Retaining Your Top Talent

The Law May Have Changed, But The Need Has Not

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THE CHALLENGES

- Recruiting and Retaining Top Talent
- Managing Expenses
- Maneuvering Through Current Tax Environment

THE BUZZ

Nonqualified Deferred Compensation: The Basics

NON-QUALIFIED

- **No need to meet the technical requirements of a qualified plan**
- **Does not trigger most ERISA requirements**

DEFERRED

- **Employee has a "legally binding right" to compensation that is payable in a future year**

COMPENSATION

- **Compensation forms to defer**
  - Salary
  - Commission
  - Bonus
  - Long-term incentives
  - Phantom stock
- **Not deferrable**
  - Stock options or stock appreciation rights

A PLAN

- **Establish for an individual or a large number of individuals**
- **Can be any written arrangement that provides for compensation deferral, such as:**
  - Employment agreement
  - Deferred compensation plan
  - Severance package/parachute arrangement

Unfunded Deferred Compensation Plan

TYPES OF PLANS

- **Deferred compensation plans**
- **Supplemental benefit plans**

FLEXIBLE STRUCTURE

- **Bookkeeping entries reflect deferred amounts**
- **New Timing Rules for deferral elections**
  - 409A—generally must be made in preceding year
    - » New participants may elect to defer within 30 days of eligibility
    - » "Performance-based compensation" is based on pre-established performance criteria determined over at least 12 months or more
      - o Participants may make deferral election up to six months before end of performance period

UNFUNDED

- **Life insurance or some other asset may be purchased by employer as an informal funding vehicle to offset cost of NQDC obligations**

TAX CONSEQUENCES

- **Executive**
  - Creation of plan causes no immediate tax liability
    - » Constructive Receipt Doctrine
      - Rev. Rul. 60-31, 1960-1 C.B. 174
      - IRC Section 451
    - » Economic Benefit Doctrine
      - Sproull v. Commissioner, 16 T.C. 244 (1951), aff'd 194 F.2d 541 (6th Cir. 1952)
      - IRC Section 83(a)
    - » FICA and FUTA
  - Deferred amounts are subject to federal income tax upon distribution

TAX CONSEQUENCES

- **Employer**
  - No deduction received until benefits are paid
  - FICA and FUTA

TOP HAT PLAN ERISA SECTION 201

- **Top Hat: "…maintained primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees."**

DEFINING “SELECT GROUP”

- **Belka - up to 4.6% of workforce covered by the plan (approx. 73 out of 1,600). Maryland district court concludes that it qualifies as a “top hat” plan**

- **Darden - covered 18.7% of the employees - 4th cir. Says it’s not a “top hat” plan (approx. 3,840 out of 20,500)**

DEFINING “SELECT GROUP”

- **DOL Advisory Opinion 85-37A–DOL concludes that plan covering 6.66% (50 out of 750) is not a top hat plan (emphasized wide range of positions and salaries)**

- **As a result, 5% was frequently used as a rule of thumb–no more than 5% of the workforce could be included without jeopardizing top hat plan status**

RELEVANT CASE LAW

- **Demery v. Extebank**
  Deferred Compensation Plan (B)
  216 F. 3rd 283
  - 15.34% of the workforce were eligible to participate (though only 7% to 10% deferred)
  - Court analyzed both “quantitative and qualitative factors”

QUANTITATIVE FACTORS

- **“Select Group Fraction” = the number eligible (whether or not they actually participate), divided by the total workforce**
- **Court stated, “[15.34%] is probably at or near the upper limit of the acceptable size for a ‘select group’ . . . ”**

QUALITATIVE FACTORS

- **Participants' ability to negotiate or influence the plan provisions**
- **Plan benefit quality**
- **Supplemental to existing plans**
- **Purpose of the plan**
  - Is the plan designed to retain valuable employees?
  - If so, that is a favorable factor in making the Top Hat determination

EXTEBANK ALSO HELPS DEFINE "PRIMARILY"

- **Interpretations of the word "primarily" can refer to:**
  - Type of benefits
  - Type of employees who can participate
  - Both

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EXTEBANK ON "PRIMARILY"

- **Extebank concludes that a plan can still be a top hat plan even if a very small number of participants (two or three) are neither highly compensated nor management employees**

- **This can allow an "executive assistant" or similar employee to be included in the plan**

Extebank on "Workforce"
Gallione V. Flaherty
70 F 3rd 724

Total of 68 management positions with only 22 allowed to participate

22/68 = 32.35%

For calculating percentage of workforce the Court of Appeals included Union members

12,000 Union Members
22/12,000 = approximately 0.2%

IMPLICATIONS OF EXTEBANK

- **New Plans - More employees can be eligible to participate**

- **Old Plans - More employees can be added**

- **New & Old Plans - A "very small number" of employees who are neither highly compensated nor management, can be included**

UNFUNDED TOP HAT PLAN

- **No regulations—not a DOL priority**
- **DOL advisory opinion 90-14A**
- **Exempt from certain ERISA provisions**
  - Participation
  - Vesting
  - Benefit accrual
  - Minimum funding
  - Fiduciary requirements and obligations

COMPLYING WITH IRC § 409A

- **American Jobs Creation Act of 2004**
  - Enacted October 22, 2004
- **IRS Notice 2005-1**
  - Published January 10, 2005
- **Proposed regulations**
  - Published September 29, 2005
- **Final regulations**
  - Published April 10, 2007
  - Fully effective January 1, 2009

409A DOES NOT APPLY TO THE FOLLOWING

- Qualified plans: e.g., 401(k), pension plans
- 457(b) plans: government and tax-exempt
- Restricted property (IRC § 83)
- At- or above-market stock options
- Bonuses payable within 2-1/2 months after year-end, other "short-term deferrals"
- Independent contractors: multiple, unrelated clients
- Bona fide vacation leave, sick leave, disability, or death benefit plans
- Pre-409A arrangements: "grandfathered" plans that are not materially modified after October 3, 2004

PENALTIES FOR FAILURE TO COMPLY WITH 409A

- Tax on all previous deferrals
- Interest on tax that would have been due in all prior years
- 20% penalty tax
- Proposed regulations relating to income inclusion Notice 2008-115

409A DISTRIBUTION REQUIREMENTS

- **Deferred compensation cannot be distributed before:**
  - Death
  - Disability
    - » Special definition must be used
  - Separation from service
    - » Special 6-month rule for "key employees" of publicly traded companies
  - Fixed time or payment schedule
    - » Must be specified at the date the election to defer is made
  - Change of ownership or control
    - » Special definition must be used
  - Occurrence of an unforeseeable emergency

409A PROHIBITION ON ACCELERATIONS

- **No accelerations are permitted unless certain exceptions are met:**
  - Limited cash out option if the entire deferred compensation balance is less than IRC Code Section 402(g)(1)(B)
    - For example, $17,000 for 2012
  - A plan may allow for an acceleration to a lump sum payment if, after installment payments have commenced, the remaining present value of the deferred compensation balance falls below a predetermined amount
    - This feature, including the predetermined amount, must be established no later than the time the payment election must be made and is subject to the subsequent change rules

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409A ELECTION RULES

- **Prior-year rule for regular compensation**
- **6-month rule for "performance-based compensation"**
- **Change in Time and Form of Payment (i.e., the subsequent change rule)**
  - Election cannot take effect until at least 12 months after the election is made;
  - For a specified time payment, election must be made at least 12 months prior to the first payment subject to the change; and
  - The first payment must be deferred for at least 5 years (except for payments relating to death, disability, and unforeseeable emergency)

409A GRANDFATHER RULE – MATERIAL MODIFICATIONS

- **Grandfathering: amounts deferred and vested prior to January 1, 2005**
- **Grandfathered plans are subject to 409A if materially modified: benefit is enhanced or a new benefit or right is added**
- **Participants may continue to make elections under terms of grandfathered plan**

409A GRANDFATHER RULE – MATERIAL MODIFICATIONS

- Grandfather protection is lost if a "benefit or right existing as of October 3, 2004, is enhanced or a new benefit or right is added"

- "It is not a material modification for [an employee] to exercise discretion over the time and manner of payment of benefits to the extent such discretion is provided under the terms of the plan as of October 3, 2004." IRS Notice 2005-1, Q&A #18(a)

REQUIREMENT FOR WRITTEN DOCUMENTS

- **Plans must be in writing and administered according to their terms and the requirements of IRC § 409A**
  - Conditions under which an initial deferral election can be made
  - Amount of compensation to be deferred
  - Time and form of payment
  - Provisions for modifying time and form of payments
  - Six-month delay of payments upon separation from service of certain "key" employees

ADVANTAGES OF LIFE INSURANCE

- **No income tax on "inside buildup"; i.e., cash surrender value increases**
- **Tax-free death benefit if certain conditions are met**

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COLI BEST PRACTICES

- **Pension Protection Act imposed consent and annual reporting requirements, based on "COLI Best Practices" IRC § 101(j)**
- **Generally, only HCE's may be covered by the policy**
- **Consent as to coverage and maximum face amount of policy**
- **Notice that coverage may be retained after termination of employment**
- **Annual IRS reporting: face amount, number of lives covered, total employees, compliance with notice and consent rules**

ADVANTAGES OF DEFERRED COMPENSATION PLANS (DCP)

- **Executive Perspective**
  - Current salary and/or bonus deferrals
    - » Reduce current federal and state taxable income
  - Supplement 401(k) retirement savings
  - Ability to have performance—based employer contributions subject to vesting
  - In-service access to account for planned or unplanned events without penalty
    - » Child college expenses (planned)
    - » Medical emergencies (unplanned)
  - Personalized retirement goals
  - Greater planning flexibility: short- and long-term goals
  - Estate planning tool: supplemental survivor benefits available

ADVANTAGES OF DEFERRED COMPENSATION PLANS (DCP) (CONT.)

- **Employer Perspective**
  - Recruit, reward, retain
  - Can provide additional benefits for selected groups within the plan
  - Proper funding strategies can have positive effects on the P&L
  - Stay competitive: 93% of Fortune 1000* have DCPs
  - Enhances employee benefit program
  - Golden handcuffs: provide a benefit plan that meets or exceeds executive needs
  - A properly designed program gives the company a cost-efficient result

SAMPLE OF "BEST PRACTICE" DEFERRED COMPENSATION PLAN DESIGN

Plan Feature and Provision	Explanation of Options
Purpose	• Attract, retain and reward key management employees • Supplement participant 401(k) contributions to encourage savings for retirement • Provide a vehicle for highly compensated executives to receive their total 401(k) contributions and lost 401(k) match
Eligibility	• Participation is a select group of employees determined by the Board or management

SAMPLE OF "BEST PRACTICE" DEFERRED COMPENSATION PLAN DESIGN (CONT.)

Plan Feature and Provision	Explanation of Options
Deferral Amounts	• Participants may defer base compensation and/or bonus • Company may contribute a discretionary match
Vesting	• Participants are 100% vested in their deferrals • A vesting schedule may apply for matching or discretionary employer contributions

SAMPLE OF "BEST PRACTICE" DEFERRED COMPENSATION PLAN DESIGN (CONT.)

Plan Feature and Provision	Explanation of Options
Retirement Benefits	Separation from Service after age 65 • Payment options: lump sum or payout over 5, 10, or 15 years; options may be changed subject to the 409A subsequent change rules • Balance of deferral account, not distributed at separation from service, continues to grow tax-deferred while payment stream continues
Informal Funding	• Informal funding can be structured to offset most of Company costs • Based on reasonable assumptions, Plan could have minimal financial effect; may be cost neutral

EXECUTIVE'S RISKS

- **Change of control**
- **Cash flow**
- **Bankruptcy**

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TAX CONSEQUENCES - EXECUTIVE

If properly structured:

- **Constructive receipt doctrine does not apply**
- **Economic benefit doctrine does not apply**

409A does not prohibit the use of a United States Rabbi Trust

TAX CONSEQUENCES – EMPLOYEE

- No deduction for trust contribution
- Treated as owner of trust
- Grantor trust rules

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BASIC RABBI TRUST

- First discussed in letter ruling 8113107
- Protect future benefits

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BASIC RABBI TRUST

- **Trust requirements include:**
  - Generally irrevocable
  - For the benefit of certain participants
  - Generally Trustee pays benefits when due
  - Plan participant or beneficiary has no interest in trust assets
  - Plan participant or beneficiary is an unsecured creditor
  - Trustee must be notified of insolvency
  - Trustee must hold assets for general creditors
  - Trustee must deliver assets to satisfy creditor claims

BASIC RABBI TRUST

- Avoids current taxation, if properly structured
- Addresses change of control and cash flow risks
- Does not resolve bankruptcy/insolvency risk

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FUNDING RESTRICTIONS

- **Pension Protection Act amended IRC § 409A to impose tax on "covered employees" if assets are set aside while tax-qualified pension plans remain "at-risk"**
- **Apparently, the rule applies only to public company covered employees**
  - Reference to IRC § 162(m)
- **"At-risk" apparently means bankruptcy/ insolvency in 2007**
- **"At-risk" in 2008 and beyond includes underfunded plans**
  - 65% funded for 2008, increasing in subsequent years

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FUNDING RESTRICTIONS

- **Assets set aside in rabbi trust, or otherwise set aside for "covered employees" while pension plan is "at risk" likely result in IRC § 409A violation**
- **Apparently, set asides could continue for executives who are not "covered employees" under IRC § 162(m)**

SECULAR TRUST

- **Irrevocable trust**
- **Benefits vested**
- **Taxable event**
- **Currently deductible**
- **Letter ruling 8841023**
- **Is it an employer grantor trust?**
  - IRC section 402 (b)(2)

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SECULAR TRUST (CONT.)

- **Grantor trust status: employer**
  - IRS letter rulings: 9206009, 9207010, 9212019, and 9212024
- **Distribution from trust taxed as an annuity**
  - IRS letter rulings 9212019 and 9212024
- **IRS has reversed its position on the application of IRC section 72**
  - IRS letter ruling 9417013

COMPARISON OF RABBI TRUST AND SECULAR TRUST

1. **Forfeit ability**
   - Rabbi: yes
   - Secular: no
2. **Availability to executive**
   - Rabbi: benefits paid under terms of plan
   - Secular: at expiration of deferral

COMPARISON OF TRUSTS (CONT.)

3. **Requirement to fund**
   - Rabbi: generally no; company may be required to fund at triggering event, such as change in control, under terms of trust
   - Secular: may be funded at inception
4. **Employer control over funds**
   - Rabbi: depends on trust terms
   - Secular: depends upon trust terms

COMPARISON OF TRUSTS (CONT.)

5. **Creditor protection**
   - Rabbi: protected, except for bankruptcy/ insolvency
   - Secular: protected at all times
6. **Contributions to trust currently taxable to executive**
   - Rabbi: no
   - Secular: yes

COMPARISON OF TRUSTS (CONT.)

7. **Contributions to trust deductible to employer**
   - Rabbi: no
   - Secular: yes
8. **Taxable to executive at distribution**
   - Rabbi: yes
   - Secular: no; the executive already paid tax at time of contributions

COMPARISON OF TRUSTS (CONT.)

9. **Employer deduction at distribution**
   - Rabbi: yes
   - Secular: no; employer received deduction when first contributed to trust
10. **ERISA requirements**
    - Rabbi: generally exempt from most requirements
    - Secular: exempt from most requirements if it is an employee-created plan

COMPARISON OF TRUSTS (CONT.)

11. **Golden handcuffs**
    - Rabbi: yes
    - Secular: yes, but more palatable because funds are secure

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GRANTOR TRUST STATUS - EMPLOYEE

- **Recontribution to trust by an employee creates an employee grantor trust**
- **Crummey style power - "MIKE" PowerSM - IRC section 678 power should be released**
  - IRS letter ruling 9316008 - employee demand right
  - IRS letter ruling 9316018 - 30-day withdrawal right
    service mark of Michael G. Goldstein, 1994

MOGLIA RABBI TRUSTS

- **Origin. Bank of America v. Moglia, 330 F.3rd 942 (7th Cir. June 2, 2003), aff'g 278 B.R. 778 (N.D. Ill. 2002), aff'g 2002 WL 571661 (Bank. N.D. Ill.)**
  - Potential Implication. Assets in a Rabbi Trust can be sheltered from the claims of **secured** creditors

DESIGNING A MOGLIA TRUST

- **Timing. Assets must be contributed before the security agreement is granted (or security agreement could expressly exclude assets in Rabbi Trust)**
  - Language in a Moglia Rabbi Trust. Documents should prohibit the company from creating a security interest in the Rabbi Trust assets in favor of "**any creditor**"
  - Choice of Law. 7th Circuit includes Illinois, Indiana, and Wisconsin

MOGLIA CHOICE OF LAW ISSUE

- **State law specified in the Rabbi Trust**
  - State law specified in the Security Agreement
  - Location of the trustee (in Moglia, the trustee was Northern Trust)
  - Location and state of incorporation of the company

ADVANTAGES OF DEFERRED COMPENSATION PLANS (DCP)

Executive Perspective

- **Current salary and/or bonus deferrals**
  - Reduce current federal and state taxable income
- **Supplement 401(k) retirement savings via Excess Plan**
- **Ability to have performance based employer contributions subject to vesting**
- **Tax deferred capital accumulation**

ADVANTAGES OF DEFERRED COMPENSATION PLANS (DCP)

Executive Perspective

- **In service access to account for planned or unplanned events without penalty**
  - Child college expenses (planned)
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- **Personalized retirement goals**
- **Greater planning flexibility–short and long term goals**
- **Estate planning tool–supplemental survivor benefits available**

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IN-SERVICE ACCOUNT EXAMPLE

Annual Deferral Allocations

20%	20%	10%	50%
1	2	3	4
	College	Boat	Retire
Payout 2012	Payout 2014 Payments 4	Payout 2016 Payments 1	Retirement Payments 10
	Moderate Portfolio	Moderate-Aggressive Portfolio	Aggressive Portfolio

ADVANTAGES OF DEFERRED COMPENSATION PLANS (DCP)

Hypothetical Tax Investment (HTI)	Corporate Owned Life Insurance
Taxable Returns	Tax Deferred Returns
• **Familiar vehicle** • **Funds similar to 401(k) plan or may be enhanced by additional funds** • **Benefit of simplicity** • **The Company pays taxes on earnings** • **Cost of money on taxes adversely affects P&L** • **Adverse accounting treatment (per SFAS 115)**	• **Investment funds similar to those available in 401(k)** • **Requires some understanding of the funding vehicle** • **The Company pays insurance expense but defers tax** • **Reduces plan costs plan costs** • **Favorable accounting treatment**

COMPARISON OF AFTER TAX BENEFITS