Designing a Non-Qualified Deferred Compensation Plan: The Basics

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Executive Compensation Webinar Series
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Housekeeping: About Anthony "Tony" Eppert

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- Tony practices in the areas of executive compensation and employee benefits

- Before entering private practice, Tony:
  - Served as a judicial clerk to the Hon. Richard F. Suhrheinrich of the United States Court of Appeals for the Sixth Circuit
  - Obtained his LL.M. (Taxation) from New York University
  - Obtained his J.D. (Tax Concentration) from Michigan State University College of Law
    - Editor-in-Chief, Journal of Medicine and Law
    - President, Tax and Estate Planning Society

Our Compensation Practice – What Sets Us Apart

- Compensation issues are complex, especially for publicly-traded companies, and involve substantive areas of:
  - Tax,
  - Securities,
  - Accounting,
  - Governance,
  - Surveys, and
  - Human resources

- Historically, compensation issues were addressed using multiple service providers, including:
  - Tax lawyers,
  - Securities/corporate lawyers,
  - Labor & employment lawyers,
  - Accountants, and
  - Survey consultants

Our Compensation Practice – What Sets Us Apart (cont.)

- The members of our Compensation Practice Group are multi-disciplinary within the various substantive areas of compensation. As multi-disciplinary practitioners, we take a holistic and full-service approach to compensation matters that considers all substantive areas of compensation

Housekeeping: Upcoming 2017 Webinars

- Upcoming 2017 webinars:
  - Navigating Employee v. Independent Contractor Classifications (11/9/2017)
  - Sharing the Dream: M&A Transactions & Retaining Key Employees (12/14/2017)

- Upcoming 2018 webinars
  - Compensation: ISS Concerns & Mandates (Annual Program) (1/11/2018)
  - Energy Companies: Compensation Governance Survey/Trends (2/8/2018)
  - How to Structure Management Carve-Out and Change-in-Control Plans (3/8/2018)
  - Effective Compensation Governance – The A-Z Course (4/12/2018)
  - Accounting Considerations that Impact Equity Compensation Design (5/10/2018)
  - Training Course on Forms 3, 4 and 5 (6/14/2018)
  - Pay Ratio: Developments from Last Proxy Season (7/12/2018)
  - Preparing for Proxy Season: Start Now (Annual Program) (8/9/2018)
  - Planning for an IPO: Compensation Considerations (Phase I of II) (9/13/2018)
  - Compensation Changes Due to Loss of EGC Status (Phase II of II) (10/11/2018)
  - Taxation of Equity Awards: The 101 Training Course (11/8/2018)
  - How to Negotiate Executive Employment Contracts (12/13/2018)

Purpose of this Presentation

- The purpose of this presentation is to discuss the design of a non-qualified deferred compensation plan

- To that end, this presentation covers:
  - What is it,
  - Types of deferred compensation plans,
  - General tax treatment,
  - Application of Section 409A,
  - Securing the benefit,
  - Design considerations,
  - Form 4 considerations, and
  - Possible application to stock ownership policies

- Please note that this presentation is intended to be only an introduction to deferred compensation plans/arrangements and is discussed at a entry level

What Is It?

- In the employment context, a non-qualified deferred compensation plan is an unfunded and unsecured promise by the employer to pay future benefits

- Generally, the deferred benefits are subject to the claims of the employer's general creditors
  - Thus, it is the employee that is burdened with this risk of loss if the employer were to liquidate or claim bankruptcy

- A possible attribute to offset the above risk of loss is that these non-qualified deferred compensation offer design flexibility not otherwise available under qualified retirement plans due to, for example:
  - Non-discrimination testing,
  - Benefit limitations

- Additional attributes of mon-qualified deferred compensation plans include:
  - A deferral of current taxes to a future date (hopefully when the employee is in a lower tax bracket), and
  - The ability for the employee to build wealth beyond what would otherwise been available to him/her under qualified retirement plan rules

Types of Deferred Compensation Plans

- There are a variety of deferred compensation plans and arrangements, including:
  - Certain employment agreements are deemed to be deferred compensation under Section 409A;
  - Salary continuation arrangements;
  - Traditional non-qualified deferred compensation arrangements;
  - Salary reductions and bonus deferrals;
  - In-the-money stock option grants, or stock options that are "modified" after the date of grant while they are in-the-money;
  - Phantom equity plans (including RSUs) that defer payout until some date after vesting;
  - Supplemental executive retirement plans (*a.k.a.*, SERPs);
  - Excess benefit plans; and
  - Tandem 401(k) plans

- The following slides focus on traditional non-qualified deferred compensation arrangements

General Tax Treatment

- As a general rule:
  - FICA taxes and the additional Medicare tax under the Affordable Care Act are triggered when the deferred compensation becomes vested and without regard to whether such deferred compensation is distributed (*a.k.*a., the "special timing rule")
  - Ordinary taxable income is recognized by the employee at the time the monies are distributed to him/her, and wage withholding applies at such time
  - The employer is generally entitled to a compensatory deduction at the time the employee recognizes the income

- FICA taxes and the special timing rule
  - Generally, the FICA tax rate equals 6.2% (Old-Age, Survivor and Disability Insurance), plus 1.45% (Hospital Insurance), plus 0.9% (Affordable Care Act) for wages exceeding certain levels
  - FICA taxes are triggered at vesting
  - Whether deferred compensation has vested is determined in accordance with Section 83 and the rules governing whether a "substantial risk of forfeiture" exists
  - Deferred amounts that were previously taken into account for FICA purposes, plus any income attributable to such deferred amounts, are not later treated as wages (*a.k.a*., the "non-duplication rule") for FICA purposes
  - Thus, FICA taxes should not apply to earnings on deferred amounts that were previously taxed under the FICA rules

Application of Section 409A

- Absent an applicable exception (*e.g.*, short-term deferral rule), compliance with Section 409A is generally required in order to avoid an earlier inclusion in gross income and a 20% excise tax

- Generally, compliance with Section 409A means that distributions could only occur upon the earlier of certain events that are stated in the document or chosen by the employee. The payout events that are permitted by Section 409A include:
  - A specified time or pursuant to a fixed schedule,
  - A separation from service,
  - A change in ownership or control of the service recipient,
  - The disability of the participant,
  - Death of the participant,
  - An unforeseeable emergency, and
  - Lapse of a substantial risk of forfeiture

- Once the timing of the payout is chosen by the employee (or by the employer if no election is offered to the employee), a change in the timing of the payout can only occur if such change complies with the subsequent deferral rules of Section 409A

Securing the Benefit

- Amounts subject to a deferred compensation arrangement are unfunded, which means that, as a general rule, the deferred compensation is subject to the claims of the employer's general creditors

- Use of a sinking fund or liability entry
  - Most often employers create a liability entry or sinking fund for the amounts owed under a deferred compensation arrangement, with such amount increasing or decreasing based upon the return of any deemed investment choices

- Use of a rabbi trust to hold the assets
  - This trust is designed to be a grantor trust for federal income tax purposes
  - Any investment earnings are taxable to the employer
  - Due to possible mismatch of having investment earnings taxed to the employer at a time when the employer is not otherwise entitled to a deduction, the benefit could be funded with an insurance product (thus allowing for tax-deferred buildup of cash value under the insurance policy)
  - The terms of a rabbi trust generally provide that the employer cannot divert the trust's funds for any purpose other than the payment of benefits, expenses and taxes
  - Additionally, the terms of a rabbi trust (or the deferred compensation arrangements) generally require the employer to fully fund the payment obligation upon a change in control of the employer, along with provisions to address the acceleration of vesting and payment obligations in change in control situations

Securing the Benefit (cont.)

- Use of a secular trust to hold the assets
  - Transfers from the employer to the secular trust are irrevocable
  - The assets of the secular trust are not subject to the claims of the employer's general creditors
  - The transfer from the employer to the secular trust could be subject to a vesting schedule or a clawback provision
  - The employer would be entitled to a compensatory deduction when the employee recognizes ordinary taxable income
  - The employee would recognize ordinary taxable income on the amount of his/her beneficial interest under the trust at the time such amounts become vested
  - If minimum participation and coverage standards under Sections 401(a)(26) and 410(b) are satisfied, then earnings on the corpus of the trust that accrue after vesting would not be taxable to the employee until they are actually distributed
  - However, if either of the foregoing Sections are not satisfied, then highly compensated employees would include in their taxable income the value of vested benefits at the end of each calendar year, offset by previously recognized amounts
  - To help offset negative tax consequences to the employee, some insurance companies offer a variable universal life insurance policy that could provide the employee with a non-recourse loan within the insured product

Design Considerations

- Eligibility
  - Which employees are eligible to participate

- If employees are deferring compensation, then should such deferrals be:
  - A flat dollar amount,
  - A percentage of his/her paycheck, or
  - Both

- How often must deferral elections be effectuated
  - Every year so that employees have to re-enroll on an annual basis, or
  - Is an evergreen election used so that the prior election continues until it is affirmatively stopped or timely changed by the employee

- Will the employer be providing any discretionary matches or contributions, or will contributions be based upon a particular formula
  - And too, consider a design that triggers a contribution upon satisfaction of certain performance-based metrics

Design Considerations (cont.)

- Will a vesting schedule apply
  - The goal is retain the employee
  - Consideration should be given to vesting schedules that are longer than typical vesting schedules associated with equity awards
- How should the rate of return be determined (assuming a rate of return is offered)
  - Should there be a menu of choices, for example, choices that mirror the 401(k)
  - Should the rate of return be pegged to the increases and decreases in the value of the employer's common stock
  - Should the rate of return be performance based and mirror a financial metric of the employer (*e.g.*, return on assets, EBITDA, etc.)
  - Should a flat interest rate apply, pegged to the AFR or to some financial index
- How should the employer fund for the liability
  - Sinking fund or book entry
  - Make actual investments that mirror the hypothetical investments
  - Insurance products (but consider whether the tax advantage is offset by the cost of insurance and the administrative costs)
- How should benefits be paid
  - Lump sum
  - Installments (annual or otherwise)

Form 4 Considerations

- With respect to publicly-traded corporations, it is common for a non-qualified deferred compensation plan to allow for investments to be made (on a phantom basis) in employer stock

- As background:
  - Even if all distributions from such plan are required to be made in cash, the assets otherwise deemed to be invested in employer stock are considered a derivative security
  - As a derivative security, compliance with Form 4 requirements is required for "trades" in and out of such derivative security that are made by a Section 16 insider
  - Compliance with the company's insider trading policies and pre-clearance procedures should be considered
  - Administration of the plan could become burdensome if Form 4s are triggered frequently and irregularly

- Considerations to streamline administration:
  - Limit trades in and out of employer stock (*e.g.*, 1x to 2x per calendar year, or to the first trading day of the year)
  - Limit such trades to open windows (*e.g.*, 10 days following the release of quarterly earnings)
  - Allow for only a one-way trade into employer stock (*i.e.*, transfers are permitted into the stock account by Section 16 insiders, but not out)

Stock Ownership Policies

- Stock ownership policies of public companies
  - Assuming deemed investments in employer stock are permitted, should any such deemed investments count towards the employee satisfying the employer’s stock ownership policies

Don’t Forget Next Month’s Webinar

- Title:
  - Navigating Employee v. Independent Contractor Classifications
- When:
  - 10:00 am to 11:00 am Central
  - November 9, 2017

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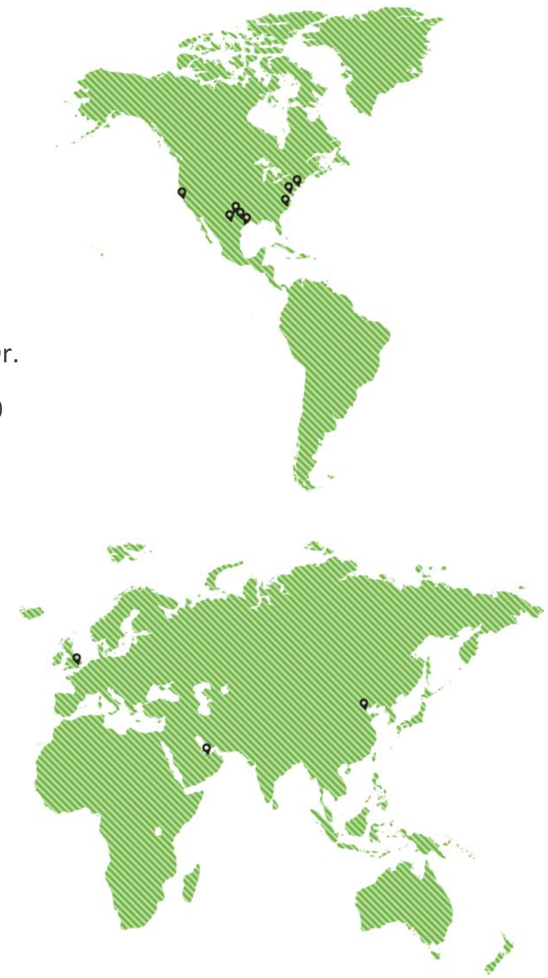

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