Bloomberg BNA

Pension & Benefits Daily ™

Reproduced with permission from Pension & Benefits Daily, PBD, 07/23/2014. Copyright © 2014 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

View From Groom: Taking the 'Risk' Out of De-Risking—Issues to Keep in Mind When Terminating a SERP

BY JEFFREY W. KROH AND ALLISON ULLMAN

For many years, companies have taken steps to reduce the costs of their tax-qualified defined benefit programs (each, a ''pension plan'')—including redesigning formulas and freezing plans with respect to new participants or future benefit accruals—as well as to soften the impact of investment volatility by adopting ''liability-driven investment strategies.'' Although these changes are helpful, many companies continue to pursue further reductions of overall risk and financial statement volatility due to accumulated pension liabilities under active or legacy programs. Since 2012, companies have been considering more aggressive strategies to transfer all or a portion of a pension plan's assets and liabilities to an insurance company through an involuntary annuity buyout or directly to plan participants through a voluntary lump-sum distribution (collectively, to ''de-risk'' or a ''de-risking'').[1]

Jeffrey W. Kroh (jkroh@groom.com) is a principal at Groom Law Group, Chartered. His practice focuses on counseling plan sponsors and financial institutions regarding the design and administration of executive deferred compensation plans, equity compensation plans, and qualified retirement plans for public and private companies.

Allison Ullman (aullman@groom.com) is a principal at Groom Law Group, Chartered. She advises clients on a wide range of federal tax and ERISA matters regarding employee benefits, including executive compensation arrangements, qualified retirement plans, and health and welfare plans.

Recently, the popularity of these de-risking strategies has increased significantly. Beyond the financial, legal and accounting factors that arise in de-risking a pension plan, this article addresses the potentially overlooked impact that such strategies may have on a company's related supplemental executive retirement plan (''SERP''). We provide below an overview of the relevant tax rules under Section 409A of the Internal Revenue Code and a summary of Section 409A and other key issues to be considered in connection with de-risking a SERP.

I. Overview of Section 409A Rules

Section 409A was enacted in 2004 as part of the American Jobs Creation Act and applies to ''nonqualified deferred compensation,'' which is broadly defined to potentially cover, unless an exception applies, any right to a payment in a future tax year, including benefits provided under a SERP.[2] The benefits under a SERP typically are determined under a formula offset by the benefits provided in the pension plan, and, prior to Section 409A, the time and form of payment of SERP benefits typically tracked the payment election under the pension plan (a ''piggy-back election''). Beginning in 2009, the payment of SERP benefits subject to Section 409A (i.e., earned or vested after 2004) must be delinked from the pension plan and have a compliant time and form of payment (e.g., single life annuity upon later of separation from service or age 55).

If the requirements of Section 409A are violated, the value of a participant's benefit under the SERP and other plans of that type (e.g., nonaccount balance plans) are taxed immediately or upon the lapse of a substantial risk of forfeiture (i.e., vesting), if later. In addition to immediate taxation, Section 409A imposes a 20 percent additional tax on the amount of compensation that is required to be included in income, plus interest

[1] In 2012, Ford, General Motors and Verizon led the way in transferring significant portions of their pension plan liabilities by doing lump-sum buyouts or annuity purchases.

[2] American Jobs Creation Act of 2004, Pub. L. No. 108–357, 118 Stat. 1418 (2004).

COPYRIGHT © 2014 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN

at the Internal Revenue Service (''IRS'') underpayment rate plus one percent (the ''adverse tax consequences'').[3]

Importantly, the IRS provided some grandfathering relief, which states that amounts deferred *and* vested before 2005 are not subject to Section 409A unless the plan under which the compensation is deferred is ''materially modified'' on or after Oct. 3, 2004.[4] As a result, grandfathered SERP benefits exempt from Section 409A may continue using a piggy-back election to determine the time and form of payment. Generally, a plan is materially modified if a benefit or right existing as of Oct. 3, 2004, is enhanced or a new benefit or right is added. In the event of a material modification, the entire plan is subject to, and must immediately comply with, Section 409A. For benefits subject to Section 409A, a company must follow specific requirements to terminate and accelerate the payment of SERP benefits. We address these technical permitted acceleration requirements and the material modification issue in the de-risking context in more detail below.

II. Section 409A Issues Related to Lump-Sum SERP Distributions

At the outset, we note that there may be more than one way in which a company may de-risk its SERP. For example, a company may be able to de-risk its grandfathered SERP benefits without affecting its non-grandfathered SERP benefits, and vice-versa. Unlike the flexibility available when de-risking a pension plan (e.g., only certain populations of participants receive a lump-sum distribution in satisfaction of their pension plan benefits), de-risking a SERP typically requires more uniform treatment, especially with respect to non-grandfathered SERP benefits. In particular, this section specifically focuses on the issues that arise under Section 409A in connection with de-risking the grandfathered and non-grandfathered portions of a SERP, in the typical case where the company desires to make lump-sum distributions of all benefits accrued thereunder.

A. Issues Related to De-Risking Non-Grandfathered SERPs. In the case of a non-grandfathered SERP subject to Section 409A, the de-risking analysis in connection with lump-sum distributions is fairly straight-forward.[5] Since 2009, benefits credited under the SERP must have a specified time and form of payment, and the payment of such benefits generally may not be accelerated unless an exception applies.[6] One such exception permits accelerated payment in the event of certain plan terminations.[7] Specifically, a SERP subject to Section 409A may provide for accelerated payment upon a termination and liquidation if the following requirements are satisfied:

- The termination and liquidation does not occur proximate to a downturn in the financial health of the company;

- The company terminates and liquidates all plans and other arrangements that would be aggregated with the terminating SERP under Section 409A if the same service provider had deferrals of compensation under all the plans and other arrangements;

- No payments in liquidation of the SERP are made within 12 months of the date the company takes all necessary action to irrevocably terminate and liquidate the SERP (other than payments that would have been made had the action to terminate and liquidate not been taken);

- All payments are made within 24 months of the date the company takes all necessary action to irrevocably terminate and liquidate the SERP; and

- The company does not adopt a new plan or other arrangement that would be aggregated with the terminated and liquidated plan under Section 409A at any time within three years following the date the company takes all necessary action to irrevocably terminate and liquidate the plan.[8]

Assuming the above requirements are met, a company may successfully de-risk its non-grandfathered SERP by paying all participants lump-sum benefits as set forth above. Importantly, if a company de-risks any portion of the non-grandfathered SERP benefit it must terminate and liquidate all non-grandfathered SERP benefits and may not continue a non-grandfathered SERP for any participant.

B. Issues Related to De-Risking Grandfathered SERPs. The legal implications of de-risking a grandfathered SERP are less clear than those applicable to a non-grandfathered SERP. As noted above, many grandfathered SERP designs involve a piggy-back election to trigger payment. If an underlying pension plan benefit has been distributed as a lump sum in connection with a de-risking, it is unclear whether the piggy-back election survives. If the SERP benefit is distributed as a lump-sum benefit as a result of the piggy-back election, there is a significant risk the SERP may lose its grandfathered status and potentially violate Section 409A because the form of benefit was materially modified (i.e., a lump-sum payment).[9] Alternatively, assuming the company desires to make lump-sum distributions as stated above, the company may consider whether it may terminate and liquidate the grandfathered SERP benefit. Such termination and liquidation raises additional material modification concerns, as discussed in more detail below.

Whether a grandfathered SERP is, or must be, materially modified in order to de-risk (i.e., to terminate and liquidate the SERP benefit) is, in large part, determined based on plan terms. In the absence of either (i) clear authority under the terms of the grandfathered SERP, or (ii) sufficient discretion under the terms of the grand-

[3] I.R.C. § 409A(a)(1)(B).

[4] Treas. Reg. § 1.409A-6(a).

[5] In the case of a non-grandfathered SERP, a company could choose to merely freeze the SERP and allow the plan terms to operate to distribute benefits at the original Section 409A-compliant time and form in lieu of terminating and liquidating the plan in accordance with Section 409A. This will not operate to immediately and fully de-risk the plan, however, as contractual benefit obligations between the company and SERP participants would generally remain in effect.

[6] *See* Treas. Reg. § 1.409A-3(j)(1).

[7] *See* Treas. Reg. § 1.409A-3(j)(4)(ix).

[8] *See* Treas. Reg. § 1.409A-3(j)(4)(ix)(C).

[9] By contrast, whether a company may de-link and continue its SERP after a de-risking of the underlying pension plan depends on the specific circumstances and involves complex material modification issues that are outside the scope of this article.

 COPYRIGHT © 2014 BY THE BUREAU OF NATIONAL AFFAIRS, INC.

fathered SERP, the company may have to amend the SERP in order to terminate and liquidate it.[10] Such an amendment could, quite possibly, result in a ''material modification'' of the SERP, which would result in the SERP becoming subject to, and being required to immediately comply with, Section 409A.[11] Thus, a company must evaluate whether an amendment is needed in order to de-risk its SERP and, if so, whether such amendment constitutes a material modification.

The Treasury Regulations under Section 409A state that:

> [A] modification of a plan is a material modification if a benefit or right existing as of October 3, 2004, is materially enhanced or a new material benefit or right is added, and such material enhancement or addition affects amounts earned and vested before January 1, 2005. Such material benefit enhancement or addition is a material modification whether it occurs pursuant to an amendment or to the service recipient's exercise of discretion under the terms of the plan.[12]

These regulations also state that a company may, without constituting a material modification: (1) terminate a plan ''pursuant to the provisions of such plan''; or (2) exercise discretion over the time and manner of payment of a benefit to the extent such discretion was provided under the terms of the plan as of Oct. 3, 2004.[13]

The company's permitted exercise of discretion appears to extend to plan terminations, to the extent the necessary discretion is provided by plan terms in effect on Oct. 3, 2004. In such a case, a company may be able to terminate and liquidate its grandfathered SERP without materially modifying it. What constitutes a plan ''termination'' for purposes of the material modification rules is not entirely clear, especially for plans that are silent with respect to post-termination payments. In other words, the mere fact that the Treasury Regulations allow a grandfathered plan to be terminated without resulting in a material modification does not clearly permit the company to liquidate (and thus de-risk) the SERP in connection with such termination without materially modifying the plan. Moreover, formally amending the SERP to change the post-termination payment terms or provide for new discretion under a grandfathered SERP likely would result in a material modification. For example, amending a grandfathered SERP to add a haircut would result in a material modification.[14]

Whether a company may de-risk its grandfathered SERP depends in large part upon the terms of the plan. Based on the above, it is crucial for a company to determine whether, under the terms of the grandfathered SERP, it has the express or implied discretion to terminate *and* liquidate the grandfathered SERP benefits via a lump-sum payment. Specifically, assuming the company has the discretion to terminate the grandfathered SERP, the company must analyze whether the SERP's termination provision: (x) explicitly provides for liquidation in connection with termination; (y) expressly directs the manner in which benefits should be paid in connection with termination; or (z) is silent regarding liquidation in connection with termination.

- If the SERP's termination provision expressly allows for liquidation of the SERP upon termination, the grandfathered SERP may be de-risked by terminating and liquidating the benefits.

- If a grandfathered SERP provides for a specified time and/or form of payment post-termination, the company must take care to adhere to those provisions or risk materially modifying the SERP. For example, the SERP's termination provision may explicitly prohibit acceleration or direct that payment be made in accordance with the distribution provisions of the SERP (e.g., in accordance with a piggy-back election). Amending this SERP to provide for liquidation via a lump-sum payment likely would result in a material modification.

- If a grandfathered SERP permits termination but does not expressly allow for liquidation (i.e., the termination provision is silent as to how benefits are to be paid upon termination), the company must examine the SERP as a whole and determine whether it has sufficient discretion to liquidate. Although there are reasonable arguments that liquidation is implied in the termination of a SERP, liquidating the SERP benefits via a lump-sum payment pursuant to unstated discretion involves some degree of risk that such payment may result in a material modification under Section 409A.

If a company determines that it is unable to terminate its grandfathered SERP and liquidate pursuant to the existing plan provisions without incurring unacceptable levels of risk, it may want to consider whether it should materially modify the SERP to provide for the desired lump-sum payment at a specific date in accordance with Section 409A. If so desired, the company would need to utilize the ''one free bite'' approach, discussed below, to simultaneously materially modify its grandfathered SERP to permit a lump-sum payment and to bring all terms of the SERP into compliance with Section 409A.

C. ''One Free Bite.'' According to informal IRS comments, grandfathered plans that are materially modified such that they cease to be grandfathered have ''one free bite'' to be amended concurrently with the material modification to comply with Section 409A. Treasury Regulation Section 1.409A-6(a)(i) provides in relevant part that, following a material modification, ''whether the plan complies with the requirements of [S]ection

[10] Although it is clear that a company may suspend benefit accrual under its grandfathered SERP without resulting in a material modification, merely suspending benefit accrual does not equate to a complete SERP de-risking. The company is still bound by its promise to provide benefits to participants in the future under the SERP. *See* Treas. Reg. § 1.409A-6(a)(4)(iii) (''A cessation of deferrals under, or termination of, a plan, pursuant to the provisions of such plan, is not a material modification.'').

[11] *See* Treas. Reg. § 1.409A-6(a)(1). Whether such a SERP complies with the requirements of Section 409A is determined by reference to the terms of the SERP in effect as of the date of the material modification.

[12] Treas. Reg. § 1.409A-6(a)(4)(i). Note that a material modification may occur if the plan is actually amended *or if the service recipient exercises discretion under the terms of the plan*. This reemphasizes the need for a company to carefully evaluate up front whether it has adequate discretion in deciding to liquidate its SERP. If a company concludes it has appropriate discretion and liquidates the SERP, only to later determine that it materially modified the SERP, participants may be subject to adverse tax consequences if the SERP did not comply in form or in operation with Section 409A.

[13] *See* Treas. Reg. §§ 1.409A-6(a)(4)(i), (iii).

[14] *See id.*

409A and these regulations is determined by reference to the terms of the plan in effect as of, and any actions taken under the plan on or after, the date of the material modification.'' As a result, a company has one opportunity to bring the plan into compliance with Section 409A at the same time it materially modifies the plan to allow for liquidation following termination. Under the one free bite approach, new payment terms, so long as they comply with Section 409A, are not restricted by the design of the prior SERP. Thus, for example, a company could amend existing grandfathered payment provisions to provide for a lump sum on a specific date as opposed to providing for termination and liquidation in connection with Section 409A.[15]

In the event that a SERP continues to have provisions that do not comply with Section 409A following the loss of its grandfathered status, participants in the SERP may be subject to adverse tax consequences. As a result, it is crucial for a company that is contemplating a material modification to its grandfathered SERP to perform a Section 409A compliance check and make any necessary amendments concurrently with the material modification of the SERP. Taking into account the risks described in this article, the one free bite approach likely provides a workable alternative to de-risk a SERP that does not otherwise provide for the discretion to liquidate benefits upon termination.

III. Other Key Issues

In addition to the Section 409A concerns above, a company contemplating de-risking its SERP likely will need to consider several other miscellaneous issues identified below.

A. Unilateral Contract Issues Under Federal Common Law. Generally, the de-risking strategies discussed above involve changes to the time and form of payment for amounts previously deferred under a SERP and often require benefit calculations based on actuarial factors that were not anticipated under the original plan design. Without consent, these changes may be viewed unfavorably by participants and challenged under unilateral contract principles.

Although a SERP, as a ''top hat'' pension plan, is exempt from the vesting rules of ERISA,[16] the courts have determined that an employer generally may not unilaterally amend such a plan in a way that negatively affects a participant's rights to vested benefits. A participant's rights under a SERP are governed by the federal common law of contracts, as opposed to trust or fiduciary principles under ERISA. Essentially, the courts consider top hat plans to be equivalent to a unilateral contract offered by the company and accepted by the employee through his or her performance.[17] One exception to this amendment rule, under federal contract law, is where the plan explicitly reserves a right to terminate or amend a participant's right to benefits after performance.[18] Accordingly, a company considering one of the de-risking strategies should consider whether the terms of its SERP provide an *explicit* right to amend the plan adverse to the participants' rights to previously vested benefits.

A few recent cases reflecting participant challenges to the benefit determinations and lump-sum payments under a SERP are discussed below.

- In *Collins v. Frank Rewold & Son, Inc.*,[19] the company terminated its SERP and made lump-sum payments to participants equal to the present value of their benefits. Despite plan language prohibiting an amendment or termination from accelerating the payment of benefits, the court held that the company was reasonable in its termination and liquidation of its SERP, granted the company's motion for entry of judgment, and dismissed the plaintiff's claims with prejudice.

- In *Gill v. Bausch & Lomb Supplemental Ret. Income Plan I*,[20] the company terminated its SERP and converted the executives' benefits to a lump-sum cash payment in connection with a change of control. The executives claimed their benefits were terminated and wrongfully reduced (i.e., the lump-sum payments were less than the present value of the benefits). Noting the company's bad faith, procedural violations, reversion of assets, and inherent conflict of interest, the court found that the company's employees lacked the discretionary authority to interpret the plan terms or to determine the rights and benefits of the executives and, as a result, granted the executives' motion for summary judgment.

- In *Aucoin v. Regions Fin. Corp.*,[21] a former bank director challenged the amount of benefits determined under the bank's plan when he reached age 62. Upon reaching age 62, the bank commenced lower annual payments than had been projected in prior estimates and offered to pay a lump sum in lieu of the annual payments promised under the plan. The court determined that the director did not have a right to the lump sum and had no further claim for benefits under ERISA.

B. FICA Issues Under Section 3121(v)(2). Section 3121(v)(2) of the Internal Revenue Code provides special rules for Federal Insurance Contributions Act taxation of benefits under a SERP. These rules generally provide that an amount deferred under such a plan is required to be treated as wages and subjected to FICA taxes at the later of: (1) when the services creating the right to the amount are performed; or (2) when the right to the amount is no longer subject to a substantial risk

---

[15] Although discussed informally by the IRS, this ''one free bite'' approach still may involve some minor risk under Section 409A depending on the circumstances.

[16] ERISA § 201(2).

[17] *Carr v. First Nationwide Bank*, 816 F. Supp. 1476, 16 EBC 2859 (N.D. Cal. 1993) (requiring payment of vested benefits in accordance with the interest rates and payment schedules in effect at the time of deferral); *Kemmerer v. ICI Ams., Inc.*, 70 F.3d 281, 20 EBC 1184 (3d Cir. 1995), *cert. denied*, 517 U.S. 1209 (1996) (prohibiting changes to the payment schedules elected by the participants following plan termination); *Craig v. Pillsbury Non-Qualified Pension Plan*, 458 F.3d 748, 38 EBC 1974 (8th Cir. 2006) (permitting the recalculation of a participant's benefits in a top hat plan based on unilateral contract principles); *Miller v. Pharmacia Corp.*, No. 4:04CV981RWS, 2005 WL 1661500 (E.D. Mo. July 8, 2005) (prohibiting assignment of company's obligations under a top hat plan based on unilateral contract principles).

[18] *See Kemmerer*, 70 F.3d at 287-88.

[19] *Collins v. Frank Rewold & Son, Inc.*, No. 13-13945, 2014 WL 2587581, 2014 BL 160644 (E.D. Mich. June 10, 2014).

[20] *Gill v. Bausch & Lomb Supplemental Ret. Income Plan I*, No. 6:09-CV-6043 (MAT), 2014 WL 823451, 2014 BL 57270, 53 EBC 2851 (W.D.N.Y. March 3, 2014).

[21] *Aucoin v. Regions Fin. Corp.*, Civ. A. No. 09-3835, 2014 WL 2527046, 2014 BL 155142 (E.D. La. June 4, 2014).

COPYRIGHT © 2014 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN

of forfeiture (i.e., when the amount is vested).[22] For purposes of these special rules, a SERP typically is classified as a ''nonaccount balance plan,'' which is any plan that does not satisfy the definition of an account balance plan.[23]

As a result, the amount treated as subject to FICA in a SERP is the present value of benefits under the SERP that become vested during the year. If uncertainties relating to future events make it impracticable to determine the present value of a future benefit under the SERP in the year that the benefit becomes vested, the benefit does not have to be taken into account for FICA purposes until ''the first date on which all of the amount deferred is reasonably ascertainable.''[24] An amount is ''reasonably ascertainable'' on the first date that the amount, form and commencement date of the benefit payments are known, and the only actuarial assumptions needed to determine the amount deferred are interest, mortality and/or cost-of-living assumptions.[25] Further, the form and commencement date are treated as known so long as all forms of payment are actuarially equivalent.

Often, the de-risking strategies above involve the cessation of future accruals, the vesting of a participant's SERP benefit and the establishment of a date or period for a lump-sum payment. As a result, a participant's SERP benefit may become reasonably ascertainable and subject to FICA taxes in the year a company adopts and resolves to undertake one of the de-risking strategies.

C. Deduction Issues Under Section 162(m). Code Section 162(m) limits to $1 million a publicly traded company's deduction for compensation paid to any covered employee in a single year. Although certain ''performance-based compensation'' is exempt from the $1 million limit, payments from a SERP do not meet the requirements of this exemption. Importantly, this limitation only applies to ''covered employees'' employed on the last day of the tax year.[26]

As a result, if a covered employee is not employed by the company as an officer on the last day of the tax year, he or she would not be subject to this deduction limitation, and any payments received post-termination, including the SERP benefits, likely would be deductible compensation.[27] Under many de-risking strategies, the participants in the SERP, including the executive officers, likely will receive in-service lump-sum payments that may no longer be deductible due to the limitation under Code Section 162(m).

D. Proxy Disclosure Issues. Generally, public companies must file proxy statements that are required to include a Compensation Discussion and Analysis (''CD&A'') section and certain compensation tables describing the company's executive compensation programs for certain executive officers for the most recently completed year. The changes to a SERP contemplated in connection with many de-risking strategies (e.g., the accelerated lump-sum payment) may require public disclosure in the proxy statement. For example, the company may consider some level of discussion in the CD&A regarding the SERP termination and distributions. Also, a quantitative disclosure of the distribution in the Pension Benefits table will likely be required.

E. State Source Tax Issues. Generally, federal law prohibits a state from imposing income tax on ''retirement income'' from a SERP to a participant who no longer resides in the state, even if the participant earned the benefits while he or she was a resident of that state. For this purpose, retirement income includes payments from a SERP only if (1) the SERP is a pure excess plan (i.e., a plan that restores benefits that cannot be provided under the company's qualified plans due to Code qualified plan limits), or (2) the payments are made in the form of an annuity or for a period of at least ten years.

The conversion of an annuity benefit to a lump-sum payment under a SERP in connection with one of the de-risking strategies may cause otherwise exempt SERP benefits (i.e., retirement income) to be subject to state source taxes. This means that, if a participant relocated post-retirement, he or she may be subject to state taxes on the lump-sum payment in both the current and former states of residence.

IV. Conclusion

This summary provides a starting point for a company that desires to de-risk its SERP along with the underlying pension plan. While there are significant Section 409A issues to consider, it is prudent for a company to keep in mind the other key issues identified above, including the company's contract obligations to participants, FICA timing, deductions under Section 162(m), proxy disclosure and state source tax issues.

---

[22] Treas. Reg. § 31.3121(v)(2)-1(a)(2)(ii).

[23] Treas. Reg. § 31.3121(v)(2)-1(c)(2)(i).

[24] Treas. Reg. § 31.3121(v)(2)-1(e)(4)(i)(A).

[25] Treas. Reg. § 31.3121(v)(2)-1(e)(4)(i)(B).

[26] I.R.C. § 162(m)(3); Treas. Reg. § 1.162-27(c)(2)(ii); Notice 2007-49, 2007-1 C.B. 1429.

[27] Many companies have used SERPs to help minimize the impact of the compensation deduction limits of Code Section 162(m). Note, however, that one of the proposed changes under Code Section 162(m) in the Tax Reform Act of 2014 discussion draft released by House Ways and Means Chairman David Camp (R-Mich.) on Feb. 26, 2014, requires that once an employee is a covered employee after 2013, he or she would always be treated as a covered employee for all future compensation (39 PBD, 2/27/14; 41 BPR 463, 3/4/14).