

# THE NONQUALIFIED ADVISOR

An Independent Resource for Plan Sponsors and Participants of Nonqualified Plans

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## Overview: IRC Section Regulations

### Background

In 2004, President George W. Bush signed the American Jobs Creation Act (H.R. 4520) into law. The Act created sweeping changes to the design and operation of nonqualified deferred compensation plans. As a result, plan sponsors and key executives will need review and update executive benefit programs as well as many other benefit plans that could be construed as deferred compensation under the statute.

Internal Revenue Section 409A sets forth specific requirements for nonqualified deferred compensation. Deferred compensation plans that fail or violate any aspect of Section 409A will subject all amounts deferred under the plan to current income tax, plus a 20% penalty on the amount includable in income, and interest on the underpayment of tax at an enhanced rate.

Due to the broad nature of the statute, the significant number of affected plans, and the severe penalty associated with any form of noncompliance, section 409A is expected to generate significant revenues for the Treasury. According to the Congressional Joint Committee on Taxation, the statute is expected to generate tax revenues of \$158 million in the first year and \$1.051 billion over the next ten years. Consequently, employers should take an active role in understanding Section 409A, what it covers, how to comply, and how to avoid being a casualty of the tax changes taking effect in January 2009.

### Definition of Nonqualified Deferred Compensation

Section 409A defines a “nonqualified deferred compensation plan” as any plan that provides for the deferral of compensation, unless it is otherwise excluded by the statute.

This broad definition includes, but is not limited to the following benefit arrangements:

- Supplemental retirement plans
- Salary continuation plans
- Nonqualified defined contribution plans
- Excess benefit plans
- Phantom stock plans
- Certain severance arrangements
- Discounted stock rights (i.e. stock options and stock appreciation rights with an exercise price less than fair market value on the date of grant)
- Employment agreements that provide change of control benefits or other future payments
- Other elective and non-elective salary or bonus deferral plans
- Certain split dollar arrangements

The following benefit plans typically do not meet the definition of a “nonqualified deferred compensation plan” and thus are generally excluded from the provisions of Section 409A:

- Qualified employer plans, such as 401(k) plans
- Welfare benefits such as sick leave, vacation, disability pay, and medical benefits
- Short term deferrals (e.g. bonuses and deferred payments made within 2 ½ months following the end of the year in which the participant is vested.)
- Statutory stock rights granted under an employee stock purchase plan
- Most non-discounted stock options and stock appreciation rights
- Most restricted stock plans

The definition also clarifies that a "plan" includes any agreement or arrangement that provides for deferred compensation, including an agreement or arrangement with one person. The new law is also not limited to employer-employee relationships. Director plans and arrangements with independent contractors are also subject to section 409A.

### **Distribution Restrictions**

Section 409A restricts distributions of deferred compensation to specific events. The six distribution events are as follows:

- Separation from service (6 months after separation for “specified employees” of publicly held companies)
- Death
- Disability
- A fixed time, or pursuant to a fixed schedule specified under the plan
- Change in ownership or effective control of the employer, or change in ownership of a substantial portion of the assets
- Unforeseeable emergency

The acceleration of payments before the specified time is prohibited. This rule eliminates the use of “haircut” provisions, changes to the form of payment when it accelerates payments (e.g. installment to a lump sum payment, and eliminates acceleration of benefits due to plan termination.

### **Initial Deferral Election**

To defer compensation, the participant must elect to defer in the tax year preceding the year in which the compensation is earned. Newly eligible participants may elect to defer within 30 days from the date of they become eligible to participate. The plan or participant must specify the time and form of payment to be received when the deferral election is made.

For performance-based plans with a service period of at least 12 months, the election to defer must occur no later than six months before the end of the service period. To qualify, the benefit must be variable and contingent upon the satisfaction of pre-established performance criteria, and cannot be readily ascertainable.

### **Subsequent Deferral Elections**

Any subsequent election to delay the timing or change the form of payment must satisfy the following requirements:

- Election must not take effect until at least 12 months after the date of the election;
- Must delay payment for at least 5 years from the original payment date; and

- The election must occur at least 12 months prior to the date of the first scheduled payment.

### **Informal Funding Restrictions**

Section 409A eliminates two funding techniques for nonqualified deferred compensation. Under the new law, nonqualified deferred compensation can no longer be “funded” with:

- Offshore rabbi trusts
- Financial trigger trusts

A plan that has assets set aside or restricted inappropriately is subject to immediate taxation. (See Penalty for Violation) The use of domestic rabbi trusts remains unchanged.

### **Reporting and Withholding**

Under Section 409A, employers are required to report nonqualified deferrals and taxable distributions under Section 409A on Federal Form W-2 or Form 1099 (for nonemployees). Deferrals, plus earnings attributed to those deferrals are identified by entering code Y in box 12 of Form W-2, or box 15a of Form 1099-MISC. Taxable distributions (i.e. amounts from a plan that does not comply with Section 409A) are identified by entering code Z in box 12 of Form W-2 or box 15a of Form 1099-MISC. Retiree payments from a plan that complies with Section 409A are not reported.

The IRS suspended the reporting of nonqualified deferrals for 2005, 2006, 2007 and 2008. Employers are required to report deferrals beginning January 1, 2009. For amounts includable in income due to a failure under Section 409A, reporting was suspended during 2005 and 2006. Reporting and wage withholding requirements for taxable distributions became effective January 1, 2007.

### **Penalty for Violation**

If a plan violates any requirement under section 409A, all amounts deferred under the plan, which are not subject to a substantial risk of forfeiture, are includable in the participant’s gross income. In addition to current income tax, the participant is assessed a 20% penalty on the amount includable in income, and interest at the IRS underpayment rate plus 1%. The interest component is applied to the tax year in which the deferral amounts would have been included in income if it had not been deferred, or if later, the first year the amounts are not subject to a substantial risk of forfeiture.

Note: The income tax, penalty and interest are imposed on the individual participant, not the employer.

### **Effective Date**

Technically, Section 409A is effective January 1, 2005 and applies to:

- Amounts deferred after December 31, 2004;
- Amounts deferred before January 1, 2005, if “materially modified” after October 3, 2004;
- Plans established after October 3, 2004 that constitute a “material modification”.

Due to the complexity of Section 409A and the lack of clear regulatory guidance in a timely manner, the IRS has provided extensive transition relief through December 31, 2008. During the transition period employers are required to operate plans in good faith compliance with interim 409A guidance, but documentation compliance is not required until the release of the final regulations.

In April 2007, the IRS released the final regulations for Section 409A requiring full compliance by December 31, 2007; however, the IRS later extended the deadline for another year. In accordance with Revenue Notice 2007-78, documentary and operational compliance with the final regulations is required beginning January 1, 2009.

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