CHAPTER I

INTRODUCTION TO NQDC AS A PROBLEM SOLVER

I. INTRODUCTION

If clients had no problems, they would not need our help. There are a variety of problems that may be encountered in practice that can be addressed by nonqualified deferred compensation ("NQDC") arrangements. As will be discussed in greater detail in this and the succeeding chapters, a NQDC arrangement is essentially a compensation arrangement that (i) provides for the payment of cash, property or benefits in a calendar year which is later than the calendar year in which the services being compensated are performed, and (ii) does not come within one of the categories of deferred compensation arrangements which are "qualified" under applicable tax statutes. This first section describes a variety of problems for which NQDC can be a solution.

A. Employee Problems.

1. The Retirement Gap. My annual social security benefits and qualified plan benefits (such as pension or profit-sharing plans) after retirement will be small compared to my current salary and will not provide me with enough annual income for retirement. What can I do?

2. My Qualified Plan Benefits Are Disappearing. The qualified plan rules continue to change, and I am afraid that I will not be able to receive the level of benefits from my qualified plan that I need to retire. How can I make up the difference?

3. My Faith in Social Security and Government Health Care Programs Is Shaken. In planning for retirement, I always counted on receiving something from Social Security, and I always thought Medicare would cover my health care costs. What if they collapse or simply fail to provide the level of benefits expected?

4. Anticipated Future Expenses. I have elementary school age children who have no athletic abilities and I am now concerned about how I will be able to pay for their college education. How can I plan for this?

5. Burying Some Nuts — the Entertainer or Athlete. I am earning plenty of compensation now and I am paying a lot of taxes, but what will I be receiving at retirement? A lot of famous people have ended up bankrupt. What can I do?

B. Employer Problems.

1. Key Employees Keep Leaving. Several of our key employees have quit and gone to work for the competition. This is very expensive. For example, if a sales representative quits, we have to recruit a new sales representative who will need to be trained and introduced to the sales territory and the customers, all while trying to keep the customers happy. How can we create a financial incentive for our employees to stay with the company?

2. Enforcing Covenants Not to Compete and Confidentiality Agreements. After a key employee retires or otherwise terminates employment with our company, it is very important that the employee (1) not go to work for the competition, and (ii) not disclose any trade secrets, marketing strategy, customer information, etc. We talked to our attorney who included a covenant not to compete in all of our employment contracts with key personnel in states where this is permissible, but even in those states the covenant is only for a limited period of time and only applies within a limited geographic area. The attorney said the rules are not clear on when a covenant will be enforced and to what extent it will be enforced. For example, although we wanted the covenant to apply for more years and to cover a bigger geographic area, the attorney said that even the time and distance terms set out in the employment contracts could be second-guessed and deemed unenforceable by a court. The attorney could not give us any guarantees. Furthermore, the attorney said that because of all the uncertainty surrounding covenants not to compete, it can be expensive to try to enforce a covenant not to compete and that litigation often occurs. This is an important issue for the company. Is there anything else we can do to protect our business from competition from former employees?

3. Employee Recruitment and Retention. We want to recruit a key employee. We will need to make a significant financial commitment to hire this person. How can we attract the employee away from our competition and what can we do to make sure she stays with the company long enough to justify our financial outlay? In some cases, we want to recruit a key employee who we know will forfeit certain qualified plan or NQDC plan benefits or equity interests upon termination from their current employer. What can we offer to make this up to them?

4. Giving Employees "Skin in the Game." We want our employees to have a financial interest in the successful operations of our business. Their long-term compensation should be tied to the long-term success of the company and be at risk if the company should go down. How can we accomplish this?

5. Recruiting or Motivating Employees While in a "Cash Crunch." We want to recruit a key employee. As a start-up business we will be in a "cash crunch" for several years. How can we put together a compensation package that will attract a high quality executive without draining the company's cash during the start-up period? Alternatively, the company is doing well but is at a difficult stage. The company needs to keep expanding but the company is not big enough yet and does not have a long enough history to "go public." The company has already borrowed substantial amounts from its bank and the bank is reluctant to loan more money for working capital. The company wants to create performance incentives for its valued employees, but an annual cash bonus program would be another cash drain on the company. How can we motivate and reward the employees without exacerbating the cash crunch?

6. Returned Qualified Plan Contributions. Many of our key employees are receiving a portion of their 401(k) contributions back because many of our rank and file employees chose not to participate in our 401(k) plan. What can we do to avoid this problem?

7. The Hospital. A hospital has a fixed number of beds, and is faced with constant competition and changes in the health care industry. Many other hospitals have been forced to close. The hospital needs to develop long-term arrangements with physicians that will

allow the hospital to provide high-quality care to a consistent volume of patients. How can the hospital cement its relationships with its doctors?

8. Tax-Exempts. Our organization does not have equity that can be offered to attract and retain key executives. How can we replicate the typical for-profit equity incentive plans for our key employees?

9. Financial Institutions. We want to attract and reward our key employees but want to make sure that rewards are tied to the long-term stability of the company and are available for claw back if the current financial performance of the company turns out to have been misrepresented.

10. Early Retirement. The company needs certain employees to retire and allow other individuals to fill those positions. However, if an employee retires early (i) in some cases the employee might *forfeit* certain qualified plan benefits, and (ii) in some cases, benefits will not be payable for several years (after the employee attains retirement age). What type of incentive can we offer to encourage these employees to retire early?

II. WHAT IS NQDC?

NQDC or "nonqualified deferrer compensation" as the term is most commonly construed is an arrangement between employer and employee in which payments for services will be delayed to a later year, and since the arrangement will not meet the requirements of Section 401 of the Internal Revenue Code, it is not a qualified plan (in this Book, except as otherwise specifically noted, the term "Section" shall refer to sections of the Internal Revenue Code of 1986, as amended). While NQDC is normally used for employees, a NQDC arrangement also can be established for an independent contractor, such as a director of the corporation.

As an example, a NQDC plan designed to provide retirement benefits might provide that if an employee remains employed with the company until attaining normal retirement age, the employee will be entitled to receive retirement benefits equal to a certain dollar amount per month for life beginning on the date of retirement (in this type of plan the amount of the benefit is defined so we call it a "defined benefit" plan). Another type of NQDC plan structure might allow an employee to elect to delay receipt of a portion of next year's salary until retirement (in this type of plan, the amount of the contribution is defined so we call it a "defined contribution" plan).

As an introduction, it can be helpful to simply consider each word — "nonqualified," "deferred," and "compensation."

A. "Nonqualified." "Nonqualified" simply means that the arrangement does not meet the various requirements of Section 401 of the Internal Revenue Code. In order to be a "qualified" plan, a plan must meet those Section 401 requirements. Typical "qualified" plans include pension plans, profit-sharing plans, 401(k) plans, money purchase plans, and Keogh plans. The fact that a NQDC does not have to satisfy the detailed requirements of Section 401 makes NQDC arrangements different from "qualified" plans in many important ways. Some of the major differences are:

1. Flexibility. Since a qualified plan must satisfy many requirements, flexibility is greatly restricted. In contrast, NQDC arrangements can deliberately violate qualified plan rules. This can allow a NQDC plan to be tailored specifically to the needs of the individual employer and employee. For example, in calculating contributions or benefits for an employee, qualified plans are prohibited from considering compensation to the employee in excess of a certain dollar amount ($245,000 in 2011).[1] Thus, in general, in 2011, the qualified plan benefit accrued for a top employee earning far in excess of $245,000 per year cannot be higher than the benefit accrued for another employee earning only $245,000. In contrast, a NQDC arrangement could be adopted that would provide benefits only to employees receiving compensation in excess of $245,000 which might make up the difference for benefits not able to be provided under the qualified plan.[2] However, in some ways NQDC plans are less flexible than qualified plans, for example, under Section 409A there are limitations on the ability to change the timing of benefit payments or roll over distributions.[3]

2. IRS Pre-Approval. A "qualified" plan is designed to meet various Internal Revenue Service ("IRS") requirements. Before contributing significant funds to a qualified plan that eventually will be paid to the employees as benefits, the employer generally will want to (i) have the plan documents prepared, (ii) have an IRS application form prepared, (iii) submit the plan documents and the application to the IRS along with a check payable to the IRS as an application fee, and (iv) wait for the IRS to issue a "determination letter" acknowledging that based on the documents submitted and the information in the application, the plan is "qualified."[4] The IRS provides no guarantee on the length of the waiting period.[5] It is often somewhat less expensive to purchase a master or prototype qualified plan, often marketed by banks, insurance companies or qualified plan administrators which have already received IRS approval.[6] In contrast, a NQDC arrangement does not need to satisfy these special rules and typically no IRS approval is requested before adopting a NQDC plan. In some situations, when new approaches or unique circumstances arise, the employer and employees might want to obtain a prior ruling from the IRS on the expected tax results of the NQDC plan, but this is very rare.[7] In fact, there are certain circumstances when the IRS will not issue a determination on a NQDC plan, even when the parties voluntarily request a ruling.[8]

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[1] This is the rounded limit for 2011. Section 401(a)(17)(A) established the amount at $200,000, and the amount is adjusted for the cost-of-living. Id.; IRC § 401(a)(17)(B).

[2] This type of plan is often called a "qualified plan make-up plan" or a "supplemental executive retirement plan" ("SERP"), although this terms can also refer to other types of plans.

[3] Section 409A(a)(2).

[4] Rev. Proc. 2010-6, 2010-1 I.R.B. 193; IRS Pub. 794; see also IRS Form 5300.

[5] Id. at Section 19.

[6] IRS Form 5307. Financial institutions often charge less for preparation of qualified plan documents or administrative services because they expect to profit from the funding products (such as mutual funds, annuities or insurance policies) that the adopting company may be required to purchase from the institution to fund the qualified plan.

[7] See e.g., PLR 9508014 (Nov. 22, 1994).

[8] See e.g., Rev. Proc. 92-64, 1992-2 C.B. 422, 423 (model "rabbi trust" Revenue Procedure) ("rulings will not be issued on unfunded deferred compensation arrangements that use a trust other than the model trust, except in rare and unusual circumstances").

3. No IRS Form 5500 Required Every Year. In general, the employer maintaining a qualified plan is required to submit a tax return (Form 5500 or one of its variations) every year to the IRS.[9] In contrast, with a NQDC plan the employer's only government reporting requirement is satisfied by filing a one-page letter with the Department of Labor within 120 days of the adoption of the NQDC plan (and complying with employment tax requirements as the benefits are paid).[10]

4. Discrimination Against Lower Paid Employees Allowed and Even Required. Qualified plans must allow certain numbers or percentages of lower paid employees to be eligible to participate and be covered under the qualified plan, and there are detailed rules generally designed to prevent discrimination in providing benefits against the lower paid employees.[11] As a result, if an employer wants to increase benefits to higher paid employees by increasing benefits under the qualified plan, the cost can be substantial because benefits also may have to be increased for the lower paid employees. In contrast, NQDC plans frequently are designed to benefit only the highly compensated employees. In fact, certain rules compel an employer to design NQDC retirement plans so that only a select group of management or highly compensated employees benefit.[12] Thus, the employer can create a NQDC plan for higher paid employee or increase the benefits to that higher paid employee under a NQDC plan, without paying increased benefits to lower paid employees.

B. "Deferred." In a NQDC plan, compensation for services performed in one year is "deferred," such that it is not paid until a later year. The payment of the money might be deferred until a certain date or until the employee attains a certain age (for example, normal retirement age) or until the occurrence of a certain event (for example, the employee's death or disability). Applicable tax rules limit the types of events that may trigger the payment of NQDC.[13] If properly structured, the tax consequences for the employee and employer also will be deferred so that the employee will not be taxed on the amount until the payment is actually received (and the employer will not be entitled to an income tax deduction until it pays the amount). In the case of a qualified plan, the payment of the benefits will be deferred and the tax consequences to the employee will be deferred, but under Section 404, the employer will be entitled to a current income tax deduction as amounts are contributed to the trust established in connection with the qualified plan.

C. "Compensation." The thing deferred is "compensation" for service. It might be compensation for an employee or an independent contractor, such as a director or consultant. It might be salary, bonus or incentive compensation, equity, production or earnings rights, retirement or disability benefits, or severance payments.

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9 See IRC § 6058(a).

10 29 CFR § 2520.104-23. As discussed in Chapter IV, "NQDC and FICA and Other Payroll Taxes," benefits paid under a NQDC plan to an employee or former employee will be subject to employment taxes and the related information reporting requirements.

11 IRC § 6058(a).

12 29 USC §§ 1051(2), 1081(a)(3), 1101(a)(1)(1994) (these types of plans are called "top hat plans" and are discussed in Chapter VI, "ERISA and NQDC").

13 See Section 409A rules which are discussed in Chapter III, "Income Tax Consequences of NQDC for the Employee".

III. HOW DOES A NQDC PLAN SOLVE PROBLEMS?

A. Solutions for the Employee.

1. The Retirement Gap. Different people have different plans for retirement. In most cases, people would like to continue to live in the manner to which they have become accustomed. Some may need more money to travel or pursue a hobby. The two primary sources of retirement income are Social Security and qualified plan benefits, but it may be necessary to supplement these with NQDC.

a. Social Security Benefits. In general, an individual can begin receiving Social Security benefits at age 62, but the monthly benefit will be reduced if the benefit is claimed before attaining age 65 (for individuals born after 1937, the age is greater than 65). The Social Security benefit otherwise payable to the individual will be reduced if the individual has "earnings" (wages or self-employment income) in excess of certain amounts before the individual attains age 70.[14] A key factor in calculating Social Security benefits is that wages in excess of the applicable annual wage ceiling are irrelevant. As a result, the middle-manager who earns $106,800 in 2011 accrues approximately the same amount of Social Security benefits as the CEO who earns millions. Thus, Social Security benefits for lower paid employees represent a much higher percentage of compensation than for highly compensated employees.

b. Qualified Plan Benefits. There are many different types of qualified plan benefits. Examples include pension plans, profit-sharing plans, 401(k)s, money purchase plans, and Keogh plans. There are defined benefit plans and defined contribution plans as described above. Defined benefit plans typically pay a certain dollar amount or percentage of final compensation each year beginning at a certain age. In defined contribution plans, certain amounts are contributed to the plan by the employer (sometimes through salary reduction) each year, and the amount of benefits eventually paid will depend on the amounts contributed and the amounts earned on those contributions. The qualified plan rules have changed so often, and likely will continue to change at such a fast rate, that it is difficult to generalize about the level of benefits that can be received from qualified plans. However, one rule in particular is worth discussing in this introductory segment.

Contributions to, and benefits from, qualified plans usually are based on the employee's level of compensation — the higher the compensation, the higher the contributions to, or benefits from, the qualified plan. However, the maximum amount of compensation that can be considered in making contributions to, or receiving benefits from, qualified plans is limited to $245,000 in 2011.[15] Thus, whether an employee earns $245,000 or $3 million during the year, the maximum employer contribution to a defined contribution plan on behalf of the employee for the year, or the maximum benefit that can be provided under a defined benefit plan for the employee, is the same. If the employee earning $3 million per year has bigger plans for retirement than the

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[14] Social Security benefits are discussed in Chapter XIII, "The Impact of NQDC on Social Security Benefits."

[15] See IRC § 401(a)(17). This amount is adjusted for the cost-of-living each year pursuant to IRC § 401(a)(17)(B).

employee earning $245,000 per year, the employee earning $3 million needs some additional planning.

c. Determining the Size of the "Gap." Thus, there are severe limitations on the amount of social security benefits an employee can receive during retirement and on the amount that can be received from a qualified plan. The preliminary legislative discussions around the adoption of the includable compensation limit discussed above suggested that individuals earning in excess of the includable compensation limit (originally $150,000 and $245,000 in 2011) are able to save sufficient additional amounts for retirement by setting aside "after-tax" dollars.[16] In reality, many people do not save sufficient after-tax dollars to use for retirement. The artificial caps placed on qualified plan contributions and social security benefits create a "Retirement Income Gap" for many highly compensated employees. The Retirement Income Gap is the shortfall between the amount of income needed during retirement and the income provided by personal savings, qualified plan benefits and social security benefits. NQDC can fill the Retirement Income Gap because it is not subject to the restrictions that apply to social security and qualified plan benefits. In contrast to both social security and qualified plans, a NQDC plan can cover only highly compensated employees. In fact, a NQDC agreement can be established that will benefit only one highly compensated employee.

A very popular type of NQDC arrangement used to fill the "Retirement Income Gap" is a "Salary Continuation Plan," often called a "Supplemental Employee Retirement Plan" ("SERP"). In this type of NQDC arrangement there is generally no reduction in the employee's salary when the plan is established. Instead, the employer simply provides the payments as "additional" or "supplemental" compensation. The SERP can be designed so that the payments by the employer will approximate the expected "Retirement Income Gap."

2. My Qualified Plan Benefits Are Disappearing.

a. Advantages of Qualified Plans. Qualified plan benefits provide two extremely significant advantages that are not available with NQDC. First, when an employer contributes amounts to a trust to fund benefits under a qualified plan, the employer is entitled to an income tax deduction for the amount of the contribution,[17] and the employee is not required to include the amount in taxable income.[18] In fact, the employee is not required to include the amount in taxable income until he or she receives the benefit payment, which may be many years after the employer deducts the contribution. This type of asymmetry in the tax law — one party being entitled to a tax deduction immediately while the other party is not required to pay tax on the amount for many years — is rare.[19] With NQDC, as in most areas, one

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16 See BNA Daily Tax Report, Special Supplement, Draft Summaries of Administration's Revenue Proposals, Report No. 34 (Feb. 23, 1993) ("Although the reduction in the section 401(a)(17) limit would reduce the amount of benefits and contributions that could be provided through a tax-qualified plan for some employees, the affected individuals would be employees at higher compensation levels who are most able to save for retirement outside of the qualified plan system").

17 IRC § 404(a)(1).

18 See id. § 402(a) (providing that the "amount actually distributed" shall be taxable).

19 Actually, the tax treatment of qualified plans follows a consumption tax model and is one of a number of consumption tax structures intentionally built into the tax code to encourage savings and balance the bias that the income tax system has against savings. See Joint Committee on Taxation, *Present Law and*

party (the employer) can claim a tax deduction for a benefit only if the recipient (the employee) of the benefit must include the amount in taxable income.[20]

A second important advantage of qualified plans is that the funds used to make the benefit payments are set aside in a separate trust[21] and are not subject to the claims of the employer's creditors.[22] Thus, the employer could declare bankruptcy, the employer's creditors could receive nothing in payment of their valid debts in the bankruptcy proceeding, but the employees still could collect their qualified plan benefits. In a NQDC arrangement, if assets were set aside in a trust and could not be reached by the employer's general creditors, the NQDC plan would be considered "formally funded."[23] In that case, the employees would be taxed immediately when the assets are set aside even though the benefits might not be paid for many years (e.g., when the employee retires). Qualified plans are required to provide security to employees that their benefits are safe from the financial instability of the employer while NQDC is required to be unsecured and subject to the claims of the employer's creditors. However, aligning the interest of executive participants in a NQDC plan with the financial stability of the company is often one of the goals of NQDC arrangements.

b. Restrictions on the Amount of Qualified Benefits. While there are significant advantages to qualified plans, the amounts that can be received from a qualified plan are limited. While there are several limitations impacting qualified plans, two major ones are discussed below to illustrate how NQDC arrangements can be used to offset a reduction in qualified plan benefits.

Section 415 Limits. Section 415 imposes certain limits on the amounts that can be deferred under both defined contribution plans and defined benefit plans. For defined contribution plans, the maximum annual contribution to a qualified plan by the employer or employee is generally the lesser of (i) $49,000 (for 2011), or (ii) 25% of compensation.[24] For defined benefit plans, the maximum annual benefit that can be accrued in a year is the lesser of (i) $195,000 (for 2011), or (ii) 100% of the employee's average compensation for his or her high three years.[25] The Section 415 limitations were introduced when the Employee Retirement Income Security Act ("ERISA") was first enacted (in 1974), and ERISA expressly excludes from

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Background Relating to the Tax Treatment of Retirement Savings (JCX-44-11), September 13, 2011, at 44; see also Joseph Bankman and David Weisbach, "*The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax,*" 58 Stanford Law Review, 2005–2006.

20 IRC § 404(a)(5).

21 29 U.S.C. § 1103(a). Among the exceptions to the "trust" requirement are "any assets of a plan which consist of insurance contracts or policies." Id. § 1103(b)(1).

22 11 U.S.C. § 541(c)(2); see Patterson v. Shumate, 504 U.S. 753 (1992), 119 L. Ed. 2d 519, 532 ("a debtor's interest in an ERISA-qualified pension plan may be excluded from the property of the bankruptcy estate pursuant to 11 USC § 541(c)(2)").

23 Chapter III, "Income Tax Consequences of NQDC for the Employee" discusses the economic benefit doctrine and Section 83, under which an employee would be taxed immediately on vested NQDC benefits (even if the benefits will not be paid for many years) if the NQDC plan is "formally funded."

24 IRC § 415(c)(1).

25 Id. § 415(b)(1).

its coverage unfunded plans that provide benefits to compensate for the Section 415 limits.[26] Such a plan is called an "excess benefit plan" and is defined as a "plan maintained by an employer solely for the purpose of providing benefits for certain employees in excess of the limitations on contributions and benefits imposed by Section 415. . . ."[27] Thus, when the Section 415 limitations were enacted, Congress anticipated that NQDC arrangements would be established to provide benefits in excess of the limitations. However, the Section 415 limitations are not the only limitations typically made up by NQDC plans such that the use of an ERISA "excess benefit plan" has become largely obsolete.

Section 401(a)(17) Compensation Cap. Contributions to, and benefits from, qualified plans can be based on a percentage of the employee's compensation. However, as discussed earlier, the maximum amount of compensation that can be taken into account in determining qualified plan contributions or benefits is limited to $245,000 (for 2011).[28] As a result, the maximum amount of qualified plan contributions or benefits that can be provided for an employee earning substantially in excess of the limit cannot be more than the maximum amount of qualified plan contributions or benefits that can be provided an employee earning at the limit.

> <u>Example</u>: If a qualified plan bases benefits on 50% of compensation, the amount for an employee earning $245,000 would be $122,500. The amount for an employee earning $600,000 also would be $122,500 because only $245,000 of compensation can be taken into account. In this type of situation, a NQDC arrangement could allow the employee to accrue a benefit based on 50% of the employee's entire compensation. Thus, based on 50%, the employee earning $600,000 would have a qualified plan benefit amount of $122,500 and a NQDC benefit amount of $177,500.[29]

Because of these and other such significant limitations on the benefits that can be accrued under such plans by top executives, NQDC can be a valuable source of additional retirement benefits for such executives.

3. <u>My Faith in Social Security and Government Health Care Programs Is Shaken</u>. In planning for retirement, one of the first sources of retirement income considered is Social Security benefits. One of the reasons workers may think of Social Security first is because workers and their employers pay Social Security taxes. Shortly before the Presidential election on November 3, 1936, many employees' pay envelopes contained a flyer that read:

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[26] 29 U.S.C. § 1003(b)(5).

[27] <u>Id</u>. § 1002(36).

[28] IRC § 401(a)(17).

[29] The NQDC benefit would be: ($600,000 x 50%) – $122,500 = $177,500.

> You're sentenced to a weekly pay reduction for all your working life. You'll have to serve the sentence unless you help reverse it on November 3.[30]

Although workers and their employers continue to pay FICA taxes on an always rising amount of annual earnings, the Social Security System is in a dire financial situation. The latest projections of Social Security suggest that trust fund reserves will be exhausted in 2036.[31] In calendar year 2010, for the first time since the enactment of the Social Security Amendments of 1983, annual outlays for the program exceeded annual revenues, excluding interest credited to the trust funds. The Congressional Budget Office projects that the gap will continue: "Over the next five years, outlays will be about 5% greater than such revenues. However, as more members of the baby-boom generation (that is, people born between 1946 and 1964) enter retirement, outlays will increase relative to the size of the economy, whereas tax revenues will remain at an almost constant share of the economy. As a result, the shortfall will begin to grow around 2017."[32] Cuts in Social Security benefits (or their complete elimination) may widen the "Retirement Income Gap" discussed above. In addition, the reduction or elimination of government health care programs could significantly increase the amount of income needed during retirement years. NQDC can help fill this "Retirement Income Gap."

4. Anticipated Future Expenses. Any executive with children is likely to have college expenses as a looming financial crisis. A NQDC plan with flexible scheduled distribution provisions (as discussed in Chapter III, "Tax Consequences of NQDC for the Employee") can create access to funds during anticipated college years. If the child decided that a rock band is a better career path than attending the hallowed ivy halls, the scheduled distributions can be rolled out a year in advance by a minimum of five years to provide for the more academic second born or further to provide additional retirement funds.

5. Burying Some Nuts. While many NQDC arrangements are established because the employee needs extra compensation, some NQDC arrangements provide for the deferral of amounts that the employee would otherwise receive in the current year. In these arrangements the employee or independent contractor already has enough income in the current year and wishes to defer some of the money into the future. This type of arrangement is generally referred to as a "voluntary deferral" arrangement.

One of the most famous examples involved prizefighter "Sugar Ray" Robinson.[33] Sugar Ray's real name was William Smith, Jr. He acquired his ring name when he borrowed the birth certificate of a friend named Ray Robinson so that he could box while he was still below the minimum age. In 1957, Sugar Ray was 36 years old, had been a professional prizefighter for

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[30] D. McWhirter, Your Rights at Work, 259 (Wiley 2d ed. 1993).

[31] See J. VanDerhei, Testimony for the U.S Senate Committee on Finance, *Hearing on Tax Reform Options: Promoting Retirement Security*, September 15, 2011, at 3; see also J. VanDerhei, *Testimony for the U.S. Senate Special Committee on Aging Hearing on Retirement Planning: Retirement Savings Shortfalls for Today's Workers*. EBRI Notes, no. 10 (Employee Benefit Research Institute, October 2010a): 2–9.

[32] See CBO's 2011 Long-Term Projections for Social Security: Additional Information (August 5, 2011).

[33] Robinson v. Commissioner, 44 T.C. 20 (1965), acq. 1970-2 C.B. xxiii, acq. 1976-2 C.B. 2.

over 20 years, had been in approximately 170 professional fights and had been world middleweight champion five times. A prizefight between Sugar Ray, the then world middleweight champion, and Carmen Basilio, the then world welterweight champion, was scheduled for September 23, 1957 at Yankee Stadium in New York City for the world middleweight championship. On July 31, 1957, Sugar Ray and the promoter entered into a contract providing that Sugar Ray would receive 45% of the ticket revenue and 45% of the radio, theater/television, and motion picture receipts. According to the agreement, Sugar Ray would receive 40% of his payment within two weeks of the fight, 20% in quarterly payments in 1958, 20% in quarterly payments in 1959, and 20% in quarterly payments in 1960. Thus, Sugar Ray used a NQDC arrangement to stretch out the payments from the fight over 4 years.

However, not all deferred compensation arrangements turn out to actually benefit the service provider. A 1959 article stated:

> For appearing in *Bridge on the River Kwai,* William Holden agreed to 10% of the gross, but for tax reasons wanted it paid to him at the rate of only $50,000 a year. The picture has already made so much money (between $20 and $30 million) that Holden's share now stands at between $2,000,000 and $3,000,000. Not only will it take 40-year old Holden at least 40 years to get the last of his money, but [the producer] can in the meantime invest it and make well over $50,000 a year, thus in effect having got Holden's services in Kwai for nothing.[34]

William Holden (birth name, William Franklin Beedle, Jr.) died in 1981, 24 years after the release of Bridge on the River Kwai. Everything did not turn out perfectly for Sugar Ray either. He lost the world middleweight championship to Carmen Basilio in the 15th round on September 23, 1957.[35]

NQDC voluntary deferral arrangements are now very common among corporate executives as well as entertainers and athletes as a method of deferring taxes and supplementing their own retirement income.

B. Solutions for the Employer.

1. Key Employees Leaving — "Golden Handcuffs." Lateral hiring can be extremely effective. Instead of hiring new graduates who will need years of training, it is often easier to hire an experienced employee from the competition. In turn, firms with experienced,

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34 B. Bittker & L. Lokken, 2 Federal Taxation of Income, Estates and Gifts, 1 60.2.1, page 60–11 (2d ed., 1990) (quoting Time, Jan. 19, 1959, at 66).

35 A. Ashe, A Hard Road to Glory, 337 (1988). See also, Buffalo Bills, Inc. v. United States, 74 AFTR 2d ¶ 94-5330, at page 94-6006 and 6011 (Fed. Ct. Cl. 1994) (the court considered a contract in which the player was to receive a total of $175,000, with $100,000 payable during the regular football season from September to December, and the balance of $75,000 payable in the following year. The court stated, "[t]he length of a professional athlete's career depends upon his ability to out-perform others who are themselves aggressively competing for coveted employment contracts. Consequently, professional athletes structure their payment schedules to ensure a degree of financial stability.").

valuable employees want to keep those employees. One way to improve the company's chances of retaining its key personnel is to create financial incentives — also known as "golden handcuffs" — that encourage the key personnel to stay.

The financial incentive can be created by delaying the "vesting" of benefits. For these purposes, "vested" means not subject to a substantial risk of forfeiture. A benefit is considered nonforfeitable when the employee is entitled to the accrued benefit even if he or she voluntarily resigns. For example, a plan might provide that for every year of service, the employee is entitled to a retirement benefit equal to 1% of average compensation for the three highest earning years, provided that the employee is only 10% vested after one year of service, 20% vested after two years of service, etc., until he or she is completely vested after ten years of service. The following chart illustrates the "vested benefit" the employee would be entitled to after each year during the ten years of service.

Year of Service	Accrued Benefit w/o Considering Vesting	Vesting Percentage	Vested Benefit
1	1%	10%	.1%
2	2%	20%	.4%
3	3%	30%	.9%
4	4%	40%	1.6%
5	5%	50%	2.5%
6	6%	60%	3.6%
7	7 %	70%	4.9%
8	8%	80%	6.4%
9	9%	90%	8.1%
10	10%	100%	10.0%

A lengthier vesting schedule increases an employee's financial cost of resigning and going to work for the competition.

> Example: Assume the employee's average compensation is $200,000 per year. If the employee resigns in year 9, the vested benefit would be $16,200 per year (8.1% x $200,000). In contrast, if the employee stays another year (and completes 10 years of service), the vested benefit would be $20,000 per year.

In order to be "qualified," qualified plans must provide that an employee's benefits vest completely within the first 7 years of service. As a result, a qualified plan cannot provide "golden handcuffs" for retaining a key employee beyond seven years.

In contrast, the qualified plan limitations on vesting do not apply to NQDC arrangements.[36] Thus, NQDC arrangement can be designed to create a significant financial incentive for the employee to stay with the company beyond seven years. A NQDC arrangement could be structured so that the employee must work until normal retirement age (or any other

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[36] 29 U.S.C. § 1051(2) (the vesting rules do not apply to "top hat" plans). The definition of "top hat" plans is discussed in detail in Chapter VI, "ERISA and NQDC."

age) in order to receive any NQDC retirement benefits. Another way to structure a NQDC arrangement would be to provide that the employee will receive no benefits if he or she resigns or is terminated for "cause"[37] before attaining normal retirement age (or any other age). NQDC arrangements often provide that the employee will be 100% vested if the termination of employment is because of events such as permanent disability, death, change in control of the employer or, in some cases, even involuntary termination without cause.

A vesting structure which has become popular recently for "golden handcuff" arrangements is a "rolling vesting structure" where each annual contribution is vested over a specified period of time, typically 3 to 5 years. The idea is that the vesting period is short enough to provide a good incentive for the executive to perform well but still acts as a golden handcuff because at any given time, resignation will cause the executive to forfeit a portion of each of the last 3 to 5 years of contributions.

2. Enforcing Covenants Not to Compete and Confidentiality Agreements. In many industries, the enforceability of covenants not to compete and confidentiality agreements can be crucial to the success of the business. Frequently, the company has trade secrets, know-how, customer lists and various other proprietary information that it wishes to retain as confidential and which would be very beneficial to its competitors. In addition, key employees may have developed important relationships with customers and/or suppliers. If a key employee with those contacts leaves and goes to work for the competition, some customers may take their business to the competition. As a result, it is often critical that the company be able to prevent this type of competition and disclosure.

An initial step is to include covenants not to compete and confidentiality agreements in the employment contracts of the company's key employees. These provisions normally will provide that if the employee violates the terms, the company is entitled to obtain injunctive relief in addition to monetary damages. This can allow the company to obtain an injunction to force the former employee to stop the competitive activity or to maintain the confidentiality of the company's information.

However, covenants not to compete are not enforceable in some states such as California.[38] Even where they are not prohibited, covenants not to compete are generally disfavored under state law such that there is substantial uncertainty with respect to enforceability under state law.[39] In general, a covenant not to compete will only be enforceable if it is (i) limited to a reasonable geographic scope, (ii) limited to a reasonable period of time, (iii) limited to a reasonable extent of activities effected, and (iv) designed to protect a legitimate interest of the employer.[40] Whether the various provisions are "reasonable" depends on the

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[37] It can be difficult to (i) define "cause," and (ii) decide who should determine if "cause" exists for these purposes. Also, denying benefits based on a vague standard can lead to disputes and litigation.

[38] See e.g., California Business and Professions Code Section 16600; see also Edwards v. Arthur Andersen LLP, 44 C. 4th 937, 81 Cal. Rptr. 3d 282, 189 P.3d 285 (2008).

[39] For example, in New York covenants not to compete are disfavored and contrary to public policy. Columbia Ribbon & Carbon Mfg. Co. v. A-1-A Corp., 42 N.Y.2d 496, 499, 398 N.Y.S.2d 1004, 1006 (1977). For a general discussion of the enforceability of covenants not to compete under state law.

[40] See A. Valiulis, Covenants Not to Compete: Forms, Tactics, and the Law, 1, 4, 48 (1985).

extent of the employer's interest. As a result, what is "reasonable" in one circumstance may be considered unduly burdensome and unenforceable in another. The amount of litigation involving covenants restricting competition has always been substantial and continues to increase. There are few other areas of the law in which there is more litigation or a greater number of conflicting decisions. In regards to enforcing a covenant not to compete by litigation, one author states:

> As every good trial lawyer knows, litigation is expensive, time-consuming, and unpredictable. This is especially true in the area of restrictive covenants. No matter how strong your case is, there are no guarantees that you will win at trial. The same case, tried by the same lawyers, can have entirely opposite results, depending on the judge or jury.[41]

In light of the inability or uncertainty of including covenants not to compete and confidentiality provisions in employment contracts, an employer may want to use a NQDC arrangement to provide a further incentive to prevent the former employee from engaging in competitive activities or disclosing confidential information. The limitations and uncertainties under applicable state laws may be avoided in the context of a NQDC arrangement which is structured as an executive retirement plan under ERISA. This is because ERISA generally preempts state law and brings such arrangement under federal law which has far fewer applicable limitations.[42]

The covenant not to compete in the employment agreement may provide that the employee shall not engage in any competitive activity for three years after terminating employment, and that only activities within a 50-mile radius of the employer's place of business can be considered competitive. The same employer and employee might have a NQDC arrangement which provides that the employee will immediately forfeit any rights to any future retirement benefits under the NQDC arrangement if the former employee engages in any competitive activity, regardless of when or where the competitive activity takes place. Although a court might not grant an injunction that would prohibit competitive activity outside the scope of the covenant not to compete clause in the employment contract, this provision in the NQDC plan could create a financial incentive for the employee to refrain from the competitive activity.

> Example: Assume: (i) the employment agreement provides that the employee shall not compete for three years after termination of employment; (ii) the NQDC arrangement provides that the employee will receive a monthly retirement benefit for life if the employee remains employed by the company until attaining age 55 and complies with a covenant not to compete for life; and (iii) the employee retires at age 55 and receives monthly retirement benefits, but at age 59 the employee goes to work for the competition. In this situation, the employee would not be in violation of the

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41 Id. at 81.

42 29 U.S.C. § 1144. See also Fort Halifax Packing Co. v. Coyne, 482 U.S. 11 (1987) in which the US Supreme Court states that "Congress intended pre-emption to afford employers the advantages of a uniform set of administrative procedures governed by a single set of regulations."

covenant not to compete in the employment agreement (because the employee refrained from competing for 3 years), but the company would be able to cut off the retirement payments. Thus, the NQDC arrangement can create an incentive for an employee to refrain from competing in situations when a court would not enforce a covenant not to compete.

3. Employee Recruitment and Retention — Giving Employees "Skin in the Game." As discussed above, lateral hiring can be very effective. However, if the employer is going to pay a new employee substantial amounts, it will most likely want to make sure that the key employee will stay long enough to justify the employer's expense. The employer can use a NQDC arrangement to create a financial incentive for the employee to stay by structuring the NQDC agreement with a delayed vesting schedule, as discussed above in Section III,B.1 re "Key Employees Leaving — 'Golden Handcuffs.'" In addition, the structure of NQDC contributions and benefits can be based on the long-term financial success of the business. Finally, NQDC being unfunded is always ultimately subject to the financial stability of the company, making it the ideal vehicle for giving the employees "skin in the game."

4. Employee Recruitment When Employee Will Forfeit Benefits with Current Employer. Not all benefits are "portable." As discussed above, qualified plan benefits can be subject to a 5-year cliff vesting schedule or a 7-year graduated vesting schedule. NQDC arrangements can be structured so that the employee will forfeit future benefits upon going to work for the competition at any time. As a result, an employer desiring to hire a lateral employee may need to match the benefits package that the key employee would be leaving behind. NQDC can be an extremely flexible tool for making up the difference.

5. Recruiting or Motivating Employees While in a "Cash Crunch." Many employers, particularly start-up ventures, have a bright future, but are short on cash and need key personnel to realize that potential. One way to recruit and retain key personnel is to create NQDC arrangements so that the employer will not be obligated to pay the additional compensation for many years. In addition, the deferred compensation can be contingent on the success of the business. For example, a NQDC arrangement could be structured in which the employee could earn benefits based on profitability. The employer would not be required to pay the cash until it has several years of successful operations.

6. Returned Qualified Plan Contributions. A NQDC plan can be used to track with a 401(k) and receive any excess payment that would be caused by a failure to have a larger participation in a company's 401(k) plan. A discussion of one such approach is found in Chapter XII, "NQDC in Connection with Other Plans; Split-Dollar and 401(k) Wrap Plans."[43]

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[43] See also discussion of relationship between qualified and nonqualified plan benefits in Chapter III, "Income Tax Consequences of NQDC for the Employee" at Section VI.K.

7. The Hospital. For the last several years, hospitals have been structuring new types of relationships with physicians.[44] A popular type of arrangement is for the hospital to "purchase" the physician's practice and to employ the physician. In structuring the employment agreement between the hospital and the physician, the arrangement can include a NQDC arrangement. The NQDC arrangement can accomplish a number of objectives for the hospital: (i) delay payment of part of the compensation to the physician which may ease part of the hospital's "cash crunch;" and (ii) allow the hospital to impose "golden handcuffs" so that the physician will have a greater financial incentive to remain with the hospital and comply with the contract (although a non-competition agreement imposed on a physician may be more difficult to enforce).[45]

8. Tax-Exempts. Tax-exempt organizations are generally unable to attract highly qualified executives with equity participation arrangements and, at the same time, are severely limited in their ability to provide equity supplemental retirement and deferred compensation to executives because of special tax rules applicable to state and tax-exempt employers.[46] However, a carefully constructed NQDC arrangement can be structured to mirror incentive and equity participation plans and supplement executive retirement benefits if applicable limitations are understood and addressed.

9. Financial Institution. Recent legislation and administrative supervision of financial institutions strongly favors long-term performance based compensation and aligning the interest of executives with the long-term interest of the company.[47] NQDC is an ideal vehicle for

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44 Jaklevic, Acquiring Doc Practices Can Be Risky Investment, Modern Health Care, 64 (Sept. 25, 1995) ("Buying physician practices is a popular strategy for hospitals to ensure future revenues"). NQDC plans for tax-exempt hospitals are discussed in Chapter IX, "Tax-Exempt Organizations and NQDC Planning."

45 See Council on Ethical and Judicial Affairs of the American Medical Association, 1992 Code of Medical Ethics — Current Opinions, 43 ("The Council . . . discourages any agreement between physicians which restricts the right of a physician to practice medicine for a specified period of time or in a specified area upon termination of employment or a partnership or a corporate agreement. Such restrictive agreements are not in the public interest").

46 See e.g., IRC Section 457(f); NQDC plans for tax-exempt entities are discussed in Chapter IX, "Tax-Exempt Organizations and NQDC Planning."

47 In October, 2008, the Department of the Treasury (Treasury) established the Troubled Asset Relief Program ("TARP") under the Emergency Economic Stabilization Act of 2008, as amended (12 U.S.C. 5021 et seq.) (EESA). EESA provided immediate authority and facilities that the Secretary of the Treasury (Secretary) could use to restore liquidity and stability to the financial system. EESA was subsequently amended by the American Recovery and Reinvestment Act of 2009 (ARRA) signed into law on February 17, 2009. Title VII of Division B of ARRA provides that certain entities that receive financial assistance from Treasury under the TARP (TARP recipients) will be subject to specified executive compensation and corporate governance standards to be established by the Secretary. On June 15, 2009, Treasury issued an Interim Final Rule setting forth the rules on executive compensation and corporate governance applicable to TARP recipients (74 FR 28394). The rules apply solely to TARP recipients, as defined in § 30.1 (Q-1) of the Interim Final Rule. Section 30.16 (Q-16) of the Interim Final Rule establishes an Office of the Special Master for TARP Executive Compensation (the Special Master). Hundreds of banks received assistance under TARP and became subject to the TARP legislation. Limitations include prohibitions as to payments of severance and limitations in the amount of bonus that can be paid to certain levels of executives, as specified in ARRA. Seven institutions have received "exceptional financial assistance" under TARP. In addition to being subject to TARP rules generally, as noted above, the pay of top executives at an

fulfillment of these goals. NQDC is essentially a long-term unsecured loan to the company by the executive similar to the investment of shareholders thereby aligning the interest of the executives with the interest of shareholders. NQDC can even be structured to credit contributions and/or earnings based on the financial performance of the company and can hold captive a pool of funds to allow the clawback of performance based awards if performance measures later prove to be inaccurate, as required under specified circumstances by recent legislation.[48] Thus, NQDC has the flexibility to incentivize executives to ensure the long-term stability and profitability of the company, to discourage pumping up of short-term gains to the detriment of shareholders and the economy, and to eliminate the need for legal action seeking clawbacks from the executives since the nonqualified deferrals remain under the company's control.

10. Early Retirement. For various reasons a company may need some of its key employees to retire early. Social Security benefits become available when an employee attains age 62, but the benefits will be reduced if the benefit is claimed before attaining age 65 (for individuals born after 1937, the age is greater than 65).[49] While there can be some flexibility in providing qualified plan benefits to an employee taking early retirement, in general, many qualified plan benefits will not become payable until the employee attains normal retirement age. As a result, an employee who takes early retirement may not have sufficient benefits to retire comfortably. NQDC arrangements can be used to provide the employees with additional benefits that can allow the employees to retire early. The benefits can be structured to decrease or disappear when the employee's other benefits become payable in full.

IV. THE POPULARITY OF NQDC

NQDC plans have become a very popular mechanism for providing supplemental benefits to an organization's key executives. About nine out of ten Fortune 1000 companies offer nonqualified plans to key executives.[50] A 2011 survey found that NQDC arrangements are becoming a "mainstream" benefit not just for top executives of public companies but for mid-level managers and midsize employers.[51] According to the survey, employers sponsoring NQDC plans cited as the five primary reasons the plans were offered, that such plans:

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institution receiving "exceptional financial assistance" is subject to direct control by the Special Master for TARP Executive Compensation, Kenneth Feinberg. The goals specified by the Special Master include a significant emphasis on equity and performance based compensation that focus on long-term rather than short-term success and stability of the company.

48 The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 creates new executive compensation disclosures, mandates and clawback requirements in the form of the Investor Protection and Securities Reform Act of 2010, Title IX, Subtitle E.

49 Social Security benefits are discussed in Chapter XIII, "The Impact of NQDC on Social Security Benefits."

50 Clark Consulting, *2009 Financial Services and Insurance Results, 14th Edition of Executive Benefits — A Survey of Current Trends*, at *http://www.clarkconsulting.com/execbenefitssurvey;* Newport Group has a similar survey found at *surveys@newportgroup.com*.

51 The Principal Financial Group worked with Boston Research Group to design and survey nonqualified plan sponsors and plan participants. The plan sponsor survey included 199 telephone interviews conducted from July 23, 2010 to August 16, 2010. Principal Financial Group, *How to Recruit, Retain & Retire Key Employees* (2010) at *https://secure02.principal.com/publicvsupply/GetFile?fm=BB10385&ty=VOP&EXT=.VOP.*

- Allow retirement savings in excess of qualified plan limits — 86%
- Help comprise competitive benefit package for recruiting — 86%
- Provide a retention tool to keep key employees — 81%
- Replace qualified plan benefits lost because of IRS limitations — 60%
- Assist in motivating employees to meet performance goals — 46%

Nearly 97% of the plan sponsors surveyed said that they intended to maintain their NQDC plans and 91% of plan participants said that they intend to maintain or increase their annual deferral contributions to such plans in the future. Thus, NQDC is clearly an important and valuable compensation vehicle for the future.