

Washington Update

Proposed changes that could affect your Retirement Program



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Highlights of Proposed Rules For Nonqualified Deferred Compensation Plans

On October 4, 2005, the IRS published proposed rules affecting nonqualified deferred compensation plans. These rules provide guidance for complying with the new Internal Revenue Code section 409A rules, which were enacted as part of [the American Jobs Creation Act of 2004 \(AJCA\)](#). These rules apply to any nonqualified defined benefit or defined contribution plan that provides for the deferral of compensation including 457(f) plans. The rules do not apply to qualified retirement plans (for example, 401(k) plans or qualified defined benefit pension plans), section 403(b) arrangements, section 457(b) plans, simplified employee pension plans, SIMPLEs, and section 501(c)(18) trusts.

In October 2005, we published a *Compliance Bulletin* titled [“IRS Publishes Proposed Regulations for Nonqualified Deferred Compensation Plans,”](#) which provided an overview of the actions that plan sponsors may need to take before December 31, 2005, to comply with these rules, and highlighted important additional transitional period relief. This publication provides an overview of other important provisions of the proposed rules that affect the types of nonqualified deferred compensation plans serviced by Prudential Retirement. As a result, this publication does not discuss the application of these rules to severance plans, stock option plans, or stock appreciation rights.

Effective Date

Except for the transition relief that expired in 2005 and the transition relief that has been extended to 2006, the proposed rules are scheduled to become effective on January 1, 2007. While a plan sponsor does not have to comply with these proposed rules before their effective date, a plan sponsor may follow this guidance before January 1, 2007. For the 2005 and 2006 plan years, plan sponsors must operate their plans in accordance with either [the provisions of Notice 2005-1](#), these proposed rules or the final rules, when they are published.

It is important to remember that these rules are only proposed and are still subject to change. A public hearing is currently scheduled for January 25, 2006. IRS officials, speaking at recent industry conferences, have acknowledged that these rules are not perfect and employers should expect to see some differences in the final regulations.

Scope of Section 409A

The proposed regulations clarify the scope of Internal Revenue Code (Code) section 409A. In general, these rules apply to any plan that provides for the deferral of compensation, with the exception of qualified retirement plans (such as 401(k) plans), section 403(b) arrangements, section 457(b) plans, simplified employee pension plans, SIMPLEs, and section 501(c)(18) trusts.

A plan provides for the deferral of compensation only if the individual providing services to the employer has a legally binding right to receive compensation in a future year for services provided in the current year. The rules identify four types of nonqualified deferred compensation plans:

- Account balance (defined contribution) plans;
- Non-account balance (defined benefit) plans;
- Separation pay arrangements; and
- Other plans (e.g., discounted stock options and other equity-based compensation).

Short Term Deferrals

However, a short term deferral of compensation is not subject to the section 409A rules if it meets specific requirements. To be exempt from the section 409A rules, the compensation must be actually or constructively received by the individual by the later of (1) 2½ months after the end of the individual's tax year or (2) 2½ months after the end of the company's taxable year. Payments delayed past this standard deadline will be exempt from the section 409A rules if the delay is due to unforeseeable administrative or solvency issues. However, if the delay does not qualify for this exception, the deferred compensation will be subject to the section 409A rules and may then violate those rules. Under this special provision, many multi-year bonus arrangements that require payments to be made promptly after vesting will not be subject to the section 409A rules.

Application to U.S. Expatriates, Resident Aliens and Nonresident Aliens

The proposed rules also clarify how section 409A applies to U.S. citizens and resident aliens working abroad (who are generally subject to taxation on worldwide income) and nonresident aliens (who are generally subject to taxation on U.S.-source income). Special exceptions are provided for U.S. citizens and resident aliens, including exceptions for nonelective deferrals under broad-based foreign retirement plans.

Deferral Election Rules

In general, the proposed rules confirm that an individual's initial 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 2006 must be made by December 31, 2005.* The election must also specify the form and time of payment, and must be irrevocable. So-called "evergreen" elections, meaning elections that roll from year-to-year unless affirmatively 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 2006 calendar year and wants to allow salespeople to defer this bonus compensation. Since the performance period ends on December 31, 2006, Employer X must document the performance criteria by March 31, 2006. Individual salespeople must make their elections to defer all or part of this bonus compensation by June 30, 2006.

Many plan sponsors will not want to manage two separate enrollment periods for standard deferrals and deferrals of performance-based compensation. The proposed rules would not prevent them from applying the standard election timing rules to performance-based compensation for the upcoming year.

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 account balance plan) maintained by the employer.

Termination of Deferrals

In general, deferral elections are irrevocable once the appropriate election period has ended. However, a plan may terminate a deferral election if (1) the individual receives a payment from the nonqualified plan due to an unforeseeable emergency or (2) the termination is needed for the employee to obtain a hardship distribution from a 401(k) plan. In each case, the deferral election must be terminated, and not merely suspended.

Distribution Rules

In general, Code section 409A requires distributions to be made no earlier than:

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

If a plan allows an employee to select the time and form of the distribution, that election must be made at the time the deferral election is made. For plans that require annual deferral elections, separate distribution elections are allowed 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. However, the proposed rules permit plans to simply specify the year in which the payment is to be made without specifying the month and day as well. A payment will be treated as made on the designated date if it is made by the later of the first date it is administratively feasible to make such payment or the end of the calendar year containing the designated date (or the end of the calendar year if only a year is designated).

Special Rules for Key Employees

Separation from service payments to a key employee of a corporation whose stock is publicly traded on an established securities market must be delayed at least six months following his separation from service. For these purposes, a key employee is:

- Any officer earning more than \$140,000 (year 2006 amount; adjusted annually for inflation);
- Any 5% owner; and
- Any 1% owner earning more than \$150,000.

The identification of key employees is based upon the 12-month period ending on an “identification date” chosen by the employer and the employee is considered a key employee for the 12-month period beginning on the first day of the 4th month following the “identification date”. 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.

A plan must specify how the six-month delay will be handled. It may simply provide that payments will not begin until the end of the six-month period. Alternatively, it may provide that the payments due during the six-month period will be aggregated and paid at the end of that period.

Delay in payment by the employer

Under certain circumstances the employer can defer the payment, e.g., where the employer cannot take a tax deduction for the payment because it represents excessive employee remuneration under Code section 162(m). The date the payment must be made depends on the situation. *For example, in the case of non-deductibility, the payments may be delayed until they become deductible.* The plan would have to include these provisions. If a plan does not contain them, they can be added but would not be effective for a period of 12 months.

Subsequent Election Rules

The “subsequent election rules” allow a participant to change the time or form of a distribution after an amount has been deferred. A subsequent election may not take effect for 12 months and must provide for a new distribution date that is at least five years after the date the distribution would have otherwise been made. In addition, for any scheduled payment, the change must be made at least 12 months before the first scheduled payment date.

The proposed rules permit a plan to classify an installment payout as either a series of individual payments or a single payment. However, the plan must apply this treatment consistently. The manner in which the plan treats installment payouts will determine how the subsequent election rule is applied, and each method has its own advantages. *For example, if a plan treats installment payouts as a series of individual payments, the individual would be able to postpone receipt of some installments without delaying all*

installments. On the other hand, if a plan treats installments as single payment, the individual may change to a lump sum distribution as long as that distribution is made no sooner than five years from the original first installment date.

Exceptions to the Subsequent Election Rules

The proposed rules clarify that changes in the form and time of payment apply to each payout election separately. *For example, if the participant elects to receive five annual installments upon separation from service or a lump sum 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 separation from service, but also provide that if the participant dies after the payments begin, all remaining benefits will be commuted and paid in a lump sum.*

Voluntary Plan Terminations

There are also three circumstances under which a plan may be terminated at the employer's discretion, resulting in accelerated payments to participants. These circumstances must be spelled out in the plan document and may include:

- Voluntary termination of all the employer's nonqualified plan arrangements of the same type, provided that the employer does not adopt a new arrangement of the same type for a period of five years, no payments other than those due under the plan are made within 12 months of the termination, and all other payments are made within 24 months of the termination;
- Termination within 12 months of a change in control; and
- Termination within 12 months of a corporate dissolution, or with the approval of a bankruptcy court.

Nonqualified Plans Linked to a Qualified Plan

The proposed rules provide additional relief for nonqualified deferred compensation plans where the time and form of payments is controlled by the time and form of payment elected by the participant under a qualified plan. Through December 31, 2006, a nonqualified plan payment election that is controlled by a qualified plan election will not violate the section 409A rules, as long as it is made in accordance with the payment terms of the nonqualified plan as in effect on October 3, 2004. These rules also provide specific relief for mirror/wrap-around plans and defined benefit supplemental executive benefit plans (SERPs).

Mirror Plans

A "mirror plan" (sometimes referred to as a "pour-over plan" or a "wrap-around plan") is a nonqualified plan that is designed to supplement a 401(k) plan. Typically, a mirror plan will accept salary deferral contributions and employer contributions in excess of the amounts permitted under the 401(k) plan and basic plan design will mimic the 401(k) plan provisions. The proposed rules provide that any amendment made to a qualified plan or election made by an individual in a qualified plan that, as a result, increases or decreases a benefit under a nonqualified plan will not violate the section 409A rules. However, if a change is made to a deferral election under a 401(k) plan, the corresponding increase or decrease in both the

deferral and any associated match to the nonqualified plan is limited to the current year's deferral limit (e.g., \$15,000 in 2006).

The proposed rules also retain the ability to transfer, or *wrap*, deferrals from the nonqualified plan to the qualified plan. The amount which can be wrapped is the maximum amount that may be deferred under the 401(k) plan, not to exceed the applicable deferral limit for the year. This addresses those situations where deferrals made to a nonqualified plan are transferred to the 401(k) plan after the completion of the 401(k) plan's ADP and ACP tests.

Defined Benefit SERPs

While the proposed regulations apply to both defined contribution and defined benefit type non-qualified plans, most of the provisions have a defined contribution feel to them. However, there are some provisions that specifically apply to defined benefit SERPs.

After December 31, 2006, the proposed regulations require that a distribution election under a "non-elective" arrangement, such as a defined benefit SERP, must be made no later than the time an individual has a legally binding right to the compensation. In other words, the election must be made before the participant is vested in the nonqualified plan benefits, not at the time the benefits are earned.

In addition, the proposed rules provide that if an amendment or other action causes the future accrual of benefits under a qualified defined benefit plan to cease or be cut back, resulting in an increase in the nonqualified defined benefit plan, that increase will not be viewed as a violation of the section 409A rules.

Next Steps

The IRS has asked for comments on these proposed regulations by January 3, 2006, and a public hearing is scheduled for January 25, 2006. As a result, we do not expect to see the final regulations until the end of the first quarter of 2006, at the earliest. When the final regulations are published, we will publish a *Pension Analyst* summarizing the details. In the meantime, if you would like to discuss the possible application of these proposed regulations to your deferred compensation program, please contact your Prudential Retirement representative.

Washington Update by Prudential Retirement

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