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Boards Rush to Change Deferred Comp Plans

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By Janine Sagar

Chubb, RadioShack and Coca-Cola Enterprises last month amended their deferred compensation plans to put them in compliance with a relatively new provision of the Internal Revenue Code. While the provision took effect back in December 2004, many boards are just now adjusting their deferred comp plans to get them in line with the new rules, and the terms of their companies' own deferred comp plans are taking some directors by surprise.

"We have discovered that our plans weren't in compliance with the new rules and we're scrambling to get that [amended] as fast as we can," says Warren Batts, a director at Methode Electronics. "There's a lot of gnashing of teeth to not cost the executives any money."

Methode was able to put off amending its deferred comp plan for this long because of the way 409A—the relevant section of the tax code—works. While all deferral elections regarding compensation that vested after Dec. 31, 2004 must be 409A-compliant, companies have until Dec. 31, 2007, to officially make their deferred compensation plans consistent with 409A. In anticipation of the Internal Revenue Service's issuance of further guidance on the reg, many companies are doing just that, says Jim Barrall, global chair of Latham & Watkins' Benefits and Compensation Group.

"The key point is that—in operation—you need to comply with the new rules now, even if your plan has not yet been amended to comply with them," says Barrall.

The SEC's newly enacted compensation disclosure rules are a likely catalyst for the many formal changes to deferred compensation plans in the last few months. The new disclosure rules require, among other things, a complete description of the deferred compensation plan, its philosophy, and its relationship to other compensation arrangements. For some directors, participating in the drafting or review of these descriptions has been an eye-opening experience.

"I think that, with a careful review against the new [SEC] standards, [directors] have found some kind of glitch or another in their plan that they're trying to correct," Batts says.

Correcting a plan means requiring its participants to, among other things, make elections the year before they provide the relevant services if they want to defer a portion of their bonuses or salary, according to Barrall. "So if you're a calendar-year taxpayer, and you want portions of your 2007 compensation to be deferred, you've generally got to make your election in 2006. Once you make an election you cannot change it, you cannot accelerate it, you cannot put it off," he says, adding that 409A does provide very narrow

exceptions to these rules.

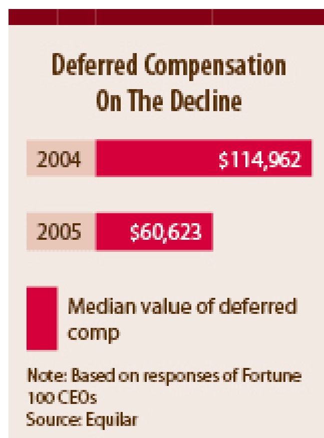
If deferred compensation plan participants do not meet these and 409A's many other requirements, they are subject to heavy penalties. Recipients of deferred compensation that violates the statute will have to pay tax on it as ordinary income when the compensation vests, not when it's paid. In addition, they will have to pay a 20% penalty tax under 409A, according to Barrall.

Kay Koplovitz, a compensation committee member at Liz Claiborne, says the disclosure rules likely will open directors' eyes to another aspect of deferred compensation plans: their potential payouts.

"The comp packages have become fairly complex. There are sometimes six, seven entries in these comp packages and you have to align them according to what they're based on in one place and how they pay out in order to really understand the total impact of them," she says. "And I think the deferred comp is one of those elements that has been somewhat opaque to people in the past."

The SEC's new rules also require companies to disclose above-market interest rate credits and company contributions to deferred compensation plans—two things that have the potential to incite investors.

"Certainly any kind of deferral plan that would include premium interest rates, any kind of favorable earnings rates, will likely get a big negative reaction from investors," says Carol Bowie, vice president of governance research at Institutional Shareholder Services.



That reaction would be understandable. By not changing the interest rates it paid on deferred compensation to match market rates, the New York Stock Exchange contributed to the $140 million package its former CEO Dick Grasso got in 2003. In reaction to the negative publicity, Boeing in 2006 stopped matching 25% of the portions of the salaries the $54.8 billion aircraft company's executives deferred. And General Electric last year lowered the interest rate it pays on deferred comp to a percentage closer to the market rate.

The disclosures required by the SEC are likely to encourage at least a few boards to eliminate their companies' deferred compensation plans altogether. More will probably curtail those payouts in some way.

Numbers back up the connection between reining in potential deferred compensation payouts and disclosure. According to Equilar's 2006 CEO Benefits & Perquisites Report, Fortune 100 CEOs received a median of approximately $61,000 in earnings on deferred compensation, "a large drop-off from the median value of approximately $115,000 reported in 2004." Meanwhile, more companies reported the actual value of their CEO's compensation in 2005 than they did in 2004: 20 compared to 16.

In fact, of all the benefits studied in Equilar's report, the median value of earnings on deferred compensation for Fortune 100 CEOs had the sharpest decline: It fell by more

than 47% from 2004 to 2005.

That's not to say that deferred compensation plans are anywhere near extinction, however.

"There's nothing wrong with the concept of deferred compensation, setting aside some portion of compensation for future payout," says Koplovitz. "Allowing compensation to grow pre-tax [has been] a benefit that has helped to attract good talent into companies."

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