

The Pension Protection Act of 2006

Prohibits Funding of Non-Qualified Deferred Compensation Benefits for Senior Executives of Companies with Underfunded Defined Benefit Plans

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The Pension Protection Act of 2006 (the “Act”) contains a very significant new rule that will prohibit employers with under-funded defined benefit pension plans from making contributions to a Rabbi Trust or other funding vehicle to fund future benefits of senior executives under a non-qualified deferred compensation plan. This new rule, which is contained in Section 116 of the Act, amends Section 409A of the Internal Revenue Code of 1986, as amended (the “Code”) to provide that if during a “restricted period” an employer sets aside amounts in, or transfers amounts to, a trust (or other arrangement as determined by the IRS) to pay benefits under non-qualified deferred compensation plan to an “applicable covered employee”, then the assets so set aside or transferred will be treated as if they had been paid to, and thus will be immediately taxable to, the applicable covered employee at the time they are so set aside or transferred. This is true without regard to whether the assets are in a rabbi trust or otherwise are available to satisfy the claims of the employer’s general creditors.

Similarly, under the new provision, if a non-qualified deferred compensation plan of a plan sponsor or a member of its controlled group provides that assets can only be used to pay benefits under the plan during a “restricted period” (or similar financial measure determined by the IRS), or the assets are so restricted, then those assets also will be treated as having been immediately paid to the participant.

The term “restricted period” is generally defined for this purpose to mean any of the following:

- Any period during which a single-employer defined benefit plan of the plan sponsor or a member of its controlled group is considered to be in “at risk status” under the new funding requirements imposed by the Act (which generally will be the case if the assets of the plan are less than a percentage (which is 65% for 2008, 70% for 2009, 75% for 2010, and 80% thereafter) of the value of the benefits under the plan);

- Any period during which the plan sponsor is a debtor in a Federal or State bankruptcy proceeding; or
- The twelve-month period that begins 6 months before any defined benefit pension plan of the plan sponsor or any member of its controlled group is terminated without sufficient assets to satisfy benefit liabilities.

The term “applicable covered employee” is generally defined to mean any “covered employee” of a plan sponsor or of any member of its controlled group, or any former employee who was such a covered employee at the time of termination of employment. The term “covered employee” is defined as any individual described in Section 162(m)(3) of the Code (which includes the company’s chief executive officer and the 4 next most highly compensated officers) or any individual that is subject to the reporting requirements of Section 16(a) of the Securities Exchange Act of 1934.

The new rules do not apply to any assets set aside, transferred, restricted or reserved before the restricted period. They also do not preclude payment of deferred amounts in a manner that complies with Section 409A.

As indicated above, one consequence of violating the foregoing rules is that the employee is immediately taxed on the amount set aside, transferred, or restricted to pay his or her deferred compensation. The participant also would be required to pay a 20% additional tax on the amount that must be included in income, and interest at the underpayment rate plus 1% on the tax that would have resulted if the compensation had been includible in income when originally deferred (or if later, when it ceased to be subject to a substantial risk of forfeiture). The failure also could cause other similar non-qualified deferred compensation plans to be deemed to violate the requirements of Section 409A of the Code, and thus to be subject to the same potential penalties.

The Act also provides that if a company reimburses an employee for any taxes that are imposed as a result of this provision, then the employee not only will be taxable on the reimbursement but also will be subject to a 20% additional tax on the reimbursement (as if the reimbursement was part of the deferred compensation to which it relates), and interest (presumably calculated in the same manner as interest on the tax imposed on the deferred compensation itself). In addition, the employer would not be entitled to any tax deduction for the reimbursement.

This new provision applies to transfers or other reservations of assets after August 17, 2006, which is the date of enactment of the Act. Thus, it appears that an employer that sponsors a defined benefit pension plan that is in “at risk status” would need to immediately cease making contributions to a Rabbi Trust or other funding arrangement to fund benefits under its non-qualified deferred compensation plans in order to avoid a violation of Section 409A and the adverse tax consequences described above. It is interesting to note that the provisions of

the Act that relate to the funding of pension plans that are in “at risk status” do not become effective until January 1, 2008. An argument therefore could be made that the definition of an “at risk status” plan does not become effective until that date, and that the forgoing rules should not apply until then either. Unless and until there is some clarification of this, however, it would be prudent for employers with defined benefit plans to cease the funding of their deferred compensation plans immediately.

Based upon the foregoing, it is extremely important that companies immediately determine whether they (or members of their controlled group) sponsor any defined benefit pension plans that would constitute “at risk status” plans under the new funding rules contained in the Act, or whether they otherwise are within a “restricted period” because they are subject to a bankruptcy proceeding or they, or a member of their controlled group, recently terminated a defined benefit plan with insufficient assets. If so, we would recommend that the company immediately stop funding any benefits of “applicable covered employees” under any of their non-qualified deferred compensation plans. Similarly, companies should review all of their non-qualified deferred compensation plans to make sure that they do not provide for assets to be restricted to pay benefits under the plan during a “restricted period”. In conducting this review, companies should bear in mind that the definition of a non-qualified deferred compensation plan for purposes of Section 409A is very broad, and includes not only traditional deferred compensation plans, but also certain equity based compensation (such as restricted stock units, and stock options or stock appreciation rights issued at a discount) and severance arrangements that provide for the deferral of compensation.

If you have any questions with regard to the foregoing, please feel free to contact any of the members of our Firm's Executive Compensation and Employee Benefits group.

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