

NONQUALIFIED DEFERRED COMPENSATION PLANS

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By

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2026-2027 Edition Highlights

By Bruce J. McNeil

This unique work provides step-by-step guidance to draft accurate and complete nonqualified retirement plans. It offers expert analysis of the law as well as discussion of specific points of law on nonqualified deferred compensation plans.

The author, an expert in this area, walks you through this particularly complex area of practice, providing insightful practical guidance while covering such relevant topical areas as:

- Assignment of income doctrine
- Cash equivalency doctrine
- Participant-directed investments
- Securities law
- Expanded coverage of Section 457(f) of the Internal Revenue Code
- Determination of normal retirement age
- Deferral of additional amounts
- Expanded coverage of shadow or nonqualified 401(k) plans
- Other recent amendments and private letter rulings

Highlights in this Edition include:

- *Newly revised* Chapter 2 Section 83
- *Newly revised* Chapter 3 Top-Hat Plans
- *Newly revised* Chapter 5 An Election to Defer Compensation
- *Newly revised* Chapter 12 Tax Withholding
- *Newly revised* Chapter 16 Executive Compensation and Bankruptcy

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Bruce J. McNeil is a Partner with Leech Tishman and a member of the Labor and Employment Practice Group where he leads the ERISA, Employee Benefits and Executive Compensation Group. Bruce is based in the firm's Washington, D.C. office, where he focuses his practice on assisting clients in a variety of employee benefits matters including tax-qualified plans, executive and nonqualified deferred compensation arrangements, employee benefits litigation, and the tax aspects of equity arrangements and phantom equity arrangements.

Bruce is a Fellow of the American College of Employee Benefits Counsel (the "ACEBC") and he is a member of the Board of Governors of the ACEBC. He is one of the few lawyers in the country who is listed in "Best Lawyers in America" in two employee benefit categories – ERISA Law and ERISA Litigation. He was appointed to serve on the U.S. Department of Labor's Advisory Council on Employee Welfare and Pension Benefit Plans by the Cabinet Secretary of Labor, Elaine Chao, and he is considered one of the country's foremost authorities on executive and deferred compensation.

Bruce regularly advises clients on a wide variety of issues with respect to tax-qualified retirement plans, including 401(k) plans, 403(b) plans, 457 plans, nonqualified deferred compensation arrangements, equity arrangements, split-dollar life insurance arrangements, corporate owned life insurance, and other forms of executive compensation. Bruce counsels clients on all aspects of tax-qualified and executive and nonqualified deferred

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compensation plans and arrangements for taxable and tax-exempt employers, employee benefit issues in mergers and acquisitions, fiduciary responsibility and prohibited transaction issues.

Bruce also has experience in practicing before the Internal Revenue Service, the U.S. Department of Labor and the Pension Benefit Guaranty Corporation in examinations, correction programs, and ruling requests.

Bruce has served as an expert in federal hearings and investigations, including:

- Testifying before the U.S. Senate Committee on Finance as an expert witness in the hearings on the collapse of the Enron Corporation and its nonqualified deferred compensation plans.
- Testifying before the U.S. Department of Labor ERISA Advisory Council on executive compensation, nonqualified deferred compensation plans and other employee benefits matters.
- Participating in several investigations by the U.S. Government Accountability Office (the “GAO”) on the impact of mergers and acquisitions on employee benefits, cybersecurity and employee benefit plans, reporting and disclosure for nonqualified deferred compensation plans at the request of U.S. Senator Patty Murray (D-WA), U.S. Representative Robert Scott (D-VA), and other members of Congress.
- Participating in an investigation by the GAO on nonqualified deferred compensation plans at the request of U.S. Senator Bernie Sanders (D-VT).

As a leader in employee benefits law, Bruce has served on the Board of Directors of the Plan Sponsor Council of America and was the chair of its Nonqualified Deferred Compensation Plan Committee. He serves on the Board of Directors and he is the president of the Western Pension & Benefits Council – Seattle Chapter, and serves as a member of the Western Pension & Benefits Council Governing Board of Directors. He is a past president and the Chair of the Board of Directors of the Joint TE/GE Council national organization.

Bruce is the Editor-in-Chief of both the *Journal of Pension Planning & Compliance* and the *Journal of Deferred Compensation: Nonqualified Plans and Executive Compensation*, quarterly publications published by Wolters Kluwer, and nationally distributed. He is also a Contributing Editor of the *401(k) Advisor*, a monthly publication published by Wolters Kluwer. Bruce is also the author of more than 45 books on various employee benefits matters including 30 annual editions of *Nonqualified Deferred Compensation Plans*, published by Thomson Reuters; the co-author of the *Individual Retirement Account Answer Book*, published by Wolters Kluwer, the author of several

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editions of *Tax-Sheltered Annuities Under § 403(b) and Nonqualified § 457 Plans*, published by the RIA Group; and several editions of the *401(k) Plans: A Comprehensive Guide*, published by John Wiley & Sons, Inc. He is also the author or co-author of over 200 articles on employee benefit matters.

Bruce has a B.A. from Concordia College, an M.A. in English from Georgetown University, a J.D. from Drake University Law School, and an LL.M. from the Georgetown University Law Center.

Bruce is admitted to the District of Columbia Bar, the Minnesota State Bar, the Connecticut State Bar, the Washington State Bar, the Iowa State Bar, the North Dakota State Bar, the U.S. Supreme Court, the U.S. Tax Court, the U.S. Court of Appeals, District of Columbia, and the U.S. Court of Appeals, Eighth Circuit.

In addition, Bruce has been an adjunct professor at the University of Minnesota Law School, Drake University Law School, and the University of Iowa College of Law and is a frequent lecturer on employee benefits matters at other law schools and conferences.

PREFACE

On June 25-26, 1876, a little more than 150 years ago, Lt. Col. George Armstrong Custer and the Seventh Cavalry Regiment of the U.S. Army he commanded died in the Battle of the Little Bighorn. The battle was waged where the Little Bighorn River winds through grassy hills in southeastern Montana and is popularly known as “Custer’s Last Stand.” In the battle, more than 210 soldiers and an estimated 60 to 100 Native Americans died. Custer earned his command of the Seventh Cavalry after he led the Michigan Cavalry Brigade in the Battle of Gettysburg, participated in other important Civil War battles, and was known for his battlefield bravery and successes. The Hunkpapa Lakota leader, Sitting Bull, who is said to have had a vision that presaged a great victory that came weeks later for warriors led by Crazy Horse, was fatally shot in 1890 on the Standing Rock Indian Reservation during a careless arrest by Native American police officers following orders from U.S. officials.

George Armstrong Custer was a lieutenant colonel in the United States Army who became one of the most celebrated soldiers in American history. Custer began his military career at the United States Military Academy at West Point, from which he graduated in 1861 dead last in his class of thirty-four, having collected demerits at a rate that should have ended a career before it began. The Civil War rescued him. His audacity in the saddle earned him the brevet rank of major general of volunteers while he was still in his twenties, along with the admiring nickname “the boy general.”

A brevet was greatly beneficial for Custer: a higher rank conferred for gallantry, carrying the title and the honor but, very often, none of the pay that ordinarily accompanied it. An executive promised a benefit today and paid, if ever, years later, holds something not unlike a brevet, and the law that governs that promise is the subject of this book. In this edition, the rules of Section 409A of the Internal Revenue Code—which dictate when deferred amounts must be elected, when they may be paid, and what befalls the recipient when the timing is mistaken—are examined at length, including the twenty percent additional tax and the premium interest charge that fall upon the plan participant, and not the employer, when a plan fails.

Custer was born in 1839 in New Rumley, Ohio, and raised in part by a half-sister in Monroe, Michigan. Commissioned just as

the Civil War began, he rose with extraordinary speed under generals who prized his reckless courage, leading mounted charges at Gettysburg and through the Shenandoah Valley. At Appomattox in 1865 his division helped to corner the Army of Northern Virginia, and the table on which the surrender terms were drafted was later presented to his wife, Elizabeth. When the war ended the brevets evaporated, and Custer reverted to the regular-army rank of lieutenant colonel.

The evaporation of a brevet illustrates a principle at the very center of deferred compensation: a benefit subject to a substantial risk of forfeiture is not yet truly the recipient's. Section 83 of the Code, and Sections 409A and 457(f) that build upon it, turn in large part on the moment that risk lapses and the benefit vests. This edition addresses the authorities that test where the line falls in Chapters 1, 3, 4, 5, and 11 which have been significantly revised in this edition of the book, like a wartime commission, contingent upon events not yet concluded.

In 1866 Custer accepted a commission with the newly organized Seventh Cavalry, the regiment with which his name would forever be joined. In 1868 he led a controversial dawn attack on a Cheyenne village at the Washita River, and in 1874 he commanded an expedition into the Black Hills of Dakota Territory—land guaranteed to the Lakota by the Fort Laramie Treaty of 1868—where his geologists confirmed the presence of gold. The Fort Laramie Treaty of 1868 recognized the Black Hills as part of the Great Sioux Reservation, but the discovery of gold in the region created enormous pressure to open the area to white settlement. Prospectors poured onto treaty ground and the government's attempt to purchase the hills failed. When many Lakota and Cheyenne bands refused to relocate to reservations, the federal government launched the Great Sioux War of 1876.

Gold has a way of provoking conflict, and not only on the frontier. The gold of the modern executive suite is the golden parachute, and Sections 280G and 4999 of the Code wage their own campaign against it, denying the corporation a deduction for, and imposing a twenty percent excise tax upon, the "excess parachute payments" triggered by a change in control. Chapter 10, which has been significantly revised in this edition, addresses the parachute rules and their entanglement with deferred compensation, where a single change-in-control event may set off both at once and leave the executive holding far less of his treasure than he had counted upon.

The campaign of 1876 was built upon a plan of three converging columns. The bands that had not reported to the reservations

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by the government's deadline of January 31, 1876—an ultimatum effectively impossible to satisfy, since runners could not cross the frozen plains in time—were declared hostile, and the columns of Generals Terry, Gibbon, and Crook set out to compel them.

Deadlines in deferred compensation are no kinder than the one issued from Washington in 1876, and the penalty for missing them is nearly as unforgiving. Under Section 409A a deferral election must generally be made before the year in which the services are performed, and a payment may be accelerated or postponed only within narrow, pre-specified rules; the participant who misses the date receives not an extension but immediate income inclusion, the additional tax, and the interest charge. This edition reviews the correction programs of Notice 2008-113, Notice 2010-6, and IRS Notice 2010-80 (which contained certain deadlines) which afford relief in some circumstances, together with the many situations in which they afford none at all.

The encampment on the Little Bighorn River was one of the largest gatherings of Plains Indians in history. It included Lakota, Sioux, Northern Cheyenne, and Arapaho families and warriors. Leaders such as Sitting Bull, Crazy Horse, Gall, Two Moons, and Lamé White Man played crucial roles in the battle.

On the eve of the campaign, at a Sun Dance, Sitting Bull of the Hunkpapa Lakota offered a hundred small pieces of his own flesh and beheld a vision of soldiers falling upside down into the Indian camp, which his people understood as a prophecy of victory delivered into their hands.

Income, too, can fall into one's hands uninvited. The doctrines of constructive receipt and economic benefit treat an executive as taxed the moment deferred amounts are made available to him and within his control, whether or not the executive reaches out to take them; a plan drafted without care can cause the benefit to descend upon the participant years before he wished to receive it. Chapters 1 and 5, which were both significantly revised in this edition, examine how those doctrines constrain the design of nonqualified arrangements, and how the careful use of a substantial risk of forfeiture keeps the prophesied windfall from arriving ahead of schedule.

Custer was already a national figure because of his Civil War service. He was charismatic and ambitious, and cultivated an image of courage and daring, but critics viewed him as reckless and vain. At Little Bighorn, these qualities influenced his decision-making and contributed to one of the most significant defeats in U.S. military history.

On the morning of June 25, 1876, Custer sighted the enormous encampment of Native Americans along the Little Bighorn River. Believing that the Native camp might scatter if Custer delayed his attack, he made a decision that became one of the most debated military decisions in American history and divided the Seventh Cavalry. Custer divided his roughly seven hundred men into battalions, retaining about 210 under his direct command and dispatching the remainder under Major Marcus Reno and Captain Frederick Benteen. Custer then made the decision to attack immediately. Custer believed that the Seventh Cavalry was a select unit, and he treated it as one that could not lose.

Calling a group “select” carries legal weight in this field. A plan maintained for “a select group of management or highly compensated employees” is a top-hat plan, exempt from much of ERISA’s participation, vesting, and funding machinery—though not from its reach altogether—and an employer that assumes its select group may be treated as it pleases is apt to be as mistaken as a commander who assumes the same of an elite regiment. This edition collects the decisions on how small and how selective such a group must be, among them *Demery v. Extebank Deferred Compensation Plan (B)*, *Bond v. Marriott International*, and *Sikora v. UPMC* in Chapters 1 and 3, and the consequences when a plan administered as a top-hat plan proves not to qualify.

Reno’s charge stalled almost at once as warriors poured out to meet it, and his command broke in a costly retreat to the bluffs, where it was joined by Benteen and besieged for the better part of two days. Custer, meanwhile, had ridden north along the ridges with five companies and when Reno’s attack collapsed, the Native warriors turned toward Custer’s position, and his battalion became isolated and was overwhelmed. Native testimony and the archaeology of the spent cartridges describe not the orderly heroic circle of legend but a swift disintegration of the soldiers.

For years it was believed that the final moments were of a heroic circle of soldiers fighting to the last man. Archaeological evidence and Native accounts suggest a much more chaotic battle. Soldiers fought in small groups, attempted withdrawals, and were rapidly overwhelmed by highly mobile warriors defending their families and homes. Custer and every man under his immediate command were killed.

Historians generally identify several causes of the defeat *i.e.*, severe underestimation of the strength of the Native people, poor intelligence, division of forces, lack of communication, difficult terrain, and Custer’s overconfidence. The Native warriors also

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possessed substantial tactical advantages, including superior knowledge of the landscape and extraordinary motivation to defend their community.

It is often forgotten that Custer rode to his defeat having declined the help that was offered him. Before the march he turned away a battery of Gatling guns and four additional companies of the Second Cavalry, reasoning that the guns would slow him down and that his own regiment was sufficient.

The refusal of available protection is a recurring theme in this book as well. An employer may decline to set assets aside in a rabbi trust covered in Chapter 6, leaving the executive's benefit exposed to the company's creditors; a participant may decline to cure a documentary defect while the cure is still cheap. This edition addresses the model trust of Revenue Procedure 92-64, the constraints that informal funding must observe, and the special timing rule of Section 3121(v)(2) for FICA, the mishandling of which produced the cautionary judgment in *Davidson v. Henkel Corp.* covered in Chapter 12.

Reno, his conduct questioned for years afterward, at last demanded a formal Court of Inquiry, which convened in 1879 and, after hearing the testimony, declined to condemn him.

A hearing, once demanded, is difficult to escape. Even a top-hat plan, for all that it is excused from the bulk of ERISA, does not escape the statute's claims-and-appeals procedure or the civil enforcement that stands behind it, and the administrator who denies a benefit without a reasoned process invites precisely the inquiry the executive hoped to avoid. Chapters 1 and 3 of this edition set out what that procedure requires of an unfunded nonqualified deferred compensation plan, and the deference a court will, and will not, extend to the decision it produces.

The Lakota and Cheyenne won a stunning victory and could not keep it. News of the disaster, arriving in the week of the nation's centennial in July 1876, hardened the public will, and within a few years the bands were confined to reservations and the buffalo were gone. The battlefield, long named for Custer, was renamed the Little Bighorn Battlefield National Monument in 1991, and in 2003 a memorial to the Native defenders was dedicated upon it, so that the ground might at last tell both halves of its story.

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*Major General George Armstrong Custer, Credit: Library of Congress
Prints and Photographs Division*

Bruce J. McNeil

FOREWORD

As I contemplated the labyrinth of references and cross-references among those sections of the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 that are involved in the rules pertaining to non-qualified deferred compensation plans, I was reminded of the following comments by Judge Learned Hand:

[T]he words of such an act as the Income Tax, for example, merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception—couched in abstract terms that offer no handle to seize hold of—leave in my mind only a confused sense of some vitally important, but successfully concealed, purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time. I know that these monsters are the result of fabulous industry and ingenuity, plugging up this hole and casting out that net, against all possible evasion; yet at times I cannot help recalling a saying of William James about certain passages of Hegel: that they were no doubt written with a passion of rationality; but that one cannot help wondering whether to the reader they have any significance save that the words are strung together with syntactical correctness. Hand, “Thomas Walter Swan,” 57 Yale L.J. 167, 169 (1947).

After many hours preparing this book I sometimes wonder whether syntactical correctness is enough.

BRUCE J. McNEIL

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