



NYLEX News

News and Events in the Executive Benefit Program Marketplace

Section 409A Final Regulations ***Section 409A Alert***

TO OUR CLIENTS AND FRIENDS

THIS ISSUE OF NYLEX NEWS DISCUSSES THE FINAL REGULATIONS ISSUED UNDER SECTION 409A OF THE INTERNAL REVENUE CODE. THESE REGULATIONS ARE EFFECTIVE APRIL 17, 2007 AND CONFIRM THAT THE CURRENT TRANSITION PERIOD WILL END DECEMBER 31, 2007. ALL AFFECTED PLAN DOCUMENTS MUST BE AMENDED BY THAT DATE. PLEASE SEND COMMENTS ABOUT THIS NEWSLETTER, AS WELL AS SUGGESTIONS FOR FUTURE ISSUES, TO OUR STAMFORD, CT OFFICE.

INTRODUCTION

Internal Revenue Code Section 409A, enacted as part of the American Jobs Creation Act of 2004, provides rules for the income tax treatment of amounts deferred under nonqualified deferred compensation plans. Amounts accruing under supplemental executive retirement plans ("SERPs"), as well as other deferral arrangements, also are subject to these rules.

Final 409A Regulations

Issuance of these final regulations signals the end of the transition period that has been in effect since October 2004. Employers have until the end of 2007 to amend their plans to conform to the new requirements.

On April 10, 2007 Treasury and the Internal Revenue Service issued final regulations under Section 409A.

The final 409A regulations are effective April 17, 2007 (when the regulations were published in the *Federal Register*) and do not extend the current transition period beyond December 31, 2007. Therefore, all plans must operate in accordance with these rules by the end of 2007 and required amendments to plan documents must be made by that date.

The final regulations just released generally follow the proposed regulations published in 2005, but include revisions reflecting numerous comments re-

ceived from taxpayers and practitioners.

STATUTORY OVERVIEW

Coverage under Section 409A

The deferred compensation rules under Section 409A generally apply to any arrangement that provides for the deferral of compensation (including those covering only one individual). Although defined benefit plans such as supplementary executive retirement plans (SERPs) are not thought of as deferred compensation plans, it is clear that SERPs and similar nonqualified plans are covered by Section 409A.

However, certain tax favored retirement plans, such as qualified retirement plans and 403 (b) plans, and bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plans are statutorily excepted from the new rules.

Three New Key Requirements

Section 409A imposes new restrictions on deferral arrangements in the following areas:

1. Distributions
2. Acceleration provisions and
3. Elections

These new requirements, which must be satisfied both in the form and operation of the plans, are in addition to the existing statutory and judicially imposed rules.

Distribution Restrictions

The statute provides that deferred compensation cannot be distributed any earlier than the occurrence of one of six specified events:

1. Separation from service
2. Disability
3. Death
4. A specified time
5. Change in ownership or control
6. The occurrence of an unforeseeable emergency (as defined).

Election Restrictions

Section 409A sets forth requirements for both the ini-

tial deferral election as well as elections with respect to the time and form of distribution. Generally, deferral elections must be made prior to the year in which the relevant compensation is earned. Exceptions are made in the case of a newly established plan or where a participant is newly eligible to participate. Elections to defer "performance based compensation" may be made no later than six months before the end of the performance period, as long as such period is at least 12 months.

Elections as to the time and form of distribution must be made when the deferral elections are made. Changes in distribution elections are permitted, as long as certain specific requirements discussed below are met.

Consequences of Non-compliance

If a plan is determined not to comply with Section 409A, either because the plan itself is deficient or it has not operated in accordance with the rules, the tax consequences can be severe. An affected participant may be taxed immediately on all amounts deferred under the plan, plus an interest charge dating back to the year the compensation was deferred or became vested. In addition, a 20% penalty tax will be imposed on the deferred amounts.

There is no remedial action available once a plan is determined to have violated Section 409A. Therefore, it is important that plans conform to these requirements.

FINAL REGULATIONS UNDER SECTION 409A

The final regulations are similar in form to the proposed regulations, but include many changes designed to promote flexibility in complying with the rules. The preamble and the regulations themselves are 400 pages long, so this issue of NYLEX News is intended to be a summary of some of the more significant provisions. This analysis should not be regarded as a comprehensive analysis of the final regulations.

Plans Must Be In Writing

Under the new regulations, all plans must be in writing, although a plan may be contained in more than one document. Each plan must provide:

1. The amount payable.
2. The schedule or event that determines payment.
3. A six month delay requirement for payments to the specified top executives of public companies.
4. The conditions for making a deferral election.

These are the minimum items that must be included

in the plan, but other provisions may be required depending on the terms of the plan.

The documentation requirements must be met by December 31, 2007, although plan sponsors must be able to show that plans have been operated in accordance with Section 409A before that date.

The regulations make clear that a “savings clause”, that is a statement that plan provisions not in conformance with Section 409A will be disregarded, will not be taken into consideration. Therefore, plan sponsors must be careful to ensure that their plan documentation complies with the new requirements.

Plans Subject to 409A

Section 409A generally applies to all amounts deferred under a nonqualified deferred compensation plan on or after January 1, 2005. For this purpose, plan is defined to include any plan or arrangement providing for the deferral of compensation, even an arrangement covering one person, with certain limited exceptions.

Included in the definition of deferred compensation plans are supplemental executive retirement plans, and certain stock option, stock appreciation rights and severance plans. Also included are arrangements with independent contractors, unless the service pro-

vider meets certain requirements evidencing that they truly are an independent contractor rendering substantial services to two or more unrelated service recipients.

Exceptions to the provisions of Section 409A include:

1. Short-term deferrals, which are defined as arrangements where amounts are actually or constructively received by the service provider by the later of 2½ months after the service provider’s or service recipient’s taxable year in which the amount is no longer subject to a substantial risk of forfeiture. Under limited circumstances, such as unforeseeable administrative impracticality, certain payments delayed beyond the 2½ month date may still qualify for exemption as short-term deferrals.
2. Stock options Also excepted are incentive stock options (ISOs) and options granted under Code Section 423. Nonqualified stock options on employer stock also are excluded from Section 409A, as long as the exercise price is not less than the fair market value of the stock on date of grant and there is no feature for the deferral of compensation.
3. Stock Appreciation Rights (SARs) on employer stock also are excluded if the compensation payable cannot be greater than the excess of the fair market value at exercise over the amount specified on the date of grant, the exercise price is not less than fair market value at date of grant and there is no feature for the deferral of compensation.
4. Separation pay arrangements are excluded as long as they do not act as substitutes for, or replacements of, amounts due from deferred compensation plans. Separation payments are defined as compensation due only upon separation from service and which would not be payable absent such an event. Certain short term payments due upon an involuntary separation are excluded from Section 409A coverage if specified amount and timing limitations are satisfied. “Good reason” separations will qualify as involuntary in some situations.
5. Foreign arrangements where the compensation would not have been subject to U.S. taxation and the service provider was a nonresident alien.

Deferral Elections

General rule Section 409A generally requires that deferral elections be made in the taxable year (typically the calendar year) prior to the year in which services are performed. Thus, an election to defer salary for services to be performed in 2008 must be made by December 31, 2007. Similarly, an election to defer a bonus for services to be performed in 2008 must be made by December 31, 2007, even if the bonus will not be determined and is not payable until 2009.

The election to defer must include an election as to when payment will be made and the form of payment.

“Evergreen” elections, which provide that the election will remain in effect for subsequent periods unless changed or revoked, are allowed as long as the election is made by the stated deadline.

Elections to defer “performance-based compensation” can be made up to 6 months before the end of the performance period, provided that the performance period is at least 12 months and the election is made before the amount of the bonus is readily ascertainable. Amounts paid regardless of performance will not qualify under this exception. Thus in the case of a performance based bonus payable for services performed for the calendar

year 2008, a valid election to defer may be made as late as June 30, 2008.

To qualify as performance-based compensation, the amount payable must be dependent on the satisfaction of pre-established organizational or individual performance criteria. Subjective performance criteria will qualify, as long as the determination of whether the standards have been met is not made by the service provider or a member of his or her family, or a subordinate of the service provider.

Compensation also can qualify as performance based compensation if it based solely on the increase in value of the service recipient or the value of the service recipient’s stock.

Newly eligible participants can make an election to defer within 30 days of initial eligibility, but only as to compensation for services performed after the election. For purposes of this exception the plan aggregation rules apply, so that if a participant previously was eligible to participate in another plan of the same type, e.g., an elective deferred compensation plan, the participant will not be considered to be “newly eligible” with respect to a similar plan of that employer.

Distributions

Section 409A requires that payment of deferred compensation be made only

upon an event or time as follows:

1. A fixed date or schedule which can be determined objectively. For this purpose, specifying a calendar year for payment will suffice, without the need to indicate a specific date.
2. Separation from service, with the regulations providing criteria for determining when such a separation has occurred. No distinction is made as to whether the separation was voluntary or involuntary.
3. Plans of public companies must specify that payments to specified key employees triggered by a separation from service may not be made until 6 months after the date of the employee’s separation, or the employee’s death if earlier.
4. Disability as defined in the regulations.
5. Death.
6. Change in ownership or effective control. However, provisions that are automatically triggered upon a change in control may result in an unwanted distribution. Alternatives to automatic distributions, such as the immediate vesting of account balances, should be considered.
7. The occurrence of a severe financial hard-

ship, as set forth in Section 409A and the regulations.

Subsequent changes in the time or form of payment are permitted if all of the following are required by the plan:

1. The change does not take effect for 12 months after the change is made.
2. Where payment is made because of a separation from service, a specified time or schedule, or following a change in control, the first payment must be deferred for at least 5 years from the date the payment otherwise would have been made.
3. Any election must be made no less than 12 months before the first scheduled payment.

Delay of payment The regulations provide that a plan may delay a payment otherwise due if: (i) the services recipient's deduction would be limited by Section 162(m) (the \$1 million deduction cap on compensation); (ii) the making of the payment would jeopardize the ability of the service recipient to continue as a going concern; or (iii) the making of the payment would violate federal securities or other applicable law.

In addition, a payment can be delayed if the payment is in dispute and the service provider makes a reasonable, good faith effort to collect.

Acceleration Restrictions

Section 409A provides that, except as expressly permitted, a plan may not allow any acceleration of the time or schedule of a payment.

Exceptions to the rule against the acceleration of a payment include:

1. Payment upon plan termination, under one of the following circumstances: (i) where all of the employer's plans of the same type are terminated; (ii) termination follows a change in control (as defined in Section 409A); or (iii) termination follows a corporate dissolution.
2. Where the plan permits the payment of an amount that the participant must include in taxable income under Section 409A.
3. Distributions in an amount necessary to pay income taxes due under Section 457(f) upon a vesting event
4. To comply with a domestic relations order.
5. Distributions on account of death, disability or unforeseeable emergency.
6. Distributions to individuals equal to FICA and other employment taxes payable on amounts deferred under the plan.
7. A deferral election may be cancelled in the event

of an unforeseeable emergency or where there is a hardship distribution under the employer's 401(k) plan.

8. Where the plan permits or requires a mandatory lump sum cashout of a participant's de minimis account balance.

Effective Dates

The final regulations are effective April 17, 2007, the date they were published in the *Federal Register*, and are applicable for taxable years beginning on or after January 1, 2008. The final regulations do not extend the existing transition rules, which are effective until December 31, 2007. Therefore, all plans subject to the new rules must comply with the final regulations by the end of 2007.

Grandfathered plans Section 409A applies only to amounts deferred in taxable years beginning after December 31, 2004. However, where a plan combines pre- and post-December 31, 2004 deferrals, the entire plan will have to meet the Section 409A requirements.

Therefore, where a pre-Section 409A plan exists that includes significant provisions that no longer may be permitted under Section 409A, it may make sense to "freeze" that plan and establish a new plan for post-Section 409A contributions. Plan sponsors may conclude that the relatively

minor inconvenience of maintaining two plans is justified by the benefit of having a portion of the participants' deferrals governed by certain less restrictive provisions.

A plan that includes only pre-Section 409A deferrals will become subject to Section 409A only if the plan is materially modified (as that term is defined) after October 3, 2004. Material modifications include the addition to a plan of a new material benefit that affects amounts earned and vested before 2005. This applies even if the new benefit is permitted under Section 409A. The material enhancement of an existing benefit also may be considered a material modification.

Transition Rules

The proposed regulations issued in 2005 included a number of transition provisions which were applicable through the end of 2006. The application of many of these provisions was extended through 2007. The final regulations do not extend any of these transition rules beyond 2007.

The final regulations make clear that plan documents must be amended to conform to Section 409A by December 31, 2007. Until that date plans must be operated in good faith compliance with Section 409A.

Under transition guidance previously issued, new payment elections or amendments may be made through 2007. However, elections or amendments made in 2007 cannot apply to amounts that would otherwise be payable in 2007, or operate so to make amounts payable in 2007 that would not otherwise be so payable.

Importantly, the transition rules give participants the opportunity to make changes with respect to both the time and form of payment for elections previously made.

Issues Not Addressed in the Regulations

The final regulations do not address the calculation and timing of amounts that must be included in taxable income under Section 409A. Nor do the regulations provide further guidance as to the reporting and withholding requirements imposed by that section. Further guidance has been promised with regard to these matters.

Matters for Immediate Consideration

Plan sponsors and their advisors should conduct a review of all deferred compensation plans and arrangements to ascertain what provisions must be changed to conform to Section 409A and the final regulations. Virtually all plans will have to be

amended to deal with issues such as:

1. Distributions and participants' ability to modify previous elections
2. Definitions of such terms as "change in control" and "disability"
3. The six-month delay in distributions by public companies resulting from a key employee's separation from service
4. The requirement that certain provisions be included in the plan document
5. Hardship distribution provisions

The transition provisions also may permit changes to plans provisions, or changes to elections made previously by plan participants.

Conclusion

The final Section 409A regulations include many provisions more liberal than were contained in the proposed regulations previously issued. Nevertheless, the regulations as finally adopted include rules that must be followed if a deferred compensation plan is to meet the requirements of Section 409A. If the IRS determines that a plan has not complied with these rules, the consequences can be harsh and expensive. Therefore, a review of existing plans is imperative for all concerned.

About NYLEXBenefits

NYL Executive Benefits LLC (“NYLEX Benefits”) provides supplemental executive benefit programs to a wide range of commercial clients. We focus on developing cost effective executive benefit solutions that are designed to attract, reward and retain key employees. Our services are designed to assist clients at all stages in the adoption and operation of executive benefit programs and include:

- Initial assessment
- Plan design
- Funding
- Plan implementation
- Ongoing administration

NYLEX Benefits’ professional staff includes the following professional disciplines, all

dedicated to supporting our client’s programs, processes, systems and services:

- Accountants
- Actuaries
- Attorneys
- Benefit specialists
- Insurance specialists

We take great care to assure that client programs are practical and cost effective and that they are designed to achieve our clients’ strategic and operational goals.

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