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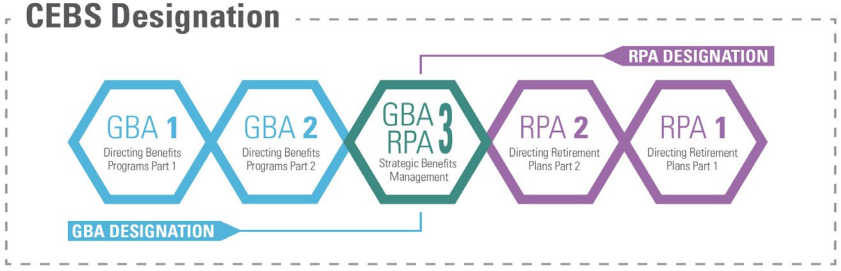

Legal Update

Kirsten Garcia, Counsel

Haynes Boone

HAYNES BOONE

DFW CHAPTER OF ISCEBS

Legal Update

Kirsten Garcia

September 8, 2022

Health & Welfare Plans

- ACA FAQs Part 54: Contraceptive Coverage
  - Cover items and services that are integral to the furnishing of a recommended preventive service, e.g., anesthesia for tubal ligation or pregnancy test before IUD;
  - Cover, without cost-sharing, FDA-approved contraception not described in the HRSA-supported guidelines;
  - Reasonable medical management techniques
    - Suspect: denial of particular brand name if medically necessary and fail first requirements; and
  - Preemption of state laws.
- ACA FAQs Part 55: Transparency
  - Network and Out-of-Network Files Posted Publicly by July 1
    - Posting by TPA: (1) requires written agreement and (2) where posted?
  - Lots of other info – IDR, etc.

ERISA Plans

- Case: Walsh v. Alight Solutions LLC
- DOL investigation of unauthorized distributions due to cybersecurity breaches in the ERISA plan accounts serviced by Alight
- Court stated Alight's non-fiduciary status does not affect the DOL's investigatory authority
- Case reinforces the DOL's broad subpoena authority, including requests made to a third-party service provider
- Plan sponsors should discuss cybersecurity with their plan's service providers at least annually and should ensure that their service provider agreements clearly provide that the service provider will cooperate with DOL requests in accordance with the law

HAYNES BOONE

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Today's Speaker & Topic

Traci M. Clements, Partner

McGinnis Lochridge, LLP

"Structuring Non-Qualified Deferred Compensation (NQDC) Plans"

Dallas / Ft. Worth ISCEBS Chapter

Structuring Non-Qualified Deferred Compensation Plans

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SEPTEMBER 8, 2022

Learning Objectives—Why are we here?

- Considerations in establishing NQDC plans
- A brief overview of the applicable laws including 409A and ERISA
- Common pitfalls to avoid including modifying and terminating NQDC plans
- Corrections and Practical Advice

What is a Non-Qualified Deferred Compensation Plan?

Any arrangement outside of a tax-qualified retirement or welfare benefit plan whereby an employee (or other “service provider”) has a “legally binding right” to income or a benefit in one year, that he/she/they/it ***may*** take or receive in a later year, thereby deferring taxation on the income or benefit until the year in which it is received.

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Why Use a Non-Qualified Deferred Compensation Plan?

- Exempt from many ERISA requirements (can discriminate, no annual filings, no SPDs, “no” fiduciary duties)
- Not limited in amounts deferred
- Tax deferred
- Unfunded (see Rabbi Trusts for Top Hat plans)
- Can help HCEs offset income to avoid receiving corrective distributions from qualified plans (e.g., 401(k))
- Most likely minimal or no recordkeeping or administrative fees

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Consider This

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Consider This

- What kind of organization is the sponsor? (public, tax exempt, c-corp, partnership)
- What are we trying to accomplish with this Plan?
- Who is eligible to participate?
- Do we fund this Plan? (Rabbi Trust – see Rev. Proc. 92-64)
- What is the form of benefit? Are there investments?
- When/how does it begin? When/how does it end?
- Is it subject to vesting?
- Can it ever be amended or terminated?
- Can the participant change the timing and form of payment? (Five-Year Rule)
- What laws govern the Plan?

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Consider This

Salary and Bonus Deferrals	Excess Contribution Plans	SERPS ("Top Hat Plans")	Phantom Equity
RSUs	Severance Plans	457(f)	Change In Control

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Applicable Laws

"Constructive Receipt"	"Economic Benefit"	§ 409A
ERISA	DOL	§ 457(f)

Applicable Laws

- Constructive Receipt: Treas. Reg. § 1.451-2
  - constructively received in the tax year in which it is either:
    - Credited to the taxpayer's account.
    - Set apart for the taxpayer.
    - Made available so that the taxpayer:
      - may draw on it any time; or
      - could have drawn on it during the tax year if notice of intent to withdraw had been given.
- Economic Benefit
  - a taxpayer is taxed when the taxpayer receives an "economic benefit" from an absolute right to receive property in the future:
    - Benefits that are fixed
    - Benefits that are placed in an irrevocable trust or fund to be used for the participant's sole benefit
    - Not subject to the employer's debtors

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Applicable Laws

- 409A
  - Applies to NQDCs
  - Requirements
    - Written Plan Document
      - Time and form of payment
      - Election rules
      - Ability to change election subject to five-year rule
      - Six-month delay in payment for “specified employees”

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Applicable Laws

- 409A
  - Requirements
    - Strict operational rules
      - Permissible payment events
        - Death
        - Disability
        - Separation from service (20% rule)
        - Specific date or schedule of payments
        - Unforeseeable emergency
        - Change in Control (see definition)

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Applicable Laws

- 409A
  - Requirements
    - Strict operational rules
      - Anti-acceleration provisions
      - No offsets from Plan distributions
      - Legally binding right in one taxable year to payment that ***may be*** made in a later taxable year

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Applicable Laws

- 409A
  - Plan Aggregation
    - Common Categories:
      - Elective account balance plans
      - Non-elective account balance plans
      - Non-account balance plans
      - Involuntary separation pay or window programs
      - In-kind benefits or reimbursement programs
      - Split-dollar insurance plans
      - Stock rights (unless otherwise exempt from 409A)

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Applicable Laws

- 409A
  - Comply with all terms
  - Exemptions
    - Qualified Plans
    - Non-taxable welfare benefits
    - Stock Options at FMV
  - Exceptions
    - Short term deferral rule
    - Window program

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Applicable Laws

- 409A
  - Ordinary income on *all* vested amounts (i.e., those no longer subject to a "substantial risk of forfeiture")
  - 20% federal excise tax (additional 5% in California)
  - Possible late fees/penalties
  - Interest
    - Short term AFR + 3%
    - Premium interest rate based on the underpayment that would have occurred if the amount had been included in the recipient's income in the taxable year it was first deferred (or if later, when vested)

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Applicable Laws

- ERISA
  - 29 USC § 1002(2)(A)(ii)

    – ERISA covers a company's deferred income plan when the plan *results in* a deferral of income by employees for periods *extending to* the termination of covered employment or beyond.
      - Results in = “to cause” or “have (something) as a result.
      - Extending to = “to reach” or “that reach”

      Wilson v. Safelite Grp., Inc., 930 F.3d 429, 444 (6th Cir. 2019).

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Applicable Laws

- ERISA
  - 1002(2)(A)(ii)
    - *Wilson v. Safelite Grp., Inc.*, 930 F.3d 429 (6th Cir. 2019)
      - The Plan did not meet the bonus exemption under 29 CFR § 2510.3-2(c).
    - *Tolbert v. RBC Capital Mkts. Corp.*, 758 F.3d 619, 624 (5th Cir. 2014).
      - The critical inquiry is whether the plan results in a deferral of income by employees for periods extending to the termination of covered employment or beyond.
    - *Boos v. AT&T, Inc.*, 643 F.3d 127, 134 (5th Cir. 2011).
      - to establish coverage via subsection (ii), employees must show that they forewent income at some point in exchange for receiving income from the plan at a later date.
    - *Fort Halifax Packing Co. v. Coyne*, 482 U.S. 1, 12, 107 S. Ct. 2211, 96 L. Ed. 2d 1 (1987); *Winterrowd v. American General Annuity Ins. Co.*, 321 F.3d 933, 938-39 (9th Cir. 2003); *Donovan v. Dillingham*, 688 F.2d 1367, 1373 (11th Cir. 1982) (en banc)); *Miller v. Olsen*, No. 3:15-cv-00571-AC, 2016 U.S. Dist. LEXIS 102272, at *5 (D. Or. 2016)
      - an ERISA plan must invoke an 'ongoing administrative program,' and must enable reasonable persons to 'ascertain the intended benefits, beneficiaries, source of financing, and procedures for receiving benefits.'

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Applicable Laws

- DOL
  - 29 C.F.R. § 2510.3-1(a) – Health and Welfare Plans
    - The practices covered under this section are not ERISA plans.
      - For example, a system of payroll deductions by an employer for deposit in savings accounts owned by its employees is not an employee welfare benefit plan because it does not provide benefits described in section 3(1)(A) of the Act;
      - In addition, if each employee has the right to withdraw the balance in his or her account at any time, such a payroll savings plan does not meet the requirements for a pension plan and is not an employee benefit plan.
  - 29 C.F.R. § 2510.3-2(b) – Severance Plans
    - Not an employee pension benefit plan provided that:
      - Such payments are not contingent upon the employee's retirement;
      - The total amount does not exceed 2x the employee's annual compensation during the immediately preceding year;
      - All payments are completed within 24 months.
  - 29 C.F.R. § 2510.3-2(c) – Bonus Program
    - Not an employee pension benefit plan provided that:
      - Payments were made as a bonus for work performed;
      - Payments are not systematically deferred to the termination or beyond so as to provide retirement income to the individual.

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Applicable Laws

- DOL
  - 29 C.F.R. § 2520.104-23(b)(1)
    - Allows Top Hat Plans to avoid disclosure requirements under ERISA
    - One-time filing obligation
      - Statement declaring the arrangement is a Top Hat Plan;
      - Filed within 120 days of implementing Plan;
    - May be required to provide plan document upon request

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Applicable Laws

- DOL
  - 29 C.F.R. § 2520.104-23(b)(1)
  - "Top hat plans" are exempt from *most* of the substantive provisions of ERISA;
  - A top hat plan is an unfunded deferred compensation plan maintained primarily for a select group of management or highly compensated employees;
  - Still subject to claims procedures under ERISA:
    - Disability
    - Limitations Period
    - Exhaustion of Administrative Remedies
    - Discovery
    - Preemption of state law claims

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Applicable Laws

- 457(f)
  - Applies to tax exempt entities (not all non-profits are tax exempt);
  - Can only accept employer contributions;
  - Taxable upon vesting ("no longer subject to substantial risk of forfeiture") unless substantial risk of forfeiture applies during the entire deferral period;
    - This is different than 409A for *taxable* entities;
    - Also 457(f) has its own definition of "substantial risk of forfeiture", must comply with both in a 457(f) plan;
  - Plan must comply with 457(f) and 409A.

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Common Pitfalls to Avoid

- Failure to include “savings clause”
- Undefined Payment Events
- Impermissible Payments
- Impermissible Elections
- Failure to Apply the Five-Year Rule
- Specified Employee Delay
- Failure to File for DOL Exemption

409A Savings Clause

- It is a clause in the NQDC plan that says that the NQDC plan is intended to comply with Code Section 409A.
- The intended purpose of the savings clause is to make sure that any ambiguity is resolved in favor of a pro- Code Section 409A interpretation.

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409A Savings Clause

- **When it works:**
  - If a term is ambiguous or not clearly defined, a savings clause *may* tip the balance in favor of a Code Section 409A-compliant interpretation.
- **When it doesn't work:**
  - If a term in the NQDC plan contradicts Code Section 409A.
  - If the administration of the NQDC plan violates Code Section 409A (regardless of whether the document is compliant).
  - When it's an ERISA plan under 29 USC § 1002(2)(A)(ii) (see *Wilson v. Safelite Grp., Inc.*).

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Undefined Payment Events

- Terms should not be ambiguous such as:
  - Termination of employment
  - Disability
  - Change in Control

- Each of the above terms are defined in 409A
- IRS Notice 2010-6: documentary compliance under Section 409A requires that these terms be defined in accordance with Section 409A.

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Impermissible Payment

- Payments that are not based on:
  - Death
  - Disability
  - Separation from Service
  - **Specified time or event**
  - Change in Control
  - Unforeseeable emergency

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Impermissible Elections

See attached Deferral Election Deadlines Chart

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Five-Year Rule

Deferral elections must be made at least 12 months **before** the date on which the compensation ceases to be subject to a substantial risk of forfeiture.

- Once changed, the payment must be delayed for at least five years beyond the otherwise applicable payment date, except for payments made on:
  - Change in Control changes;
  - Disability payments;
  - Death;
  - Unforeseeable emergency

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Five-Year Rule

Example: The employee would like to defer an annual bonus for 2021 to be paid on February 15, 2022, only if the employee is employed by the employer on the payment date, the employee can make the election on or before February 14, 2021. Unless the employee elects to defer payment until death, disability, unforeseeable emergency or a change in control, the **earliest** elected payment date must be February 15, 2027 (five years from the original payment date).

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Specified Employee

For Public Companies

- A distribution to a specified employee from a nonqualified deferred compensation plan on account of separation from service may not be made before the 1st day of the 7th month after termination of employment (unless the payment is due to death);
- An employee is a specified employee if he or she is a “key employee” as defined under Section 409A;
- Generally, top 50 highest paid officers (or, if less, the greater of 3 officers and 10% of the employees);
- Certain shareholder-employees;

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Specified Employee

For Public Companies

- Specified employees must be designated each year as of a uniform "identification date" elected by the company. The identification does not become effective until the beginning of the 4th calendar month after the identification date and the identified individuals remain specified employees for the next 12 months;
- Alternative compliance method is to delay payments for all participants in the NQDC plan;
- *Plan document requirement*.

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One-Time DOL Exemption Filing

Top Hat Plans

- Technically, a top hat plan is still subject to ERISA's reporting requirements (i.e., annual Form 5500)
- DOL regulatory exemption
  - Must make a one-time filing
    - Name of the plan
    - Number of participants
    - Only needs to be updated if sponsor changes address
  - Must be filed electronically
  - Must be filed within 120 days of the plan becomes subject to ERISA

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Correction Programs

- Operational Corrections:
  - Improper accelerations or deferrals
  - Stock options bearing a discount

- Documentary Corrections
  - Impermissible definitions of payment events
  - Failure to provide Specified Employee delay
  - Impermissible acceleration allowed
  - Impermissible payment events

Correction Programs

- Correction Conditions:
  - Notice 2008-113
    - A discounted option can be corrected by adjusting the exercise price upwards;
    - Provide notice to the IRS
    - Provide notice to the employee (“Service Provider”) if it occurs within the first year
  - Notice 2010-6
    - If no permissible payment trigger: make correction prior to payment
    - 50% of vested amount is subject to 409A penalties
    - Attach correction notices to tax returns (both the Service Provider and Service Recipient)

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Correction Programs

- Correction Conditions:
  - Unvested Amounts
    - If subject to substantial risk of forfeiture during the entire taxable year of correction, can make corrections freely;
    - If NOT subject to substantial risk of forfeiture during the entire taxable year of correction, then corrections are limited

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Practical Advice

- Go through the suggested considerations and others;
- Review the laws governing the type of plan you want to implement;
- Remember 409A doesn't override the Constructive Receipt or Economic Benefit doctrines;
- Include the savings clause, but don't rely on it;
- Use the 409A definitions and payment events;
- If for a tax-exempt entity use both 409A and 457(f) (don't forget to use both in drafting and operation);
- If a SERP (Top Hat Plan) file your DOL declaration within 120 days;
- Don't forget to administer it – can appoint a committee;
- Don't panic – correction procedures are available.

Questions?

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Thursday, November 10, 2022 12pm – 1pm

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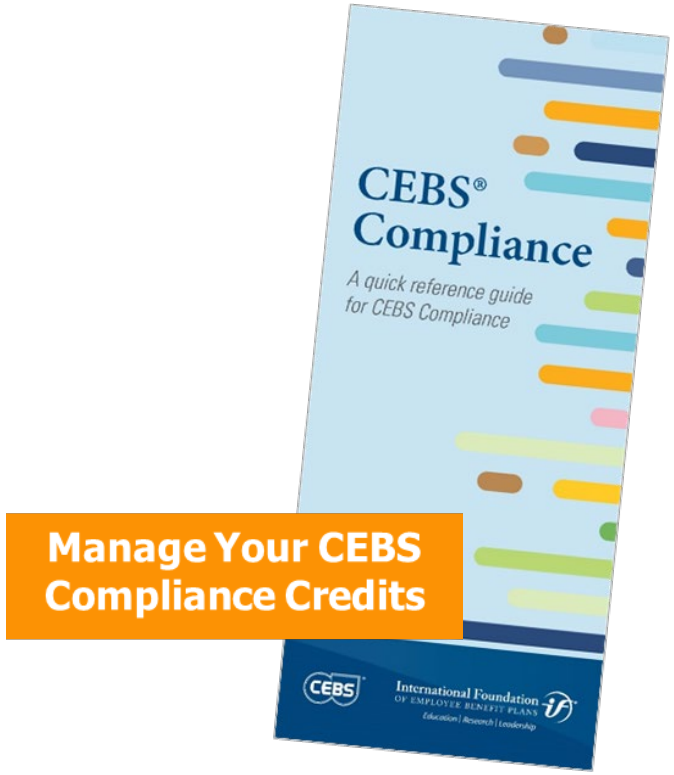
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