

BENEFITS LAW JOURNAL

Executive Compensation

Sponsors and Participants Must Follow 409A True to Form

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As examined in the article “Take 409A’s Advice . . . Please: Timing Is Everything for Nonqualified Plans,”¹ Internal Revenue Code Section 409A contains strict rules limiting the ability of nonqualified deferred compensation plan (NDCP) participants to change their benefit commencement date (BCD) under the plan. These rules provide that, subject to certain exceptions, a change in the BCD will usually constitute an impermissible acceleration or deferral of payments under the NDCP. However, even when the BCD is not changed, a participant’s election to change the form of payment in which benefits

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under the plan are paid will also, subject to certain exceptions, usually constitute an impermissible acceleration or deferral of payment under Code Section 409A. For example, changing the form of payment from installment payments payable over five years to a lump sum payment, while maintaining the same BCD, will usually constitute an impermissible acceleration of payments. Accordingly, the rules with respect to changing BCD and changing the form of payment are connected because they share a common purpose: preventing a participant from having the type of excessive control over the timing of payment that Code Section 409A was enacted to eliminate while, at the same time, containing certain exceptions that provide participants with some degree of flexibility in certain circumstances. This column examines how NDCP sponsors can navigate these rules to ensure that their NDCP comply with Code Section 409A with respect to changes in form of payment elections.

GROUNDING FORM FLIGHTS OF FANCY

Participants are used to the free-flowing flexibility of the qualified pension plan world, in which they can typically wait right up until their BCD before having to commit to the form of payment under which they wish to have their plan benefits distributed. A further false sense of flexibility may arise from pre-409A NDCPs, which permitted the linking of the form of payment from the NDCP to the form of payment elected by the participant under the qualified plan that the NDCP was intended to supplement. These were most prevalent in NDCPs that are linked to defined benefit (DB)-style plans but occasionally also appeared in some NDCPs linked to defined contribution (DC) plans. The Code Section 409A rules allow grandfathering of amounts earned or vested prior to January 1, 2005; however, such linking is prohibited for benefits earned or vested on or following January 1, 2005, and, hence, any such non-grandfathered amounts must comply with Section 409A.²

Because the rules governing NDCP change in form elections for such amounts are much more rigid under Code Section 409A, NDCP sponsors must make sure they clearly communicate these differences to participants, develop the appropriate 409A-compliant plan designs for their executive groups, and vigilantly administer their NDCPs in accordance with such designs. The rules for Code Section 409A generally require that a participant's form of payment under an NDCP be designated much earlier than would be the case under the qualified pension plan. With respect to most NDCPs, the rule requires participants to elect their form of payments within 30 days of first becoming eligible to participate in the NDCP, but only with respect to compensation to be earned following such election.³ Accordingly, sponsors need

to provide participants with sufficient notice and the ability to make this election prior to the expiration of their initial eligibility period.

EXCEPTIONS TO THE RULE

There are two exceptions to the rule requiring participants to make form elections when first eligible:

1. **The “how do you meet a deadline you didn’t know existed?” exception.** This exception applies to NDCPs that are “nonelective excess benefit” plans (*i.e.*, NDCPs linked to a qualified pension plan that make up for benefits that would be payable under such qualified pension plan but for certain limitations under the IRS Code). Under these nonelective excess benefit plans, a participant often automatically becomes eligible when benefits under the qualified plan become limited under the rules governing qualified plans. Because determining whether a participant is eligible requires calculations, both the participant and the NDCP sponsor may be unaware that the participant has become eligible in the plan for some time after actually first becoming eligible and may not be able to comply with the 30-day rule discussed above. Code Section 409A addresses this concern with a special rule giving participants in these plans a one-time opportunity to elect the form of distributions within 30 days after the first day of the taxable year following the taxable year in which the participant first accrues a benefit under the plan.⁴ No new elections are permitted if the participant subsequently accrues benefits under a different excess benefit plan of the same NDCP sponsor.⁵
2. **The real-life annuities of NDCPs under Code Section 409A.** Section 409A permits NDCPs to treat all “actuarially equivalent life annuities” as one form of payment. This treatment is extremely beneficial because it means such annuities are not only free from the previously discussed Code Section 409A rule regarding initial form elections but also from the “12-month/five-year” rules described later in this article. As a result, participants who limit their elections to only these annuities are free to initially elect and then switch back and forth among as many of such annuity options as their NDCP offers, right up until their BCD. So the key question is: Which forms of payment have Code Section 409A deemed worth of casting in this role? The general definition under Code Section 409A makes it clear that the traditional single life annuity (*e.g.*, an annuity payable until the death of the participant) and joint and survivor annuities (*e.g.*,

an annuity payable until the later of the death of the participant or another person, usually his or her spouse) qualify, as long as they are payable not less frequently than annually and are actuarially equivalent, applying reasonable actuarial methods and assumptions.⁶ Although “actuarially equivalent” and “reasonable actuarial methods and assumptions” are not specifically defined, the rules do offer the following guidance:

- a. When determining whether two life annuities are actuarially equivalent, the same actuarial assumptions and methods must be used in valuing each life annuity.⁷
- b. The above requirement applies over the entire term of the participant's participation in the plan, such that the annuities must be actuarially equivalent at all times for the annuity options to be treated as one time and form of payment.⁸
- c. As long as the actuarial methods and assumptions are reasonable, there is no requirement that consistent actuarial assumptions and methods be used over the term of the participant's participation in the plan.⁹
- d. The plan may change the actuarial assumptions and methods used to determine the life annuity payments, provided that all of the actuarial assumptions and methods are reasonable.¹⁰
- e. There is no requirement that the actuarial assumptions and methods used under an NDCP plan be the same as those used in a qualified plan sponsored by the NDCP sponsor.¹¹

In addition, the rules generally provide that certain specified features are ignored for purposes of determining whether a particular annuity is treated as a life annuity under the form of payment rules (but not for purposes of determining whether a life annuity with such a feature is actuarially equivalent to a life annuity without such a feature). These include the following:

- Term-certain features (under which annuity payments continue for the longer of the life of the annuitant or a fixed period of time);¹²
- Pop-up provisions (under which payments increase upon the death of the beneficiary or another event that eliminates the right to a survivor annuity);¹³

- Cash refund features (under which payment is provided upon the death of the last annuitant in an amount that is not greater than the excess of the present value of the annuity at the annuity starting date over the total of payments before the death of the last annuitant);¹⁴
- Social Security or railroad retirement leveling features (including leveling features related to early retirement, survivor, or disability benefits)¹⁵ and
- Features applying a permissible cost-of-living index¹⁶

Accordingly, a life annuity with any of these specified features may be treated as a life annuity if the two life annuities are actuarially equivalent (taking into account the features) and have the same initial payment date. With respect to subsidized joint and survivor annuities, such forms are treated as actuarially equivalent to a single life annuity, provided that neither the annual lifetime annuity benefit nor the annual survivor benefit available under the joint and survivor annuity is greater than the annual lifetime annuity benefit available under the single life annuity.¹⁷ For example, a single-life annuity providing \$200 a month for the lifetime of the participant may be treated as actuarially equivalent to a joint and survivor annuity providing up to \$200 a month for the lifetime of the participant and up to \$200 a month to the surviving joint annuitant.

LIFE-ONLY SENTENCE: NOT THE ONLY OPTION

While limiting the NDCP form of payment option to only life annuities options described in the previous section certainly provides the maximum flexibility permitted under Code Section 409A when it comes to the timing of the election, such enhanced flexibility may not be sufficient motivation for participants to eagerly eschew two of the more popular payments forms under NDCPs: lump sums and installment payments. This is especially true in NDCPs linked to DC qualified plans and other DC-style NDCP where, as with their qualified plan counterparts, such options are much more prevalent than life annuities.

If the NDCP provides these options—either along with or in lieu of the aforementioned life annuity options—then it must include and enforce the early form election procedures discussed earlier (*i.e.*, participants must make the form of payment election when first eligible to participate). Once the participant makes the initial form of payment election, the ability to change such election in the future will then depend on which form is chosen. Assuming life

annuities are offered and such annuities meet the criteria previously discussed, participants electing one of these alternatives will be able to switch back and forth among such annuities all the way up to the BCD. Once a lump sum or installment option election, however, is made (whether as an initial election or as a change from an initial life annuity election), the Code Section 409A subsequent deferral rules apply. These rules provide that a plan may permit a subsequent election to change the form of payment, provided that the new election meets three conditions (*i.e.*, the 12-month/five-year rule):

- a. Made not less than 12 months before the first date a payment scheduled for a specified time or based on a fixed schedule would otherwise have been paid.¹⁸
- b. Takes effect at least 12 months after the date the new election is made.¹⁹
- c. Defers payment for no less than five years from the date the first payment otherwise would have been made.²⁰

As a result, a participant who wants to change the form of payment must not only be sure to make a timely election but also factor in the decision whether or not the change is worth the mandatory five-year wait. For example, suppose a participant originally elected a life annuity that would commence at age 65 but later decides that a lump sum would be preferable. In addition to submitting the change election to the plan sponsor before attaining age 64, the participant would also have to be content with not receiving the lump sum until age 70 or later.

Because the Code Section 409A rules described above apply both to participants and NDCP sponsors, both a participant and an NDCP sponsor may have and exercise impermissible discretion to defer payment after the form of payment has been specified. Accordingly, such discretion to defer payment is usually limited to changes that comply with the 12-month/five-year rule. This is important to note because it means that an NDCP sponsor is not able to avoid this requirement by amending the plan. The rules, however, do not apply to changes in the form of payment under the terms of a domestic relations order to the extent the change in the form of payment applies to a payment that will be made to the alternate payee and not the participant.²¹ For example, a domestic relations order generally may provide for a new form of payment to a spouse or former spouse of the participant or provide such spouse or former spouse discretion to determine the form of payment to such spouse or former spouse.

If installment payments are in the election mix, the sponsor and participants need to also consider whether such installments are considered as a single or separate payment for purposes of applying the 12-month/five-year rule. The first step is to check the plan document to see if it indicates the applicable treatment. Under the Code Section 409A rules, if the plan is silent, installment payments are treated as a single payment.²² Any subsequent elections for installment payments treated as a single payment must be made at least 12 months before the installments were scheduled to begin and the payment of the first of the installments must be deferred at least five years from the original commencement date.²³ Alternatively, installment payments may be treated as separate payments. In this case, the 12-month/five-year rule applies to each separately identified payment.²⁴ This approach enables participants to make subsequent elections after commencement has already begun (*i.e.*, the employer or participant could then subsequently elect to further defer a portion of the installment payments rather than all of them). The following two examples illustrate the difference between the single and separate approaches:

Single. Assume the participant is in an NDCP that provides for payment in a series of five equal annual amounts that are not designated as a series of five separate payments. The first amount is scheduled to be paid on January 1, 2021. Provided the participant makes the election on or before January 1, 2020, he or she may elect for the first payment scheduled to be deferred until January 1, 2026. Because the single payment rule is in effect, the remainder of the payments will automatically commence on January 1, 2027, and each January 1 thereafter.

Separate. Assume the same facts as above except that, under its terms, the NDCP designates each payment as a separate payment. The first payment is scheduled to be made on January 1, 2021. Provided the participant makes the election on or before January 1, 2020, he or she may elect for the first payment scheduled to be made on January 1, 2021, to be deferred until January 1, 2026. If the participant makes that election but does not elect to defer the remaining payments, the remaining payments continue to be due upon January 1 of the four consecutive calendar years commencing on January 1, 2022.

Special consideration must be given if the employer or employee wishes to change the form of payment from installments to a lump-sum payment if the plan provides that each installment is treated as a separate payment. The lump-sum payment date must be at least five years after the final installment payment date.²⁵ For example, consider a plan that provides for the payment of five equal annual amounts, each of which is designated as a separate payment. The first installment is scheduled for January 1, 2021, and the last is scheduled for January 1, 2025. The employee wishes to convert these five

installments into a lump sum payment. Provided the election is made on or before December 31, 2019, the earliest the employee may receive the lump-sum payment is January 1, 2030, which is five years after the last scheduled installment payment under the original election. If the plan did not provide that each installment payment was treated as a separate payment, the lump-sum payment could be made as early as January 1, 2026 (*i.e.*, five years after the initial installment payment).

SPONSOR'S CHOICE

Form of payment flexibility is a fine feature for participants but can add administrative complexity and thus corresponding cost to plan sponsors. The sponsor's decision regarding which, if any, choices, it provides to participants may also be influenced by whether it wants to hold on to the assets for participants who separate from service. Consequently, some sponsors may opt for a more simplistic approach by designing the plan to only include a single form of payment, with no choice for participants, or only provide choices between forms that are not subject to the 12-month/five-year rule. For example, some DC NDCPs only permit lump-sum distributions, whereas some DB NDCPs may limit the participants to choosing between the previously discussed "actuarially equivalent" life annuities.

Another device available to sponsors to help simplify this process are default provisions that can be used to either mandate a certain form of payment, if no timely participant election is made, and/or to specify separate forms of payment for various distribution triggering events. In the case of the latter, the Code Section 409A rules require that the following requirements be met regarding such default provisions:

- Must be objectively determinable when payment is triggered;
- May vary by triggering event (*e.g.*, lump sum upon death; 10 annual installments upon separation from service); or
- Alternative payment schedule may apply if triggering event (other than fixed date) occurs on or before one (and only one) specified date (*e.g.*, lump sum upon separation before age 55; life annuity upon separation thereafter).²⁶

The Code Section 409A rules also contain two separate mandatory cash-out provisions, which NDCP sponsors may use to ease their administrative burdens by giving them the ability to eliminate ongoing tracking and processing of installment payments in amounts under certain dollar limits.

Cash-Out Option 1

Under the first cash-out option, an NDCP may require (or include a provision granting the sponsor the discretion to require) a mandatory lump-sum payment of amounts deferred that do not exceed a specified amount provided that the payment: (1) results in the termination of the employee's entire interest in the plan (and all plans of the same type under the plan aggregation rules—so a sponsor may not use this rule to cash out an amount under one arrangement but not another arrangement where the two arrangements would be treated as one plan); and (2) does not exceed the limit on elective deferrals under Code Section 402(g) for the calendar year of reference (*e.g.*, \$19,500 for 2020). In addition, any employer discretion must be evidenced in writing no later than the date of such payment. The rules do not require that a participant has separated from service for the sponsor to cash out the amount deferred.²⁷

Cash-Out Option 2

The rules also offer a second cash-out option, which provides that plans under which amounts are to be paid in installments and/or under life annuity options may permit immediate payment of (1) all remaining installments or (2) in the case of annuity payments, the present value of the remaining annuity payments, without causing an impermissible acceleration if the present value of the unpaid deferred post-409A amount falls below a predetermined amount. Such a provision must specify the predetermined amount no later than the time and form of payment is otherwise required to be established.²⁸ The immediate portion can be any amount, as distinguished from cash-out option 1, which is tied to the Code Section 402(g) limit.

Any immediate distribution of the remaining sum of an installment series or the present value of remaining annuity payments, however, will result in an impermissible acceleration if it is paid at the discretion of the employer or the participant unless the payment does not exceed the Code Section 402(g) limit. Furthermore, any change in an immediate distribution provision, including a change in the predetermined amount, is treated as a change in the time and form of payment (*i.e.*, subject to one-year/five-year rule).²⁹

ROUNDING INTO 409A FORM

The many Section 409A rules governing the permissible forms of payment can lead to a lot of confusion for participants and sponsors

alike. Even worse, if they fail to make sure that their NDCPs' document and administration comply with these rules, participants are exposed to substantial penalties: Code Section 409A failures require participants to include all previously deferred amounts under the NDCP in gross income and pay income taxes, employment taxes, and a 20-percent penalty tax, on such amount, as well as interest and penalties on this amount at the underpayment rate plus one percent and underpayment penalties. Because of the complexity of these rules and the severe consequences of noncompliance, sponsors and participants should seek the assistance of their benefit consultants and ERISA counsel in order to stay true to Code Section 409A form.

NOTES

1. Dominick Pizzano, Henrik Patel, and Kenneth Barr. *Benefits Law Journal*, Summer 2019, pp. 70–79.
2. Treas. Reg. § 1.409A-6(a)(3).
3. Treas. Reg. § 1.409A-2(a)(7)(i).
4. Treas. Reg. § 1.409A-2(a)(7)(iii).
5. Preamble § VI(D), 72 Fed. Reg. 19,234,19,253.
6. Treas. Reg. § 1.409A-2(b)(2).
7. Treas. Reg. § 1.409A-2(b)(2)(ii)(D).
8. *Id.*
9. *Id.*
10. *Id.*
11. See Preamble § IX(B) (fourth paragraph).
12. Treas. Reg. § 1.409A-2(b)(2)(iii)(B).
13. *Id.*
14. *Id.*
15. *Id.*
16. *Id.*
17. Treas. Reg. § 1.409A-2(b)(2)(ii)(C).
18. Treas. Reg. § 1.409A-2(b)(1)(i).
19. Treas. Reg. § 1.409A-2(b)(1)(ii).
20. Treas. Reg. § 1.409A-2(b)(1)(iii).
21. Treas. Reg. § 1.409A-2(b)(4).

22. Treas. Reg. § 1.409A-2(b)(2)(iii).
23. Treas. Reg. § 1.409A-2(b)(9) Ex. 19.
24. Treas. Reg. § 1.409A-2(b)(9) Ex. 18.
25. *Id.*
26. *See* Treas. Reg. § 1.409A-3(c).
27. Treas. Reg. § 1.409A-3(j)(4)(v).
28. Treas. Reg. § 1.409A-2(b)(2)(iii) and Treas. Reg. § 1.409A-2(b)(2)(ii)(A).
29. *Id.*

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