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CAB 16-3

IRS Proposes Additional Guidance for Nonqualified Deferred Compensation under 409A

SUMMARY

Concluding that clarifications and modifications could help taxpayers comply with the requirements applicable to nonqualified deferred compensation plans (NDCPs) under tax code section 409A, the IRS issued additional guidance in the form of a proposed rule. Compliance with the 409A requirements enables individuals covered by and employers sponsoring NDCPs to avoid adverse tax treatment of the amounts payable under these arrangements. The proposed rule, which taxpayers may rely upon immediately, is lengthy and complex, covering a diverse range of topics, most of which are beyond the scope of this *Client Action Bulletin.* This CAB focuses on four key areas that may have the broadest application to NDCP sponsors.

DISCUSSION

NDCP Overview

In general, NDCPs are arrangements established by employers to provide enhanced benefits to their top-level executives and managers. While not bound by the various dollar limits applicable to tax-qualified plans, NDCPs must comply with section 409A requirements that, among other things, affect the timing and form of distributions, deadlines for deferral elections, prohibitions on acceleration of payments, and funding restrictions. Noncompliance results in the immediate taxation to the participant of the amounts deferred, plus interest and an additional 20% penalty.

Employee vs. Independent Contractor Separation from Service

There had been some confusion over when NDCP sponsors should use the general "separation from service" standard (i.e., "20%/36-month rule") applicable to employees, as compared with the specific rule that applies only to independent contractors. Under the 20%/36-month rule, a participant who is an employee separates from service if the employer and employee reasonably anticipate that the level of services to be performed after a certain date (*as an employee or as an independent contractor*) would permanently decrease to no more than 20% of the average level of services performed (*as an employee or an independent contractor*) over the immediately preceding 36-month period. Meanwhile, the independent contractor rule indicates that the participant separates from service upon the expiration of the contract(s) under which services are performed for the NDCP sponsor.

The proposed rule confirms that when making a determination for a participant who changes employment status from employee to independent contractor or vice versa, sponsors must always first look to the 20%/36-month rule. Thus, if this rule is met when the individual changes status, the participant is considered separated from service under the terms of the plan. The new proposed guidance clarifies how to handle situations where applying the 20%/36-month rule does not result in a separation from service at the time a participant changes status from an employee to an independent contractor. In such cases, the NDCP sponsor can then instead rely on the independent contractor rule (i.e., upon expiration of the contract(s)) to determine the date the participant's future separation of service occurs.

Payments Following the Death of a Participant or Beneficiary

Amounts deferred under an NDCP may be paid only at a specified time or upon certain permissible events. One such event is the participant's death. Under previous guidance, if a payment is payable upon the participant's death, it must be paid within the same taxable year or, if later, by the 15th day of the third calendar month following the individual's death, provided that the participant is not permitted to designate the year of the payment.

The proposed rule clarifies that the rules applicable upon the participant's death also apply to amounts payable upon the death of any beneficiary who has become entitled to amounts payable upon the participant's death. Also, recognizing the need for a longer period to resolve certain issues related to the participant's death (e.g., confirming the death and completing probate), the proposed rule also creates a separate timing rule for an amount payable following the death of a participant or a participant's beneficiary: the amounts may be paid at any time beginning on the date of death and ending on December 31 of the calendar year following the calendar year of death. The proposed rule provides NDCP sponsors significant flexibility regarding the administrative and/or plan amendment options they can use to incorporate this extended payment deadline.

Accelerated Payments to Beneficiaries

The proposed rule expands permissible early payout alternatives to an NDCP participant's beneficiaries in cases of death, disability, or unforeseeable emergencies. The guidance also clarifies that the NDCP may provide that the occurrence of death, disability, or an unforeseeable emergency may accelerate a schedule of payments that has already commenced prior to a participant's or beneficiary's death.

Plan Terminations and Accelerated Payments

In addition to allowing accelerated payments upon the occurrence of such events as a corporate dissolution, approval by a bankruptcy court, or a change in control of the plan sponsor, section 409A permits an NDCP to accelerate payments upon a plan termination executed at the discretion of the plan sponsor. To effect such a discretionary termination and liquidation of an NDCP, the sponsor must meet certain conditions. Two of these conditions involve the section 409A aggregation rules, which identify nine separate types of NDCPs (e.g., elective account balance plans, nonelective account balance plans, nonaccount balance plans). Specifically, these conditions, as stated in the prior guidance, mandated:

- the termination/liquidation of all NDCPs that would be aggregated with the terminated NDCP if the same participant had a benefit under each NDCP; and
- a three-year prohibition on adopting a new NDCP that would be aggregated with the terminated NDCP if the same participant had a benefit under each NDCP.

Some practitioners thus interpreted these conditions as only requiring the termination of current NDCPs of the same type and applying the three-year moratorium on future NDCPs of the same type if a common employee participated in each of the NDCPs. The new proposed rule clarifies that the acceleration of a payment pursuant to an NDCP termination is permitted only if the sponsor meets these conditions with respect to *all of its plans of the same category*, as opposed to just all plans in the same category in which a particular employee actually participates.

ACTION Plan sponsors should review the entire proposed rule with their employee benefits/compensation consultants and ERISA counsel to ascertain if their plan documents and/or administrative procedures will require changes. The proposed rule includes, for example: 1) modifications to the short-term deferral rule to permit a delay in payments to avoid securities laws violations; 2) four separate changes affecting employer stock-related NDCPs; 3) revisions affecting recurring part-year compensation; 4) permitted acceleration of payments to comply with federal debt collection laws; 5) clarification that the election to treat a participant as having separated from service only applies to actual asset sales and not to stock transactions that me treated as "deemed asset sales" under the corporate tax rules; and 6) an amendment of the income inclusion rules to limit the ability to change the payment timing for non-vested benefits or to create errors for non-vested benefits as a means to change payment timing. Plan sponsors need to ensure that their NDCPs remain in compliance with 409A while deciding if they wish to incorporate the additional flexibility afforded by certain provisions of the new rule. In addition, communications materials should be reviewed and revised as necessary.

For additional information about the IRS's proposed rule affecting NDCPs, please contact your Milliman consultant.

