

# Pension ANALYST

Important Information

Plan Design

January 2008



## Highlights of Final Rules For Nonqualified Defined Benefit Deferred Compensation Plans

**WHO'S AFFECTED** These rules apply to sponsors of and participants in nonqualified defined benefit plans, commonly referred to as Supplemental Executive Retirement Plans (SERPs). These rules do not apply to qualified defined benefit plans.

**BACKGROUND AND SUMMARY** On April 10, 2007, the IRS published final rules affecting nonqualified deferred compensation plans. These rules provide guidance for complying with the Internal Revenue Code section 409A rules, which were enacted as part of [the American Jobs Creation Act of 2004 \(AJCA\)](#) and finalize the proposed regulations issued on October 4, 2005. These rules:

- Identify different types of nonqualified plans;
- Provide special rules for identifying the sponsoring employer;
- Clarify the written plan document requirement;
- Provide guidance regarding payment rules; and
- Clarify the interaction between certain qualified and nonqualified plans.

The final rules also include substantial guidance regarding certain types of deferred compensation plans that Prudential Retirement normally does not administer, e.g., separation pay plans, stock option plans, stock appreciation rights, and arrangements between employers and independent contractors. This publication does not address these aspects of the final rules.

Originally, the final rules required employers to adopt written documents for their nonqualified plans by December 31, 2007. On September 10, 2007, the IRS released [Notice 2007-78](#), which extended this document adoption deadline to December 31, 2008, but required plan sponsors to comply with several December 31, 2007 deadlines established by the final rules. However, in response to comments from law firms and retirement industry groups, the IRS provided much welcome relief on October 22, 2007, in the form of Notice 2007-86. This notice replaces the relief that was provided in Notice 2007-78 with broader relief and extends the prior transition relief to December 31, 2008.

**ACTION AND NEXT STEPS** Plan sponsors should review the information provided in this publication to determine how the new rules impact the operation of their plans and whether current plan documentation must be updated. Although the IRS has provided relief until December 31, 2008, plan sponsors are encouraged to begin taking steps early to ensure compliance by the deadline. Plan sponsors should always consult their defined benefit plan's enrolled actuary before making any plan design changes.

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## Transition Relief Extended

The Code section 409A provisions generally apply to compensation deferred under nonqualified plans after December 31, 2004. However, special transition rules apply for 2005, 2006, 2007 and 2008. Until the end of December 31, 2008, plans must be operated with a reasonable good faith interpretation of Section 409A and other applicable guidance. Plan sponsors were permitted to rely on either the proposed rules or final rules as reasonable, good faith compliance through the end of 2007. However, beginning January 1, 2008, plan sponsors may no longer rely on the proposed rules as a reasonable good faith interpretation of the rules. Beginning January 1, 2009, plan sponsors must administer their plans in accordance with the new final rules.

For the period 2005 through 2008, transition relief permits SERPs to allow changes to distribution options without invoking the 12-month notice/five-year deferral restriction. However, changes to distribution options made in 2008 may not be made for any payment due in 2008 and any payment due after December 31, 2008, cannot be paid in 2008. This transition relief ends as of December 31, 2008, and plans must comply with the final rules, as discussed in greater detail below.

## Definition of "Plan"

Unlike a qualified plan, which is typically viewed as an agreement between an employer and a group of employees, a nonqualified plan is viewed as a collection of agreements between the employer and each individual employee. As a result, a violation of the terms of a nonqualified plan impacts only those participants affected by the violation, unlike a qualified plan where a violation of the plan's terms with respect to just one employee can negatively affect all plan participants.

The final rules identify nine different types of nonqualified deferred compensation plans, with a "SERP" being one type. The final rules are applied separately to these nine different types of plans. *For example, if an eligible employee is accruing a benefit under a SERP and also deferring income to a defined contribution type of nonqualified plan, the section 409A rules are applied separately to the two arrangements.*

However, if a participant accrues benefits under more than one SERP sponsored by an employer, those benefits are treated as being earned under one plan.

These aggregation and disaggregation rules are important to keep in mind as many aspects of the regulations are applied on this basis.

## Definition of “Employer”

In general, the final rules provide that the new 409A rules must be applied to all nonqualified plans maintained by an “employer.” If an employer is a member of a controlled group of corporations or businesses under control (a “controlled group”), all nonqualified plans maintained by all members of the controlled group are subject to the plan aggregation rules mentioned above.

Under the standard controlled group rules, an 80% common ownership threshold applies for identifying controlled group members. However, for purposes of applying the 409A final rules, the 80% ownership level is reduced to 50%, unless the employer specifically indicates a different level in the plan. A plan may designate any percentage that is between 50% and 80%.

In addition, for purposes of determining whether an individual has terminated employment with the controlled group, the common ownership percentage can be lowered to no less than 20%. This might prove helpful to delay distributions to executives.

If an employer wants to apply any ownership requirement other than the standard 50% requirement, for any purpose (e.g., plan aggregation or a participant’s termination of employment), that non-standard percentage must be specified in the plan document. It must be added to the plan document no later than the time the employee must elect a payment option.

## Written Plan Documents

All nonqualified plans must have written plan documents. Originally, the final rules required these plans to have written documents no later than December 31, 2007. However, Notice 2007-86 extended this plan adoption deadline to December 31, 2008. New plans must have written documents no later than the last day of the plan year in which the first contribution is made or, if later, December 31, 2008.

In a notable exception to the delayed documentation deadline, a participant must document his distribution election designating the time and form of payment to be made when *he first accrues a benefit under the plan (even if the benefit relates to services before the election)*.

The basic provisions that must be addressed in plan documents are:

- The formula for determining how benefits will be earned;
- The time and form of payment rules, including payment options and later changes; and
- Any rules that would restrict the payment of benefits to specified “key employees.”

Since a nonqualified plan is viewed as a collection of agreements between the sponsoring employer and each individual employee, the written plan document requirement may be met by creating individual documents for each employee. The final rules do not require employers to use any specific form or format or specimen plan language to satisfy the written document requirement. In fact, a collection of documents that describe different aspects of the plan’s operation would meet this requirement. *For example, an election form that adequately satisfies the three conditions above could constitute a “plan document.”*

It is important to note that an existing plan that needs to be updated to comply with the new rules cannot simply be amended to state that the plan will be interpreted to be consistent with these rules and that any provision of the plan that does not comply will be of no force or effect. The plan must be amended to specifically reflect the new rules.

## Payment Election Rules

In general, section 409A permits nonqualified deferred compensation plans to make distributions only:

- Upon the employee's separation from service;
- Upon the employee's death;
- Upon the employee's disability;
- Upon occurrence of an unforeseeable emergency for the employee;
- At a specified time (or according to a fixed schedule); or
- Upon change in control of the employer.

If a nonqualified defined benefit plan allows a participant to elect the time and form of payment he will receive upon the occurrence of one of these events, the participant must make that election earlier than he would be able to make a similar election under a qualified defined benefit plan. The participant must elect the payment option at the time he first accrues a benefit under the plan.

In most situations, an employee may not realize that he has accrued a benefit under the nonqualified plan until the qualified plan's actuarial valuation has been completed. As a result, the final rules allow the participant to make the payment election as late as 30 days after the beginning of the next calendar year following the plan year in which he accrues his initial benefit in the nonqualified plan. This exception can only be used once per employee.

*For example, the XYZ SERP has a calendar plan year and allows employees to elect a lump sum or annuity for their accrued benefit under the plan. In 2008, Mary's compensation exceeds the qualified plan compensation limit and she accrues her first benefit under the SERP in 2008. Mary must elect whether she will receive her payment upon retirement in a lump sum or in an annuity as soon as she is informed that she has accrued that benefit, but no later than January 30, 2009.*

Under certain circumstances, an employer may delay a participant's elected payment date. *For example, an employer may delay a payment if it cannot take a tax deduction for the payment because it represents excessive employee remuneration.* The date the payment must be made depends on the situation but generally must be made as soon as the employer anticipates that the payment can be deducted. The final rules list other situations that may result in a deferral of the payment

## Later Changes in Time or Form of Payment

The final rules allow an employee (or beneficiary) to change a previously-elected time or form of a payment, subject to certain limitations. A change in either the time or form of payment may not take effect for 12 months and must provide for a new payment beginning date that is at least five years after the original beginning date. In addition, if the payment is made as an annuity or as installment payments, the election must be made 12 months before the date the first amount was scheduled to be paid.

There are some exceptions to this general rule. A payment starting date does not have to be delayed five years when the employee changes the form of payment to be made in the event of death, disability or unforeseeable emergency. However, the change in the form of payment cannot take effect for 12 months from the date the new election is made.

If a payment is made in installments, the plan must specify whether the payment is viewed as a single payment or a series of separate payments. If viewed as a single payment, the 5 year deferral rule starts from

when the initial payment is due. If they are considered as separate payments, then each payment is subject to its own 5 year deferral rule.

Also, if an employee originally elected an annuity form of payment, he may elect a different form of annuity anytime up to retirement without regard to the 12-month and five-year rules. The form of the new payment must be actuarially equivalent to the form originally elected applying reasonable actuarial methods and assumptions.

*For example, assume Mary elected a joint and 50% survivor annuity to begin at age 65. Shortly before retirement, Mary decides that she would prefer a joint and 100% survivor annuity. As long as the assumptions used to calculate both benefits are the same, Mary will not need to delay the start of her benefit payments for five years (i.e., to age 70). However, if Mary wanted to elect a lump sum, she would need to make that election before age 64 and could not receive the payment until age 70.*

The final rules clarify that changes in the form or time of payment apply separately to each payout election. *For example, if the participant originally elected to receive a life annuity upon retirement or death, the participant can change the form of payment for retirement without changing the form of distribution upon death.*

The rules also permit a plan to provide that an intervening event will override an existing payment schedule already in pay status. *For example, a plan may provide that a participant will receive equal installments paid over 15 years upon retirement, but also provide that if the participant dies after the payments begin, all remaining benefits will be commuted and paid in a lump sum.*

Additionally, the final rules permit a nonqualified plan that does not already have a small benefit cash-out provision to add such a provision, subject to the following rules:

- The participant's entire benefit in all nonqualified defined benefit plans sponsored by the employer must be cashed out; and
- The present value of the total cash-out amount cannot exceed the current year's 401(k) deferral limit (e.g., \$15,500 for 2008).

## **Special Rules for Specified Employees**

Payments to a "specified employee" of a corporation that has publicly-traded stock must be delayed at least six months following his separation from service for reasons other than death, disability or change in control. This rule applies to all members of a controlled group as long as any one member of the controlled group has publicly-traded stock, including stock traded on a foreign exchange.

For these purposes, a specified employee is defined in the same manner as a "key employee" as any:

- Officer earning more than \$150,000 per year in 2008 (adjusted annually for inflation);
- 5% owner; and
- 1% owner earning more than \$150,000.

For administrative ease, an employer may delay payment for six months for a larger group of employees (but not more than 200) covered by the plan, even if some of the employees are not key employees.

The identification of key employees is based on a 12-month period ending on an "identification date" chosen by the employer, which must be consistently applied to *all* nonqualified deferred compensation plans. The identification date can be any date selected by the employer. Once selected, it must be used consistently from

year to year. The employer may change the identification date prospectively, but that change can not be effective for at least 12 months. If no date is chosen, the default identification date is December 31. An employee is considered a key employee for the 12-month period beginning no later than the first day of the fourth month following the identification date.

The employer may choose whether to simply begin making payments for specified employees at the end of the six-month period or to aggregate the six months of delayed payments and pay the total amount at the end of that period. It appears that an employer may treat individual specified employees differently in this regard, i.e., either aggregate payments for one but delay payments for another, and need not be consistent in his treatment of all affected employees. It is clear that employees do not have a choice in this regard.

## **Voluntary Plan Terminations**

The final rules identify three circumstances under which a plan may be terminated at the employer's discretion, resulting in accelerated payments to employees. These circumstances do not have to be spelled out in the written plan document and may include:

- Termination within 30 days preceding or 12 months following a change in control;
- Termination within 12 months of a corporate dissolution, or with the approval of a bankruptcy court; and
- Voluntary termination of the plan for reasons other than the financial health of the company. In this situation, the employer and all members of its controlled group must terminate all of their nonqualified defined benefit plans and cannot adopt any new nonqualified defined benefit plan for three years. No payments other than those due under the plan may be made within 12 months of the termination date, and all other assets must be paid out within 24 months of the termination date.

## **Nonqualified Plans Linked to Qualified Plans**

The ability to link the time and form of payment under a nonqualified defined benefit plan to an employee's payment election under a related qualified defined benefit plan is extended to December 31, 2008. However, it is acceptable, even after 2008, for a participant's qualified plan election or non-election to result in a decrease in benefits payable under the related nonqualified plan.

## **Next Steps**

Prudential has administered nonqualified plans in accordance with section 409A requirements and all related IRS guidance since the rules first took effect in 2005. Sponsors of nonqualified plans must ensure that distribution elections are timely captured. Also, consideration should be given to permit participants to change distribution options prior to December 31, 2008. If you would like to discuss the application of these rules to your deferred compensation program, please contact your Prudential Retirement representative.

### **Pension Analyst by Prudential Retirement**

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