

New Deferred Compensation Rules Under the American Jobs Creation Act

Introduction

The American Jobs Creation Act of 2004 (H.R. 4520) creates new Internal Revenue Code Section 409A, which deals with deferred compensation plans. The Act was signed into law October 22, 2004. Since then, Treasury has issued several rounds of guidance, including final regulations in March, 2007.

This is not an exhaustive analysis of all provisions of Section 409A, but instead a look at the provisions most important to plan sponsors of typical non-qualified deferred compensation plans. The information contained herein is not intended as legal advice. Employers should consult with their legal counsel for advice regarding their non-qualified plans.

For over three decades BBVA Compass Consulting & Benefits has been in the business of working with our clients and their advisers, using sophisticated proprietary tools to help design, install, fund and administer non-qualified deferred compensation plans. We welcome your inquiries regarding your existing or proposed non-qualified plans.

Overview of Section 409A Provisions – A Working Model

For purposes of this article, we'll focus on the major changes brought about by Section 409A that will require the attention of plan sponsors. In each case, we'll also review plan provisions that may be helpful to provide maximum flexibility to participants, consistent with compliance with the new rules.

An easy way to think of a non-qualified plan is to look at each of the fundamental moving parts of the plan, specifically i) Deferrals, ii) Account Balances, and iii) Distributions. We will use that basic model to consider the new rules under Section 409A, followed by additional points.

Deferrals

Section 409A specifies that the election to defer income must generally occur before the beginning of the employee's tax year in which the compensation is earned. The deferral election should also include an election as to the timing and form of payment of the amounts deferred (see Distributions below).

- Special rules apply to performance-based compensation that is based on an earning period of at least 12 months. In this case, the election to defer may occur as late as six months before the end of the performance period. To qualify as performance-based compensation the payment must be i) contingent on satisfaction of organizational or individual performance criteria, and ii) the performance criteria cannot be substantially certain to be met at the time the deferral election is permitted. **Observation >>** Use care in designing incentive programs if the delayed election is permitted; if the bonus is already earned, no deferral would be allowed.
- For new plans (or newly-eligible participants in existing plans) the election to defer may be made within 30 days of eligibility to participate. The participant may elect to defer income earned after the election. If compensation is earned based on a specific performance period such as an annual bonus, the election to defer may apply to a pro-rata portion of the bonus; the ratio of income deferrable is the number of days remaining in the performance period divided by the total number of days in the performance period.

Account Balances

Early versions of what became Section 409A limited a plan's "deemed investments" to be no more flexible nor numerous than those offered in the qualified defined contribution plan sponsored by the employer that had the fewest investment choices. Fortunately, that provision did not survive the legislative process, and plans may have as many deemed investments as employers wish.

Section 409A does require that if a corporate grantor irrevocable trust (typically a “rabbi trust”) is used, then the trust must be domiciled domestically.

Distributions

Congress’s intent in Section 409A was to protect shareholders and creditors from non-qualified plan participants who might use insider information to their personal advantage. That intent dictates that the bulk of the law is about distributions, and primarily about the limitation of distribution flexibility.

Section 409A is specific as to the events upon which distributions may be made:

- **Separation from Service**

Separation is defined by the Secretary of the Treasury. In the case of a participant who is a key employee as defined in Section 416(i) (generally an officer of a publicly-traded company who earns more than \$160,000), distributions may not be made earlier than six months following separation.

- **Disability**

Disability is defined in Section 409A. To paraphrase the definition, a participant is disabled if he i) is unable to be gainfully employed due to physical or mental impairment that can be expected to end in death or expected to last for at least 12 months, or ii) is, because of a physical or mental impairment that can be expected to end in death or expected to last for at least 12 months, receiving income replacement benefits for at least three months under the employer’s accident and health plan.

- **Death**

- **Specified Date**

A specific time specified under the plan on the date of the deferral (e.g., in the deferral election).

- **Change in Ownership of the Employer**

Change in ownership is defined by the Secretary.

- **Occurrence of an Unforeseeable Emergency**

An unforeseeable emergency, as defined by the Secretary, is a severe financial hardship resulting from an illness or accident of the participant, spouse or dependent, loss of the participant’s property due to casualty, or other extraordinary and unforeseeable circumstances arising as a result of events beyond the participant’s control. The emergency distribution may not exceed the amounts necessary to satisfy the emergency (plus taxes on the distribution), after taking into account reimbursement or compensation by insurance or otherwise, or by liquidation of participant’s assets (to the extent that the liquidation itself would not cause severe financial hardship).

A provision found in some pre-409A plans is a “haircut” distribution in which a participant could demand payment of his or her deferred compensation balance at any time, even while employed, subject to a penalty of typically 10%. This technique is clearly ruled out under the new rules.

Modifying Distribution Elections

The new rules provide that a participant may change a distribution election, but there are two requirements: i) the change must occur at least a year in advance of the date that distribution otherwise would have begun, and ii) commencement of payment must be delayed at least five years from the date payment would have otherwise commenced.

Observation>> The pre-409A practice was generally to allow any kind of distribution restructuring, as long as an advance period (typically one year), was observed. **Tip>>** This new rule establishes, for the first time, statutory sanction of “redeferrals.” Before Section 409A, there was no statutory basis for delaying payments that were otherwise scheduled to occur.

Code Section 409A specifically prohibits “acceleration of the time or schedule of any payment under the plan, except as provided in regulations by the Secretary.” This paragraph raised a number of questions. Two in particular that the proposed regulations answer:

- If a participant has made a distribution election to receive 2005 deferrals (and related earnings) in 2010, payable over 20 years, would an election in 2008 to “re-defer” those amounts to 2015, payable in a lump sum, be considered an acceleration? **No.** The proposed regulations permit a change in the form of payments (from payout to lump sum or vice-versa) without being considered an acceleration of benefits. The five-year pushback must still be observed; i.e., the payment

commencement date under the new election must fall at least five years after the payment commencement date under the prior election.

- If a plan is terminated and balances are distributed to participants, is that considered an acceleration of benefits? **No.** While the statute specifies the permissible payment events, prohibits acceleration, and is silent on the subject of plan termination, the proposed regulations provide relief, and do indeed permit plan termination. The rules are that: i) all plans of the same type must be terminated, ii) no distributions may occur for at least 12 months, iii) all payments must be completed within 24 months, and iv) the employer may not establish a new plan for at least five years.

Additional Points

Providing Maximum Flexibility

Before Section 409A, plans generally limited payment to death, disability, separation from service (including retirement) and change of control. While some plans permitted inservice “haircut” distributions, those provisions were not prevalent. Also, plans often permitted specified date distributions, but as a general rule, most participants did not make use of them. Perhaps plan participants were reluctant to specify a distribution date earlier than retirement because they would likely be in a higher tax bracket. The result might be a distribution that – ultimately - the participant didn’t want. (A typical solution offered for this dilemma was to defer other income that same year, resulting in a wash for tax purposes. For all that to work, though, the participant would need enough income to defer to “cover” the distribution, and all elections would have to be carefully coordinated.)

Tip>> Now that Section 409A has sanctioned redeferrals (the ability to delay payment of an otherwise-scheduled payment), the deferred compensation world has changed. No longer forced to defer income until death, disability or separation from service, a participant can now make annual deferral elections, schedule them to be distributed in a few years, and then – optionally – re-defer those amounts to be paid later. By “pushing” annual buckets along the line, a participant has far more flexibility and less general creditor risk than in traditional pre-409A plan designs.

What Was Congress’ Intent in the New Rules?

It’s clear that Congress’ intent was to protect other creditors and shareholders of the company. Like Sarbanes-Oxley, the impetus for the new law was the string of failures (or, at least, misbehaviors) by companies in the 2001-2002 era, notably Enron. In some cases some participants were permitted to cash in their balances using so-called “haircut” provisions that allowed on-demand balance distributions, even while still employed, subject to a 10% forfeiture. Meanwhile, shareholders were left holding the bag. Interestingly enough, haircuts in non-qualified plans had neither statutory authority nor case law precedent. Nevertheless, many companies included these provisions in their non-qualified plans.

The irony is that the new rules, while sometimes complicated and cumbersome, may actually prompt plan design changes that provide the opportunity for more flexibility and effective security to non-qualified plan participants than was typical in pre-Section 409A plan designs.

What Amounts are Covered Under the New Law?

Non-qualified plan balances that were vested as of December 31, 2004 (and earnings on these vested amounts) are not subject to the new rules. These are considered “grandfathered” amounts under the new law. Any funds that were not vested as of December 31, 2004, plus all contributions (employer and employee) after 2004, are subject to the new law. **Tip>>** Plan sponsors should take care to avoid unintentional “material modifications” to plan provisions with respect to grandfathered amounts. (A material modification is any change to a plan that enhances a benefit or right existing as of October 3, 2004, or adds a new benefit or right, even if permissible under Section 409A.) A material modification will un-grandfather those amounts, making them subject to the new rules.

What are the Penalties for Non-Compliance with Section 409A?

If a plan fails to meet the requirements of Section 409A, all amounts deferred under the plan for the taxable year and all preceding taxable years will be taxed to the participants with respect to whom the failure relates. (In other words, the penalty for failure to meet the requirement is levied at the participant level.) In addition, interest is charged (at the underpayment rate plus 1%), and there is a 20% penalty of the amount not in compliance.

What is a Non-Qualified Plan?

Generally, a non-qualified plan is either a defined contribution or defined benefit plan designed to provide retirement benefits to a select group of highly-compensated or management employees. The arrangement is not intended to qualify under Section 401 and

related sections of the Internal Revenue Code. In non-qualified plans, amounts in participants' account balances are general corporate liabilities; therefore, participants are general creditors of the employer. It's this general creditor status that creates a "substantial risk of forfeiture," which in turn allows deferral of income tax on deferred compensation balances until amounts are actually received by participants. [What's new in 409A>>](#) Section 409A significantly broadens the definition of a deferred compensation plan. For example, if an employee has earned compensation, but payment of that compensation occurs more than 2½ months after the end of the first taxable year in which the employee has a binding right to it, the resulting arrangement is now considered a deferred compensation plan. [Tip>>](#) Employers should review all compensation programs, including equity-based plans, to assure that they do not have "unintentional" deferred compensation plans that are subject to the provisions of Section 409A.

W2, 1099 Reporting

Code Sections 6041 and 6051 require employers to report non-qualified plan deferrals on a Form W-2 or 1099.

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