

Non-qualified deferred compensation
programs
What needs to be done to comply with
IRC 409A

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Today's discussion

- ▶ Background
- ▶ Section 409A—what does it impact, who does it harm
- ▶ What needs to be done and when

Background

- ▶ The evolution of deferred compensation programs
 - Constructive receipt
 - Economic benefit

- ▶ What were the perceived abuses?
 - Employees had too much discretion over distribution timing
 - Haircuts made it a sham
 - A tax planning tool for the privileged

- ▶ Equity is also a problem—is this merely a tool for the higher ups?

- ▶ Section 409A was the biggest change in this area in over 20 years

Section 409A—what is it's status

- ▶ Enacted as part of the American Jobs Creation Act of 2004, Section 409A imposes significant restrictions on a variety of compensation programs.
- ▶ Applies to all deferred compensation arrangements which are earned or vested after December 31, 2004.
- ▶ The IRS issued final regulations which are effective January 1, 2008, although there is some limited transition relief.
- ▶ It appears that a voluntary corrections program will be offered

Overview of Section 409A

- ▶ Provides general rules for the timing of deferral elections and payments relating to nonqualified deferred compensation programs (NQDC)
- ▶ Violation of the rules impact both the recipient and the employer.
 - Penalties on the recipient:
 - Taxation at vesting, as opposed to receipt
 - 20% additional income tax
 - Potential interest at the underpayment rate increased by 1%
 - Penalty on the employer—penalty for failure to withhold at the time of vesting
- ▶ If one NQDC program for a particular employee is found to violate Section 409A, all programs of that type for that employee will violate Section 409A
 - Grandfathering can exempt some programs, but this must already have occurred

What types of programs are subject to Section 409A?

- ▶ Equity related programs
 - Discounted stock options
 - SARs
 - Restricted Stock Units
 - Any equity program with additional deferral provisions

- ▶ Elective deferral plans (mirror 401k)

- ▶ SERPs and other post-retirement compensation arrangements

- ▶ Severance and change in control programs

- ▶ Long term incentive programs

- ▶ Certain types of split dollar plans

What types of programs are not subject to Section 409A?

- ▶ Short term deferral programs—programs that do not provide for deferred payments and makes the payment within 2 ½ months of the end of the calendar year, or if later, the end of the employer’s tax year, when the right to payment is no longer subject to a substantial risk of forfeiture
 - Issues can arise relating to retirement payments that would appear to meet this rule but in actuality do not

- ▶ Equity based vehicles—but we need to be concerned about valuation issues (particularly for privately held companies) and the impact of modifications
 - Fair market value stock options—includes ISOs
 - Premium stock options
 - Restricted stock

What types of programs are not subject to Section 409A (continued)?

- ▶ Tax qualified retirement plans
- ▶ Certain types of separation pay
 - Must be due to an ‘involuntary separation from service’—this includes voluntary separation for ‘good reason’, as defined in the regulations
 - Must be made by the end of the second year following the separation from service
 - Can not exceed twice the Section 401(a)(17) limit (\$450,000 in total, as of now)—if the only violation is this subsection, only amounts over the limit are treated as NQDC
- ▶ Certain types of reimbursement or fringe benefit programs
- ▶ Certain foreign pay programs
- ▶ Grandfathered programs

What makes a program subject to Section 409A?

- ▶ It must be a program that provides for the deferral of compensation. Key elements:
 - A service provider (does not have to be an employee) has a ‘legally binding right’ during a tax year
 - To compensation that may be payable in a later year.

- ▶ A ‘legally binding right’ is very broad, and includes —
 - A right to severance if involuntarily terminated
 - Non-compete agreements
 - Commissions/bonus based on the employer selling a certain piece of property

- ▶ The program must be written and must contain:
 - The amount to be paid, or if it is subject to a non-discretionary objective formula, the terms of the formula
 - Payment schedule or events that trigger payment
 - How the payments will be made

- ▶ “Savings” clauses will not work

Section 409A deferral elections

- ▶ A deferral must be made by the end of the calendar year before the year in which the services are rendered
 - If performance based compensation is to be deferred, the election can be made no later than six months before the end of the performance period

- ▶ A deferral can be extended, if the extension is made at least 12 months before the payment is to be made and the extension is for a period of at least 5 years

- ▶ The deferral must provide the time that the payment will be made, how the payment will be made, and the amount (or formula) of the payment

Appropriate payment events

- ▶ Separation from service
- ▶ Death
- ▶ Disability
- ▶ A fixed date or schedule as indicated in the plan
- ▶ Change in control
- ▶ Unforeseeable emergency

Special rules for special people

- ▶ For certain classes of employees, payment of any type cannot be made until six months have elapsed after separation from service
- ▶ Known as “specified employees”, these people are key employees of any publicly traded corporation
 - Key employee definition is the same as the ‘top heavy’ regulations under IRC 416
- ▶ What are the practical implications of this policy?

Can programs accelerate benefits and avoid Section 409A?

- ▶ Generally, acceleration of payments is prohibited
- ▶ Certain exceptions exist:
 - Conformance with a domestic relations order, in certain cases, primarily to pay taxes (employment and withholding) on the deferred amount—but not the amount itself
 - Plan termination, if needed to avoid certain ethics or conflict of interest rules
 - Change in control, if plans terminate and distribution is made within a specified time frame
 - Corporate dissolution or bankruptcy
- ▶ Vesting can be accelerated without impacting Section 409A status, but the payment date cannot be moved.

What should we be doing before year end?

- ▶ All programs must be in full operational compliance with the regulations on January 1, 2008. The prior ability to rely on a 'good faith' interpretation and application of the regulations expires on December 31, 2007. As a result, employers must now make sure that their programs are in compliance.

- ▶ Determine (and document) which employer programs will be impacted by Section 409A. Programs which should be reviewed include:
 - Employment agreements/offer letters
 - Change in control programs
 - Severance programs
 - Long term incentive plans
 - Equity programs
 - Non-qualified deferral or retirement programs split dollar programs
 - Post-retirement consulting arrangements

- ▶ Determine 'specified employees' if you are a publicly traded company

What should we be doing before year end (continued)?

- ▶ Determine if any programs are ‘grandfathered’ and exempt from these rules—chances are they won’t be unless action was taken over the last two years
- ▶ Determine if any programs are not written; non-written programs, if discovered by the IRS, will automatically be subject to 409A’s penalties
- ▶ Review the terms of each program for Section 409A compliance, focusing on:
 - When can an election to defer be made
 - Distribution timing and participant’s power to impact the timing
 - Acceleration issues

What should we be doing before year end (continued)?

- ▶ Aggregate programs by type and participant to assess compliance issues, remembering that a failing program will taint all similar programs in respect to a particular participant.
- ▶ Amend plans to comply with Section 409A; if plans cannot be amended, consider termination
 - Some of the amendments could require participants to make new payment elections
 - Most amendments will involve specific times and form of payment
 - Plans involving or which could involve 'specified employees' will need special attention
- ▶ Document the steps that you have taken in the event of an IRS audit; the IRS has indicated that 409A compliance will be on their audit programs.

Very limited transition relief

- ▶ Recall that the final regulations are effective January 1, 2008, and that the rules were effective for compensation deferred after December 31, 2004.
- ▶ The IRS has said that plans could operate under a 'good faith' interpretation of the regulations until December 31, 2007, but after that date, full operational compliance with the regulations is required
- ▶ Transition relief in IRS Notice 2007-78 allows for final written amendment to documents by December 31, 2008, but all payment elections must be in compliance with the rules by December 31, 2007
 - Payment elections which must be in compliance include not only future deferrals, but past deferral amounts

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Today's speaker

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Ted Ginsburg, a principal and founder of Remedy, focuses on executive compensation consulting for both publicly traded and privately held employers, and specializes in employment agreements, non-qualified deferred compensation plans, SEC filings, equity based arrangements, golden parachute design and valuation, and due diligence issues arising from mergers and acquisitions. Prior to founding Remedy, Ted has served as a consulting principal for Top Five Data Services, Inc., a principal and national executive compensation practice leader for Buck Consultants (an ACS Company), co-national practice leader of employee benefit consulting with Grant Thornton LLP, an employee benefits tax partner with KPMG, as well as a partner and employee benefits practice head of Laner Muchin et. al., (a boutique labor law firm) and of counsel with Mayer Brown & Platt (now Mayer Brown Rose and Maw). Ted is an active public speaker and has published articles in such periodicals as MX Magazine and the Tax Advisor. He is an attorney (licensed in Missouri and Illinois) as well as a Certified Public Accountant (licensed in Missouri, Texas and Ohio), and holds AB, MBA and JD degrees from Washington University in St. Louis, Missouri.