

NON-QUALIFIED DEFERRED COMPENSATION OFFERS FLEXIBILITY AND ADVANTAGEOUS TAX TREATMENT

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REPORT FROM COUNSEL

NON-QUALIFIED DEFERRED COMPENSATION ARRANGEMENTS

RETAIN KEY EMPLOYEES

The non-qualified deferred compensation arrangement (“NQDC”) offers advantageous tax treatment that can assist employers in attracting and retaining talented employees. Under an NQDC, the payment of a portion of an employee’s compensation is deferred until a later tax-year (or years) than the current tax-year in which the services were performed. NQDCs are exempt from the strict requirements (funding, vesting, nondiscrimination, etc.) of qualified plans, however, certain

requirements must be met to ensure validity of these arrangements, including those set forth in Section 409A of the Internal Revenue Code and accompanying regulations more recently established by Congress (in the wake of the Enron scandal). While NQDC plan documents must strictly adhere to these rules, they offer employers more flexibility than through qualified pension or profit-sharing plans.

NQDCs are attractive to employers because: (i) they do not require an undertaking as exacting and comprehensive as a qualified pension or profit-sharing plan; (ii) they do not have to be offered to the entire staff; and (iii) employers may already be maximizing qualified pension and profit-sharing plan contributions. NQDCs are a particularly useful tax, retirement, or business planning tool for closely held companies because they can be offered solely to key personnel. Employers can utilize an NQDC to tie management (or other key personnel) into long-term employment via extended vesting schedules, which is especially useful where certain employees require specialized training and/or acquire extensive understanding of the employer's business affairs and operations, or by conditioning payment of the deferred compensation on providing post-retirement consulting or upon compliance with a non-compete restriction, or a combination of the above.

Payment of the deferred compensation is a deductible expense to the employer in the tax-year in which payments are includable in the employee's gross income (i.e., actually received), and in the same year is treated by the employee as ordinary income. Thus, ideally the deferred compensation is paid to the employee in a post-retirement tax-year (or years) when the employee falls into a lower tax bracket, thereby reducing the overall tax liability to the employee, which reduction can be significant in many instances.

NQDC COMPLIANCE

The big pitfall for NQDC arrangements is that noncompliance with Section 409A of the Code and accompanying regulations could result in the immediate inclusion of all deferred amounts under the NQDC in the employee's current gross income, a penalty tax of twenty percent (20%), plus interest at a rate of one percent (1%) above the underpayment rate. Thus, NQDC arrangements have to be carefully drafted to ensure 409A compliance.

As the name implies, NQDCs are a deferral of the payment of compensation to a later tax-year that might otherwise be payable to an employee in the current tax-year. Thus to avoid the constructive receipt of income, and the corresponding obligation to include such income immediately in the employee's gross income, NQDCs must be entered into prior to the performance of the services for which the compensation is deferred. Treasury Regulations 1.409A-2(a) provides for the timing of the initial deferral election and the requirement that such election become irrevocable (if an election is provided to the employee). Generally an employee must make the initial election to defer compensation before the year in which the services are performed for which the deferred compensation is earned. In an employee's first year of eligibility under an NQDC, the employee may make a deferral election in the first thirty (30) days of participation. However, such election may only apply to compensation earned after the election was made. There are other special rules affecting

initial deferral elections which depend on the type of compensation to be earned (performance-based, commissions, etc.) which have to be considered.

Treasury Regulations 1.409A-3(a) provides for acceptable timing form of payments of deferred compensation. Payments under an NQDC must be made at a fixed date, under a fixed schedule, or upon any of the following events: (i) at death; (ii) upon disability; (iii) after a separation from service; (iv) upon a change in ownership or control of the [company]; or, (v) in the event of an unforeseeable emergency. Each of the foregoing is specifically defined in the regulations and any variance from the definition may subject the employee to the extreme penalties discussed above. If the timing of payment is based on a specified event, the plan must designate an objectively determinable date or year after the event in which payment is to be made.

Treasury Regulations 1.409A-3(j) provides that, with limited exceptions, payments under an NQDC may not be accelerated. For example, accelerated payments necessary to comply with a domestic relations order or conflict-of-interest rules, and upon certain plan terminations (i.e., accelerations that are not within the discretion of the employer or employee), may be permitted.

Treasury Regulations 1.409A-2(b) provides for subsequent changes to timing/ form of payment of deferred compensation. If an NQDC permits an employee to elect to delay or change the form of a payment, the following conditions must be met: (i) the election may not take effect until at least 12 months after the date on which it was made; (ii) if the election relates to a payment that is not made on account of death, disability or unforeseeable emergency, the first payment for which the election is made must be deferred for at least five years; and, (iii) any election related to a payment at a specified time or under a fixed schedule may not be made less than 12 months before the date of the first scheduled payment.

FUNDING

NQDCs must remain unfunded, that is, the funds for the payment of deferred compensation cannot be placed beyond the reach of the employer's general creditors. Thus, the employee becomes one of the employer's general creditors whose claim arises through the NQDC Agreement itself, and the employee assumes the risk that the funds may not be there at the time the deferred compensation is scheduled to be paid.

SUMMARY

In summary, as long as NQDCs are drafted to comply with applicable rules, including Section 409A of the Code and accompanying regulations, NQDC arrangements are an effective and attractive tax, retirement and business planning tool for employers in attracting and retaining talented employees.

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