

LEGISLATIVE AND REGULATORY DEVELOPMENTS IN EMPLOYEE BENEFITS

PROPOSED REGULATIONS ON DEFERRED COMPENSATION

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OVERVIEW

- Deferred Compensation Arrangements
- Deferral Elections
- Distribution Restrictions
- Effects of Non-compliance
- Transition Relief
- What to Do Now

Deferred Compensation Arrangements

- Plan, arrangement or agreement with one or more service providers
- Provides for deferral of compensation, and
- Not excluded under statute or guidance

Provides for Deferral of Compensation

- A plan provides for deferral of compensation if:
 - ◆ Legally binding right to compensation that is not taxable in current year
 - Generally, may not be unilaterally reduced after services performed
 - May, however, be subject to reduction or forfeiture based on objective plan terms
 - ◆ Compensation not payable until a later year

Service Providers

- Includes arrangements with
 - ◆ Employees
 - ◆ Directors
 - ◆ Partners/LLC members
 - ◆ Certain personal service entities
 - ◆ Independent contractors
 - Unless significant services are provided to two or more unrelated service recipients

Nonqualified Deferred Compensation Plans

Examples of plans covered by 409A:

- Nonqualified plan where employee or director elects to defer compensation
- Nonqualified plan providing benefits in excess of Code limits
- SERP (supplemental executive retirement plan)
- 457(f) plan
- Discounted option/SAR plan
- Certain bonus or incentive plans
- Certain severance plans and agreements

Plans & Arrangements Excluded By Type of Plan

- Qualified retirement plan (pension, profit-sharing, 401(k), 403(a))
- Tax-deferred annuity (403(b))
- 457(b) plan (tax-exempt organization)
- Bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plan
- Medical reimbursement arrangements (such as HSAs)
- Simplified employee pension (SEP) (Code §408(k))
- SIMPLE retirement account (Code §408(p))
- Certain foreign plans
- Employee stock purchase plans (Code §423)
- Incentive stock options (Code §422)
- Restricted stock awards (or other restricted property subject to Code §83)
 - ◆ But restricted stock units may be subject to 409A

Exclusion of Grandfathered Amounts

“Grandfathered Amounts”

- Amounts deferred before 2005
 - ◆ Earned at 12/31/04
 - AND
 - ◆ Vested at 12/31/04
 - AND
 - ◆ Service provider has a legally binding right to at 12/31/04
 - AND
- Plan not materially modified after October 3, 2004

Plans & Arrangements Excluded As Short-Term Deferrals

- Payment made not later than 2½ months following year in which compensation is “vested”
- “Vested” = no longer subject to a substantial risk of forfeiture

Example – Plan requires employment from 2006 through 2008. Plan provides for payment by March 15, 2009 unless participant has elected to defer payment. Payment is made by March 15, 2009. Payment is NOT subject to 409A.

- Requirement for plan to specify payment date in writing is dropped from proposed regulations

Plans & Arrangements Excluded If Meet Certain Requirements

- A non-union separation pay arrangement that provides:
 - ◆ Involuntary termination or window program ≤ 1 year; and
 - ◆ Entire amount of payment does not exceed lesser of:
 - Two times employee's annual compensation; or
 - Two times the 401(a)(17) limit (\$220,000 for 2006); and
 - ◆ All payments completed by end of 2nd calendar year following year of termination

Plans & Arrangements Excluded If Meet Certain Requirements

- Nonqualified stock options are excluded, if:
 - ◆ Exercise price never less than FMV on date of grant
 - ◆ Stock purchased is stock of “service recipient” (or “controlled group” member) using relaxed rules
 - ◆ Number of shares underlying option is fixed at grant
 - ◆ No other deferral feature

Plans & Arrangements Excluded If Meet Certain Requirements

- Stock appreciation rights (SARs) whether settled in cash or in stock are excluded, if:
 - ◆ Amount payable is never greater than the difference between FMV on date of grant and FMV on date of exercise
 - ◆ Number of shares underlying right is fixed at grant
 - ◆ Right is with respect to stock of “service recipient” (or “controlled group” member) using relaxed rules
 - ◆ No other deferral feature
- Dividend equivalent rights
 - ◆ May be treated as offset against fair market value resulting in discount
 - ◆ Okay if paid under a separate plan

Plan Aggregation Rules

- Types of plans
 - ◆ Account balance plans
 - ◆ Nonaccount balance plans
 - ◆ Equity compensation plans
 - ◆ Separation pay plans

- Aggregate for purposes of:
 - ◆ Determining penalties
 - ◆ Determining whether newly eligible employee election rule applies
 - ◆ Certain plan terminations

Deferral Elections - General Rule

- Must be made in year before the year in which services are performed
 - ◆ 2006 base salary – must make election by 12/31/2005
 - ◆ Nonperformance-based bonus earned in 2006 and payable in 2007 – must make election by 12/31/2005

Deferral Elections - General Rule

- Must be irrevocable no later than the last day that such election may be made
 - ◆ Evergreen elections
 - E.g., X makes election to defer 10% of salary during 2006 and plan provides that election remains effective until changed. Deferral election for 2007 may be revoked on or before December 31, 2006
- Time/form of payment must be specified before service provider obtains legally binding right to payment
 - ◆ By participant election, as described above, or
 - ◆ As specified in plan in lieu of election or as default

Deferral Elections – Special Rules

- First eligible during year – within 30 days
 - ◆ Plan aggregation rules apply

- Ad-hoc grants – within 30 days after grant
 - ◆ provided election made at least 12 months in advance of end of service period

- Negotiated separation pay – Before legally binding right arises
 - ◆ Involuntary termination
 - ◆ Result of bona fide arm's-length negotiations

Deferral Elections – Special Rules

- Performance-based compensation
 - ◆ No later than six months before end of performance period
 - 1/1/2005 – 12/31/2007 service period – election must be made before 7/1/2007
 - Election must be made at a time when:
 - Amount is not readily ascertainable; or
 - Right to the amount is not substantially certain
- What is performance-based compensation
 - ◆ Based on services performed over at least 12 months
 - ◆ Payment contingent upon satisfaction of individual/organizational criteria
 - ◆ Performance criteria not substantially certain to be met at the time criteria are established

Distribution Restrictions

ONLY permissible distribution events:

- Death
- Disability (as defined in 409A)
- Separation from service
 - ◆ Must separate from entire “controlled group”
 - ◆ 6-month delay for certain “key employees” of “public company”

Distribution Restrictions

- Unforeseeable emergency
 - ◆ Not the 401(k) hardship rule
 - ◆ Severe financial hardship to participant resulting from extraordinary/unforeseeable circumstances not in participant's control
- Change in control (as defined under 409A)

Distribution Restrictions

- Specified time (or pursuant to fixed schedule)
 - ◆ Date/year must be specified under deferral agreement or plan at time of deferral
 - ◆ Must be a time not an event
 - Amount to be paid on attaining age 65 – o.k.
 - Amount to be paid when daughter enters college – not o.k.
 - ◆ Date may be determined with reference to one of the preceding events
 - E.g., on first anniversary of separation from service
 - ◆ Date may be determined with reference to a date on which substantial risk of forfeiture lapses
 - E.g., amount to be paid in two annual installments starting on the earlier of completion of three years of service, or an IPO

Other Distribution Rules

- May be the earliest or latest of a permissible event (and different forms may be specified for each event)
 - ◆ E.g., Five annual installments on first of month following age 55 or, if earlier, a lump sum upon death
- Alternative payments may be designated if an event occurs on or before a specified date
 - ◆ E.g., A lump sum 30 days after separation from service before age 55; five annual installments on first anniversary of separation of service after age 55

Specified Time – Relaxation of Rule

- Payment treated as made on designated date if made by later of:
 - ◆ End of the calendar year containing the designated date, or
 - ◆ 15th day of third calendar month following the designated date
- Payment treated as made in designated year if made by
 - ◆ End of the calendar year

Acceptable Payment Delays

- Delay in Payment by Service Recipient
 - ◆ Deduction limited or eliminated under 162(m)
 - ◆ Payment would violate loan covenant/similar contractual requirement
 - Material harm requirement
 - ◆ Payment would violate securities law

- Must be provided in plan

Distribution Restrictions

Common current distribution rules that are NOT acceptable under 409A

- Qualified plan election governs payment of SERP benefit
 - ◆ Exception for distributions commencing prior to 2007
- Payment upon a termination of plan
 - ◆ Exception for certain permitted terminations

Limited Acceleration

- Election to accelerate date of payment generally not allowed UNLESS
 - ◆ Unforeseeable emergency
 - ◆ Domestic relations order
 - ◆ Federal conflicts of interest divestiture requirements
 - ◆ Payment of taxes (e.g., income tax upon vesting under a 457(f) plan)
 - ◆ De minimis (\$10,000) and specified amounts
- Acceleration okay if service provider is required to include amount in income because of 409A failure
- Acceleration okay upon permitted plan termination

Subsequent Changes in Time/Form of Payment

- Election must be made at least 12 months before a separately identified payment would otherwise be made or commence
- Must not take effect for 12 months
 - ◆ For payments at a specified time or pursuant to a fixed schedule
- Minimum five-year delay
 - ◆ Between date of payment under old election and new election
 - ◆ NOT required for payment dates tied to death, disability, unforeseeable emergency, domestic relations order, etc.

Subsequent Changes in Time/Form of Payment

- Each separately identified amount to which service provider is entitled is a “payment”
 - ◆ E.g., 50% of benefit paid as lump sum at separation from service, and 50% paid as lump sum at age 60 may be identified as two separate payments
- Installments may be treated as one payment or separate payments

Subsequent Changes in Time/Form of Payment

Example 1 – Change time of lump-sum distribution

Scheduled time of payment – age 55

Change election – must make on or before 54th birthday

New payment date – on or after 60th birthday

Example 2 – Change from lump sum to annuity

MUST ALSO DELAY TIME

Scheduled time of lump sum distribution
–age 55

Change election – must make on or before 54th birthday

Start of annuity payments – on or after 60th birthday

Subsequent Changes in Time/Form of Payment

Example 3 – *Multiple payment events*

- ◆ Payment as annuity at age 65, or if earlier, a lump sum payment upon separation from service
- ◆ Can change to annuity at age 70, or if earlier, a lump sum payment upon separation from service

Example 4 – *Addition of new payment events*

- ◆ Payment on January 1, 2010
- ◆ Cannot make deferral election to be paid on later of January 1, 2010, or separation from service
- ◆ Can make deferral election to be paid on later of January 1, 2015, or separation from service

Subsequent Changes in Time/Form of Payment

Example 5 – Installment Payments

- Original Schedule
 - ◆ 2011 Installment # 1
 - ◆ 2012 Installment # 2
 - ◆ 2013 Installment # 3
 - ◆ 2014 Installment # 4
 - ◆ 2015 Installment # 5
- If each installment is a separate payment
 - ◆ 2011 can be moved to 2016, but 2015 cannot
 - ◆ Cannot get lump sum until 2020
- If entire installment is one payment
 - ◆ Can get lump sum in 2016

Three Tax Effects of Noncompliance

- Deferred compensation (and earnings thereon) includable in income if:
 - (a) Not subject to a substantial risk of forfeiture, and
 - (b) Not previously included in income

- ◆ All amounts deferred under plan for current and all preceding taxable years (if not “grandfathered”)
 - “Similar” plans treated as one plan
 - Generally, each participant treated as covered by a separate plan

Three Tax Effects of Noncompliance

- Additional 20% tax
 - ◆ Applies to amounts included in income

- Interest
 - ◆ Underpayment rate + 1%
 - ◆ Applies to tax that would have been due at later of:
 - When first deferred, or
 - When first not subject to substantial risk of forfeiture

Tax Effects of Noncompliance

Example

- CEO elects to defer \$10,000 per year under Plan 1 from 2006-2015
- Deferrals are NOT subject to a substantial risk of forfeiture when made
- Payment of deferrals scheduled to be made in 2018
- CEO demands payment from Plan 1 in 2015
- Payment of full account (\$100,000 + \$15,000 earnings) paid on December 1, 2015 contrary to Plan 1 terms and 409A
- CEO also has \$200,000 account balance in another nonqualified deferred compensation plan – Plan 2
- No distribution made from Plan 2

Tax Effects of Noncompliance

Tax Effects

- \$315,000 includable in CEO's gross income for 2015
 $\$315,000 \times 36\% = \mathbf{\$113,400}$
- CEO responsible for 20% ADDITIONAL TAX on amount includable in income
 $\$315,000 \times 20\% = \mathbf{\$63,000}$
- CEO responsible for additional tax = interest
(at underpayment rate (assumed at 5% + 1%) = $\mathbf{\$23,328}$
Total tax = $\mathbf{\$199,728}$
Total distribution (before tax) = $\mathbf{\$115,000}$
(Although CEO may request distribution from Plan 2)

Reporting Requirements

- All deferrals (taxable or not) must be reported on Form 1099 or Form W-2
- Additional guidance to be issued for determining amount of deferrals made – e.g., under a SERP
- Need not report if aggregate amount of deferrals for employee \leq \$600
- Effective for amounts deferred in 2005 and later years

Withholding Requirements

- Employer must withhold on any amount includable in income under 409A
- Additional guidance to be issued on computing amount includable in income

Transition Rules

- Plan must be amended to conform to 409A by December 31, 2006
- Plan must be operated in good faith compliance during 2005 and 2006
- Payment elections
 - ◆ SERPs may be paid under qualified plan election until December 31, 2006
 - ◆ Subject to certain exceptions, new time & form of payment elections may be made through December 31, 2006

Transition Rules – Stock Options/SARs

- Substitution of non-discounted options/SARs for discounted options/SARs – December 31, 2006
- Exercise of such option/SAR in 2006 would result in violation of 409A

Transition Rules – No Extensions

- Deferral election for 2005 compensation – March 15, 2005
- Election to terminate participation/cancellation of deferrals – December 31, 2005
- Termination of grandfathered plans – December 31, 2005

What To Do Now

- Identify all plans that may be subject to 409A
- Act promptly on grandfathered plans you wish to terminate
- Permit participants to terminate deferral elections?
- Determine grandfathered amounts for existing plans
- Identify any modifications to grandfathered plans
- Obtain deferral elections for 2006 compensation
 - ◆ December 31, 2005
 - ◆ June 30, 2006 (performance-based); performance period ending 12/31/2006
- Permit time and form of payment elections?
- Amend continuing plans to conform to 409A
- Modify payroll systems to accommodate reporting and withholding requirements