

Are There More Shoes to Drop?

What legislative and regulatory changes are still possible for nonqualified plans? What effect might these changes have?

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With the passage of Section 409A as part of the American Jobs Creation Act of 2004 and the issuance of final regulations in April of 2007, many of us expected to see a clear path forward. For many companies, however, this may not be the case. As Congress continues to look at nonqualified plans as a potential source of revenue and as a method to reign in “runaway executive pay,” we can expect nonqualified plans to remain in the sights of lawmakers and regulators, especially as those plans provide benefits to higher income executives. We will attempt in this article to take a close look at future regulatory changes we might expect and what their passage might mean.

One important factor to keep in mind: Section 409A is scheduled to become effective on January 1, 2009, with little further opportunity to amend plans. Thus, if any of these changes become effective, a company’s ability to react will be dramatically curtailed after December 31, 2008. Thus, companies should understand the potential changes, assess the impact on their plans, and make changes as necessary before the end of the year.

A Look Back

First, let’s take a look back. The last decade has brought many changes in legislation and regulation that impact all varieties of plan design and tax treatment. Here is a summary of some of the more consequential actions:

- 2001 - IRS releases Notice 2001-10, which changes decades of tax protocol and begins treating split dollar as a loan.
- 2002 – Sarbanes-Oxley is passed, requiring increased oversight of many elements of public companies, including executive compensation.
- 2003 – New 457(f) regulations disallow a popular executive benefit, discounted mutual fund option plans, in not-for-profit companies.
- 2003 – Final split dollar regulations are released.
- 2004 – New Code Section 409A is signed into law as part of the American Jobs Creation Act, promising comprehensive regulation of nonqualified deferred compensation for the first time ever.
- 2005 – Notice 2005-1 provides temporary and proposed regulations of Section 409A.
- 2007 – Final regulations for Section 409A are released, potentially impacting a broad range of executive benefit plans including deferred compensation, SERPs, severance arrangements, split dollar plans, certain stock option arrangements, etc.

With this broad array of new regulations it is more difficult than ever for companies to develop plans to attract, reward, and retain key executives. In some cases, the tax benefits that were available under the old rules have disappeared, making those plans no longer effective. In other cases, the new rules to which plans must adhere make the benefits so inflexible and restrictive that they are no longer attractive to the participant, or carry too much risk. Many companies have responded by adopting new approaches to provide the best benefit possible, but in many cases the plans have been terminated and distributed.

What's Driving the Changes?

There are three forces creating momentum to further restrict nonqualified plans.

The force of increasing taxation.

We now enjoy tax rates that are at historic lows. One need only open their eyes and ears to current political rhetoric to develop the belief that this, however, is likely to change, especially for those who enjoy higher than average incomes. As Congress looks at nonqualified deferred compensation they see two things they don't like:

1. High-income taxpayers are delaying the payment of taxes.
2. Companies are deferring the payment of taxes through the use of Corporate-Owned Life Insurance (COLI).

The force of limiting executive pay.

We've been hearing much about the inflation of executive pay. One study purports that in the 1970s CEOs made, on average, 40 times the compensation of the average worker, while the average CEO of the early years of the 2000s earned 170 times more. When those CEOs run companies that fail, the disgust becomes even greater. Probably the best example of the focus of politicians on the "problem" of executive pay can be found in the recent quote of the Republican nominee for President, John McCain, in response to the publicity given to the pay packages of CEOs who ran companies that have experienced difficulties: "If there are ways we can prevent this from happening again, we should exercise those options."

The force of "PAYGO."

PAYGO (or "pay-as-you-go") is a doctrine of Congress that provides that all direct spending increases or revenue decreases must be offset by other spending decreases or revenue increases. The effect of PAYGO is designed to keep all actions of Congress revenue-neutral. PAYGO was first introduced in 1990, and most recently in 2007. As long as PAYGO is in force, Congress will be looking for sources of revenue (tax increases) to pay for new legislation (spending increases).

These three forces are combining to create what many believe is the high probability that further restrictions on nonqualified plans are on the way. What form will these restrictions take? Again, no one knows for sure, but we can look at recent legislative activity for some clues.

Legislative History

In January of 2007, the Senate Finance Committee introduced the “Small Business and Work Opportunity Act of 2007” (“the Act”), which proposed two major changes to executive benefits:

- Limitations on NQ plan deferrals
- Expansion of the 162(m) limitation on deductible compensation

Both of these changes were removed from the bill before it was passed in May of 2007. However, our sources tell us that both provisions are very much alive and are likely to re-appear in future legislation as “revenue raisers” under PAYGO. Let’s look at each in more detail.

Limitations on NQ Plan Deferrals

This first provision of the Act impacting nonqualified plans would have amended Section 409A to limit annual deferrals or contributions into a nonqualified plan to the lesser of 1) \$1 million or 2) the individual's average taxable compensation from the employer during the preceding five years. As written in the original bill, the limitation would apply to both elective (employee deferral) and non-elective (employer) contributions. The limitation would also apply to earnings on the plan(s), although later discussions seemed to indicate that the earnings limitation might be dropped. The limitations would apply on an aggregate basis, meaning that contributions for a participant in more than one plan offered by an employer, whether account balance (defined contribution) or non-account balance (defined benefit) would be lumped together to calculate a violation. The limitations would have applied to amounts deferred after January 1, 2007, and the earnings on those amounts.

It is not difficult to build hypothetical scenarios under which participants run the risk of exceeding the limits imposed by these rules, in which case the entire amount deferred from the law’s effective date would be subject to the egregious tax and penalties of Section 409A. This is especially true for higher-income executives who have substantial SERP benefits. As their income increases and as they age, the annual accruals to the SERP have a high likelihood of exceeding the limits, especially when combined with any other “deferrals” subject to the definitions under 409A.

Expansion of 162(m)

Under current law, compensation paid to the “covered employees” of public companies in excess of \$1 million is not deductible unless it satisfies a “performance-based” exception. Covered employees for this purpose are the chief executive officer as of the close of the taxable year and the four other most highly compensated officers as reported in the company’s proxy statement. (Due to a conflict with the new SEC proxy disclosure rules, CFOs are not currently included in the 162(m) calculations.) The proposal would treat as a covered employee any individual (or his or her beneficiary) **who previously was a covered employee for any taxable year beginning after December 31, 2006.**

Under current law, deferred compensation paid to a former CEO or to an individual who was otherwise formerly a covered employee would not be subject to the section 162(m) deduction limitation. If this change became effective, this would no longer be the case and the rule would be, "once a proxy officer, always a proxy officer."

The proposed change was significantly retroactive in that it would have applied to disallow a public company's deductions for payments of past compensation deferrals with respect to individuals who were covered employees of the company at any time after December 31, 2006. From a financial perspective, nonqualified plans are installed by companies predicated on the expectation that the payment of benefits in the future will be deductible to the company. Thus, this change could be financially punitive to the sponsoring company if a sizable portion of ultimate benefits is not deductible.

What Should Companies Do Now?

It is difficult to justify changes to plans based on what might happen in the future, but there seems to be enough danger in these possible changes that companies cannot afford to ignore the implications. Thus, here's a suggested road map to deal with the potential problems:

1. Assess your plan(s). Is there the possibility that annual aggregate deferrals or accruals into all 409A plans, plus the earnings on those amounts, might one day exceed \$1 million per participant, or the average of the previous 5 years compensation?
2. Similarly, if yours is a public company, is there the possibility that aggregate distributions from 409A plans to former employees covered under 162(m) would exceed \$1 million?
3. If the answer to either or both of those questions is "yes," then you should consider alternative designs for the affected plans.

RCG has worked with a number of companies to restructure deferred compensation and SERP plans in a way that preserves the benefits for the executive while protecting against the potential risks described in this article.

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