Ayco Compensation & Benefits DIGEST

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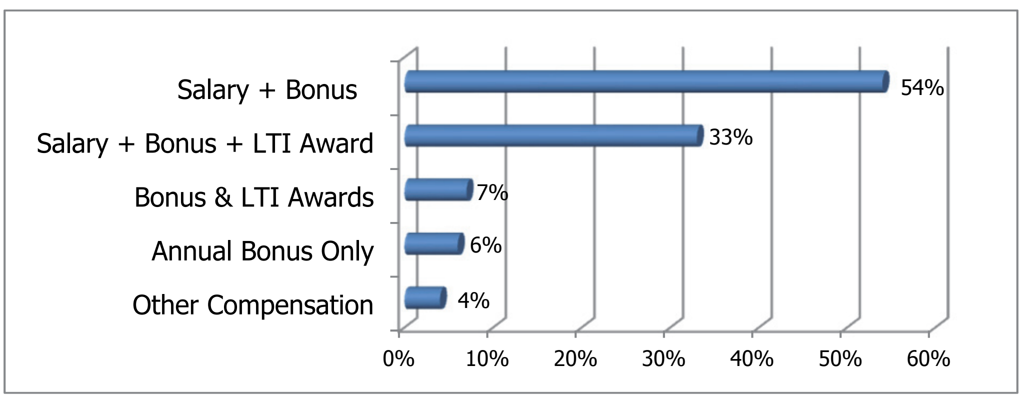
Our Updated Survey of Nonqualified Deferred Compensation Plans

It is now ten years since the enactment of IRC §409A and a bit over five years since the economic instability of 2007/2008. We continue to see a resurgence in the utilization of nonqualified deferred compensation (NQDC) plans. This is likely due to tax rate increases, as well as higher compensation payouts, especially annual bonus awards. An elective NQDC plan can be an important component of an executive compensation program, helping to attract and retain key executives. Plus, elective deferral plans have not been characterized as a problematic pay practice by corporate governance monitors in the current "say on pay" environment. But these plans come with risks that often are under-appreciated and poorly understood. And the IRS recently announced they will begin audits as to §409A compliance.

We have been monitoring the design of NQDC plans for the past 20 years. Our survey group is 350 companies where Ayco provides financial counseling or financial education services. While 9% of this group either froze, terminated or never offered a nonqualified deferral plan after the enactment of IRC §409A in 2004, the remaining 91% currently maintain an elective NQDC plan or an excess 401(k) plan. The plans we will focus on in this survey are designed primarily as top-hat, elective deferred compensation plans for a select group rather than purely as excess 401(k) plans (see our January 2014 *Digest* for our last survey on excess 401(k) plans).

❖ Compensation Eligible For Deferral

Originally designed to allow only the highest paid executives a chance to defer annual bonus awards and receive a fixed rate of return, NQDC plans have evolved into flexible, multi-use executive compensation plans. Beginning in the 1990s, many companies expanded what compensation could be voluntarily deferred under these plans. This included permitting the deferral of long-term performance awards, restricted stock units, and even stock option gains. IRC §409A has required companies to reconsider the elements of compensation that can be deferred, as well as restrict the timing of deferral elections. The following indicates how companies in our survey group currently define pay eligible for deferral:



Included in the category long-term incentive award ("LTI") are performance awards (performance units or shares), and/or restricted stock units. But option gain deferral has effectively ceased due to §409A implications. Generally, any deferral of RSUs or performance share awards will remain denominated as deferred stock units and may be required to be paid out in stock to retain favorable accounting treatment. Approximately 4% of our survey group allow for the deferral of other elements of compensation, including severance, nonqualified pension payouts, sign-on bonuses, or certain cash allowances in addition to other pay (which is why the total % in the chart is 104%).

Highlights

Deferred Comp Survey *cont'd…*

❖ **Maximum Deferral Amounts/Company Contribution**

A large majority of plans in our survey group (69%) permit any amount, up to 100%, of annual bonus to be deferred. This is also the typical maximum deferral amount where LTI awards may be deferred – often in multiples of 25%. But, where salary is permitted to be deferred, the maximum usually is much less than 100%. In fact, 13% of the companies in our survey do not permit salary to be deferred at all into their elective NQDC plan. At these companies, salary deferrals are allowed only to a 401(k) plan. Deferral into a NQDC plan reduces what counts as eligible pay for 401(k) and qualified pension plan purposes. A difference between excess 401(k) plans and NQDC plans is with regard to company contributions. They are much less common in NQDC plans with about 50% of the plans we reviewed having a company contribution or match.

❖ **Participation Eligibility**

Companies typically limit eligibility to participate in a NQDC plan to those in management positions. There is no bright line defining who can be eligible for a "top-hat" plan. Companies typically base eligibility on job position, invitation by the CEO or having pay at or above a stated amount, such as the IRC compensation limit. In our recent informal survey, just over 40% of companies defined eligibility by compensation level, just over 55% by position or grade, and at the remaining 5% eligibility was discretionary or by invitation.

A plan where eligibility is limited to a select group of key management or highly compensated employees constitutes a "top-hat" plan, exempt from many ERISA rules and eligible for a one-time filing with the Department of Labor (DOL). Neither the DOL nor the IRS has defined what constitutes a top-hat group. In Advisory Opinion 90-14A, the DOL implied that a top-hat plan must cover only those individuals who, by virtue of position or compensation, have the ability to affect or substantially influence the design and operation of the plan. A number of courts have concluded that where participation is limited to no more than 5% of the company's workforce, the top-hat rules will be satisfied.

❖ **Timing Of Deferral Election**

Under IRC §409A rules, an election to defer compensation generally must be made prior to the year in which the compensation will be earned. IRS regulations permit a distinct deferral period for newly eligible plan participants - within 30 days of becoming eligible for the plan. In addition, deferral of restricted stock units (RSUs) may be permitted within 30 days of grant. For performance-based pay, a company could (but need not) allow a deferral election to be made six months before the end of the performance period. This means that companies could allow a deferral election for most annual bonus and long-term performance awards to be made up until June 30 (for calendar year plans). But this could mean that an employer might have two distinct deferral election periods - one for performance-based pay and another for salary.

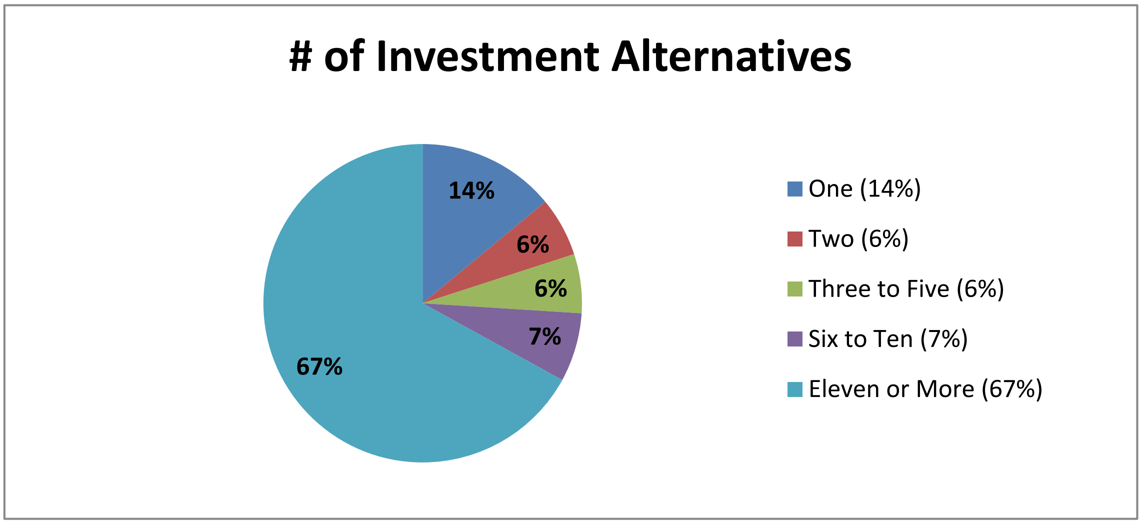
Our analysis of those companies for which we have information regarding 2013 or 2014 deferral elections indicates that just under 23% have a deferral election window in June for performance-based pay (including 5% that will have a second deferral window in November/December for salary deferrals). A large majority of our survey group have a single deferral election period in November/ December for all compensation to be earned in the subsequent year; and just over 6% will have a deferral window at a different time (mostly related to fiscal year plans). We see most companies preferring to have a single deferral election period rather than separate periods for different elements of pay. Not only does this make it easier administratively, but it can also be easier for plan participants to plan a deferral strategy.

❖ **Investment Choices**

The rate of return or crediting rate is often one of the primary factors influencing an executive's participation in a deferred compensation plan. This is not a plan feature which has been affected by §409A. While excess 401(k) plans often will have the same investment choices as the company's 401(k) plan, most elective deferred compensation plans have fewer investment alternatives. In this year's survey, over 50% of the plans offer the same funds as were available in the company 401(k) plan, and typically, the same mutual fund company is recordkeeper for both plans.

Deferred Comp Survey *cont'd…*

In our informal survey conducted 20 years ago, 54% of the plans provided a single rate of return, while only 22% offered five or more investment choices. But just as the number of choices available in 401(k) plans has increased since then, so too have the available choices in NQDC plans. The number of investment alternatives in our most recent survey is as follows:



Nearly three-quarters of the plans we reviewed offer an earnings rate based on the performance of one or more mutual funds. This is a significant increase from the 34% that utilized mutual funds in our survey conducted 20 years ago. Many more plans – just over 15% - now include target-date funds as an available option. Those plans with only one crediting rate almost always have a fixed income rate, most commonly based on a Moody's rate, U.S. Treasury rate, Prime rate or rate designated annually.

At three companies, the only investment choice is company stock units. But, we are also now seeing more companies limit or restrict company stock exposure in the NQDC plan (similar to what we are seeing in 401(k) plans). There were 11 companies that have company stock as a choice in their 401(k) plan, but not in their NQDC plan. We saw six companies that offer participants a self-directed account and one company that credited interest annually based on the company's return on equity (ROE) performance.

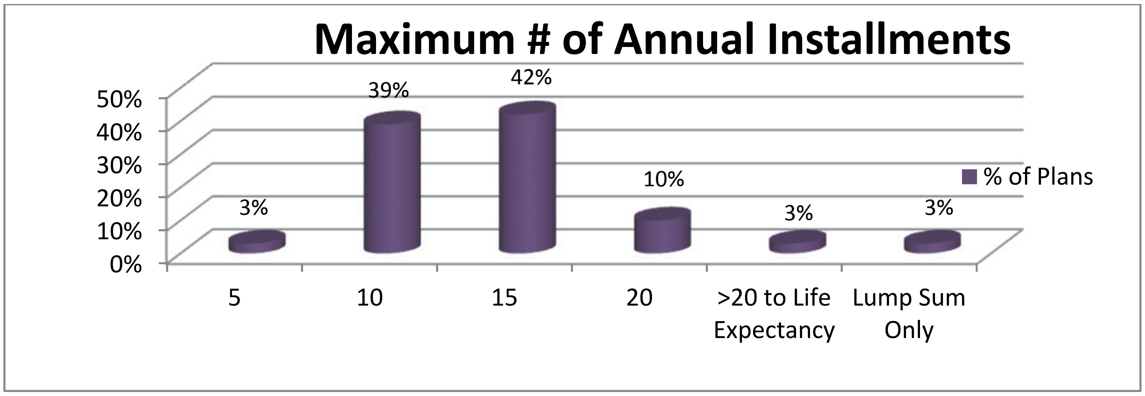
❖ **Form & Timing of Distribution**

Virtually all plans allow a participant to select the form and timing of distribution. A large majority of plans we reviewed have class-year elections; that is, a distinct payout election is made each deferral cycle. Nearly all plans permit a participant to elect to receive payment in a lump sum or periodic installments. But, we counted six plans that allow for only a lump sum payout, with the participant selecting the year of payout. At 75% of plans, the payment election made applies in the event of a qualified retirement, but with payment automatically made in a lump sum if the participant terminates prior to retirement. At the remaining 25% of plans, a participant's payment election applies regardless of when termination occurs.

One important difference between grandfathered plans not subject to §409A and post-2005 deferrals at public companies is the concept of the 6-month delay for distributions to "specified employees" triggered by a separation from service. This affects both installment and lump sum distributions. No 6-month delay is required, however, for specified date distributions or for distributions on account of death, disability, qualifying hardship, or upon a change in control (CIC). Just over 10% of plans provide an automatic lump sum cashout in the event of a CIC.

Installment payments under most plans are made annually. However, some plans (approximately 15% of our survey group) do permit participants to receive installments on a monthly, quarterly or annual basis, as elected. The following are the maximum number of annual installments that may be elected under the plans we surveyed:

Deferred Comp Survey *cont'd…*



A large majority of plans allow for installment payments only if the account balance exceeds a specified amount, such as $25,000 or $50,000. Otherwise, payment is made in a lump sum.

Specified Date Distributions - We continue to see that most plans allow distributions to commence as of a year and sometimes, month, specified by the participant, which may be during the term of employment. In some cases, a minimum period of deferral is required; a typical minimum deferral period is 3 or 5 years. Just over three-quarters of the plans we reviewed permit such fixed date or "in-service" distributions. This allows a participant to meet anticipated cash flow needs, such as a child's education expense. In most cases, a participant selects the period over which these specified date distributions are to be made – which is usually a lesser period than distributions following retirement.

Change In Distribution Election - Prior to enactment of §409A, so-called second-look, or re-deferral elections were fairly common in deferred compensation plans. While §409A does permit a change in a distribution election, an acceleration in payment (with a few limited exceptions) is prohibited; any change must be made at least 12 months prior to payment, and there must be a 5-year delay in when payments can commence. These rules and particularly, the 5-year delay have led many companies to eliminate the right to change an original distribution election. Among our group, just over one-half of the plans permit a participant to change a distribution election. We counted ten plans that allow only one such change.

Divorce – A NQDC plan can provide for division and payment to a former spouse pursuant to a state domestic relations order (not a QDRO). This is also allowed under §409A Treasury Regulations. However, plans do not have to permit such a division – and most plans have an anti-alienation clause which would prevent any division or early distribution. We estimate that only around 10% of plans have a specific provision dealing with a divorce of a plan participant.

❖ **Current §409A Issues**

Recently, the IRS announced that it will begin audits of a select group of 50 large employers as to their compliance with §409A rules. These will focus on initial deferral elections, subsequent elections, and payouts from any NQDC plan (initially reviewing payments to only the 10 highest paid employees). Interestingly, a decade after the law was enacted, regulations have not yet been finalized on a number of issues, including proper tax reporting rules.

For several years after the enactment of IRC §409A, companies struggled to reconfigure their nonqualified plans (including excess plans, SERPs, severance programs, certain long-term award, as well as NQDC plans) in order to avoid the 20% tax penalty on plan participants (none on the company). We saw several instances where a plan was properly amended, but the company inadvertently did not follow the timing rules for deferral or payment and, thus, was not in operational compliance. With regard to payouts following the execution of a release, the IRS position is that where an employee can exercise control over the year of payment by deciding when the release is signed is a §409A violation.

Deferred Comp Survey *cont'd…*

If inadvertent violations of §409A rules are caught timely, an employer can take advantage of the correction procedures outlined in IRS Notices 2010-6 and 2010-80. (We are aware of at least six of our survey group having done so.) This may not avoid the 20% penalty tax on the participant, but can limit or avoid any premium interest penalties. In several of the instances where the fault was with the company, we have seen voluntarily reimbursement to the executive for penalties incurred. Approximately 60% of our survey group also maintain "grandfathered" pre-2005 NQDC plans that are not subject to §409A rules.

❖ **Funding and Security**

While nonqualified plans cannot be formally funded, many NQDC plans are informally funded. We estimate that one-third of the plans in our survey group have at least partial informal funding using life insurance, which helps avoid tax consequences to the employer on income realized on investments. We also have seen a few companies use Total Return Swaps as a hedging strategy for the unfunded liability avoiding the cost of acquiring life insurance. Plan sponsors that offer a range of mutual fund returns typically informally invest in the actual funds that are the basis for the plan's crediting rate (using a TPA). On the other hand, a company offering a single fixed income crediting rate will be unlikely to fund the plan at all. Under MAP-21 pension legislation enacted in 2012, companies can be restricted in setting aside assets to informally fund a NQDC plan if certain pension funding is not achieved.

Approximately 50% of the survey group report having a Rabbi trust associated with the deferral plan. This is intended to help ensure that in the event of a change-in-control, a trust will be fully funded to be able to pay all promised benefits. But, as is often misunderstood by plan participants, a Rabbi trust provides absolutely no protection for the more serious risk associated with these plans – corporate bankruptcy.

Because these plans represent compensation already earned by a participant, forfeiture and clawback provisions are much less common in NQDC plans than in SERPs or other plans that are primarily employer funded. We counted less than 50% of plans with forfeiture clauses, typically associated with going to work for a competitor.

❖ **Tax Withholding & Reporting**

Amounts deferred under a NQDC plan are to be reported in box 12 of Form W-2 using code Y. However, the IRS has suspended this reporting requirement until it issues future regulations, although employers voluntarily may report deferral amounts. If a plan or arrangement is not compliant with §409A rules, income is to be reported in box 1 and box 12 using code Z. Distributions from a NQDC plan are normally considered to be "supplemental wages" and reported in box 1 of Form W-2 and in box 11 if Social Security taxes were withheld in a prior year. (However, there is no required withholding of any 20% 409A penalty tax if incurred). Federal tax withholding is at the flat supplemental rate - currently 25% for federal tax purposes, unless the aggregate total of all supplemental wages exceeds $1M, when the withholding rate jumps to the highest federal rate. Employers must withhold a special 30% rate if a U.S. citizen relinquishes their citizenship or ceases to be a permanent U.S. resident.

Social Security Taxation - Compensation voluntarily deferred is subject to FICA taxation (Social Security/Medicare plus the 0.9% Additional Medicare tax) at the time of deferral, although the withholding can be delayed until later in the year under a rule of administrative convenience per Treas. Reg. 31.3121(v)(2)-1(e)(5). Company matching or other contributions are subject to payroll taxes when vested or no longer subject to a substantial risk of forfeiture. Earnings on deferred amounts are not subject to payroll taxes - unless, the earnings rate is an "above-market" fixed rate (which the IRS has not specifically defined). Earnings under a NQDC plan are not considered to be net investment income subject to the additional 3.8% Medicare tax. Almost all companies collect the payroll taxes due from non-deferred wages, rather than reduce the deferred amount by the employee's share of the taxes.

Deferred Comp Survey *cont'd…*

The IRS has concluded that an individual who paid FICA on deferred compensation that was subsequently forfeited due to the employer's bankruptcy could not recover the FICA taxes previously paid (CCA 200823001). A recent decision of the Court of Federal Claims came to the same conclusion (*Balestra vs. U.S.*).

Louis Balestra was a pilot for United Airlines and participated in a nonqualified retirement plan which provided for annuity payments following retirement. Following the "special timing rule" for non-account balance nonqualified plans, United collected and paid all FICA taxes due in 2004 - the year of his retirement. However, United had filed for bankruptcy two years earlier. In the bankruptcy proceedings, its obligation to pay nonqualified benefits was discharged – although, this was not finalized until 2010. Balestra ended up receiving no SERP payments and requested that the FICA taxes paid to the government be returned to him. The Court of Claims refused his claim. Despite the bankruptcy filing, the company properly withheld and paid all FICA taxes. The fact that Balestra ultimately did not receive any payments from the plan (he was an unsecured general creditor) does not entitle him to the FICA properly paid on his behalf.

❖ **Why Deferral Plans Are Valuable**

From a company's perspective, advantages of offering an elective deferral plan include:

- Part of a competitive and attractive executive pay package;
- Company can be selective as to who is eligible for the plan, no discrimination testing;
- Plan is unencumbered by tax law limits; participation is voluntary;
- Can be flexible in plan design (although, less so than before §409A);
- Minimal regulatory compliance; plans are exempt from most ERISA rules;
- Cash flow savings; effectively, company is borrowing from its executives;
- Can serve as a golden handcuff and a recruiting tool for executives;
- Allows higher paid to supplement retirement savings and receive market rate returns;
- Defined contribution vehicle to replace demise of defined benefit SERP;
- For CEO and top paid, can protect corporate tax deduction under IRC §162(m);
- Company has choice of informal funding alternatives, but need not fund;
- Company stock unit investment choice creates additional opportunity to meet stock ownership requirements.

From a participant's perspective, more can be accumulated net after-tax in a NQDC plan due to tax deferred compounding than if the same investment were made outside of the plan (despite appreciation being taxed as ordinary income rather than capital gains). A NQDC plan also may be a means of legitimately avoiding state income taxes at distribution if the source tax exclusion rules are met - a potential significant planning opportunity for those working in states that tax nonresidents on amounts earned in the state (including CA, MN, NY and 20 other states). Finally, because most plans allow choice as to the form and timing of distribution, plans can be used to meet various personal planning needs, not just as a retirement supplement.

IRS Approves Pension Lump Sum Cashouts

One of the more popular recent pension plan "de-risking" strategies has been creating a special lump sum window for those former employees who have begun to receive annuity payments. Until two years ago when the IRS issued two private letter rulings (PLRs) approving limited lump sum windows, it wasn't clear whether this concept would meet ERISA and tax law rules. As a result of the rulings issued to GM and Ford, several other companies announced lump sum windows and requested private rulings from the IRS approving their actions. When the IRS did not issue any other approvals, there was concern that the IRS might be rethinking its position on lump sum windows. Late last month, the IRS released four new private letter rulings each approving a lump sum window. It should be noted that the IRS has yet to release a revenue ruling approving this concept (which would outline terms that all could rely on) and PLRs apply only to the company which receives the ruling and cannot be relied on by any other organization.

Pension LS *cont'd…*

The facts of the four new PLRs are similar to the rulings issued to GM and Ford in 2012.

- The company proposes to offer a lump sum payment option to those plan participants and beneficiaries currently receiving benefits or entitled to deferred vested benefits;
- The lump sum window will be offered on a one-time basis only with the window open for only 30-60 days or 60-90 days;
- For a married individual, any election change is subject to spousal consent; and
- Each pension plan is sufficiently funded so that the payments will not be subject to restrictions under IRC §436 (which can limit or prevent lump sum payments if the funding status of the plan is below 80% of target).

The rulings basically conclude that a plan sponsor may amend its pension plan to authorize a special lump sum window. Any election made within the window will be treated as creating a new annuity starting date for a participant who elects a change in payment. As such, any election must meet ERISA spousal consent rules. The rulings also confirm that any distribution must satisfy the IRC §415 rules as of the new distribution date even if the original distribution met this tax limit. This likely will only impact highly paid plan participants – but still needs to be taken into account. A similar acceleration or change in payment election cannot take place for a nonqualified excess plan due to §409A restrictions.

Under each ruling, a plan participant was given the ability to elect a lump sum or qualified joint and survivor annuity. Significantly from a tax perspective, the IRS confirmed that a change in payment option would not violate the required minimum distribution (RMD) rules for an individual over age 70½. If a lump sum is elected, all or any portion is eligible for rollover to an IRA, except to the extent that it represents an RMD for that year.

As a result of these new rulings, it appears that the IRS has given informal approval to lump sum windows as a pension de-risking strategy, assuming that the plan sponsor follows all of the "rules of the road." This can be viewed as a partial step to a possible future plan termination. An advantage of a lump sum window for only those in pay status is that it achieves this goal on a limited basis. Obviously, the plan sponsor will have to review the funded status of its plan and estimate what the cost and accounting implications would be of taking this step. Also to be considered should be the timing of any limited window and what assistance the employer will provide to those eligible to make this election. A lump sum may not be the right choice for all and any company considering this step should consider making financial education available to those eligible for this election (as GM did with its 2012 lump sum window).

We have now seen over a dozen companies take similar steps. If you'd like further information concerning services that Ayco can provide to those eligible for a pension window election, please contact Paul Clickman at Pclickman@ayco.com.

New Streamlined Disclosure Rules for Foreign Financial Accounts

For those U.S. taxpayers with foreign financial accounts, new reporting and disclosure rules under the Foreign Account Tax Compliance Act (FATCA) went into effect as of July 1. Nearly 100 countries now have signed FATCA agreements. These new rules, along with the U.S. government forcing foreign banks to share information about American accountholders has resulted in more than 45,000 individuals voluntarily stepping forward disclosing previously unreported foreign accounts and the IRS collecting about $6.5 **billion** in taxes, interest and penalties. The U.S. has filed criminal charges against more than 100 individuals for their failure to report and pay taxes on substantial foreign assets. Continuing its "carrot and stock" approach, the IRS recently announced a new streamlined compliance procedure for U.S. citizens and residents who have failed to disclose offshore accounts and report associated income. This new procedure expands one announced in 2012 that was available only to taxpayers residing outside the U.S. with less than $1,500 in unpaid tax liabilities. The new procedure extends this option to those residing in the U.S. and eliminates the $1,500 tax cap. It also eliminates a risk-assessment process that the IRS had used to determine the level of penalties involved.

Disclosure Rules
cont'd…

For taxpayers residing in the U.S. who certify that their failure to report all foreign income, pay all taxes due and make disclosures, (including FBAR-Report of Foreign Bank and Financial Accounts) was not willful, the only penalty will be 5% of the unreported foreign financial assets. For eligible taxpayers who reside outside the U.S., all penalties will be waived. To take advantage of these new procedures, the taxpayer must file delinquent or amended returns for each of the three most recent years, together with FBARs for six years. The full amount of the tax and interest due (plus the 5% penalty for U.S. residents) must be paid with the delivery of the amended returns. These streamlined compliance procedures are not available if the IRS has begun an audit of the taxpayer's return for any year or if the IRS determines that the failure to report income was willful or, if amended returns do not report all income.

The IRS also modified its Offshore Voluntarily Disclosure Program that can be used to avoid criminal charges for "non-willful" violations. But the penalty for failing to report foreign assets in these situations has been increased from 27.5% to 50% of the undisclosed account if the financial institution is under investigation by the IRS or the Dept. of Justice (DOJ). It is up to the IRS to determine whether a taxpayer's failure to comply was willful or unintentional. Meanwhile, the IRS continues its investigations and has indicated that if an individual has unreported assets at any of ten specified foreign institutions, the taxpayer must step forward before August 4, 2014 or face the higher 50% penalty.

Did You Know….

The IRS recently released final rules approving the incorporation of longevity or lifetime annuities into 401(k) plans and IRAs. The new rules expand previously issued rules and should lead to more employers considering the addition of this payment option to their 401(k) plan.

About This Newsletter

This newsletter is prepared for colleagues and friends of The Ayco Company, L.P. by its Benefits & Compensation Group (BCG) and is designed only to give notice of, and general information about, the developments actually covered. It is not intended to be a comprehensive treatment of recent legal developments or the topics included in the newsletter, nor is it intended to provide any legal advice. The information contained in this correspondence cannot be used, and it is not intended by Ayco to be used, for the purpose of avoiding any penalty that the Internal Revenue Service might assess upon challenging any tax treatment discussed in this correspondence and attachments, if any. For more information on any of the topics covered, contact Richard Friedman, Vice President, BCG (518-640-5250) or email us at rfriedman@ayco.com.

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