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webinar

Executive Compensation Basics | A Webinar Series

Anatomy of a Deferred Compensation Plan

Webinar 3 of 4

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Anatomy of a Deferred Compensation Plan

- Overview of Section 409A
- Structuring Deferred Compensation to Satisfy Exclusions from Section 409A
- Documentary Requirements Under Section 409A
- Initial Deferral Election Rules Under Section 409A
- Permitted Distribution Events Under Section 409A
- Permitted Subsequent Deferrals and Acceleration of Distributions Under Section 409A
- Correcting Plan Errors Under Section 409A

Section 409A – Overview

- Broad applicability – starting point is any legally binding right to taxable compensation in a future year.
- Includes:
 - Traditional deferred compensation and nonqualified retirement benefits;
 - Severance pay, generally provided under employment, severance, or change in control agreements; and
 - Equity-based compensation, such as restricted stock units or phantom shares that vest in one year and pay in a later year.

Section 409A – Overview

- Section 409A of the Internal Revenue Code imposes strict timing rules for deferral elections and distributions.
- Section 409A applies to amounts “deferred” after 2004; amounts are generally “grandfathered” if vested on 12/31/04.
- Noncompliance triggers income inclusion of all amounts deferred under plans of the same type; included amounts are subject to a 20% additional tax, plus an additional “interest tax.”
- Employer could be assessed penalties for failure to properly report, withhold, and remit (with related interest).

Important Exclusions Under 409A

- Short-term deferrals
- Involuntary separation pay
- Non-taxable benefits
- COBRA health benefits
- Certain outplacement benefits
- Moving expenses and loss on sale of primary residence
- 402(g) limit “catch-all”

Exclusions from 409A

- Statutory exclusions for qualified retirement plans and bona fide vacation, sick, and compensatory time arrangements as well as disability and death benefit plans.
- Relatively broad exclusions apply for certain non-discounted stock rights, short-term deferrals, and limited involuntary separation pay amounts.

Exclusion for Short-Term Deferrals

- Amounts that are paid shortly after vesting are not subject to Section 409A – sometimes called the “vest and pay” exception.
- Important exceptions for bonus, phantom equity, and long-term incentive plans.
- A deferral of compensation does not occur if, absent an election to otherwise defer the payment to a later period, (i) the terms of the plan require payment by, and (ii) an amount is actually or constructively received by the service provider by, the later of the date that is 2½ months from the end of the taxable year of the service provider or of the service recipient.

Exclusion for Short-Term Deferrals

- Late payment of such an amount is an automatic violation of Section 409A if plan does not provide a fixed date/year by which payments are to be made.
- Accordingly, timely payment is critical.
- Exclusion does not apply if amount is further deferred.
- Availability of election to defer does not disqualify eligibility from exclusion if no election to defer is made.

Exclusion for Short-Term Deferrals

- Generally, if one payment in a stream of payments is deferred compensation all payments are deferred compensation.
- However, if payments are designated as separate payments, some may qualify as short-term deferrals while later payments are deferred compensation.
- Payments that may be made later than 2½ month window (e.g., payments due upon separation from service or discounted option exercise) are deferred compensation even if ultimately paid during the window.

Exclusion for Involuntary Separation Pay

- Involuntary separation and window programs, and certain good reason separations, up to a limit:
 - 2x pay, capped at the 401(a)(17) limit; and
 - Paid within 2 years from year of separation.
- Certain expense reimbursements and in-kind benefits, so long as paid during above 2 year period.
- *De minimis* amounts up to \$17,500 (indexed).
- Short-term deferral amounts (you can “stack” the exceptions).

Involuntary Termination

- Both the short-term deferral exception and the involuntary separation pay exception require involuntary termination of employment.
- “Good reason” may be treated as involuntary separation.
- The good reason condition must require actions taken by the employer resulting in a material negative change in the employment relationship.

Involuntary Termination

- The amount, time, and form of payment upon a good-reason separation must be identical to the amount, time, and form of payment upon an involuntary termination.
- Employee must give notice, and the employer must have the right to cure during a cure period.
- Separation must occur within a specified period following the good reason event.

Involuntary Termination

- An agreement or plan generally will not meet the short-term deferral or involuntary separation pay exceptions if severance pay can be paid for other reasons, even if the termination is actually an involuntary termination.
 - The existence of a “walk right” provision may cause the entire severance agreement to be subject to Section 409A.

Documentary Requirements Under 409A

- The deferred compensation arrangement must be in writing.
- The arrangement may be in more than one document.
- The arrangement must set forth requirements regarding:
 - Amount to be paid or formula for calculating payment,
 - Time and form of payment, and
 - Election requirements.
 - *Both initial and re-deferral.*

Documentary Requirements Under 409A

- Document need not:
 - Contain provisions regarding accelerated payments otherwise permitted by the regulations.
 - A Section 409A savings clause probably should be included, but may not “save” you.
- Plan must contain all required terms and may not contain impermissible terms, regardless of a savings clause.

Initial Deferral Election Rules

- Initial Deferral Elections: General rule is that elections must be made before the end of the tax year preceding the year services are performed to which the compensation relates.
- Affected elections include choices as to both the time and the form of the payment and choices by the service provider or the service recipient.
- Elections for fiscal year-based compensation may be made by the last day of the prior fiscal year.

Initial Deferral Election Rules

- **First Year of Eligibility:** In the first year in which an individual becomes eligible to participate in a plan, the individual may make an initial deferral election within 30 days after the date he or she becomes eligible to participate in the plan (determined on an aggregated basis), with respect to compensation paid for services to be performed after the election.

Initial Deferral Election Rules

- A service provider can make a deferral election with respect to compensation subject to a substantial risk of forfeiture up to 30 days after the grant if the service provider is required to perform services for at least 12 months after the date of an election.
- To be used, deferral terms must be in the document and be Section 409A compliant.

Initial Deferral Election Rules

- In addition to elections under the general rule, short-term deferral amounts may be elected for deferral using:
 - One-year advance election from date of vesting with a minimum 5-year deferral (similar to the subsequent deferral rule)

Deferral Elections for Performance-Based Compensation

- In the case of “performance-based compensation,” a participant’s initial deferral election may be made up to the date that is six months before the end of the period (which must be at least 12 months), provided that the amount of compensation is not reasonably ascertainable at the time of election.
- “Performance-based compensation” is compensation the amount of or entitlement to which is contingent on the satisfaction of organizational or individual performance criteria relating to a performance period of at least 12 months; criteria generally must be established in writing no later than 90 days after the beginning of the performance period and may include subjective factors.

Permitted Distribution Events

- Distributions are only permitted on:
 - Fixed schedule or date
 - Separation from service
 - Death
 - Disability
 - Unforeseeable emergency
 - Change in control of a corporation (or partnership, pending future guidance)

Permitted Distribution Events

- Use Section 409A compliant definitions, as applicable (e.g., disability, change in control, unforeseeable emergency).
- Must elect the time and form of payment at the same time as the election to defer.
- Ability to renegotiate payment timing is VERY restricted.

Distributions on a Fixed Date or Fixed Schedule

- Plans may specify the calendar year or years in which the payments will be made, without specifying the date.
- Fixed date or schedule may be triggered by an event that is subject to a substantial risk of forfeiture where the date of the event is unknown.
 - E.g., payment due on attainment of performance goal will be paid in five annual installments beginning in the year following the change of control.
- Any election as to timing of payment is subject to the same timing rules applicable to deferral elections

Distributions on Separation from Service

- “Separation from Service” generally means the participant has a termination of employment with the company or service level has been reduced by at least 80% on a permanent basis.
- Regulations permit election in asset sale to treat transferred employees as separated or not – consistency required across affected service provider population.
- Impacts when 6-month delay starts to run.
- Can be difficult to determine if separation is not complete.

Distributions on Separation from Service

- An employee is presumed to have incurred a Separation from Service where the level of services decreases to a level equal to 20% or less of the average level of services performed by the employee during immediately preceding 36-month period.
- An employee is presumed not to have incurred a Separation from Service where the level of bona fide services performed continues at a level that is 50% or more of the average level of service during the immediately preceding 36-month period.

Toggle Issues

- Arrangement generally must provide for a single time and form of payment for each payment event.
- Arrangement cannot provide multiple payment forms for payment upon separation from service (e.g., lump sum if involuntary termination, installment payments if voluntary termination).
- Exceptions: Arrangement can provide for different forms of payment upon separation from service if:
 - Within 2 years after a 409A-compliant change in control.
 - Following specified age or service, or age and service.
 - Prior to, or following, a single fixed date.

Delay in Distributions for Key Employees

- Payments due to Separation from Service to a key employee of a publicly traded employer must be delayed at least six months following the Separation from Service.
 - Applies to payments under deferred compensation and other nonqualified plans, but also to severance treated as deferred compensation.
 - Key employee is defined under Code Section 416(i).
 - Section 409A regulations provide detailed rules for identifying affected employees, called “specified employees.”

Delay in Distributions for Key Employees

- Identification of key employees is based on the 12-month period ending on December 31 (or another identification date chosen by the corporation).
- List of identified employees generally becomes effective on the next following April 1, unless otherwise specified.

Subsequent Deferral Elections

- A participant may elect to change the time or form of a payment (a “subsequent deferral election”) only if:
 - The plan requires that such election not take effect until at least 12 months after the date on which the subsequent deferral election is made, and
 - In the case of an election related to a payment other than on account of disability, death, or unforeseeable emergency, the plan requires that the payment with respect to which the subsequent election is made be deferred for a period of not less than five years from the date such payment otherwise would have been paid.

Subsequent Deferral Elections

- The regulations generally treat the entitlement to a series of installment payments or an annuity under a particular arrangement as a single payment for purposes of the subsequent deferral rules.
- However, the regulations provide that a plan may specify that a series of installment payments is to be treated as a series of separate payments.

Acceleration of Distributions

- Plans generally cannot permit the acceleration of payments except under limited circumstances including:
 - If necessary to fulfill a domestic relations order;
 - As necessary to comply with certain conflict of interest rules;
 - To pay certain income taxes;
 - Certain payments of less than \$17,500; and
 - Payment of employment taxes imposed on unpaid deferred compensation under Code Sec. 3121(v).
- Section 409A prohibits “haircut” provisions and “Financial Health Triggers.”

Annuities

A change from one type of life annuity to another type of life annuity with the same scheduled date for the first annuity payment, or a change in the designated beneficiary, is not considered a change in the time and form of a payment, provided that the annuities are actuarially equivalent applying reasonable actuarial methods and assumptions. For this purpose, certain leveling, guaranteed term, or cash refund features are permissible.

Correction of Document Failures

IRS Notice 2010-6

- Provides the opportunity to correct certain documentary failures
- Types of plan document errors eligible for correction include:
 - Ambiguous payment terms
 - Impermissible payout triggers and payout schedules
 - Violations of deferral election rules
 - Certain impermissible discretion to delay payments
 - Certain impermissible discretion to accelerate payments

Correction of Document Failures

IRS Notice 2010-6

- The particular plan document error must be described in the Notice to be eligible for correction.
- Each specified error has its own particular correction methodology.
- Wide range of categories of errors, correction methods, and severity of consequences.
- Adverse tax consequences may be triggered, even after correction, depending upon the timing of subsequent events.
- Generally must file notices of correction to the IRS with both the individual and the corporate tax returns.

Correction of Operational Failures

IRS Notice 2008-113

- Limited opportunity to correct specified operational failures.
- Does not expressly address “form” or documentary failures.
- Availability and method of correction are generally based on the nature of the error and the proximity of the correction to the error (same year, next year, end of 2nd year).
- Availability of correction or terms of correction may be limited if affected service provider is an “insider” (i.e., directors and senior management, determined under Securities Exchange Act rules without regard to whether the company is public).



Questions?

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