Nonqualified Employee Benefits for Privately-Held Companies – Equity and Deferred Compensation Opportunities (Outline)

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I. EQUITY COMPENSATION ARRANGEMENTS FOR PRIVATE COMPANIES.¹

A. Equity Compensation Arrangements for C Corporations.²

1. Restricted Stock.

   a. Under IRC Section 83, if, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of

      i. the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or not subject to a substantial risk of forfeiture, whichever occurs earlier, over

      ii. the amount (if any) paid for such property,

      shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable.

   b. Section 83(b) Election – any person who performs services in connection with which property is transferred to any person may elect to include in his gross income, for the taxable year in which such property is transferred, the excess of (A) the fair

¹ Section I of this outline focuses on the federal income tax rules applicable to equity compensation arrangements for private companies. There are other considerations that are relevant to such arrangements as well, such as state corporate law issues, securities registration issues and accounting issues, which are beyond the scope of this outline.

² Similar equity compensation arrangements are available for S corporation as well, although S corporations must, in addition, analyze whether equity incentives present any second class of stock issues, a topic which is beyond the scope of this outline.
market value of such property at the time of transfer (determined without regard to any restriction other than a restriction which by its terms will never lapse) over (B) the amount (if any) paid for such property.

i. Must be made not later than 30 days after the date of such transfer.

ii. Election starts holding period for capital gain.

iii. Dividends paid after 83(b) election on unvested stock are taxed at dividend rates. Dividends paid on unvested stock without 83(b) election are taxed at ordinary income (compensation) rates.

c. Tax treatment – The income described above is taxed at ordinary income (compensation) rates and is subject to wage withholding. The employer receives a deduction at the same time and in the same amount.

d. Substantial risk of forfeiture – depends on facts and circumstances, but with limited exceptions, exists only if rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or upon the occurrence of a condition related to a purpose of the transfer if the possibility of forfeiture is substantial.

i. Some IRS guidance suggests that a service period must last at least 2 years from the grant date for the risk of forfeiture to be considered substantial.

e. Transfer – occurs when a person acquires a beneficial ownership interest in such property (disregarding any lapse restriction).

i. The grant of an option does not constitute a transfer.

ii. In addition, if amount paid for the transfer of property is an indebtedness secured by the transferred property, on which there is no personal liability to pay all or a substantial part of such indebtedness, such transaction may be in substance the same as of the grant of an option.
f. Use as an employee incentive – because restricted stock is subject to ordinary income tax at vesting (or at grant, if 83(b) election), when stock may still be illiquid, it is mostly used when the value of the stock at grant is low. When coupled with an 83(b) election, the grant of restricted stock with a low fair market value can be a tax-efficient compensation tool.

2. Stock Options.

a. Incentive Stock Options.

i. Under IRC Section 422, no income results to an individual who receives a share pursuant to the exercise of an incentive stock option if (1) no disposition of such share is made by him within 2 years from the date of granting of the option nor within 1 year after the transfer of the share to him, and (2) at all times during the period beginning on the date of the granting of the option an ending on the day 3 months (or 1 year if disabled) before the date of such exercise, such individual was an employee of either the corporation granting such option or a parent or subsidiary.

1. However, gain from exercise of an incentive stock options is included in income for purposes of alternative minimum tax (AMT).

ii. Subsequent tax treatment – Upon subsequent disposition after the holding period ends, any gain over the basis in the shares is taxed at capital gains rates. Disposition before expiration of the applicable holding periods (i.e., a disqualifying disposition) results in ordinary income to the optionholder in the year of disposition equal to the ordinary income he would have received on exercise if the option had not qualified as an incentive stock option (see below), with any additional gain/loss at the time of disposition treated as a capital gain or loss. The employer does not receive a tax deduction unless there is a disqualifying disposition.

iii. Incentive Stock Option – means an option granted to an individual for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary
corporation, to purchase stock of any of such corporations, but only if –

1. The option is granted pursuant to a plan which includes the aggregate number of shares which may be issued under options and the employees (or class of employees) eligible to receive options, and which is approved by the stockholders of the granting corporation within 12 months before or after the date such plan is adopted;

2. Such option is granted within 10 years from the date such plan is adopted, or the date such plan is approved by the stockholders, whichever is earlier;

3. Such option by its terms is not exercisable after the expiration of 10 years from the date such option is granted;

4. The option price is not less than the fair market value of the stock at the time such option is granted;

5. Such option by its terms is not transferable by such individual otherwise than by will or the laws of descent and distribution, and is exercisable during his lifetime, only by him;

6. Such individual, at the time the option is granted, does not own stock possessing more than 10 percent of the total combined voting power of all classes of stock of the employer corporation or of its parent or subsidiary corporation, unless the option price is at least 110 percent of the fair market value of the stock subject to the option and such option by its terms is not exercisable after the expiration of 5 years from the date such option is granted.

iv. $100,000 Limitation – To the extent that the aggregate fair market value of stock with respect to which incentive stock options are exercisable for the first time by any individual during any calendar year
(under all plans of the individual’s employer corporation and its parent and subsidiary corporations) exceeds $100,000, such options shall be treated as nonstatutory options.

v. Use as an employee incentive – because gain from exercise of incentive stock options is included for AMT purposes and because there is no deduction to the company (unless there is a disqualifying disposition), incentive stock options have fallen out of favor. However they can still provide a tax-efficient incentive for employees who are not expected to be subject to AMT.

b. Employee Stock Purchase Plans.

i. Under IRC Section 423, no income results to an individual who receives a share pursuant to the exercise of an option granted under an employee stock purchase plan (ESPP) if (1) no disposition of such share is made by him within 2 years from the date of granting of the option nor within 1 year after the transfer of the share to him, and (2) at all times during the period beginning on the date of the granting of the option an ending on the day 3 months (or 1 year if disabled) before the date of such exercise, such individual was an employee of either the corporation granting such option or a parent or subsidiary.

ii. Subsequent tax treatment – Upon subsequent disposition after the holding period ends, any gain over the basis in the shares is taxed at capital gains rates. Disposition before expiration of the applicable holding periods (i.e., a disqualifying disposition) results in ordinary income to the optionholder in the year of disposition equal to the ordinary income he would have received on exercise if the option had not qualified as an incentive stock option (see below), with any additional gain/loss at the time of disposition treated as a capital gain or loss. The employer does not receive a tax deduction unless there is a disqualifying disposition.

iii. ESPP – means a plan which meets the following requirements:
1. The plan provides that options are to be granted only to employees of the employer corporation or its parent or subsidiary corporation to purchase stock in any such corporation;

2. Such plan is approved by the stockholders of the granting corporation within 12 months before or after the date such plan is adopted;

3. Under the terms of the plan, no employee can be granted an option if such employee, immediately after the option is granted, beneficially owns stock possessing more than 5 percent or more of the total combined voting power or value of all classes of stock of the employer corporation or its parent or subsidiary corporation.

4. Under the terms of the plan, options are to be granted to all employees of any corporation whose employees are granted any of such options by reason of their employment by such corporation, with certain exclusions for recent hires, part-time, temporary and highly compensated employees.

5. Under the terms of the plan, all employees granted such options shall have the same rights and privileges, except that the amount of stock that may be purchased may be uniformly related to the employee’s compensation, and may be subject to a maximum limit fixed under the plan;

6. Under the terms of the plan, the option price is not less than the lesser of (A) an amount equal to 85 percent of the fair market value of the stock at the time such option is granted or (B) an amount which under the terms of the option may not be less than 85 percent of the fair market value of the stock at the time such option is exercised.
7. Under the terms of the plan, such option cannot be exercised after the expiration of (A) 5 years from the date such option is granted if, under the terms of such plan, the option price is to be not less than 85 percent of the fair market value of such stock at the time of the exercise of the option, or (B) 27 months from the date such option is granted if otherwise.

8. Under the terms of the plan, no employee may be granted an option which permits his rights to purchase stock under all such plans of his employer corporation and its parent and subsidiary corporations to accrue at a rate which exceeds $25,000 of fair market value of such stock (determined at the time the option is granted) for each calendar year in which such option is outstanding at any time.

9. Under the terms of the plan, such option is not transferable otherwise than by will and the laws of descent and distribution, and is exercisable, during his lifetime, only by him.

iv. Special rule where option price is between 85 percent and 100 percent of value of stock – if all ESPP conditions otherwise exist, where an option price is between 85 percent and 100 percent of the value of the stock on the grant date, upon the disposition of such share after satisfying the applicable holding period (or following his death), there is included in compensation income (and not capital gain) for such year, an amount equal to the lesser of (1) the excess of the fair market value of the share at the time of such disposition over the amount paid for such share under the option, or (2) the excess of the fair market value of the share at the time of the option was granted over the option price.

1. If the option price is not fixed or determinable at the time the option is granted, then the option price shall be determined as if the options were exercised at such time.

v. Use as an employee incentive – Because an ESPP must be made available to substantially all employees, it is unusual
for privately held companies to employee ESPPs as a management incentive. In certain cases (e.g., large privately held companies with procedures in place for regularly valuing their stock), an ESPP can provide a tax-efficient means of encouraging share ownership for all employees.

c. Nonstatutory Stock Options.

i. Under Section 83, if an option is granted which is neither an incentive stock options nor an ESPP option, and if the option does not have a readily ascertainable fair market value at the time the option is granted, the excess of the fair market value of the shares subject to the option (determined without regard to any lapse restriction) over the amount (if any) paid for such shares under the option is included in the optionholder’s income at the time of exercise.

ii. Tax treatment – The income described above is taxed at ordinary income (compensation) rates and is subject to wage withholding. The employer receives a deduction at the same time and in the same amount.

iii. Section 409A requirements – a nonstatutory stock option must satisfy additional IRC Section 409A requirements in order to qualify for the tax treatment described above. These requirements include:

1. The option price cannot be less than 100% of the fair market value of the stock as of the date of grant, using the reasonable application of a reasonable valuation method. Though not required, many privately held companies will obtain an independent valuation to help satisfy this requirement.

2. The option must be granted on “service recipient stock,” generally meaning common stock, of an “eligible issuer,” generally meaning the optionholder’s employer (or a majority owner of the optionholder’s employer).

3. The option may not include any additional features for the deferral of compensation.
4. The option may not be modified or extended after the date of grant, subject to certain limited exceptions.

5. A violation of Section 409A may subject the optionholder to early recognition of tax and additional income taxes beyond those described above.

   iv. Use as an employee incentive – although not tax efficient, and with some additional costs to obtain a valuation that complies with Section 409A, because they allow employees to defer tax until exercise upon a liquidity event, nonstatutory stock options are a very common way of incentivizing management in private corporations.


   a. Phantom stock (also known as restricted stock units) are unfunded contractual rights to receive shares of stock (or the value thereof in cash) at a fixed future payment date or event. Stock Appreciation Rights (SARs) are unfunded contractual rights to receive the increase in value of a share of stock after the date of grant, which may be paid in shares or cash.

   i. It is possible, though rare, to grant a SAR that may be exercised for stock like a nonstatutory option, subject to compliance with the same Section 409A requirements applicable to nonstatutory stock options described above.

   b. Tax treatment – if structured properly to comply with Section 409A, phantom stock/SARs result in ordinary (compensation) income upon payment to the employee, subject to wage withholding. The employer receives a deduction at the same time and in the same amount.

   c. Section 409A requirements – because phantom stock/SARs are nonqualified deferred compensation arrangements, they must be structured to comply with (or qualify for an exemption from) Section 409A. The most common exemption is the “short-term deferral exception,” which applies if the right to receive payment under the phantom stock/SARs is subject to a substantial risk of forfeiture through the payment date. A complete review of the Section 409A rules applicable to phantom stock/SAR arrangements is outside the scope of this outline, but these rules
should be reviewed carefully before entering into any such arrangements, as failure to comply with Section 409A can result in additional income taxes to the employee.

d. Use as an employee incentive – Though tax inefficient, phantom stock arrangements are common where employers wish to provide employees with the right to receive the full economic value of a share of stock (rather than just the appreciation in value), but are unable or unwilling to use restricted stock. Though less flexible than nonstatutory options, SARs may be used in circumstances where employees wish to grant an appreciation-only award but do not wish to obtain a Section 409A valuation or give the employee the right to acquire shares.

4. Qualified Equity Grants.

a. 2018 Tax Reform Act added IRC Section 83(i) which provides that if qualified stock is transferred to a qualified employee who makes an “83(i)” election with respect to such stock, the qualified employee will not recognize income equal to the value of the stock until the earliest of (i) the year the stock becomes transferable; (ii) the date the employee first becomes an excluded employee; (iii) the first date on which any stock of the corporation which issued the qualified stock becomes readily tradable on an established securities market; (iv) the date that is 5 years after the first date the rights of the employee in such stock are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier; (v) the date on which the employee revokes the 83(i) election.

i. Election must be made no later than 30 days after the first date the rights of the employee in such stock are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier.

b. Qualified stock – means with respect to any qualified employee, any stock in a corporation which is the employer of such employee, if (i) such stock is received in connection with the exercise of an option, or in settlement of a restricted stock unit, and (ii) such option or restricted stock unit was granted by the corporation in connection with the performance of services as an employee, and during a calendar year in which such corporation was an eligible corporation.
i. Does not include any stock if the employee may sell such stock to, or otherwise receive cash in lieu of stock from, the corporation at the time that the rights of the employee in such stock first become transferable or not subject to a substantial risk of forfeiture.

c. Eligible corporation – means with respect to any calendar year, any corporation if (i) no stock of such corporation (or any predecessor of such corporation) is readily tradable on an established securities market during any preceding calendar year, and (ii) such corporation has a written plan under which, in such calendar year, not less than 80 percent of all employees who provide services to such corporation in the United States are granted stock options, or are granted restricted stock units, with the same rights and privileges to receive qualified stock.

i. “Rights and privileges” similar to ESPP rules except employees shall not fail to be treated as having the same rights and privileges to receive qualified stock solely because the number of shares available to all employees is not equal in amount, so long as the number of shares available to each employee is more than a “de minimis” amount.

d. Qualified employee – generally means any individual who is not an excluded employee, where “excluded employee” means, with respect to any corporation, any individual (i) who is a 1-percent owner at any time during the calendar year or who was such a 1 percent owner at any time during the 10 preceding calendar years, (ii) who is or has been at any prior time the chief executive officer of such corporation or an individual acting in such a capacity, or the chief financial officer of such corporation or an individual acting in such a capacity, (iii) is related to the CEO or CFO in a manner described in IRS regulations, or (iv) who is one of the 4 highest compensated officers of such corporation for the taxable year, or was one of the 4 highest compensated officers of such corporation for any of the 10 preceding taxable years.

e. Use as an employee incentive – Because of the recent enactment of Section 83(i) and the absence of IRS regulations or other general guidance, and given the limitations on qualified employees and the requirement that
at least 80% of employees be offered at least a de minimis amount of qualified stock, few employers have utilized Section 83(i) as a management incentive so far. For companies willing and able to meet these requirements, qualified stock offers a potential way to plan around the “dry income”/liquidity problem by deferring tax on exercise of options or settlement of RSUs for up to 5 years after exercise/settlement.

B. Equity Compensation Arrangements for Partnerships or Limited Liability Companies Taxed as Partnerships.

1. Like corporations, partnerships may grant restricted capital interests, nonstatutory options and phantom units/unit appreciation rights, but not ISOs, ESPP options or qualified equity awards. The federal income tax rules for the grant of a capital interest, nonstatutory option or phantom unit/unit appreciation right in a partnership are similar to the rules applicable to the grant of restricted stock, nonstatutory options and phantom stock/stock appreciation rights for corporations (for which see earlier discussion above). This outline focuses on a type of equity incentive award that is unique to partnerships – the profits interest.

2. Profits Interests.

a. Rev. Proc. 93-27 – provides that a profits interest is any partnership interest other than a capital interest, where a capital interest is defined as an interest that would give the holder a share of the proceeds if the partnership’s assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership. This determination generally is made at the time of receipt of the partnership interest.

i. If a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, the IRS will not treat the receipt of such an interest as a taxable event for the partner or the partnership, unless (i) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease; (ii) within two years of receipt, the partner disposes of the profits interest; or (iii) the profits interest is a limited partnership interest in a
“publicly traded partnership” within the meaning of IRC Section 7704(b).

b. Rev. Proc. 2001-43 – provides that the determination of whether an interest granted to a service provider is a profits interest is tested at the time the interest is granted, even if, at that time, the interest is substantially nonvested. Accordingly, neither the grant of a profits interest nor the event that causes the profits interest to become substantially vested is treated as a taxable event for the partner or the partnership.

i. Taxpayers need not file a Section 83(b) election to obtain this treatment, although it is standard to file a protective 83(b) election when a profits interest is granted.

ii. Where a partnership grants an interest in the partnership that is substantially nonvested to a service provider, the service provider will be treated as receiving the interest on the date of its grant, provided that (i) the partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant and the service provider takes into account the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing the service provider’s income tax liability for the entire period during which the service provider has the interest; (ii) upon the grant of the interest or at the time that the interest becomes substantially vested, neither the partnership nor any of the partners deducts any amount (as wages, compensation, or otherwise) for the fair market value of the interest; and (iii) all other conditions of Rev. Proc. 93-27 are satisfied.

c. IRS Proposed 2005 Regulations – generally treat the issuance of a profits interest under the same principles applicable to restricted property issued in connection with the performance of services under IRC Section 83, but have not yet been finalized, so Rev. Procs 93-27 and 2001-43 continue to govern for now.

d. Tax treatment – A profits interest (properly structured) does not result in taxable income at grant or vesting. Upon disposition of the profits interest, the gain over the
employee’s basis in the profits interest is taxed at capital gains rates (which may be long-term or short-term, depending on how long the employee has held the interest).

i. An employee may incur taxable income in connection with his or her distributable share of the partnership’s profits allocable to his or her interest (vested or nonvested).

ii. IRS regulations issued in 2016 confirmed that a person who receives a profits interest in the entity for which he or she performs services (or in the parent of such entity, if the entity to which he or she performs services is a disregarded entity) must also be treated for purposes relating to compensation reporting, employment taxes, tax withholding and benefit plan participation as a self-employed individual rather than an employee.

e. Use as an employee incentive – Because of their tax efficiency, profits interest are a common way of incentivizing management of an LLC or partnership. However, because recipients of a profits interest may need to be treated as self-employed for tax and benefits purposes, profits interests are generally granted to more sophisticated members of management.

II. NONQUALIFIED DEFERRED COMPENSATION ARRANGEMENTS FOR PRIVATE COMPANIES.

A. Highly Customizable.

1. Employers have broad discretion to determine the terms and structures of nonqualified deferred compensation plans. Plans can be highly customized to specific company and executive goals and objectives.

2. Key plan design terms generally involve: (1) eligibility, (2) type of contribution (defined contribution versus defined benefit), (3) interest crediting / investment of plan assets, (4) vesting conditions, (5) distribution forms and triggering events, (6) funding mechanisms, and (7) plan administration.

B. Eligibility.

1. Employers have total discretion to select individuals for plan participation.
2. Participants may include executives, high-compensated employees, members of management, non-employee directors, consultants and/or independent contractors.

3. Unlike tax-qualified retirement plans, there are no non-discrimination tests applicable to nonqualified deferred compensation plans. Specifically, the coverage tests under Code Section 401(a)(4) and Code Section 410(b) do not apply to nonqualified deferred compensation plans.

4. However, to avoid application of ERISA to a nonqualified deferred compensation plan, participants must be limited to a “select group of management or highly compensated employees.” See, Department of Labor Regulation Section 2520.104-23. This requirement is generally referred as “top hat” plan status.

5. The law is unsettled as to how many participants may join a nonqualified deferred compensation without it becoming subject to ERISA. Practitioners generally find that plans covering the top 10% to 15% of employees fit this standard.

6. The DOL has indicated in a 1990 Opinion Letter that bargaining should also be a factor considered when determining whether a nonqualified deferred compensation plan qualifies as a top hat plan.

7. However, judicial decisions, do not necessarily follow the Department of Labor Opinion Letter. For example, the court in Sikora v. UPMC (12/22/15 W.D. PA) reviewed both quantitative and qualitative factors when considering the question of whether the plan was a top hat plan. The Sikora court stated that “the plan must cover relatively few employees [and] the plan must cover only high level employees.”

8. The Department of Labor also articulated its view that top hat plans must be exclusively comprised of management or highly compensated employees in its amicus brief to the Bond v. Marriott International, Inc. (January 29, 2016) case. In this case, plaintiffs (1) sought class action status on behalf of all plan participants for all time, and (2) argued that the plan was an ERISA plan and therefore subject to ERISA’s minimum vesting requirements.

   a. The Department of Labor contended in Bond that participation by a single individual who did not qualify as either a member of management or as a highly-compensated employee would subject the entire nonqualified deferred compensation plan to ERISA.

C. Nonqualified Defined Contribution Plans.
1. Defined contribution plans provide for a fixed contribution going into the plan. The contribution may consist of employee elective deferrals and/or employer contributions.

2. Employee elective deferrals may be made on virtually any source of compensation – salary, bonuses, equity and/or derivative equity awards.
   a. Code Section 409A generally requires that elective deferrals be made in year prior to the year in which the compensation is earned.
   b. Special rules permit deferral elections in the first year of plan eligibility to occur within 30 days of first becoming eligible to participate in the plan; provided, that the election may only apply prospectively (i.e., to compensation earned following the participant’s election).
   c. In addition, Code Section 409A also permits deferral elections to be made on “performance-based compensation” at any point prior to 6 months before the end of the applicable performance period; provided, that the amount of such compensation has not become readily ascertainable.
   d. Code Section 409A also permits deferral elections to be made with respect to “forfeitable” compensation within 30 days following the participant’s receipt of such compensation, so long as the election is made at least 12 months prior to the earliest date the forfeiture condition may lapse.

3. Employers may provide matching contributions on some or all of employee elective deferrals and/or provide for employer nonelective contributions. Employer nonelective contributions may be specified based on a pre-determined formula (e.g., 5% of compensation), may be stated as a fixed dollar amount (e.g., $50,000) or may be completely discretionary.

4. A nonqualified “excess plan” is a common defined contribution plan design and generally provides participants the ability to make elective deferrals and receive employer matching / nonelective contributions similar the a 401(k) plan; however, without regard to the limitations on such deferrals and/or contributions (e.g., Code Section 402(g) limits on elective deferrals of $18,500, Code Section 401(a)(17) compensation limits of $275,000, Code Section 415(c)(1)(A) limits on total contributions of $55,000).

5. Irrespective of whether a nonqualified defined contribution plan is structured as an excess plan, there are no limits on the amounts
participants may defer into the plan, nor are there any limits on the amounts employers may contribute to the plan on behalf of participants.

6. Further, employers have complete discretion to vary the amounts of contributions by participant and there are no nondiscrimination tests applicable to the contributions made on behalf of participants. For example the Actual Deferral Percentage (ADP) and Actual Contribution Percentage (ACP) tests required for 401(k) plans do not apply to nonqualified defined contribution plans.

7. Employers also have complete flexibility with respect to providing nonqualified defined contribution plan participants the opportunity to earn interest on amounts credited to their accounts. Employers may structure plans to provide a fixed rate of interest (e.g., 3% per year), a floating rate of interest (e.g., LIBOR plus 1%), or may allow participants to hypothetically invest their accounts in a range of investment options (e.g., provide the same investment choices as offered under the company's 401(k) plan). While less common, an employer could determine that it will not provide any interest on amounts contributed to a participant’s account.

D. Nonqualified Defined Benefit Plans.

1. Nonqualified defined benefit plans generally provide participants with a benefit based on a formula specified in the plan. Unlike nonqualified defined contribution plans, these plans do not specify the contribution going into the plan, but rather delineate the amount of the benefit the participant will receive upon distribution.

2. Employers are free to design benefit formulas in any manner they choose. Common benefit formulas are based on years of service and final average compensation. However, formulas as simple as providing a participant a stated dollar amount for life (e.g., $500,000) are also frequently employed.

3. Nonqualified defined benefit plans may also operate as excess plans by providing participants a defined benefit relative to that they may earn under a tax-qualified pension plan. For example, a nonqualified defined benefit plan may be structured to provide participants with a pension benefit equal to that they would have earned under the tax-qualified plan, absent applicable limitations (e.g., Code Section 401(a)(17) compensation limits of $275,000, or Code Section 415(b)(1)(A) limits of 220,000).

4. Irrespective of whether a nonqualified defined benefit plans is structured as an excess plan, there are no limitations on the formula
under which a benefit may be calculated, nor are there any limitations on the amount of a participant’s benefit.

5. Further, employers may vary nonqualified defined benefit formulas per participant and there are no nondiscrimination tests applicable to varying benefit formulas. For example, the coverage tests under Code Section 401(a)(4) and Code Section 410(b) do not apply to nonqualified defined benefit plans.

E. Vesting Conditions / Requirements.

1. Employers frequently require nonqualified deferred compensation plan participants to satisfy specified vesting conditions in order to earn their plan benefits.

2. In the context of nonqualified defined contribution plans, employers frequently attach vesting conditions to employer matching and employer nonelective contributions. It is extremely rare for an employer to attach vesting conditions on participant elective deferrals.

3. In the context of nonqualified defined benefit plans, employers frequently attach vesting conditions by which a participant may “earn into” all or a portion of the participant’s benefit.

4. Typical vesting conditions are service-based vesting (e.g., provide continuous service over a specified period to earn a plan benefit – 5 year installment vesting / 3 year cliff vesting) and/or performance-based vesting (e.g., achieve financial / company / individual goals – EBITDA, revenue, sales targets).

5. Vesting conditions may be varied by participant and there are no minimum vesting requirements applicable to nonqualified deferred compensation plans. Specifically, the Code Section 411 minimum vesting requirements applicable to tax-qualified defined contribution plans (generally either 3-year cliff vesting or 2-6 year installment vesting) and defined benefit plans (5-year cliff vesting or 3-7 year installment vesting) do not apply to nonqualified deferred compensation plan.

6. Employers also often include plan provisions that provide for accelerated vesting upon the occurrence of specified events. Such events typically involve: change in control, death, disability, involuntary terminations of employment (by the employer without cause or by the participant for good reason). There is no requirement to include any accelerated vesting provisions in nonqualified deferred compensation plans and employers may vary any accelerated vesting provisions on a per participant basis.
7. Further, employers may determine at any time and for any reason to waive any applicable vesting conditions.

8. Code Section 409A generally does not govern the vesting of nonqualified deferred compensation; however, care should be taken in the event vesting triggers payment, as Code Section 409A does heavily regulate the types of permissible payment events allowed under a nonqualified deferred compensation plan.

F. Distributions.

1. Nonqualified deferred compensation plans may provide for distributions in the form of lump sum payments, installment payments and/or annuity payments. Nonqualified elective deferral plans typically allow participants to take distributions as either lump sum payments or installment payments. Nonqualified defined benefit plans typically provide for annuity payments, though lump sums are sometimes offered.

2. Distribution forms may either be hard-coded into the nonqualified deferred compensation plan document (e.g., lump sum distribution upon a triggering event) or may provide participants the opportunity to select their preferred form of distribution (e.g., lump sum, installments or annuity payments).

3. In the case of nonqualified defined contribution plans, Code Section 409A generally requires participants make distribution elections at the time the compensation is deferred.

4. Code Section 409A provides similar rules in the context of nonqualified defined benefit plans, though these plans typically provide for specified forms of payment hard-coded into the plan document, thereby complying with the Code Section 409A requirements.

5. Code Section 409A also imposes significant impediments to changing previously made distribution elections.

   a. In general, Code Section 409A prohibits acceleration of deferred amounts unless such acceleration occurs as a result of a previously specified distribution acceleration event (e.g., payment typically made upon separation from service, though payment to be accelerated in the event a change in control occurs before such separation).

      1. Code Section 409A does permit accelerations of nonqualified deferred compensation in the context of a plan termination.
2. In the context of a change in control, Code Section 409A permits employers to terminate nonqualified deferred compensation plans within 30 days prior or 1 year after the change in control transaction and pay all amounts under such plan at any time within the 1 year period following plan termination. To utilize this rule, the employer must terminate all “like” plans (e.g., all nonqualified defined contribution plans or all nonqualified defined benefit plans) solely with respect to the individuals experiencing the change in control. Unlike the general plan termination rules (described below), the employer may implement a new replacement plan immediately following the change in control.

3. Absent a change in control, Code Section 409A permits employers to terminate nonqualified deferred compensation plans at any time; however, distributions may not occur until 12 months following plan termination and all distributions must be made before 24 months following plan termination. To utilize this rule, the employer must terminate all “like” plans (e.g., all nonqualified defined contribution plans or all nonqualified defined benefit plans) and the employer may not adopt a replacement plan for 3 years following the plan’s termination.

4. Code Section 409A also contains special rules for plan termination in the context of a corporate dissolution or bankruptcy.

   b. Code Section 409A does allow participants to make subsequent deferrals of nonqualified deferred compensation; however, any election to subsequently defer compensation must not become effective for 1 year following the election, be made 1 year in advance of the payment date and must delay payment for at least 5 years.

   c. With respect to nonqualified deferred compensation plans that offer participants to receive their benefits in the form of an annuity (generally, nonqualified defined benefit plans), Code Section 409A permits participants to change their form of annuity to any actuarially equivalent life annuity at any time prior to the commencement of their benefit.

6. Code Section 409A also restricts the types of events pursuant to which distributions may be made. In general, Code Section 409A
requires that distributions may only be made upon: (1) a participant’s separation from service, (2) a participant’s death, (3) a participant’s disability, (4) a change in control, (5) a specified date, or (6) an unforeseeable emergency. Each of these terms, other than death, is specifically defined by Code Section 409A.

7. Nonqualified deferred compensation plans may specify or provide participants the opportunity to elect multiple distribution events. For example, a participant could elect to commence distributions upon the earlier or (1) a separation from service, (2) the 10th anniversary of the date of deferral, or (3) a change in control.

8. Importantly, a nonqualified deferred compensation plan may provide or permit participants to elect one form of payment per permissible payment trigger. For example, a participant could elect to receive a lump sum payment upon a change in control, but 5 installment payments upon her separation from service. This rule is generally referred to as the “anti-toggle” rule.

a. However, Code Section 409A does permit alternative forms of payment to be made upon the occurrence of single payment trigger based on the triggering event occurring before or after a specified date. For example, a participant could elect to receive a lump sum payment in the event his separation from service occurs prior to age 55 and 5 installment payments if such separation occurs on or after age 55.

b. Likewise, Code Section 409A permits a participant to select an alternative form of payment in the context of a separation from service that occurs within 2 years following a change in control. For example, a participant’s normal form of payment is 5 installments, but in the event of a separation from service within 2 years following a change in control, the participant will receive a lump sum payment.

9. Below is a general description of each term; however, specific reference to Code Section 409A is required:

a. Separation for service generally occurs when a participant ceases providing services to an employer or the participant’s level of services provided decreases to 20% or less of the level of services provided by the participant over the three preceding years (in these situations there is a presumption that a separation from service has occurred). When the level of services decreases to between 20% and 50% there is no presumption and there is a presumption that no separation from service has occurred when the level of services
decreases to 50% or more of such previously provided services.

b. A participant’s disability occurs as a result of any physical or mental impairment that can either (1) be expected to result in death or span at least 12 months, (2) be expected to result in death or span at least 12 months that would entitle the participant to at least 3 months of income replacement benefit under the employer’s disability plan, or (3) result in the participant being deemed totally disabled by the Social Security Administration or Railroad Retirement Board.

c. Code Section 409A provides that a change in control generally occurs upon (1) a change in ownership of a corporation (acquisition of stock constituting more than 50% of equity value or voting power), (2) a sale of all or substantially all of a corporation’s assets (40% or more of the total gross fair market value of the company’s assets), or (3) a change in effective control (sale of stock constituting 30% or more of voting power of the company or a change in majority of board members).

d. A specified date may consist of an actual date (e.g., January 1, 2020) or may be made by reference to an anniversary of a grant date (e.g., payment to commence on the 10th anniversary of the date on which a contribution was made to the plan) or refer to a participant’s age (e.g., payment to commence upon attaining age 65).

e. An unforeseeable emergency generally occurs due to a severe financial hardship resulting from either (1) an accident or illness of the participant, the participant’s spouse or beneficiary or the participant’s dependents (as defined under Code Section 152), (2) damage to a participant’s property (e.g., home or other important property), or (3) any other extraordinary and unforeseeable circumstances arising as a result of events beyond the participant’s control. It is a facts and circumstances determination as to whether an unforeseeable emergency exists and Code Section 409A requires reference to whether the participant could alleviate such emergency via liquidation of other funds.

G. **Funding.**

1. In general, nonqualified deferred compensation plans must be unfunded. This means that participant’s benefits cannot be secured
by the employer and any reserves set aside for participant benefits must be subject to claims of the company’s general creditors.

a. This unfunded status is the exact opposite of rules applicable to tax-qualified retirement plans, which generally require that funds are held in a separate trust that is outside the reach of a company’s creditors and that the funds held within such trust be used for the exclusive purpose of providing retirement benefits to plan participants.

2. The IRS has approved the use of grantor trusts to fund nonqualified deferred compensation arrangements. These trusts, commonly referred to as “rabbi trusts” due to their original approval via an IRS private letter ruling involving a trust established for a rabbi, generally provide employers the opportunity to set aside assets to pay nonqualified deferred compensation benefits.

a. Importantly, the assets of a rabbi trust must still remain subject to the claims of a company’s general creditors.

b. The IRS has provided model rabbi trust provisions in Revenue Procedure 92-64 and, more recently, in Notice 2000-56.

c. In general, rabbi trust accounts are typically held by financial institutions which act as plan administrators and pay benefits directly to participants as they come due.

3. Employers commonly utilize bookkeeping accounts to track nonqualified deferred compensation plan benefits. Under a bookkeeping arrangement, an employer simply reflects its obligations under its nonqualified deferred compensation plans as a company liability.

4. Employers may also wish to purchase life insurance policies to fund nonqualified deferred compensation plans. In doing so, a company may take out a life insurance policy on its executives to provide assurance that it will have funds available to pay benefits when due. The life insurance policy is a company-owned assets, and as mentioned above, subject to the company’s general creditors.

5. Code Section 457A also provides that any amounts deferred under nonqualified deferred compensation plans sponsored by “nonqualified entities” (generally non-U.S. companies or partnerships) are subject tax upon the lapse of a substantial risk of forfeiture and may be subject to an additional excise tax of 20%.

H. Administration.
1. Nonqualified deferred compensation plans are typically established via approval of a company’s Board of Directors, though private companies should also consult corporate governance documents as to whether shareholder approval is also required.

2. A company’s Board of Directors typically maintains authority to amend, modify or terminate its nonqualified deferred compensation plan, as well as, to administer and interpret the plan terms.

3. Day-to-day operations are often performed by a company’s Human Resource and/or legal professionals.

4. Complex plans also generally require third-party administrative assistance. For example, plans allowing participants to hypothetically invest their accounts in various investment options generally require a third-party administrator to track and monitor participant investment performance.

I. Tax Treatment.

1. In general, nonqualified deferred compensation plan benefits become subject to ordinary income taxes upon payment or constructive receipt by the participant.

2. Likewise, employers may only take associated compensation expense deductions associated with nonqualified deferred compensation arrangements when the benefits are paid to participants.

3. A special timing rule applies for FICA taxes which generally provides that amounts payable under a nonqualified deferred compensation plan must be taken into account for FICA tax purposes upon the later of (1) the date on which the services that create the right to the payment are performed, or (2) the date on which the deferred compensation is no longer subject to a substantial risk of forfeiture (determined under Code Section 83 standards).

   a. Once an amount is taken into account for FICA tax purposes, it is subject to the non-duplication rule, which means that it is not later subject to FICA taxes upon distribution.

   b. The application of the non-duplication rule often provides participants significant FICA tax savings as they frequently have little (if any) additional FICA tax obligations due to the special timing rule while they are working and then subsequent payments are not subject to FICA tax due to the non-duplication rule.
c. Failure to follow FICA’s special timing rule results in nonqualified deferred compensation payments being subject to FICA tax when those payments are made, often when a participant may not have any additional ordinary income (e.g., the participant has already retired).

4. Failure to comply with the various Code Section 409A requirements, either due to a plan document failure or due to an administrative failure, may result in a nonqualified deferred compensation plan participant incurring immediate income inclusion of deferred amounts plus the imposition of an additional 20% excise tax on such amounts.

   a. The IRS has provided a plan document correction program and operation error correction guidance that may allow employers and participants mitigate and/or avoid these taxes.

   b. U.S. Treasury has also released proposed regulations governing the specific calculation of excise taxes applicable in the event correction is not available.