401 (a)(17) Pay Cap (currently \$245,000).
- Annual Contribution Limits (currently \$49,000 annually for defined contribution plans).

Flexibility in Design

Vesting

Coverage

Accrual

Uses

- Retention
- Severance Enhancement
- Change-in-Control Protection
- Benefit Replacement and Equalization
- Targeted Incentives

Tax Basics

Constructive Receipt Doctrine

Economic Benefit Doctrine

Substantial Risk of Forfeiture

- Payment via Transfer of Property (Code 83)
- Trigger for Employment Taxes (Code 3121(v))
- Nonqualified Arrangements of Tax-Exempt and Governmental Employers (Code 457(f))
- Section 409A

Special Concerns for Elective Deferral of Compensation

- Timing of deferral election
- Timing of payment
- Tax-exempt employers

\$1 million Compensation Deduction Cap for Executives of Public Companies (Code 162(m))

- Limited to top four or five executives
- Exceptions for shareholder approved performance compensation
- Exception for stock options granted at fair market value

Golden Parachute Payments (Code 280G)

Excess Parachute Payments

- Subject to 20% Excise Tax
- Nondeductible
- Triggered by a change of ownership or change in control
- Applicable to payments in excess of three times the “base amount”
- Base Amount – annualized compensation over prior five-year period.

Section 409A

The American Jobs Creation Act of 2004 added 409A effective 1/1/2005.

Final regulations became effective 1/1/2009.

Section 409A – Basic Provisions

- Section 409A provides strict timing rules for deferral elections, form of distribution, and timing of distribution of nonqualified deferred compensation.
- Code Section 409A applies to amounts “deferred” after 2004; amounts generally “grandfathered” if vested at 12/31/04
- Noncompliance triggers inclusion of all amounts deferred under plans of same type, with included amounts subject to a 20% additional tax, plus an additional “interest tax”

Section 409A – Avoid the Pitfalls

- Section 409A requirements are very rigid and separation pay can be subject to section 409A restrictions
- Beware of substitutions for amounts subject to section 409A – major opportunity for violations due to acceleration of “waived” deferred compensation in exchange for up-front payments
- Six-month delay requirement for “specified employees”

Section 409A – Avoid the Pitfalls

- Maximizing exclusions for involuntary separation pay and “short-term deferral” amounts
- Compliant waiver provisions – pay on fixed date (e.g., 60 days post-separation) but require execution of waiver for payment
- Section 409A savings provision

ERISA

ERISA Requirements for Pension Plans

Include:

- Reporting
- Coverage
- Vesting
- Funding
- Fiduciary Duties

Exceptions to ERISA

Excess Plans (415 limits only)

Top Hat Plans – unfunded, and maintained for a select group of management or highly compensated employees

Qualifying Severance Plans – limited to 200% of pay

Top Hat Status

Pay Level

Number of Participants

Unfunded

Notice to D.O.L.

Economic Stimulus Act (TARP)

- Generally effective immediately
- Applies to all past and future TARP recipients
- Amends large part of the existing rules limiting incentive compensation and severance
- Retains pre-existing requirements and adds new requirements

Economic Stimulus Act (TARP)

- Treasury has issued interim final rules on the application of Stimulus Act (TARP) restrictions
- Rules generally apply until TARP recipient repays the government the amounts received
- Limits on bonus, retention or incentive compensation for up to top 25 executives with limited restricted stock exception
- Exceptions for bonuses under written, valid employment agreements as of Feb. 11, 2009
- Other requirements include limits on severance; lower amount for deductible compensation; mandatory “say or pay” votes; limits on perquisites; and clawbacks.

Funding of Nonqualified Deferral Compensation

Popularity of “Rabbi” Trusts

Note potential restrictions on funding nonqualified deferred compensation added by the Pension Protection Act of 2006 if the employer (or a related employer) maintains an underfunded defined benefit plan, or if the plan sponsor is in bankruptcy

Additional Considerations – Public Companies

Securities Law Registration

Proxy Disclosure

Sarbanes Oxley

Accounting Rules

Tax - Exempt Employers

457(b) Plans

- No nondiscrimination rules
- Unfunded
- Current annual limit of er/ee contributions of \$16,500 (with limited catch-up)
- Subject to top hat requirements if employer is subject to ERISA

457(f) Plans

- Taxation when deferred amounts cease to be subject to a substantial risk of forfeiture
- Special rules for “steeple” church and governmental employers

457(f) Plans

Notice 2007-62

- Bona fide severance plans
- Substantial risk of forfeiture

Proposed Regulations on the Horizon

Other Issues for Tax-Exempt Employers

Taxpayer Bill of Rights 2 (Intermediate Sanctions)

Accounting Issues

Form 990 Disclosure

State Law Requirements