Nonqualified/Executive Compensation Plans

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Kelsey H. Mayo, J.D.
Partner
Poyner Spruill LLP

What We'll Cover

- What are executive compensation plans?
- Why would a company have such a plan?
- What options are available?
- What are common pitfalls with executive compensation arrangements?

Poll #1: About You

Which of the following best describes you:

A. Third-party administrator
B. Auditor
C. Attorney
D. Investment adviser
E. Business consultant
F. Other

Poll #2:
Experience with Executive Compensation

Which of the following best describes you:

A. I regularly work with NQ/EC plans now
B. I occasionally work with NQ/EC plans now
C. I do not currently work with NQ/EC plans, but I am expanding my business
D. I am interested in NQ/EC plans, but I don't see them as part of my main business
E. I am just here for the credit

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WHAT EXECUTIVE COMPENSATION PLANS ARE WE TALKING ABOUT?

Executive Compensation Plans

- Most common retirement plans
  - 401(k)/profit-sharing plans
  - Traditional pension plans
  - 403(b) plans
- Other arrangements used for executives
  - 457(b) plans (for tax-exempt)
  - Non-qualified plans/arrangements
  - Governmentals have even more flexibility

What Is a Non-Qualified Plan

- "Qualified plans"
  - 401(k)/403(b) plans
  - 457(b) plans
  - Pension and cash-balance plans
- "Non-qualified plans"
  - Any other arrangement
  - That pay $ in a year after it is earned

What Is a Non-Qualified Plan

- Non-qualified plans cover a broad range of plans
  - Severance arrangements
  - Employee bonus/incentive programs
  - Phantom-equity plans
  - Transaction payments
  - Executive-deferred compensation
  - The list goes on…

WHY A COMPANY MIGHT USE AN EXECUTIVE COMPENSATION PLAN

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Uses of Executive Compensation Plans

- Permit highly paid employees to defer additional compensation
  - 457(b) plan
  - Non-qualified compensation-deferral plan
- Supplement other qualified plan benefits
  - 457(b) plan
  - Supplemental Executive Retirement Plans (SERPs)
  - Excess benefit/restoration plans
  - Long-term incentive plans

Uses of Executive Compensation Plans

- Reward employee performance/attract and retain key employees
  - 457(b) plan
  - Severance
  - Employee-bonus plan
  - Stock-bonus plan
  - Phantom equity
  - Long-term incentive plans
  - Retention-bonus programs

INITIAL CONSIDERATIONS

What Type of Plan Sponsor?

- Different rules may apply
- For-profit versus non-profit
  - Taxation timing
- Governmental versus non-governmental
  - 414(d) definition
- Regulated industry
  - Financial institutions, for example

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ERISA Coverage

- Should the arrangement be an ERISA plan?
- Pros
  - ERISA generally limits claims
  - State-law claims can be more expensive
- Cons
  - Must limit eligibility
  - Must comply with certain ERISA requirements

ERISA Coverage

- When is executive compensation arrangement an ERISA "pension plan?"
  - Defers compensation to retirement or termination of employment
    - Severance benefits are "welfare" benefits
  - Limited exceptions, including:
    - Voluntary arrangements with <u>very</u> limited employer involvement
    - Governmental plans
    - Church plans

ERISA Coverage

- Executive Compensation arrangements usually subject to ERISA?
  - Supplemental executive-retirement plans
  - Non-qualified retirement plans
  - Any other plan paid at termination

Objectives?

- What does the company want to accomplish?
  - Attract?
  - Retention?
  - Incentivize behavior?
  - Retire?

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Executive Compensation Options

- Extremely flexible
  - If you can imagine it…
  - You can probably design a NQ plan to achieve it

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OPTIONS AND COMMON TYPES OF EXECUTIVE COMPENSATION PLANS

EXECUTIVE COMPENSATION PLANS: THE GROUND RULES

Executive Compensation – Ground Rules

- Extremely flexible
- With a Couple of Caveats…
  - Eligibility for ERISA pension benefit
  - Taxation of benefits
  - Compliance with 409A

Executive Compensation – Ground Rules

- Eligibility
  - As we just saw:

    If arrangement is an ERISA-covered "pension benefit," eligibility should be limited to a select group of management or highly compensated employees

Executive Compensation – Ground Rules

- Eligibility
  - Select group of management or highly compensated employees
    - No bright-line rules—facts and circumstances
      - Focus on whether employee has enough influence to negotiate plan design
      - 414 HCE definition is <u>not</u> controlling; compare to workforce
    - Covering more than 15 to 20 percent of employees may be problematic

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Executive Compensation – Ground Rules

- Be mindful of taxation
  - For-profits
    - Generally taxed at time of payment (FICA/FUTA may be due sooner)
    - 409A may accelerate taxation

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Executive Compensation – Ground Rules

- Be mindful of taxation
  - Non-profits (Tax Code §457)
    - Deferred compensation generally taxed at time of vesting
      - Taxed when substantial risk of forfeiture lapses
      - Earnings after SROF lapses are taxed at distribution
    - Certain exceptions to taxation rule
      - 457(b) "eligible" deferred compensation plans
      - 457(e)(11) plans

Executive Compensation – Ground Rules

- Be mindful of taxation
  - Non-profits
    - IRS proposed regulations under §457
    - Important changes/clarifications
      - When an arrangement has "deferred compensation" subject to 457 taxation
      - When substantial risk of forfeiture lapses
      - What plans qualify for 457(e)(11) exception

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Executive Compensation – Ground Rules

- Be mindful of taxation
  - FICA/FUTA taxes
    - Deferred compensation is FICA wages
    - Taken into account
      - When services are performed
      - Or, if later, when not subject to substantial risk of forfeiture
    - Special-timing rule
      - May recognize at any later date in the same calendar year

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Poll #3

ABC adopts a long-term incentive plan. CEO vests three years after an amount is credited to the plan. In March 2018, CEO is credited with an amount. When is amount taken into FICA?

A. March 2018
B. March 2021
C. December 2021
D. Either March or December 2021 is acceptable

Executive Compensation – Ground Rules

- Code §409A was enacted, in part, as a response to perceived corporate abuses
  - Think Enron
  - Congress didn't like executives having so much flexibility in deferred-compensation arrangements

Executive Compensation – Ground Rules

- Deferred compensation must meet Code §409A
  - Payment time and form is specified at deferral
  - Payment time must be tied to certain events
  - Limited ability to change time and form after deferral

Executive Compensation – Ground Rules

- 409A – what is not deferred compensation
  - 401(a) plans and 457(b) plans are exempt
  - Equity interests generally excluded
  - “Short-term deferrals”
  - Certain involuntary separation pay

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Executive Compensation – Ground Rules

- 409A – time and form set at deferral
  - Payment time and payment form must be established on or before the amount is deferred
  - Generally cannot change later
  - Seems easy to do…

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Poll #4

"If employee is terminated with cause, she will receive 12 months of severance pay." Which of the following is true:

A. This sets both the time and form of payment
B. This sets the time of payment but not form of payment
C. This sets the form of payment but not time of payment
D. This sets neither the time nor the form of payment

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Executive Compensation – Ground Rules

- 409A – payment events
  - Set time or fixed schedule
  - Separation from service
  - Disability
  - Change of control
  - Death
  - Unforeseeable emergency

Executive Compensation – Ground Rules

- 409A – limited ability to change
  - Once amount is deferred; difficult to change time or form of payment
  - Never change a 409A plan without attorney sign-off
  - Do not allow employee to request a different payment without attorney sign-off
  - Do not "cancel" the arrangement without advice

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EXECUTIVE COMPENSATION PLANS: SOME OPTIONS

Non-Qualified Plan Options

- Common non-qualified plan with qualified plan
  - 457(b) plan
  - Excess/restoration-benefit plan
  - Non-qualified retirement plan
- Standalone non-qualified plan examples
  - Phantom-stock plan
  - Long-term incentive plan
  - Compensation-deferral plan

457(B) PLANS

457(b) Plan Options

- Known as “eligible” deferred-compensation plans
- Who can sponsor?
  - Governmental entity
  - Tax-exempt entity (other than a church)
- Type of sponsor matters
  - Different rules apply to governmental and tax-exempt plans

457(b) Plan Options

- Must be a written plan
  - Contain all material terms
  - Meet 457(b) requirements
- May be provided to any service provider
  - Employee
  - Independent contractor
- Nondiscrimination
  - None!

457(b) Plan Options

- Contributions
  - May be employer and/or employee contributions
    - Careful! Different deferral rules from qualified plans
    - Deferral election generally must be made before the first day of the month in which deferral occurs
  - May be a defined benefit or defined-contribution type plan

457(b) Plan Options

- Contributions
  - Contribution limit = 402(g) deferral limit ($18,000 in 2017)
    - But different catch-ups may apply
    - All contributions (not just employee contributions) count toward limit
  - Cannot exceed 100 percent of 415(c)(3) compensation
  - If a DB formula, contribution is present value of the increase in accrued benefit

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457(b) Plan Options

- Contributions
  - Not coordinated with 401(k)/403(b) limits
    - Can defer to both plans
  - All 457(b) plans are aggregated, however
- Taxation
  - Not taxed until distributed (unless Roth, of course)

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457(b) Plan Options

- Vesting
  - May apply vesting schedule
  - BUT watch for impact on contribution limit
    - Contribution is not counted until risk of forfeiture lapses
    - Any earnings from contribution to vesting will be counted in the contribution limit
  - Subject to FICA/FUTA when risk of forfeiture lapses

Poll #5

ABC wants to establish a 457(b) incentive plan for its executive director. They want contribute $18,000 each year, subject to a three-year vesting schedule. Amounts may be invested in same lineup as 403(b) plan. Will this be permissible?

A. Yes
B. No
C. Probably Yes
D. Probably No

457(b) Plan Options

- Distributions
  - Severance from employment
  - Attainment of age 70½
  - Unforeseeable emergencies
  - Small benefit cash-outs
- Timing differs depending on sponsor
  - But must satisfy required minimum-distribution rules

457(b) Plan Options

- Distributions
  - Unforeseeable emergencies
    - **Not** the same as 401(k) hardship definition but some overlap
    - Severe financial hardship resulting from:
      - Illness or accident of the participant, spouse, dependent, or beneficiary
      - Casualty property loss of the participant or beneficiary
      - Other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant or beneficiary

457(b) Plan Options

- Distributions
  - Small benefit cash-outs
    - Amounts less than involuntary distribution threshold ($5,000 right now)
    - If no amount has been deferred for two-year period ending on date of distribution <u>and</u> no prior cash-out
    - No requirement to terminate
    - May be automatic or at participant’s election

457(b) Plan - Governmental

- Eligibility
  - Can allow all employees to participate
  - Can limit eligibility—no universal availability
- Funding
  - Money must be held in trust
  - May be employee and/or employer contributions

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457(b) Plan - Governmental

- Contributions
  - May permit Roth deferrals
  - May permit rollover contributions
  - Can allow catch-up contributions
    - Age 50 catch-up
    - Special 457 catch-up
    - If eligible for both, get the greater of the two catch-ups

457(b) Plan - Governmental

- Contributions
  - Age 50 catch-up
    - Available for those 50+ by EOY (additional amount is same as 414(v) catch-up)

457(b) Plan - Governmental

- Contributions
  - Special catch-up contribution:
    For three years prior to the normal retirement age, may allow catch-up equal to <u>lesser</u> of:
    - Regular deferral limit (402(g) amount)
    - The "underutilized limit" from prior years

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457(b) Plan - Governmental

- Contributions
  - Special catch-up contribution (continued)
    The "under-utilized limit" from prior years:
    - Sum of the basic annual limit for each prior year *minus* the amount of annual deferrals for such year
    - Ignore any catch-up contributions
  - Effect is that catch-up contribution may double the deferral limit for those close to retirement

457(b) Plan - Governmental

- Loans may be permitted

- Distributions
  - Participant has flexibility
    - Ability to defer payment
    - Ability to change payment timing
  - Eligible for rollover

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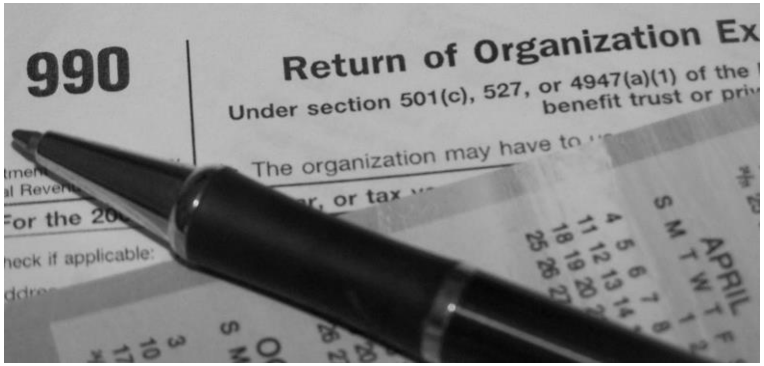
457(b) Plan – Non-Governmental

- Eligibility
  - Must be limited to top group of management or highly compensated employees



- Funding
  - Money cannot be held in trust (other than rabbi trust)
  - May be employer and/or employee contributions

457(b) Plan – Non-Governmental

- Contributions
  - Special catch-up contributions ONLY:
    For three years prior to the normal retirement age, may allow catch up equal to <u>lesser</u> of:
    - Regular deferral limit (402(g) amount)
    - The "underutilized limit" from prior years

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457(b) Plan – Non-Governmental

- Distributions
  - Plan sets earliest permissible distribution date
  - Plan may allow participant to defer distribution
    - Must set a fixed distribution date in the future
    - Must make election <u>before</u> earliest distribution date
  - Plan may allow participant <u>one</u> additional deferral
    - Must set a fixed distribution date in the future
    - Must make election <u>before</u> original deferred distribution date

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Poll #6

What are the advantages of a 457(b) plan?

A. Allows executive to defer additional money
B. Provides tax deferral beyond vesting date
C. Permits flexibility in payment timing
D. All of the above

457(b) and Qualified Plan

- Tax-exempt sponsors a 401(k) plan
  - All participants eligible
  - Executives defer maximum, but max is not enough for retirement
- Solution: 457(b) plan
  - Executive may defer $18,000 in 401(k) plan
  - May defer another $18,000 in 457(b) plan (perhaps more if eligible for special catch up)
    - Employee deferral and/or
    - Employer contribution

EXCESS BENEFIT/ RESTORATION PLANS

Excess/Restoration Benefit Plan

- Qualified plans have limits on contributions
  - Deferrals ($18,000 in 2017, $24,000 if at least 50)
  - Compensation ($270,000 in 2017)
  - Annual additions ($54,000 in 2017)
- Solution: excess/restoration benefit plan
  - Used to fully or partially restore qualified plan benefits that are limited

Excess/Restoration Benefit Plan

- Example:
  - Company intends to give everyone
    - 1:1 match up to seven percent of W-2 compensation
    - Profit-sharing contribution – four percent of total W-2 compensation
  - Amazing CFO
    - Earns $275,000 in total W-2 compensation
    - Defers $18,000 in 2016

Excess/Restoration Benefit Plan

- Limits thwart the company's intention
  - Company intends to give everyone
    - 1:1 match up to seven percent of W-2 compensation
    - Profit sharing contribution: four percent of total W-2 compensation
  - Company wants CFO to get
    - $19,250 match (seven percent of $275,000)
    - $11,000 profit sharing (four percent of $275,000)
  - CFO receives only
    - $18,000 match (1:1 on $18,000 deferrals)
    - $10,800 profit sharing (four percent of $270,000 compensation limit)

Excess/Restoration Benefit Plan

- Excess benefit plan makes up difference
  - CFO's qualified plan benefit
    - $18,000 match (1:1 on $18,000 deferrals)
    - $10,800 profit sharing (four percent of $270,000 compensation limit)
  - CFO's excess plan benefit
    - $1,250 to make up for missed match opportunity
      - Some companies require additional deferrals to receive match
      - Others just make up the match as though the employee would have deferred enough to receive the full match
    - $200 to make up for missed profit sharing contribution
  - Total benefit = company's intention

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NONQUALIFIED RETIREMENT SAVINGS PROGRAM

Non-Qualified Retirement Savings Plan

- In addition to contribution limits, qualified plans have non-discrimination testing
  - Average Deferral Percentage (ADP) test
  - Average Contribution Percentage (ACP) test
  - Top-heavy tests

    Meeting these tests or putting in a safe harbor might be too expensive for the owner/HCE
- Solution: non-qualified retirement savings plan
  - Non-qualified plans do not have limits or NDT
  - Highly compensated employees may receive almost any desired level of benefits

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Non-Qualified Retirement Savings Plan

- Example:
  - ABC Company has two executives
    - Only HCEs of ABC Company
    - Want to contribute maximum amount
  - ABC Company has many non-HCE employees that participate (at low deferral levels)
  - ABC Company's 401(k) plan routinely fails ADP/ACP
    - The HCEs are not able to get full benefits under 401(k)
  - Establish a safe harbor 401(k)?
    - Putting in a safe harbor formula may be prohibitively expensive
    - And/or may not allow HCEs to get the maximum contribution

Non-Qualified Retirement Savings Plan

- Example (continued)
  - ABC Company amends the 401(k) plan to exclude the HCEs
  - ABC Company puts in a non-qualified retirement plan
    - Each year ABC Company allocates a discretionary amount to each HCE (usually equal to the maximum contribution limit)
    - The allocated amount grows as though it were invested in the same investment options offered in the 401(k)
    - ABC Company could allocate any amount to the HCEs each year
  - The 401(k) plan now passes testing automatically
  - The HCEs still receive deferred income for retirement

Poll #7

If it’s that easy, why doesn’t everyone do it?

A. Money is not held in trust
B. Money is not eligible for rollover
C. Distribution options are less flexible
D. Administration costs
E. All of the above

NON-QUALIFIED STAND-ALONE PLANS

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Non-Qualified Stand-Alone Plans

- Broad flexibility
- Three examples:
  - Phantom-stock plan
  - Long-term incentive plan
  - Deferral-compensation plan

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PHANTOM-STOCK PLANS

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Phantom-Stock Plan

- Want key employees to act like owners
  - Make them owners
  - Design incentives to mimic ownership
- Downside of granting stock
  - Owners generally don't like diluting their ownership
  - Plans that grant actual shares dilute ownership
  - Non-profits don't have stock to grant
- Solution: phantom-stock plan
  - Mimic the financial upside of being an owner
  - But without diluting ownership

Phantom-Stock Plan

- Example
  - Owners of ABC Company turn over operations to a new CEO
  - They want to incentivize the new CEO to act like an owner, but do not want to dilute their ownership
  - ABC Company adopts a phantom-stock plan
    - CEO is credited with units equivalent to ten percent ownership
    - The units vest over a five-year period
    - The plan will pay out if the CEO terminates employment or ABC Company is acquired by another company
    - Payout equals FMV at payment *less* FMV at grant date

Phantom-Stock Plan

- Example (cont'd)
  - At time of grant, ABC Company is worth $1M (CEO's units worth $100K)
  - A few years elapse, and CEO grows the business
  - Owners are offered $5M for ABC Company by a competitor
  - If owners accept offer, phantom plan pays out
    - CEO's units are worth $500K at change of control
    - CEO receives $400K ($500K - $100K value at time of grant)
    - This is approximately the same $ value CEO would have received if he had purchased stock and then sold during change of control
    - BUT unlike stock purchase, this is all ordinary income

LONG-TERM INCENTIVE PLANS

Long-Term Incentive Plan (LTIP)

- Objective:
  - Align incentives with strategic objectives
  - Retain employees for some period
- Solution: long-term incentive plan
  - Establish objectives and rewards
  - Determine vesting

Long-Term Incentive Plan (LTIP)

- Example
  - The board desires to increase EBITDA by at least ten percent over the next five years
  - They want to incentivize the executive director to accomplish this goal or, better yet, exceed it
  - ABC Company adopts an LTIP
    - If EBITDA reaches 110 percent of current EBITDA for three consecutive years, CEO is credited with $40,000
    - If EBITDA does not reach 110 percent of current EBITDA within next five years, plan terminates
    - CEO must remain employed for two years beyond crediting date to receive payment

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NQ-DEFERRAL PLANS

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Compensation-Deferral Plan

- Qualified plans have deferral limits
  - Often this means executives can't defer enough to receive full matching contribution
- Sometimes compensation is paid before needed
  - Executive may want to defer amount to a future year
- Solution: non-qualified deferral plan
  - Allow any deferrals
  - May permit executive to select payment date

Compensation-Deferral Plan

- Example
  - ABC Company has a compensation-deferral plan
  - Executive may defer any amount of compensation
  - ABC Company will match deferral at 50 percent, up to a total of $50,000
  - Executive selects the time and form of payment
    - Executive's child will begin college in 2025
    - Executive defers $30,000 (and company matches $15,000)
    - Executive elects to receive benefit in five equal installments beginning in 2025
  - Limited ability to change time and form
    - Must defer at least five years; elect to defer before 2024

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CONSIDERATIONS FOR EXECUTIVE-COMPENSATION PLANS

Considerations

- Plan funding
- ERISA compliance
- Proper administration
- Tax code compliance
- Additional costs

Plan Funding

- Certain plan assets are held in trust
  - Qualified plans and governmental 457(b) plans
  - Company's creditors have no access
  - If company goes under, participants still have benefits
- Other plans cannot have same trust
  - Tax-exempt 457(b), non-qualified plans
  - If company goes bankrupt, benefits are not protected
  - Even if part of the benefit was salary deferred under the compensation-deferral plan

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Plan Funding

- Can protect plan benefit from company
  - Rabbi trust
    - "Trust lite"
    - Company puts money in the trust
    - Trust assets may be used only for paying benefits
    - BUT if the company goes under, creditors can access assets
  - Life insurance
    - Certain products may be used to provide benefits
    - Special plans have developed around these products

ERISA Coverage

- If Covered by ERISA
  - Eligibility
    - Broad-based and comply with non-discrimination, or
    - Limited to top group of management or highly paid employees
  - Form 5500 reporting
    - Applies to both plans
    - BUT top-hat plan only files once at creation
  - Other rules
    - Certain ERISA rules (such as claims procedures) apply to both types of plans
    - Not burdensome for top-hat plan, but must be aware to comply

Plan Administration

- Additional plan = additional administration
  - Personnel to administer
  - More complex non-discrimination testing
  - Third-party administration for new plan
  - Participant communications

Common Pitfalls - Documentation

- Tax code requires:
  - Plan must be in writing
  - Time and form of payment must be set at deferral
  - Payment must be tied to a certain date or to certain allowed payment events
    - Such as separation, death, disability, or change of control
  - VERY limited ability to change time and form of payment after deferral
  - Generally cannot terminate benefit and instead provide a different benefit

Common Pitfalls - Documentation

- Common errors
  - Plan is agreed upon, but not thoroughly documented
  - Arrangement is established in offer letter, but language regarding time and form of payment is inadequate
    - Often—payment form is set, but ambiguous regarding time
    - "Paid in installments after separation from service." When do the installments begin?
  - Start-date does not comply with regulations—particularly when releases are required
  - Description of payment event does not comply with regulations

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Common Pitfalls - Operations

- Taxation
  - Tax-exempt subject to Code §457
  - Deferred compensation subject to FICA/FUTA
- Common errors
  - Not considering how to pay taxes
  - Not paying FICA/FUTA when SROF lapses
  - Not considering impact of tax-exempt employer

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Common Pitfalls - Operations

- Plan operation requirements
  - Must comply with the document, to the letter
  - Very limited deviations permissible
  - Never amend/change without talking to attorney
- Common errors
  - Executive doesn’t like payment timing—so it is delayed
  - Administrator applies same rules as qualified benefit, even though document says to pay at different time
  - Pay benefit with last paycheck, when plan says pay on 60th day after termination

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Impact of Errors

- Compliance = benefit is taxed when paid
  - If company is tax-exempt, special rules apply
- Non-compliance = no happiness
  - Entire benefit is taxed to executive in first year of non-compliance (even if it won't be paid for ten years)
  - *Plus* interest on that tax owed
  - *Plus* 20 percent penalty on the amount deferred
  - AND, if you didn't report it correctly, accuracy and other related penalties

Plan Corrections

- 457(b) Plans - EPCRS
  - Governmental 457(b) eligible for EPCRS
  - Tax-exempt 457(b) eligible to request correction similar to EPCRS
- 457(b) Plans – outside EPCRS
  - Governmental can correct any failure to satisfy 457(b) before the first PY beginning more than 180 days after notified of failure by the IRS

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Plan Corrections

- Other non-qualified plans
  - More limited corrections available for non-qualified plans
  - Not as favorable as qualified-plan correction options

Bottom Line

- Executive compensation plans offer great benefits
  - Fairly flexible in design
  - Can provide better benefit to HCEs
  - Good incentives
- But must be established and maintained properly
  - Stakes for non-compliance are high
  - When considering the plan, must take this into account
  - Allocate appropriate resources to the plan

Questions?

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