Insight
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Final Nonqualified Deferred Compensation (409A) Regulations -- Focus on SERPs

By John Lowell, Vice President, Aon Consulting

On April 10, 2007, Treasury released final regulations under Internal Revenue Code (IRC) Section 409A, relating to the taxation of nonqualified deferred compensation. In this article we focus on the application of these new rules to retirement plans.

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On April 10, 2007, Treasury released final regulations under Internal Revenue Code (IRC) Section 409A, relating to the taxation of nonqualified deferred compensation. The regulation (with preamble) is 397 pages long (although after typesetting and publication in the Federal Register (72 FR 19234) it is a mere 93 pages long).

In this article we are going to focus only on the application of these new rules to retirement plans, which from now on we're just going to call SERPs. (SERP stands for supplemental executive retirement plan, and while, technically, there are a variety of nonqualified deferred compensation plans besides SERPs that provide retirement benefits, a lot of people use the term SERP to stand for any nonqualified retirement plan.)

For the most part we will not be discussing provisions of the regulation that solely relate to "vanilla" deferred compensation plans (i.e., those providing for a simple salary deferral), severance pay plans, stock and other equity-based plans, performance-based pay plans or foreign plans. Nor will we discuss rabbi trusts (which for the most part were not discussed in the regulation).

We want to put up front a warning: this is a very technical regulation that comprehensively deals with a wide variety of issues. We are only going to summarize the outline of the new regulation, focusing on its application to SERPs. When you undertake your review of your plans, you should do so with professional help.

We're going to start with the highlights. We'll follow with discussions of (1) the scope of the new rules, (2) rules applicable to deferral elections (including time and form of payment), (3) payment rules and (4) effective date, grandfather and transition rules.

Highlights -- what's in the new regulations?

What plans/what deferrals are covered:

- The new rules cover arrangements (formal or informal) that create an obligation to pay an amount in some future year that is not included in taxable income for the current year.
Insight

Final Nonqualified Deferred Compensation (409A) Regulations -- Focus on SERPs

• For certain purposes (e.g., the imposition of penalties), plans of a like kind -- account balance, non-account balance, stock, etc. -- are "bunched together."
• Certain plans are excepted -- e.g., qualified plans, vacation leave, sick leave, compensatory time, disability pay, and death benefit plans.
• Short-term deferrals -- benefits that are paid out within 2 1/2 months of the end of the year in which they vest -- are not covered.

Deferral rules:
• Generally, elections as to the amount deferred and the time and form of payment must be made before the taxable year in which services are rendered -- so, if an employee earns a benefit with respect to services in 2008, all elections as to the amount of his or her deferral, and when and how it will be paid, must generally be made by the end of 2007.
• Generally, an employee may make a subsequent election (changing, e.g., time and form of payment) at least 12 months before the date payment is otherwise to start, and payment of the new form may not start before a date at least five years after the date it was originally to be paid.
• Participants in excess plans may elect time and form of payment as of the first day of the year immediately following the first year they accrue a benefit; and any election made within 30 days following that date applies to pre-election benefits.
• Elections (as to payment form) between actuarially equivalent annuities are generally disregarded. So, for instance, an employee may at any time change his or her election from a single life annuity to an actuarially equivalent joint and survivor annuity.

Payment rules:
• Payment on separation of service to a "key employee" must be delayed for six months.
• Acceleration of payment is generally prohibited, but there are some useful exceptions -- e.g., to comply with a domestic relations order, to pay FICA taxes and to cash out de minimis amounts.

Effective Date:
• The new rules apply to deferrals and earnings for 2005 and after; pre-2005 deferrals and earnings on them are generally not covered so long as the plan is not materially modified after October 3, 2004.
• A good faith compliance standard applies for the period 2005-2007.

Scope of the new rules

Now, let's turn to a more detailed review of the regulations, starting with the scope of the new rules -- what plans and what deferrals they apply to.
Insight

Final Nonqualified Deferred Compensation (409A) Regulations -- Focus on SERPs

Arrangements subject to the new rules

Subject to grandfather provisions for pre-2005 amounts (discussed below), 409A rules apply to amounts deferred under a “nonqualified deferred compensation plan.” A nonqualified deferred compensation plan is an arrangement that provides for the deferral of compensation -- the creation of an obligation to pay an amount in some future year that is not included in taxable income for the current year.

What is a plan?

For purposes of the new rules, a plan is "any agreement, method, program, or other arrangement, including an agreement, method, program, or other arrangement that applies to one person or individual." It doesn't have to be formal or cover more than one person. And, generally, each employee is considered to be in a separate plan. So, if you have a single SERP for 50 executives, generally you would be treated as having 50 different plans.

In addition, for each employee, there's a set of "bunching" rules, as follows:

All account balance plans (e.g., a defined contribution SERP or a "vanilla" deferred compensation plan) covering an employee are considered a single plan.

All nonaccount balance plans (e.g., a defined benefit SERP) covering an employee are considered a single plan.

All separation pay plans covering an employee are considered a single plan.

All arrangements providing in-kind benefits or reimbursements of expenses are considered a single plan.

All arrangements providing split-dollar life insurance are considered a single plan.

All arrangements providing deferrals of amounts that would be treated as modified foreign earned income are considered a single plan.

All plans that are "stock rights" are considered a single plan.

And all other plans (that is, plans that don't fit in one of the preceding categories) are considered a single plan.
Insight

Final Nonqualified Deferred Compensation (409A) Regulations -- Focus on SERPs

That's kind of a long list. Here's an example of how the bunching rules work in a fairly simple situation:

<table>
<thead>
<tr>
<th>Employee A participates in:</th>
<th>Under the 409A rules, Employee A is treated as participating in:</th>
</tr>
</thead>
<tbody>
<tr>
<td>One account-based deferred compensation agreement and one defined contribution SERP.</td>
<td>A single account balance plan.</td>
</tr>
<tr>
<td>Two separate defined benefit SERPs.</td>
<td>A single nonaccount balance plan.</td>
</tr>
<tr>
<td>One separate separation pay plan.</td>
<td>A single separation pay plan.</td>
</tr>
<tr>
<td>A restricted stock plan and a nonstatutory stock option arrangement.</td>
<td>A single stock rights plan.</td>
</tr>
<tr>
<td>An arrangement under which he is entitled, on termination, to reimbursement of moving expenses and use of an outplacement facility.</td>
<td>A single in-kind benefits plan.</td>
</tr>
</tbody>
</table>

One of the main functions of these plan aggregation rules is to give teeth to the application of 409A’s penalty provisions. If, in the example, the restricted stock plan fails under 409A, then the other stock rights plan (the nonstatutory stock option arrangement) in which Employee A participates will also fail. But, remember, each employee is considered to have his or her own separate plan -- so employees in the nonstatutory stock option arrangement that do not participate in the restricted stock program would not have a failure.

Exceptions and exclusions -- what’s not "nonqualified deferred compensation"?

Certain plans are explicitly exempted from coverage by 409A, including:

- Qualified employer plans, defined under the regulation to include plans covered under IRC Sections 401(a), 403(a), 403(b), 408(k), 408(p), 501(c)(18) and 457(b), but not including ineligible deferred compensation plans under IRC Section 457(f).

- Certain foreign plans.
Insight

Final Nonqualified Deferred Compensation (409A) Regulations -- Focus on SERPs

Certain welfare plans, including any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan.

Statutory stock options (including incentive stock options under IRC Section 422 and employee stock purchase plans under IRC Section 423).

In addition, some deferrals are excluded from the definition of "deferred compensation." We will focus here on one exception that is significant for SERPs -- the short-term deferral rule. Note that there are also exceptions, not covered here, for: certain severance pay plans; certain stock plans; certain restricted property, IRC Section 402(b) trusts, and IRC Section 403(c) annuities; certain foreign plans; certain indemnification and liability insurance plans; certain legal settlements (generally of claims based on wrongful termination, employment discrimination, the Fair Labor Standards Act, or worker's compensation statutes); and certain educational benefit plans.

Short-term deferrals

The final regulations provide an exception from the 409A rules for plans where a benefit is paid out as soon as it's vested, or within 2 1/2 months of the end of the year in which it vests. Simple example: in 2008, an employee is promised a bonus, payable in 2010, but only if she works through December 31, 2009. If the bonus is paid by March 15, 2010, it's a short-term deferral and not subject to 409A. It's not a deferral because (more or less) as soon as the bonus "vests" it's paid and taxed.

* * *

Deferral rules -- generally

Generally, under the final regulation, an election to defer the receipt of compensation must be made not later than the close of the employee's taxable year next preceding the year in which the services, with respect to which the deferred compensation is being paid, are rendered -- the "service year." So, if an employee earns a benefit with respect to services in 2008, his or her deferral must generally be made by the end of 2007.

Designation of time and form of payment

The plan generally must designate the time and form of payment. If the employee is allowed to elect the time and form of payment, that election generally must be made at the same time as the deferral election -- under the general rule, not later than the close of the employee's taxable year next preceding the year in which the services, with respect to which the deferred compensation is being paid, are rendered.
Insight

Final Nonqualified Deferred Compensation (409A) Regulations -- Focus on SERPs

Exceptions

There are a number of exceptions to the general rule. Some are narrow and technical but at least a couple are generally significant for SERPs:

First year of eligibility rule

With respect to the first year in which an employee becomes eligible to participate in a plan, the employee may make an initial deferral election within 30 days after the eligibility date. But, that election only applies to compensation paid for services performed after the election. [Remember that plans of similar types are generally aggregated, so an employee uses up his or her one "first eligibility rule" election option for all account balance plans, for instance, when he or she becomes eligible for any account balance plan.]

Special application of the initial eligibility rule to excess benefit plan time and form of payment elections

Applying the general rule to one common form of SERP -- an excess benefit plan -- presents some problems. Generally (under the regulations), an excess plan only provides benefits that would be provided under the qualified plan but for certain IRC limits. So, participation in these plans is not initiated by an employee election -- the employee is either in the plan (and thus receiving a deferred compensation benefit) or not. In many cases, the employee does not even know he or she is in the plan. And, indeed, the employee may be in the plan one year and out the next.

For example, let's take a classic DB SERP that provides a benefit to employees equal to the benefit payable under a related qualified plan, but without the IRC Section 415 maximum benefit limits and Section 401(a)(17) maximum pay limit. And let's assume that the plan formula is 1.5 percent of final average pay times years of service, offset by the qualified plan benefit. As an employee's pay and service go up (and, in the case of pay, perhaps down), as IRC limits change, and as the qualified plan is amended, the employee may "accrue" and "un-accrue" benefits under the SERP. Often, the determination of whether an employee is entitled to a benefit under the SERP at all, and how much that benefit is, is not made until the employee actually retires.

All of this makes a pre-service period election problematic. The final regulations provide a modest accommodation to this problem. Under the regulations an employee is treated as initially eligible to participate in an excess benefit plan as of the first day of his or her taxable year immediately following the first year the employee accrues a benefit under the excess benefit plan; and any election made within 30 days following that date is treated as applying to benefits accrued under such plan for services performed before the election.
Insight

Final Nonqualified Deferred Compensation (409A) Regulations -- Focus on SERPs

For purposes of this rule, all excess benefit plans are aggregated, so an employee uses up his or her one "first excess plan initial eligibility rule" election option for all excess plans when he or she becomes eligible for any excess plan. While this excess plan rule will help to some extent, the regulations will probably require many sponsors to exercise more vigilance over who has accrued excess benefits, and when those benefits have accrued, than they have in the past. Note also, that not all SERPs that coordinate benefits with qualified plans will qualify as "excess plans" -- some SERPs provide benefits over and above those provided under the qualified plan, even without regard to IRC limits.

Election as to form -- actuarially equivalent annuities

The final regulations also provide flexibility with respect to an employee's choice of actuarially equivalent annuity options. Generally, a change in the form of a payment from one type of life annuity to another with the same scheduled date for the first annuity payment is not considered a change in the time and form of a payment, provided that the annuities are actuarially equivalent. In this regard, certain features -- e.g., a term certain, a "pop-up," a cash refund or a Social Security "level income" feature -- are disregarded in determining whether the annuity is a life annuity but not in determining actuarial equivalence. And, generally, the value of joint and survivor annuity subsidy may be disregarded in determining actuarial equivalence. In fact, this rule is so generous that the value of the joint and survivor subsidy may be disregarded for this purpose, so long as the amount of annuity, both before and after the first death, does not exceed the amount that would be paid under a single life annuity.

Beneficiaries -- same rules apply

Generally, time and form of payment elections with respect to payment of any survivor or death benefit to a beneficiary must be made at the same time as the employee's deferral/time and form of payment election. So, in effect, the employee must not only do his or her retirement planning in advance -- typically, electing time and form of payment before the tax year in which services are performed -- but must also do his or her estate planning in advance -- e.g., electing in advance whether his or her beneficiary will receive an annuity or lump sum. Changes in beneficiaries that do not affect the time of payment generally are permitted.

Subsequent changes in time or form of payment

Following the statute, the final regulations provide that an employee may make a "subsequent election" changing the time or form of payment that meets the following conditions:

The election may not take effect for at least 12 months after it is made.
In the case of an election related to a payment other than a payment on account of death, disability or the occurrence of an unforeseeable emergency, the first payment as to which the election is made must be deferred for a period of not less than 5 years from the date it would otherwise have been made.

Any election related to a payment at a specified time or pursuant to a fixed schedule may not be made less than 12 months prior to the date of the first scheduled payment.

The application of this rule raises some fairly abstract questions about “what is a payment?” Generally, lump sums and life annuities both are treated as single payments made, in the case of a life annuity, when payment begins. Unless the plan specifies otherwise, a series of essentially equal payments is also, and in the same manner, treated as a single payment.

Changes in the amount of deferrals under linked plans

Because under both the DB and DC SERP benefits are often reduced by benefits under a related qualified plan, benefits under the SERP can go up and down based on actions taken under the qualified plan. For instance, if IRC limits on the qualified plan's benefits go down, then the amount of SERP benefits goes up. Is that a deferral? Alternatively, if the limits go up, and the qualified plan benefit increases, SERP benefits go down. Is that an acceleration?

Under the regulation, where a SERP is "linked" with a qualified plan, decreases or increases in qualified plan limits do not constitute an impermissible deferral or acceleration. In addition, the following actions/inactions with respect to a linked qualified plan that affect the amount of a SERP benefit are generally permitted:

An employee’s decision to elect to receive a subsidized benefit or an ancillary benefit under the qualified employer plan.

The amendment of the qualified employer plan to add or remove a subsidized benefit or an ancillary benefit, or to freeze or limit future accruals of benefits.

An employee’s increase or decrease in elective deferrals and other employee pre-tax contributions to the qualified employer plan that are subject to the 401(k) salary reduction limits ($15,500 for 2007, plus where applicable the catch-up limit), provided that for any given taxable year, the employee’s action/inaction does not result in an increase in the amounts deferred under all nonqualified deferred compensation plans in which the service provider participates in excess of the limits. In English: Increases/decreases up to the 401(k) salary reduction limits are allowed, generally, without restriction. Deferrals, and reductions or increases in the amount of deferrals, above those limits must conform to the general nonqualified deferred compensation deferral election rules.
Insight

Final Nonqualified Deferred Compensation (409A) Regulations -- Focus on SERPs

An employee's increase or decrease in elective deferrals and other employee pre-tax contributions subject to the 401(k) salary reduction limits and after-tax contributions to the qualified employer plan that affects matching contributions under the nonqualified deferred compensation plan, provided that the total of such matching contributions never exceeds 100 percent of the matching contributions that would be provided under the qualified employer plan but for IRC related limitations.

* * *

Payment rules -- acceleration of payments generally prohibited

The 409A rules generally prohibit the acceleration of payments other than for separation from service, death, disability, an unforeseeable emergency or a change in control of the employer. In addition, the final regulations describe several other exceptions to the no-acceleration rule. A plan may accelerate payments:

- In accordance with a domestic relations order.
- In accordance with a plan provision for de minimis cashout payments; the maximum amount you can cash out under this rule is limited to the applicable dollar amount under IRC Section 402(g)(1)(B) (the 401(k) salary reduction dollar limit -- $15,500 for 2007).
- To pay FICA taxes on compensation deferred under the plan.
- To pay state, local, or foreign taxes arising from participation in the plan that apply to an amount deferred under the plan (this rule helps employees pay taxes that apply where, for instance, a state currently taxes deferred compensation).
- In connection with certain plan terminations and liquidations.

Acceleration is also permitted in certain circumstances in connection with: compliance with ethics agreements with the Federal government; compliance with ethics laws or conflicts of interest laws; under a plan subject to IRC Section 457(f) to pay Federal, state, local, and foreign income taxes due upon a vesting event; income inclusion under IRC Section 409A; avoidance of a nonallocation year under IRC Section 409(p); certain offsets (generally with respect to debts owed by the employee to the employer for amounts that do not total more than $5,000); a bona fide dispute as to a right to a payment.

Deferrals may also be cancelled due to a disability or following an unforeseeable emergency or hardship distribution under a 401(k) plan.
Insight

Final Nonqualified Deferred Compensation (409A) Regulations -- Focus on SERPs

Six-month delay in payment for key employees

Section 409A provides that payments upon a separation from service to a key employee (as defined in the top-heavy rules) of a corporation whose stock is publicly traded on an established securities market must be delayed at least six months following the separation from service. The regulations call these employees “specified employees.” As a general matter, most larger plan sponsors have not had to worry about being top-heavy and have not kept track of who is and who is not a key employee.

As a result, some companies are concerned that manual tracking of specified employees will result in underinclusion. That is, some specified employees will be left off the list. The regulations provide an alternative whereby 1) the plan sponsor will establish a reasonable alternative method for determination of specified employees; 2) the alternative method should expect to include all specified employees; and 3) the alternative method generates a list containing no more than 200 such employees. If such an alternative method is used, then there will be no violation of Section 409A merely because one of the (up to) 200 employees is not actually a specified employee. However, to the extent that a specified employee is not in the group of (up to) 200, and his payment is not delayed six months after date of termination, then with respect to that employee, the plan (and all aggregated plans) will not be in compliance with Section 409A.

Example -- how the rules for SERPs work in combination

We thought it might be useful to run through how these rules would work under in a fairly simple situation. Let's assume an employer maintains a tax-qualified defined benefit plan and a single SERP that provides benefits in excess of IRC benefit and compensation limits. An employee whose benefit under the qualified plan is limited automatically participates in the SERP.

An employee who accrues a benefit for the first time under the SERP in 2009 would have to make an election as to time and form of payment by January 30, 2010. Generally, under this sort of SERP, there is little call for complicated timing rules. Payments generally would start at a retirement age (a fixed date) or at termination of employment, with provision for earlier payment on death or disability. There may also be provision for payment on a change of control. Generally, the primary election the employee will have to make (as of January 30, 2010) is between payment in a life annuity form or as a lump sum.

Assume the employee elects a lump sum. If at some point the employee changes his or her mind and wants payment in the form of an annuity, an election of an annuity can be made in accordance with the “subsequent election” rules. Generally, the election will have to be made at least 12 months before payment is to start, and payment of the new form may not start before a date at least five years after the date it was originally to be paid.
The situation with respect to DC SERPs is, if anything, generally simpler. Often, employees will know in advance whether or not they are eligible to participate in a DC SERP. And, generally, there will be no form of payment issue -- payment will be in a lump sum.

One complicating factor -- the special rule for excess plans is only available the first time the employee participates in any excess plan of the employer. So, for instance, if the employee participates in the DC SERP excess plan first, and then later accrues a benefit under the DB SERP, he or she will not be able to use the special "following tax year" election rule for the DB SERP. To address this problem, you may want to consider a single, "master" excess plan election that is made on the first accrual of a benefit under any excess plan.

Effective date and transition rules

The final regulations are generally effective January 1, 2008. IRC Section 409A is effective January 1, 2005. Prior to 2008, here, as we understand them, are the grandfather and transition rules that apply.

Generally, the new 409A rules apply to amounts deferred after 2004. A pre-2005 accrual, and "earnings" on it, does not have to comply with the new rules so long as the plan under which the accrual was made was not materially modified after October 3, 2004. For an account balance plan, earnings are represented by the increase or decrease in an account balance due to "real" or notional investment returns. In a non-account balance plan, earnings are represented by the decrease in the discount period until payment. Early retirement subsidies that an employee has not qualified for as of December 31, 2004, that he or she subsequently qualifies for, are not pre-2005 earnings; note that this represents a reversal of the position on this issue in the proposed regulations.

Only an amount to which the employee has a "legally binding right" which is "earned and vested" on December 31, 2004 are grandfathered. A right to an amount is earned and vested only if it is not subject to either a substantial risk of forfeiture or a requirement to perform further services.

Generally, a material modification is anything that enhances the value of a benefit. The addition of a "haircut" provision is an obvious example. The acceleration of vesting would also be a material modification. Any of these sorts of changes would "de-grandfather" pre-2005 accruals under the plan.

Good faith compliance/adoption of plan amendments through 2007

A good faith standard for complying with 409A applies through 2007. The rules for amendments are pretty simple:
Insight

Final Nonqualified Deferred Compensation (409A) Regulations -- Focus on SERPs

Where there have been deferrals of compensation under a plan as of January 1, 2008 but the deferred compensation has not been paid, the plan must be made compliant with Section 409A on or before December 31, 2007, with respect to such deferred compensation. These amendments are required only to bring the document into compliance effective January 1, 2008, and are not required to reflect any amendments made or actions taken under the transition rules to the extent such amendments or actions do not affect the plan's compliance with Section 409A and these regulations for periods on or after January 1, 2008.

We note that special transition rules that applied in 2005 and 2006 are not available in 2007.

As we said at the beginning, the final regulations deal with many issues in microscopic detail. Plan aggregation rules may produce unexpected results. The process of bringing your SERPs, and your company's other nonqualified deferred compensation plans, into compliance with the final regulations will require a lot of attention to the details of the regulations, not all of which have (we are tempted to say, most of which have not) been discussed in this article. To repeat: When you undertake your review of your plans, you should do so with professional help.

For more strategies on retirement programs, contact John Lowell at 404.264.3088 or john.lowell@aon.com.