Presentation Overview

► Is it time for your ESOP to adopt a NQDC Plan?
► Benefits, Drawbacks and Tax Implications
► Types of NQDC Plans
► Funding of NQDC Plans
► A Word About Code Section 409(p)
► Governing Law (ERISA and Pre/Post-409A)
► Exemptions from Governing Law
► Trends
What is a NQDC plan?

- An employer’s unfunded unsecured promise/agreement to pay compensation to an employee at a future date.
- NQDC plans offer design flexibility to employers because they are not governed by ERISA.
Considerations:

− Would such a plan help your ESOP in recruiting high level (key) employees with a promise of significant compensation in the future? (level playing field with large corporate employers)

− Would such a plan help your ESOP retain high level (key) employees through “golden handcuffs” (deferred compensation subject to forfeiture if certain conditions are not met)
Benefits to Your Executives of a NQDC Plan

Highly compensated executives find these plans attractive (they almost suspect such a plan) because:

- They provide for a deferral of current taxes to a future date (when the employee may be in a lower tax bracket)
- They provide for wealth building (at a favorable tax treatment) beyond that provided by qualified retirement plans (that have limitations)
Drawbacks of NQDC Plan to the Executive

- Deferred cash or equity are unsecured contractual debts of the ESOP (Not protected from claims of creditors)
- Timing of deferral election governed by 409A (less flexible than 401(k) distributions)
NQDC Tax Implications for Your Exec.

► No tax consequences as long as the executive is not in constructive receipt of the deferred benefits (comparable to qualified benefits)

► No tax liability as long as the NQDC is unfunded

► 409A – executive must make the deferral election far in advance (should be tied to a life event)

► Executive is subject to FICA and Medicare payroll taxes at the time of vesting when the deferred benefit is ascertainable (unlike the situation with qualified plans)
Benefits to Your ESOP of Adopting a NQDC Plan

► Design Flexibility:

– Plans cover primarily senior management (“key” or “highly compensated”) employees offering them benefits that cannot otherwise be provided under qualified plans governed by ERISA

– Plans offer ability to avoid nondiscrimination rules thus allowing for offering benefits to a “select” group of highly compensated employees (more cost-effective than qualified plans)
− Plans provide “key” executives supplemental benefits in addition to benefits under qualified plans (full pay replacement at retirement)
− Benefits provided under the plan do not present an immediate corresponding tax obligation on the ESOP
Drawbacks to the ESOP of a NQDC Plan

► No contemporaneous tax deduction for amounts set aside by the ESOP for future benefits
► 409A issues for the employee
Tax Implications of the NQDC Plan to the ESOP

- **ESOP NQDC Plan contributions are not immediately deductible to ESOP**
- **ESOP may obtain a deduction at the time the executive pays taxes on the accrued benefit or upon constructive receipt**
- **ESOP subject to tax on earnings from investments of deferred amounts (Not applicable to Corporate-Owned Life Insurance)**
Types of NQDC Plans

Elective Deferral Arrangements

- Allow executive to defer payment of compensation (base salary, incentive compensation – in whole or in part) to a later date

Restoration Plans

- Designed to “restore” the executive’s benefits or contributions negatively affected by IRS imposed rules on qualified plans
Defined contribution plans – (under a 401(k) restoration plan an executive may make deferrals in excess of the $16,500 limit and the ESOP may make matching contributions accordingly)

Defined benefit plans – designed to “restore” benefits lost by an executive under a qualified retirement plan due to IRS imposed limits

Supplemental Executive Retirement Plans (SERP)

– generally designed to provide generous benefits based on a formula at retirement
Funding of NQDC Plans

▶ To avoid ERISA, the plan for a select group of key or highly compensated executives must be unfunded

– IRS tests: 1) set aside amounts must be available to creditors (substantial risk of forfeiture); 2) set aside amounts must be tied to a specific “key” executive
Corporately Owned Life Insurance (COLI)

- ESOP owned and premium payor
- Avoids negative impact on ESOP stock value of the NQDC plan
- Executive has no ownership
- Tax-deferred cash buildup (taxable income only at the time of policy liquidation to pay benefits)
- ESOP may chose to hold the policy until the death of the key employee – greatly increased ROI – death benefit is not taxable
Rabbi Trusts

- Establishment of a rabbi trust (irrevocable)—intended to provide security to the executive that the deferred funds will be paid
- Funds held by a rabbi trust are subject to reach of creditors in case of insolvency or bankruptcy
- Not commonly used by ESOPs because they have a negative impact on stock value since the funds in the trust may not be used for repurchase obligations
Code §409(p) is S Corp ESOP Anti-Abuse Rule

Purpose: Prevent S ESOPs from being used primarily to benefit a few individuals

Limits amount of *synthetic equity or other deferred pay* an employee can receive in an S ESOP

Rule prohibits ESOP holding shares of S corporation from allocating employer securities to “disqualified individuals” during any “nonallocation year”, i.e., year where no allocation is permitted
Synthetic Equity

- Any stock option, warrant, restricted stock, deferred issuance stock right, or similar interest or right giving holder right to receive S corporation stock in future
- Includes stock appreciation rights, phantom stock units, and similar rights to future cash payments based on value of stock

Deferred Pay

- Deferred compensation arrangements even if not payable in stock nor calculated by reference to value of stock
Avoid Code §409(p) Violation

- Ascertaining whether S corporation is subject to §409(p) requires complex analysis which must occur prior to effective date of new grant
- Draconian consequences in the event of §409(p) violation
When prohibited allocation is made:

- Subjects company to excise tax equal to 50% of amount of prohibited allocations, and
- Shares of “disqualified persons” treated as distributed and thus subject to tax
- ESOP may be disqualified (endangering S election)
- Shares actually owned and “deemed-owned” shares (with family attribution) are counted
Governing Law

► ERISA Application
  - Is it a “Plan” under ERISA?
  - General ERISA plan compliance
  - Top Hat Exemption
Governing Law

Laws specific to NQDC Arrangements

- Pre-2005 – Constructive Receipt/Economic Benefit
- Post-2004 – Internal Revenue Code ("Code") 409A
- Other applicable Law – 457(f)
Pre-Code Section 409A Benefits

► Amounts accrued and vested prior to 2005 are subject to the following rules:
  - Constructive Receipt
  - Economic Benefit
  - Practical Application
  - No “Material Modification”
Amounts accrued or vested after 2004 are subject to Code Section 409A:

- Deferral Elections.
- Distribution Events and Elections.
- Subsequent Deferral Elections.
- Acceleration of Distributions.
- Special Rules for Specified Employees.
- Other Rules.
- Penalties for Noncompliance.
Code Section 409A
Deferral Elections

► General Rule
  – A participant must elect to defer compensation prior to the year the services are performed to which the compensation relates.

► Special Rules
  – First Year of Eligibility
  – Performance-Based Compensation
  – Employer Election
  – Others
Code Section 409A
Distribution Events and Elections

▶ Timing of Distribution Election

▶ Appropriate Distribution Events
  – Fixed Date or Dates
  – Separation from Service
  – Death
  – Disability
  – Unforeseeable Emergency
  – Change in Control
Subsequent Deferrals

A participant can change his earlier time and form of payment election so long as:

− The new election does not take effect for at least 12 months.

− The payment is further deferred for a period of at least five years from the date the payment otherwise would have been made (except for disability, death or unforeseeable emergency).

Installment payments are treated as single payment unless plan calls for them to be treated as separate payments.
Code Section 409A
Acceleration of Distributions

► Distributions may not be accelerated.
  - A participant can further defer compensation subject to the 12-month/5-year rule, but cannot receive money sooner.

► Some exceptions apply, including:
  - QDROS
  - Limited Cash-outs
  - Certain Offsets
  - Plan Terminations
Code Section 409A
Specified Employee Rules

► Specified Employee:
  – Officer with annual compensation greater than $170,000 (amount adjusted for COLA),
  – 5% owner, or
  – 1% owner with annual compensation greater than $150,000.
  – No more than 50 employees (or, if fewer, the greater of 3 or 10% of all employees).
  – Other ways to identify Specified Employees.

► 6-Month delay for payments payable due to a termination of employment.
Code Section 409A
Other Rules

► Documentary Compliance

► Tandem Plans and Linked Elections

► Plan Aggregation
  – Similar nonqualified plans are aggregated.
  – Divided into several categories of plans.
Penalties for Failure to Comply:

- Penalties apply to the entire account balance (plus aggregated plans) of the affected participants.
- Amount is included in income in the year failure occurs.
- 20% excise tax.
- Premium interest tax.
- Waiting on further guidance regarding how to calculate the amount includible under Code Section 409A.
Code Section 409A
Exemptions

► Certain Types of Plans Are Exempt:
  – Qualified Plans
  – Bona Fide PTO Plans
  – Certain Foreign Plans
  – Involuntary Separation from Service Plans
  – Short Term Deferral Plans
  – Certain Equity Rights
There are two separate programs to correct failures to comply with Code Section 409A.

- Notice 2008-113
  - Correction of operational errors where the plan document is in compliance.

- Notice 2010-6
  - Correction of plan document errors.
Trends / Expected Future Guidance

► Audit Initiative
  – The IRS is conducting a limited audit to test for compliance with Code Section 409A.

► Income Inclusion Regulations
  – The IRS is working on finalizing the proposed regulations concerning how to include money in income under Code Section 409A.

► Tax Reform Proposal
  – The end of NQDC, stock options, and SARS as we know them!
Dan’s employee benefits and executive compensation law practice serves businesses as well as executives and other professionals. Dan has extensive experience designing and implementing deferred compensation plans for ESOP companies, negotiating executive and broad based benefit plans and agreements, and litigating ERISA and other benefit and executive compensation related claims.
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