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Nonqualified Deferred Compensation Plans: Lessons Learned After 10 Years of Section 409A

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It is hard to believe it has been 10 years since Section 409A was added to the Internal Revenue Code in 2004. We lived through the four-year transition period of ''good faith'' compliance that ended in 2008. At that time, companies scrambled to obtain documentary compliance for nonqualified deferred compensation plans (NQDCs) and enhance administrative platforms to accommodate the new rules. Since 2009, many companies have also had to address the nuances and timing requirements of corrective procedures when 409A errors (document and/or operational) occurred. This article is intended to take a retrospective look back in order to:

1. Assess the impact of Section 409A — *Was it the demise of NQDCs, as predicted?*

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2. Review some of the unintended consequences — *What was positive and what was negative?*

3. Outline the future for NQDCs plan sponsors — *What's next in the post-409A era?*

Was 409A the Demise Of Deferred Compensation Plans?

When Section 409A was enacted in October of 2004, many practitioners viewed it as the end of deferred compensation plans. They cited the rules as being too restrictive, the administration as being too complicated and the risks/penalties as being too steep.

In reality, we have seen little change in the prevalence of NQDCs and in fact, their popularity has held steady. Slightly less than **80 percent** of Fortune 500 companies offer a company-paid nonqualified benefit (either defined benefit (DB) and/or defined contribution (DC) plan).[1] Additionally, slightly more than **80 percent** of the Fortune 500 also offer voluntary deferral plans.[2] In particular, voluntary deferral plans have received renewed attention resulting from the increased U.S. tax rates effective in 2013 as a result of the fiscal cliff and the Affordable Care Act.

Instead of representing the demise of NQDCs, 409A codified what is permissible and in a manner that did not materially detract from the primary value propositions these plans offer:

- ability to defer pre-tax compensation (i.e., tax deferred savings),
- tax-deferred earnings growth (i.e., tax-deferred compounding of interest), and
- distribution flexibility and planning (e.g., NQDCs continue to provide the ability for both scheduled date (i.e., in-service distributions) and separation from service distributions).

Granted, Section 409A did impose more stringent deferral election and distribution timing rules. In practice, however, these have been quite manageable to implement and administer. In many cases, they were also

[1] Source: Mercer's Executive and Broad-based Employee Retirement Tool (EBeRT).
[2] Source: Mercer's EBeRT.

largely consistent with previous administrative practices.

Section 409A also banned the right of executives to ''call'' their balances at any time subject to a ''haircut'' penalty. However, while this pre-409A feature was commonly included as an option, it was infrequently used. Unfortunately, in the instances when it was utilized, it was in very visible and perceived egregious situations in response to a financial downturn of the company. In hindsight, most will agree this provision did not align with the interests of company stakeholders.

Unintended Outcomes of 409A

Section 409A sought to stem abusive practices for NQDC plans and establish guidelines as to how these plans must operate going forward. The intent was to clarify and codify these agreements, but as is the case when most laws are implemented, a number of unexpected outcomes surfaced. Some of these can be perceived as negative, whereas others are viewed in a more positive light. While not an exhaustive list, the following are examples of some of these unintended outcomes post-409A.

Unintended ''Negative'' Outcomes	Unintended ''Positive'' Outcomes
■ Reduced participation	■ Enhanced administration and servicing capabilities
■ Inadvertent errors caused massive drains on resources (both hard and soft dollars)	■ Enhanced communication and education strategies
■ Limitations on third party administrator (TPA) risk exposure	■ Increased participant engagement
■ Limited opportunities for de-risking	
■ Impediments to succession planning	

Unintended Negative Outcomes

Reduced Participation. While the core tenets of NQDCs remained intact, the magnitude of the rules, the potentially significant penalties and the overall negative press surrounding 409A had the initial effect of reducing plan participation. Additionally, when 409A came into full force, the economic downturn was at its worst, thus adding to the sense of pessimism. This was the case even though NQDCs were and continue to be an invaluable component of effective retirement planning for key management and highly compensated employees. Over the past five years, participation has rebounded and stabilized, thus 409A itself is less of an influence on participation than is the overall plan design and financial stability of the company.

Inadvertent Errors. One of the most widely vocalized issues is the concept that 409A does not distinguish among the type of errors. The idea that a very minor and simple administrative error (e.g., unintentionally missing a deferral on a payroll file) can give rise to significant income tax and penalties is an area of great concern for executives, plan sponsors and recordkeepers. The outcome is further amplified if the error is not identified in adequate time to be fixed under the 409A correction programs. When this occurs, it can create a great deal of animosity among all involved parties and expend significant resources—both hard dollar costs and resources—to identify the source of the error and comply with the applicable 409A requirements.

Limitation on TPA Risk Exposure. Another outcome resulting from the potential costs associated with 409A errors is that some recordkeepers needed to increase fees and/or reduce their limits of liability for administering the plan. As NQDC plans cover the most senior executives, participants can accumulate significant benefits under these arrangements. An error on a single participant could trigger tax and penalty costs that are many multiples of what is charged in annual administration fees. In response to this, many recordkeepers introduced language in their service agreements to limit the amount of liability they are willing to assume. This in turn increases the potential risk to the sponsoring company, whose employees will be looking to be made whole for any errors that occur as part of the plan administration.

Limitations on Liability De-Risking. De-risking strategies, especially with regard to qualified defined benefit plans, continue to increase in popularity. While there is a relatively large degree of flexibility in de-risking a qualified plan via both liability-driven strategies (redesign, liability transfer and liability settlement) and asset-driven strategies (dynamic de-risking and glide paths), there are many more complexities associated with attempting to extend the liability transfer/settlement strategies to NQDC plans. De-risking 409A plans frequently involves immediate participant taxation and full payment of benefits, as it essentially is a plan termination. Under a 409A plan termination:

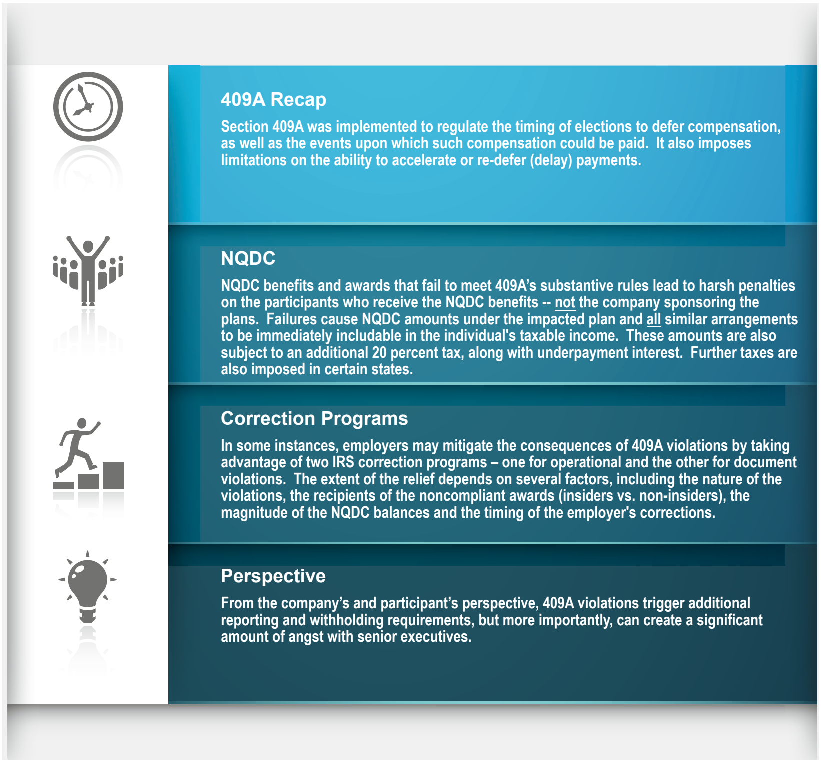
- all ''like'' plans must be terminated,
- all benefits must be paid no sooner than 12 months and no later than 24 months after plan termination,
- the company cannot sponsor a ''like'' program for 36 months, and
- termination cannot be in conjunction with a financial downturn.

In most instances, none of these requirements are desirable from perspective of the company or the participant as part of an overall de-risking strategy.

Impediments to Succession Planning. While NQDCs continue to provide a great deal of flexibility in terms of financial planning, the restrictions on what is considered a separation from service adversely impact succession planning strategies. This can be in conflict with a company's needs to effectively manage an executive transition period that overlaps between the incoming and outgoing executives. In many cases, the executive would prefer to have a phased retirement and receive reduced current compensation, mitigated by the ability to start receiving NQDC benefit payments. However, unless the executive is considered separated from service under 409A's strict definition, NQDC benefits cannot commence.

Unintended Positive Outcomes—It's Not All Bad News!

Enhanced Administration and Servicing Capabilities. From a third party administrator perspective, 409A required recordkeepers to modify their administrative platforms and systems to comply with 409A. A positive



Source: Mercer (US) Inc. A BNA Graphic/pen443g1

outcome of this was great strides in administrative system capabilities, the ability to track both pre-409A and post-409A plans within the same system, and enhanced automation to monitor and impose 409A rules governing deferral and distribution elections.

However, a trade-off was the enhancements required major—and in many cases costly—system overhauls. The very nature of these changes actually increased the likelihood of unintentional administrative errors as systems were migrated and related bugs were worked out. Many of these errors were caught early on and within the correction period provided under 409A guidance. However, some went undetected for years and were not discovered until more recently, further reinforcing the concern over the lack of distinction between inadvertent and intentional errors.

Enhanced Communications and Increased Participant Engagement. The perceived complexities associated with 409A prompted many plan sponsors to partner closely with their consultants and administrators to place renewed emphasis on plan communications. These efforts not only focused on educating eligible employees on 409A, but emphasized:

- how the plan works,
- the potential tax and wealth accumulation benefits,
- the perceived risks, and
- how to maximize the value of the plan in light of overall retirement planning.

This heightened focus on education and communication was instrumental in fostering increased awareness of the need to adequately plan for retirement readiness and how to leverage all company benefits to maximize wealth accumulation and tax planning.

What's Next for Plan Sponsors?

While there is typically a lot of emphasis on the governance of qualified plans like the 401(k) or defined benefit pension plan, NQDC plans sometimes get lost in the shuffle. They don't have the same fiduciary requirements as qualified plans, nor the materiality, thus they tend to not get the same level of oversight.

When final 409A regulations became effective in 2008, all plan sponsors were required to bring their plans into written documentary compliance. However, many companies have done little since this point to review their plans from a strategic, operational compliance or financial efficiency perspective. Assuming all companies got their plan documents right, the real risk going forward is affirming the plans are in operational compliance with 409A.

As many sponsors have experienced operational errors (some of which unfortunately were discovered outside of the correctable period under 409A), at this point in the evolution of 409A, companies are making sure they have appropriate risk management policies in place to mitigate the potential tax, financial and other legal risks.

From a governance standpoint, companies should make ongoing oversight of their NQDCs a permanent part of their internal process for the 401(k) or pension committee rather than addressing the NQDC plan on an ad hoc basis. A general outline for ongoing oversight consists of:

- Quarterly/semiannual review presented to either an investment or benefit committee that has been assigned ownership of the nonqualified plans. This update would cover basic demographics of the plan, including number of participants, plan liability, aggregate deferrals, contributions and assets, if applicable.

- Annual review focused on market trends and regulatory developments.

- Periodic ''deep dive'' review (every two to three years) that focuses in more detail on operations, financial efficiency, consistency with stated objectives and strategy, features relative to market trends and role in total compensation. This review also represents an opportunity to remind the compensation committee of the board about the purpose of nonqualified executive retirement plans and their role in the company's total pay strategy.

Summary

While Section 409A initially created a lot of stir and concern regarding NQDCs, it proved to have little impact on the popularity of these programs, given that the prevalence continues to be high. In the post-409A world, these plans are still highly attractive and provide key executives with additional tax-deferred opportunities to achieve their retirement readiness objectives. The ''cost'' of errors/violations is significant in terms of dollars and resources, which is why it is critically important for companies to ensure they have an established oversight and risk management process in place.