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409A Reference Document

Background and Important Highlights

On October 11, 2004, the American Jobs Creation Act of 2004 (AJCA) was signed into law. As part of AJCA, Internal Revenue Code section 409A (409A) was created as a tax code section devoted specifically to nonqualified deferred compensation plans (NQDCPs). Final regulations under 409A became effective January 1, 2009. Below is a high level overview of the key rules under 409A that affect the administration of NQDCPs. This overview is not intended to be complete or exhaustive and clients are advised to discuss all relevant matters with appropriate legal and tax advisors.

WRITTEN PLAN REQUIREMENTS

- 409A requires that the plan must specify in writing, at the time an amount is deferred, both:
  - The amount to which the participant has a right to be paid, and
  - The payment schedule or payment triggering events that will result in a payment of the amount

INITIAL ELIGIBILITY

- There is a special deferral election timing rule for newly eligible plan participants (see Elections section)
- Plan aggregation rules apply in determining whether a participant is considered newly eligible for a plan (i.e., plan sponsor cannot create a series of plans of the same type and treat same participant as newly eligible for each)
- For rehires or changes of position, the newly eligible plan participant deferral election rule is generally only available to a participant that has either been (i) ineligible for the plan for at least 24 months or (ii) completely paid out of the plan prior to the rehire/change of position

PERMISSIBLE DISTRIBUTIONS

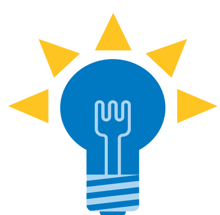
Distributions from a nonqualified deferred compensation plan may generally be allowed only upon:

- **Separation from service**
  - Under the 409A regulations, a separation from service for an employee will generally be based on a facts and circumstances determination that no further services will be performed by the employee or the level of services will permanently decrease to no more than 20% of the average level of services over the prior three years
  - Distributions triggered by the separation from service of "specified employees" (as determined under Internal Revenue Code section 416(i)) of a publicly traded company must be delayed by at least six months following the separation
- **Disability**
  - A participant is considered disabled if he or she is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months; or is receiving income replacement benefits for a period of not less than three months under an accident and health plan covering employees of the participant's employer
  - This is not a plan sponsor-determined definition of disability, and does not require separation from service in order to trigger payment
- **Death**
- **Specified time or fixed schedule (e.g., scheduled future date)**
  - Amounts payable at a specified time or pursuant to a fixed schedule must be specified under the plan at the time of deferral
- **Change in control of a corporation**
  - There are specific definitions/rules in 409A regarding distributions upon a change in the ownership or effective control of a corporation, or in the ownership of a substantial portion of the assets of a corporation
- **Occurrence of an unforeseeable emergency**
  - An unforeseeable emergency is defined as a severe financial hardship resulting from:
    - an illness or accident of the participant, the participant's spouse, or a dependent of the participant
    - loss of the participant's property due to casualty
    - other similar unforeseeable circumstances arising as a result of events beyond the participants' control
  - The distribution must be limited to the amount needed to satisfy the emergency plus anticipated taxes
  - Distributions may not be allowed to the extent that the hardship may be relieved through reimbursement or compensation by insurance or otherwise, or by liquidation of the participant's assets

ACCELERATION OF BENEFITS

- In general, no accelerations of distributions are allowed under 409A; however, the 409A regulations do contain certain limited exceptions (e.g., limited cashouts, payments pursuant to a domestic relations order, and limited circumstances in which plans can be terminated and liquidated).

- The addition of death, disability, or an unforeseeable emergency as a potentially earlier alternative payment event to an amount previously deferred will not be treated as resulting in an acceleration of a payment, even if such addition results in the payment being paid at an earlier time than such payment would have been made absent the addition of the payment event
- In general, changes in the form of distribution that accelerate payments are subject to the rule prohibiting acceleration of distributions
  - However, because installments are treated as the entitlement to a "single payment" under 409A (unless the plan specifically provides otherwise), changing from some number of annual installments to a lump sum is not considered an impermissible acceleration, provided that the 409A "subsequent change" rules are satisfied (see Changes in Time and Form of Distributions)
  - These rules generally require a five-year delay in commencement from the start date that would have applied absent the change



ELECTIONS

- General rule: 409A requires that compensation for services performed during a taxable year may be deferred at the participant's election only if the election is made no later than the close of the preceding taxable year (i.e., by December 31 for elections to defer base salary in the upcoming year)
- Performance-based compensation: In the case of any performance-based compensation, such elections may be made no later than six months before the end of the service period
  - The 409A regulations contain a number of specific rules and definitions that must be satisfied in order to take advantage of this rule and these should be thoroughly evaluated before attempting to utilize this rule
- Newly eligible participants: In the first year that an employee becomes eligible for participation in an NQDCP, the election may be made within 30 days after the date that the employee is initially eligible and pertains only to amounts earned subsequent to the election
  - The 30-day clock starts from the date of eligibility and generally should not be dependent on when the plan recordkeeper sends out enrollment material
- The time and form of distributions must be specified at the time of initial deferral
  - A plan could dictate the time and form of payments that are to be made as a result of a distribution event (e.g., a plan could specify that payments upon separation of service will be paid in lump sum within 30 days of separation from service), or
  - Could allow participants to elect the time and form of payment at the time of the initial deferral election
- If a plan allows participants to elect the time and form of payment, such elections are subject to the rules regarding initial deferral elections under 409A — that is, distribution elections are considered part of deferral elections under 409A and accordingly are subject to the same timing rules
- A plan could also allow participants to elect multiple payout events or different forms of payment for different permissible distribution events (see examples below):
  - A participant could elect to receive 25 percent of her account balance at age 50 and the remaining 75 percent at age 60
  - A participant could elect to receive 5 annual installments commencing in 2019, but would receive a lump sum distribution in the event he separates from service prior to 2019

CHANGES IN TIME AND FORM OF DISTRIBUTIONS

- An NQDCP may allow a subsequent election to delay the timing or form of distributions only if:
  - The plan requires that the change cannot be effective for at least 12 months after the date on which the election is made
  - In the case of elections relating to distributions on account of separation of service, specified time/fixed schedule or change in control, the plan requires that the payment subject to the change must be delayed for a period of <u>not less than five years</u> from the date such payment would otherwise have been made
  - The plan requires that an election related to a distribution to be made upon a specified time/fixed schedule may not be made less than 12 months prior to the date of the first scheduled payment

SUMMARY

- Deferral elections and distribution elections generally must be made in the year before the service period for the compensation commences
  - Newly eligible participants are allowed to enter the plan within 30 days of eligibility and make deferral elections as to amounts earned subsequently
  - Performance-based compensation can be deferred up to 6 months prior to the end of the service period, but is subject to specific rules under 409A
- 409A generally only permits distributions to be triggered by one of six permissible events (note not all plans have all events)
  - Distributions to “specified employees” of publicly traded companies must be delayed by at least 6 months when triggered by separation from service
- Accelerations and unscheduled withdrawals are generally forbidden
- Changes to distributions generally must be in place 12 months before the payment event, and may require payments to be delayed at least 5 years