

# TAKE NOTE

*Recent developments in estate, business and tax planning*

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## What You Need to Know and Go with Non-Qualified Deferred Compensation

*Jerry Weihs, JD, CPA, MBA, CLU, ChFC*

### **Basic Deferred Compensation**

As employers continually look for ways to benefit key employees and provide additional benefits on a selective basis, non-qualified deferred compensation programs have become increasingly important. With the flexibility available under these arrangements, many companies are finding non-qualified deferred compensation plans to be the best way for the company to recruit, retain, reward and assist key employees in supplementing their retirement savings.<sup>1</sup>

### **Overview**

In its most common form, a Non-Qualified Deferred Compensation (NQDC) plan is a promise between an employer and a key employee to pay a benefit in the future. The agreement must be in writing and usually provides for retirement benefits to the employee (for example, \$50,000 per year for 10 years beginning at age 65). The agreement may also provide pre-and post-retirement death benefits to the employee's family or trust.

Non-qualified deferred compensation plans do not have to comply with many of ERISA's complicated regulations, including the anti-discrimination rules and contribution limits. For example, a non-qualified deferred compensation plan can be totally discriminatory in operation. This means that benefits need only be provided to selected employees, often in a way that encourages and rewards superior performance.

### **How A Non-Qualified Deferred Compensation Plan Works**

The term "Deferred Compensation Plan" is the broad, generally accepted name used to describe a plan that actually defers a portion of an employee's income, as well as those plans providing supplemental future benefits provided by an employer, with no employee contribution.

Both forms of deferred compensation generally operate the same way. They are designed, administered, and informally funded in the same manner, and are treated the same for income and estate tax purposes.

Both forms are also subject to the doctrines of "constructive receipt" and "economic benefit." In order for the non-qualified deferred compensation plan to provide income tax deferral on contributions and growth, the funds

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must not be reachable by the employee nor may the employee benefit from the funds at any time prior to receipt as specified in the plan agreement. If the employee could access or receive any benefit from those funds for any reason, the employee would be considered to have either “constructive receipt” or “economic benefit” of the funds even if the employee did not take any of the funds. If it is determined that the employee has constructive receipt or is receiving an economic benefit, the employee would be income taxed on those funds immediately.

If a deferred compensation plan qualifies as a Top Hat plan, all that is required for ERISA purposes is a notice to the Department of Labor that the plan exists, and that necessary documents will be provided if requested. In addition, under Internal Revenue Code (IRC) Section 409A, the plan must be in writing.

### Methods of Financing Deferred Compensation Plans

**PAY AS YOU GO** — This method contemplates paying benefit liabilities as they come due, without previously setting aside assets to fund the future promised benefit. As a result, current corporate assets and/or current cash flow continue to be available to meet the needs of the business. The risk under this method is that there may not be sufficient available assets to meet the future promised benefits when they come due.

**SINKING FUND** — This method is the flip side of “Pay As You Go”. An employer sets aside funds in anticipation of paying the future promised benefit, but the fund is not tied directly to the deferred compensation plan. There is potential risk with this method if the funding is not sufficient to meet the future promised benefits when they come due.

### CORPORATE-OWNED LIFE INSURANCE —

This method provides an efficient and economical means for an employer to informally fund a deferred compensation plan. Life insurance provides the ability to accumulate cash value on a tax-deferred basis to informally fund the future promised benefit. There is potential risk with this method if the cash value is not sufficient to meet the future promised benefits at retirement or other triggering events under the plan. In the event of an early death of a plan participant, the death benefit can be used to fund a pre-retirement family benefit. In addition, the promised benefit may be paid out of business earnings with the policy providing for the recovery of the benefit costs.

### The Impact of Internal Revenue Code Section 409A on Non-Qualified Deferred Compensation Plans

Non-qualified deferred compensation plans are subject to a number of new rules, generally effective January 1, 2005. These rules are a result of numerous press reports, focusing on the Enron case in particular, which identified executives who bailed out of their NQDC plans. The rank and file were left holding the bag, many losing their retirement savings. Congress perceived that NQDC plans were abusive and that action was required to correct this.

As a result, Congress added new IRC Section 409A to the American Jobs Creation Act of 2004.

### Requirements of IRC Section 409A

In general, Section 409A supplements the existing rules for NQDC plans as follows:

- Distributions may only occur upon:
  - Termination of employment
  - Death
  - Disability
  - A specified date in the agreement
  - Change in control
  - Unforeseeable emergency
- No acceleration of payments is allowed (i.e., no haircut provisions)
- Election to defer must be made by December 31st of the prior year
- Ability to defer start of distributions is limited
- Funds may not be held in offshore trusts
- Restricted assets will become immediately taxable
- Trigger mechanisms may not be used to distribute funds when a change in financial condition occurs

### When Are They Effective?

The new requirements are effective for deferrals made on or after December 31, 2004. Pre-existing deferrals are grandfathered unless materially modified after October 3, 2004.

### Background of IRC Section 409A

In IRC Section 409A, Congress codified requirements for deferrals of compensation made after December 31, 2004. Operating and design rules are provided for non-qualified deferred compensation plans which, if followed, will result in deferral of taxation on the future compensation. Plans must limit distributions to certain circumstances, must not allow benefits to be accelerated, and must follow certain

restrictions with regard to elections by participants. If these requirements are not followed, the deferred amounts will immediately be included in the participant's taxable income. The penalties for violations of Section 409A are significant, *and are imposed directly on the executive* in the deferred compensation arrangement. Penalties include immediate taxation of the deferred compensation and any accrued interest plus a 20% additional penalty on the amount included in income.

## Overview of Section 409A Final Regulations

The Final Regulations under IRC Section 409A were released earlier in 2007, and generally follow the Proposed Regulations issued in October 2005.

The Final Regulations became effective April 17, 2007. At that time, the Final Regulations applied to taxable years beginning after December 31, 2007. The only compensation deferrals exempted from the new rules must have been "earned and vested" by December 31, 2004.

All existing NQDC rules still apply. The new legislation adds to these existing rules. As a result, a non-qualified deferred compensation plan will need to satisfy both the new rules and the existing rules (i.e., constructive receipt, economic benefit and Code Section 83 rules) to the extent applicable. Under the Final Regulations, all non-qualified deferred compensation plans must be in writing no later than December 31, 2008. A "written plan" must include:

- the amounts which the participant has a right to be paid;
- the payment schedule;
- the triggering events that will result in payment of the amounts;
- conditions for a deferral election;
- a 6-month delay requirement for specified employees of publicly traded companies.

## Transitional Compliance Relief Provided Under IRC Section 409A

In September 2007, the Treasury Department and the IRS released Notice 2007-78, extending transitional relief for *document* compliance through December 31, 2008 for Non-Qualified Deferred Compensation (NQDC) plans under Section 409A. Notice 2007-78 required plans to designate in writing, a compliant time and form of payment of deferred compensation under the plan subject to section 409A.

In October 2007, Treasury and the IRS released Notice 2007-86, extending transitional relief for *both documentary and operational* compliance to December 31, 2008. Under Notice 2007-86, employers need not comply with the requirements of the Final Regulations under IRC section 409A for executive benefit plans until January 1, 2009. However, they were required to operate these plans in compliance with the plan's terms to the extent consistent with Section 409A and the applicable guidance, specifically noting Notice 2005-1.

Notice 2005-1 generally outlined the scope of Section 409A and provided definitions of a plan, a non-qualified deferred compensation plan, deferred compensation, and "substantial risk of forfeiture". Guidance was provided on the application of Section 409A to welfare plans, plans covered by Section 457, stock appreciation rights, and arrangements between partners and partnerships.

Other provisions of Notice 2007-86 extending documentary and operational compliance deadlines include examples of plans not considered to be operating in good faith compliance; changes in payment elections or conditions before December 31, 2008; payments linked to qualified plans and certain other plans; substitutions of non-discounted stock options and stock appreciation rights for discounted stock options and stock appreciation rights; and other transition issues.

## IRS Releases Additional Guidance

On December 5, 2008 the Internal Revenue Service issued two items of guidance under Code section 409A – (1) Proposed Treasury Regulations section 1.409 A-4, which address the calculation of amounts includible in income and the additional taxes imposed if the requirements of section 409A are not satisfied, and (2) IRS Notice 2008-113, which updates the procedures for correcting certain operational failures under section 409A and obtain relief from the full application of the income inclusion and the additional taxes under section 409A.

## IRS Further Delays Tax Reporting for Compliant Deferred Compensation

On December 10, 2008, the IRS issued *Notice 2008-115*, which provided that tax reporting for 2008 would not be required for deferrals of compensation under nonqualified deferred compensation arrangements that comply with § 409A of the Internal Revenue Code. The Notice also provided guidance to employers and taxpayers regarding reporting and amounts includable in income in the case of non-compliant deferred compensation subject to § 409A.

In Notice 2005-1, the IRS said that deferrals of income under a nonqualified deferred compensation plan subject to Section 409A would be reported in Box 12 of Form W-2 using Code Y and Box 15a of Form 1099-MISC. In later guidance, the IRS delayed the implementation of the reporting requirement for 2006 and 2007. Notice 2008-115 provides that no reporting will be required for 2008 or later years until further notice. The IRS said it does not anticipate that reporting will be required until the calendar year following the year final regulations, (on amounts includible in income), are issued.

The Notice provided additional guidance to employers and taxpayers regarding deferred compensation arrangements that are subject to § 409A but that fail to comply with § 409A. The Notice provides interim rules for determining the amounts to be included in income, the calculation of the additional 20% tax, and tax reporting.

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### **New Rules for Employer-Owned Life Insurance**

The Pension Protection Act (PPA) of 2006 includes new IRC Sub-Section 101(j) and Sub-Section 6039I, which set out the disclosure, consent, and reporting requirements for employer-owned life insurance. The new requirements are effective for policies issued or materially changed after August 17, 2006. The thrust of 101(j) is to tax policy proceeds paid to an employer under a life insurance contract purchased by the employer on an employee's life unless certain conditions are met. Those conditions are relatively straightforward.

Notice and Consent Requirements are met if:

1. written disclosure was provided by the employer to the employee prior to issuance of the policy, stating (a) the employer's intent to purchase life insurance on the employee's life, (b) that the beneficiary of the policy (in whole or in part) will be the employer or a "related person" as defined in the Code, and (c) the maximum amount for which the employee could be insured at the time the contract is issued; and
2. prior to issuance of the policy, the employee provides the employer with written consent (a) to be insured under the contract and (b) for the coverage to continue after the employee ceases employment with the employer.

### **Reporting Requirements:**

An employer who owns one or more life insurance policies on an employee's life is required, on an annual basis, to report specific data set out under IRC Section 6039I, including, but not limited to, the total number of employees of the employer at the end of the year, the number of employees

insured by the employer at the end of the year, and that the employer has written consents from all insured employees to whom the consent requirement applies (or, if all such consents were not obtained, the number of insured employees for whom such consents were not obtained).

The Internal Revenue Code puts the onus on the employer to ensure the conditions are met if the employer expects to receive death benefits on a tax-free basis. Of particular importance to employers will be understanding that, in addition to the notice and consent requirements, insured employees must fall within certain categories for the life insurance death benefit to be tax exempt to the employer. These include an insured who was an employee at any time during the 12-month period prior to death, or who at the time the contract was issued, was a director, a highly compensated employee, or a highly compensated individual.

### **Summary**

The basic rules for non-qualified deferred compensation plans remain intact. However, IRC Section 409A has added an additional set of requirements and Section 101(j) and Section 6039(I) have further added to the complexity.

To ensure compliance with the Section 409A Final Regulations, all non-qualified deferred compensation plans should have been reviewed and brought into full compliance no later than December 31, 2008. Non-Qualified Deferred Compensation remains one of the best options available in the supplemental benefit planning arena.

This publication is intended for client advisors who provide professional guidance on these topics.

<sup>1</sup>Non-Qualified Deferred Compensation will defer compensation to a year when the individual's tax rate will be less than the current year. There is no guarantee that this will occur.

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