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Pension ANALYST

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Highlights of Final Rules For Nonqualified Defined Contribution Deferred Compensation Plans

WHO'S AFFECTED These rules apply to sponsors of and participants in nonqualified defined contribution plans, including section 457(f) plans. These rules do not apply to qualified plans (for example, 401(k) plans), section 403(b) arrangements, or section 457(b) 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 several retirement industry groups and law firms, 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 rules 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.

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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 nonqualified defined contribution plans to allow changes to distribution options without invoking the now-required five-year deferral. 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. Under these rules, elective contributions and nonelective contributions (including matching contributions) are treated as separate nonqualified defined contribution plans, even if the contributions are made under the terms of a single plan document. On the other hand, if a participant makes elective deferral contributions under more than one nonqualified plan sponsored by the same employer, those deferrals are treated as being made to one plan for purposes of applying the section 409A rules. Similarly, all nonelective contributions made for a participant under more than one nonqualified plan sponsored by the same employer are treated as being made to one plan for purposes of applying the section 409A rules.

These aggregation and disaggregation rules are important to keep in mind as many aspects of the regulations are applied on this basis. *For example, participants generally need to make deferral elections on base compensation by December 31 of the prior year. However, a newly-eligible employee has 30 days from his initial eligibility date to enroll. The standard December 31 enrollment deadline cannot be circumvented by establishing a new plan.*

Definition of “Employer”

In general, the final rules provide that the new 409A rules must be applied to all nonqualified plans maintained by the “employer.” If an employer is a member of a controlled group of corporations or businesses under common 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 plan specifically indicates a different level. 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 purposes (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 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 *at the time he makes his initial deferral contribution*.

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

- The amount or formula used to determine the amount of deferred compensation;
- The conditions under which a deferral election may be made;
- 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 enrollment form that adequately satisfies the four conditions above could be considered 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.

Deferral Election Rules

In general, the final rules confirm that an individual's election to defer compensation for services to be performed in a tax year must be made by the close of the preceding year. *For example, the election to defer compensation to be earned in 2009 must be made by December 31, 2008.* The election must also specify the form and time of payment, and must be irrevocable. So-called "evergreen" elections, which carry over from year-to year unless changed by the employee, are permissible.

Performance-Based Compensation

A special deferral election deadline applies to "performance-based compensation." Elections to defer performance-based compensation must be made no later than six months before the end of the performance period.

Performance-based compensation is compensation for services performed over a period of at least 12 months, which is contingent on satisfaction of pre-established organizational or individual performance criteria. The performance criteria must be established in writing within the first 90 days of the performance period. At the time the criteria are established, there must be substantial uncertainty that they will be met. The criteria may be objective or subjective.

> *For example: Employer X wants to establish a sales goal and related bonus program for the 2008 calendar year and wants to allow salespeople to defer this bonus compensation. Since the performance period ends on December 31, 2008, Employer X must document the performance criteria by March 30, 2008. Individual salespeople must make their elections to defer all or part of this bonus compensation by June 30, 2008.*

Many plan sponsors will not want to manage two separate enrollment periods for standard deferrals and deferrals of performance-based compensation. The final rules allow plan sponsors to apply the standard election timing rules to performance-based compensation for the upcoming year. *For example, Employer X may require salespeople to make their elections to defer their 2009 performance bonuses by December 31, 2008.*

New Participants

Another special deferral election deadline applies to individuals who become eligible to make deferrals after the start of the calendar year *(for example, a newly hired employee or an employee who is promoted mid-year to a position that is eligible to participate in the plan).* These individuals may make their initial deferral elections within the first 30 days after first becoming eligible to participate in the plan. In these situations, the deferral elections only apply to base compensation and the pro rata portion of any performance-based compensation earned after the elections are made. This special election deadline is not available if the individual has previously participated in a plan of a similar type (e.g., another defined contribution plan) maintained by the employer.

Cancellation of Deferrals

In general, deferral elections are irrevocable once the appropriate election period has ended. However, a plan may cancel a deferral election for the rest of the deferral period if:

- The individual receives a payment from the nonqualified plan due to an unforeseeable emergency;
- The cancellation is needed for the employee to obtain a hardship distribution from a 401(k) plan or 403(b) arrangement; or
- The individual incurs a disability.

In the first two situations, the cancellation must occur immediately. In the case of disability, the cancellation must occur by the later of the end of the individual's tax year or the 15th day of the third month after the individual incurs the disability. For this purpose, the definition of disability is less restrictive than the definition of disability that applies when determining if a payment may be made.

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 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 at the same time that he makes his deferral election. If a plan requires participants to make annual deferral elections, participants may make separate distribution elections for each year's deferral election (i.e., class year distribution elections).

A plan must designate an objectively determinable date on which payment will be made. Under the final rules, a payment is considered to be made by a designated date as long as it is made by the latest of:

- The designated date;
- A later date in the same tax year; or
- The 15th day of the third calendar month following the designated date, as long as the employee is not allowed to designate the taxable year of the distribution.

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. The final rules list other situations that can 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. Except for the transition rules that apply until December 31, 2008, a change in either the time or form of payment may not take effect for 12 months and must provide for a new payment commencement date that is at least five years after the original beginning date. In addition, an election to change any payment scheduled to be made at a specified time or in accordance with a fixed schedule must be made 12 months before the date the first amount was scheduled to be paid.

There are some exceptions to these general rules. 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 payments are to be made in installments, the plan must specify whether this payment method is to be treated as a single payment or a series of separate payments. If installment payments are treated as a single payment, the five-year deferral rule starts from the date the initial payment is due. If installment payments are treated as a series of separate payments, each payment is subject to its own five-year deferral rule.

In addition, 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 five annual installments upon termination of employment but a lump sum payment upon death, the participant can change the form of payment for one situation without changing the form for the other situation*.

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 six installment payments beginning at termination of employment, 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 provisions, subject to the following rules:

- The participant’s entire account balances in all such nonqualified defined contribution plans sponsored by the employer must be cashed out; and
- 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 all employees covered by the plan, even if some of the employees are not specified employees, as long as the total number of such employees is 200 or less.

The identification of specified 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 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 cannot 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 is not clear if the employer may treat individual employees differently in this regard or must be consistent in his treatment of all affected employees. However, 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 must be spelled out in the 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 contribution plans and cannot adopt any new nonqualified defined contribution plans 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

A decision made by an employee in a qualified plan that results in an increase or decrease in deferrals to a nonqualified plan is acceptable, with some limitations. For example, some nonqualified plans will accept salary deferral contributions and employer contributions only after an employee reaches a limit in a 401(k) plan that prevents the employee from continuing to make deferrals to the 401(k) plan.

The final rules provide that any change made by an employee to a 401(k), 403(b) or section 457(b) deferral election that increases or decreases a contribution under a nonqualified plan will not violate the section 409A rules. However, the corresponding increase or decrease in either the deferral or any associated match to the nonqualified plan is limited to the current year's deferral limit (e.g., $15,500 in 2008), with separate limits applied to the deferral and the match.

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 captured timely. 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.

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