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Adverse Tax Consequences for Certain Executives Covered by Nonqualified Deferred Compensation Plans as a Result of Defined Benefit Plan Funding Status

October 3, 2011

Provisions added to the Internal Revenue Code (the Code) by the Pension Protection Act of 2006 (the PPA), which went into effect on August 17, 2006, could impose adverse tax consequences on executives of publicly traded companies who are participants in a nonqualified deferred compensation plan where a rabbi trust has been established in connection with the deferred compensation plan. A "rabbi trust" is a grantor trust established to protect nonqualified deferred compensation benefits from certain kinds of risk of nonpayment. The adverse tax consequences will apply if assets are transferred to a rabbi trust while a qualified pension plan within an employer's control group is "at risk" as defined under the PPA.[1] These restrictions are currently applicable and are important for companies to keep in mind during a period of declining pension asset values.

As a result, companies that maintain one or more nonqualified deferred compensation plans with associated rabbi trusts need to know whether there are qualified defined benefit plans within their control group, and the PPA-funded status of each such plan. The terms of the nonqualified deferred compensation plans, rabbi trusts, and third-party service provider arrangements should also be reviewed to ensure that adverse tax consequences for covered executives are not inadvertently triggered.

PPA Restrictions on Funding

Code Section 409A imposes strict requirements on the design and operation of nonqualified deferred compensation arrangements. Failure to satisfy these rules results in adverse tax consequences being imposed on the employees that benefit under the plans, including the immediate recognition of taxable income, an additional 20% income tax, and a further tax calculated as interest on the unpaid tax.

The PPA amended Code Section 409A to treat amounts transferred to a rabbi trust associated with a deferred compensation plan (or amounts otherwise set aside or reserved for payment of the deferred compensation) as taxable to certain executives participating in the plan if such amounts are transferred or set aside during a period when a qualified pension plan within an employer's control group is underfunded. Specifically, Code Section 409A (as amended by the PPA) provides that if either (a) any employer assets are set aside or reserved, directly or indirectly, in a trust for the purposes of paying deferred compensation to "covered employees" during a "restricted period" for a single employer defined benefit plan or (b) a nonqualified deferred compensation plan provides that assets become

1. These same adverse tax consequences will apply if the company sponsoring the nonqualified deferred compensation plan becomes a debtor under a Chapter 11 bankruptcy proceeding.

restricted during a pension plan's restricted period, such assets will be subject to immediate taxation to the covered employees, a 20% income tax, and a further tax calculated as interest on the unpaid tax.

A "restricted period" is defined as any period (a) during which the qualified pension plan is "at risk" under the PPA, (b) during which an employer is a debtor in a Chapter 11 bankruptcy case, or (c) that includes the 12-month period that begins six months before the termination of the pension plan if the pension plan is not adequately funded for its liabilities at the time of its termination.

A covered employee includes any employee who is (a) covered under Code Section 162(m) (i.e., a company's chief executive officer and its four highest-paid officers other than the chief executive officer and the chief financial officer) or (b) a named executive officer as defined under Section 16(a) of the Securities and Exchange Act of 1934. These funding restrictions also apply to an individual who was a covered employee at the time of the individual's termination of employment.

Employers should keep in mind that any amount paid by the employer on behalf of an employee to satisfy any tax obligation imposed under these funding restrictions (e.g., a gross-up payment) will not be a deductible expense for the employer for tax purposes and will be included as part of the amount of deferred compensation taken into account to determine the taxes owed under Section 409A.

Definition of At-Risk Status

Under the PPA, a qualified pension plan is generally considered "at risk" if the plan's adjusted funding target attainment percentage (AFTAP) is less than 80%. If the plan's actuary does not complete the plan's certification before the first day of the fourth month of the plan year (e.g., April 1 for calendar-year plans), then the plan's AFTAP is presumed to be 10% less than the prior year's AFTAP until the certification is complete. If the AFTAP is not certified by the first day of the tenth month of the plan year (e.g., October 1 for calendar-year plans) then the plan's AFTAP is presumed to be below 60% for the remainder of the plan year.

If any plan within an employer's control group is "at risk," the restriction on funding applies to all of the companies within the control group. Thus, this issue is not limited to underfunding of an executive's employer—this issue can arise if any company in an employer's control group maintains an underfunded pension plan.

Plan Sponsor Action

Companies that sponsor nonqualified deferred compensation plans with associated rabbi trusts should identify the qualified pension plans within their control group and be aware of such plans' funded status. In addition, companies should review their nonqualified deferred compensation plans, rabbi trust agreements, and agreements with third-party service providers to determine how the funding restrictions could impact their deferred compensation plan administration. Many rabbi trusts are built into nonqualified plan recordkeeping arrangements and are funded on an ongoing basis with regular employer contributions occurring on a preestablished basis. Without a careful review of these recordkeeping agreements, a company may not be aware that such agreements could result in adverse tax consequences to its executives.

Additionally, some deferred compensation arrangements provide for automatic accelerated funding upon a change in control, which could violate these funding restrictions if a pension plan within an employer's control group is "at risk" under the PPA at the time of the change in control. This concern is therefore a highly relevant due diligence consideration in M&A transactions.

The Internal Revenue Service has not yet issued any guidance on these "restricted period" funding rules under Code Section 409A. Although it is unclear whether funding through corporate-owned life insurance would be subject to these restrictions, companies with these types of funding arrangements should consider the restrictions on these insurance policies.

If you have any questions or would like more information on the issues discussed in this LawFlash, please contact any of the following Morgan Lewis attorneys:

Chicago

Brian D. Hector	312.324.1160	bhector@morganlewis.com
Louis L. Joseph	312.324.1726	louis.joseph@morganlewis.com

Dallas

John A. Kober	214.466.4105	jkober@morganlewis.com

New York

Craig A. Bitman	212.309.7190	cbitman@morganlewis.com
Gary S. Rothstein	212.309.6360	grothstein@morganlewis.com

Palo Alto

S. James DiBernardo	650.843.7560	jdibernardo@morganlewis.com
Zaitun Poonja	650.843.7540	zpoonja@morganlewis.com

Philadelphia

Robert L. Abramowitz	215.963.4811	rabramowitz@morganlewis.com
Brian J. Dougherty	215.963.4812	bdougherty@morganlewis.com
I. Lee Falk	215.963.5616	ilfalk@morganlewis.com
Amy Pocino Kelly	215.963.5042	akelly@morganlewis.com
Robert J. Lichtenstein	215.963.5726	rlichtenstein@morganlewis.com
Vivian S. McCardell	215.963.5810	vmccardell@morganlewis.com
Joseph E. Ronan, Jr.	215.963.5793	jronan@morganlewis.com
Steven D. Spencer	215.963.5714	sspencer@morganlewis.com
Mims Maynard Zabriskie	215.963.5036	mzabriskie@morganlewis.com
David B. Zelikoff	215.963.5360	dzelikoff@morganlewis.com

Pittsburgh

Lisa H. Barton	412.560.3375	lbarton@morganlewis.com
John G. Ferreira	412.560.3350	jferreira@morganlewis.com
Randall C. McGeorge	412.560.7410	rmcgeorge@morganlewis.com
R. Randall Tracht	412.560.3352	rtracht@morganlewis.com

Washington, D.C.

Althea R. Day	202.739.5366	aday@morganlewis.com
Leslie E. DuPuy	202.739.5519	ldupuy@morganlewis.com
David R. Fuller	202.739.5990	dfuller@morganlewis.com
Mary B. (Handy) Hevener	202.739.5982	mhevener@morganlewis.com
Daniel L. Hogans	202.739.5510	dhogans@morganlewis.com
Gregory L. Needles	202.739.5448	gneedles@morganlewis.com

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