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LIFE INSURANCE

Advanced Markets

Because You Asked

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Answers to Questions Frequently Asked of the Advanced Markets Group

The Impact of Section 409A on Nonqualified Deferred Compensation Plans

Introduction. On October 22, 2004, the American Jobs Creation Act (AJCA) was signed into law by President Bush. The AJCA contained many provisions affecting nonqualified deferred compensation which have been incorporated into Section 409A of the tax code. These provisions were enacted in response to reported abuses of nonqualified deferred compensation arrangements by or on behalf of executives.

If a deferred compensation plan that is subject to the provisions of 409A does not meet its requirements for distribution, acceleration and elections or if a plan is not operated in accordance with the requirements of 409A, ***income deferred may be currently includible in gross income. In addition to the income tax, there is a 20% excise tax on the amount included in income as well as interest at the underpayment rate plus 1%***. Section 409A applies to all amounts deferred after December 31, 2004. Amounts of income that are deferred before January 1, 2005 are generally grandfathered from the provisions of Section 409A, except if the plan under which the deferral is made is materially modified after October 3, 2004.

IRS and Treasury Guidance on 409A. Following the passage of the AJCA, the IRS has issued numerous Notices to clarify issues and provide guidance under the AJCA (Notice 2005-1, Notice 2005-94, Notice 2006-4, Notice 2006-33, Notice 2006-64, Notice 2006-79). On April 10, 2007, the Treasury Department issued the long-awaited final regulations on Section 409A, as well as Notice 2007-34 on split-dollar arrangements and Section 409A. The final regulations generally follow the outline of the proposed regulations that were issued in September 2005. The final regulations will not be effective until January 1, 2008, but they may be relied upon before then to show a good effort to comply with the provisions of Section 409A. All plans that may be subject to Section 409A should be reviewed and in many cases updated, in light of the final regulations.

Definitions and Provisions under 409A and Regulations. The regulations define a nonqualified deferred compensation (NQDC) plan as ***any plan that provides for the deferral of compensation, which means that a "service provider" has a legally binding right during a taxable year to compensation that, pursuant to its terms, is or may be payable to (or on behalf of) the service provider in a later year.*** (Deferral of compensation can include a right to the employer's earnings under certain circumstances, and may also include payment for a non-compete agreement.)

Definition of Plan. A "plan," is broadly defined by the regulations as **"any agreement, method, or arrangement, including those that apply to only one person or individual."** Section 409A may apply to arrangements between an employer and an employee, or an independent contractor or arrangements between a partnership and a partner.

Section 409A does not apply to:[1]

- **Qualified employer retirement plans;**
- **Welfare benefit plans and welfare benefits** such as vacation, sick leave, compensatory time, disability pay or death benefit plans;
- **Short-term deferrals** in which the service provider receives the compensation 2½ months after the end of the taxable year when the income is not subject to a substantial risk of forfeiture, and the payment event or date is specified by the plan (there is an exception for payments after the short-term deferral period due to unforeseeable events);
- **Incentive stock options and option grants** under an employee stock purchase plan;
- **Nonstatutory stock options** for which the exercise price can never be less than the fair market value (FMV) of the stock on the grant date, the option is subject to taxation under Section 83 and there is no deferral beyond the exercise or disposition of the option;
- **Certain stock appreciation rights (SAR) plans** for which: 1) the SAR exercise price may never be less than the FMV of the stock on the grant date, 2) the stock is traded on an established securities market, 3) only publicly traded stock can be used to settle the right upon exercise and 4) there is no deferral beyond the exercise or disposition of the option;
- **Restricted property where the service provider receives property that is not included in income (under Section 83)** because the property is nontransferable and subject to a substantial risk of forfeiture or is includible in income (under Section 83) due to a valid 83(b) election. However, a situation in which the service provider has a legally binding right to receive property in a future year may be treated as a nonqualified deferred compensation;
- **Archer Medical Savings Accounts, Health Savings Accounts and any other medical reimbursement arrangement** that satisfies the requirements of tax code Sections 105 and 106 and does not provide taxable benefits, and
- **Certain broad-based foreign retirement plans.**

Section 409A can apply to §457(f) (ineligible) plans and to some post-employment reimbursement arrangements to the extent that they furnish taxable benefits.

Definition of Service Recipient. The definition of "service recipient" in the regulation is the person for whom the services are provided and with respect to whom the legally binding right to compensation arises, including controlled groups of corporations and entities under common control. The regulation adds that IRC §409A still applies even if the payment of compensation is made by a person other than the one for whom the services are performed.

Definition of Service Provider. The regulation provides a definition of service provider that encompasses traditional employees and much more, and provides specific exclusions. A service provider can be an individual, corporation, partnership, or a personal service corporation. Notably, the regulation provides that IRC §409A does not apply to a deferral under an arrangement with a service provider that obtains a legally binding right to compensation in any year that the service provider is an accrual basis taxpayer.

Substantial Risk of Forfeiture. The definition of "substantial risk of forfeiture" in the final regulation is that compensation is subject to a substantial risk of **forfeiture *if entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial.*** Any extension of or addition to the substantial risk of forfeiture after the legally binding right to the compensation arises (i.e., after the lapse of the initial risk of forfeiture) is disregarded. Likewise, the regulation makes clear that an employee's salary deferral could not be made subject to a substantial risk of forfeiture, since the employee could have had the salary but for the election to defer.

Exclusion from 409A for Independent Contractors. IRC §409A generally does not apply to amounts deferred under an arrangement with an independent contractor if: (1) the contractor is in the business of providing such services (but not as an employee), (2) the contractor provides "significant services" to at least two unrelated service recipients, and (3) the contractor is not related to the service recipient (generally defined as a family member or 20% owner of the other).

Additional Safe Harbors for Independent Contractors. The final regulations also provide for additional safe harbors from Section 409A for independent contractors who become employees in future years and independent contractors who meet the exclusion above for three years in a row, and do not know that they will fail to meet the exclusion requirements in the next year when income is deferred.

Plan Aggregation. The regulation has the following plan aggregation rules: (1) all amounts deferred under an account balance plan are treated as deferred under a single plan, (2) all amounts deferred under a nonaccount balance are treated as deferred under a single plan, and (3) all amounts deferred under any other type of plan (e.g., equity-based compensation) are treated as deferred under a single plan. These aggregation rules allowed the Service to find a §409A violation with respect to a particular participant, across several plans, without necessarily disqualifying the arrangement as to all participants. The final regulations include additional categories of plans, such as split-dollar life insurance, reimbursement plans and non-exempt stock rights, in addition to account balance plans, non-account balance plans, separation pay plans, and foreign plans. As a result of the additional categories of plans, a Section 409A violation with respect to one type of arrangement might not result in 409A penalties for other types of arrangements.

Severance Pay. The final regulations also allow an exemption from 409A for certain "good reason" terminations of employment, initiated by the employee, which will be eligible for the short-term deferral exception to 409A. In addition, there is a limit of how much severance pay will be exempted from 409A; the limit is the lesser of up to two times the employee's annual compensation or two times the limit on compensation of Section 401(a)(17) of the tax code ($225,000 in 2007). Amounts in excess of the limit will generally be subject to 409A.

Other Exclusions from 409A. Also specifically excluded from the definition of "deferral of compensation" is property transferred to the service provider but excluded from gross income under IRC §83 because it is subject to a substantial risk of forfeiture (or such excludible property included in gross income solely because of an election under IRC §83(b)). However, the deferral of transfer of such property, that the service recipient otherwise has a legally binding right to receive, at *a future date*, can be deferral of compensation whether or not it would be "substantially nonvested" under IRC §83 at the time of the grant. As a result, the taxable transfer of an annuity may be treated as a payment for purposes of Section 409A.

Stock Options and Stock Appreciation Rights. In addition, deferral of compensation does not include certain stock options and stock appreciation rights. Nonstatutory stock options are excluded if (1) the exercise price is equal to or greater than the stock price when the option is granted, (2) transfer or exercise of the option is subject to taxation under IRC §83, and (3) the option does not include any feature of further deferral. Stock appreciation rights also do not constitute deferral of compensation if (1) maximum compensation under the right is the difference between the prices of the stock at the time of grant and exercise, (2) the minimum exercise price is the stock price at the time of grant, and (3) the right does not include a feature of further deferral.

Service Recipient Stock Definition Expanded. In order to qualify for one of the exceptions under Section 409A, the stock underlying the option or SAR must be "service recipient stock". The final regulations provide an expanded definition of service recipient stock as "any class of common stock within the meaning of Section 305 of the Internal Revenue Code, including a class of common stock that has liquidation preferences". The final regulations also provided additional guidance on the standards for valuing privately owned company stock.

Extension of Stock Rights. The final regulations provide additional flexibility from the proposed regulations in that *the extension of a stock right's exercise period will not generally be treated as an additional deferral or modification of the stock right for purposes of Section 409A if the exercise period is not extended beyond the original maximum term of the stock right, but no longer than 10 years from the original grant date of the stock right*.

Performance-based Compensation (Bonuses). While IRC §409A generally requires that a qualifying election to defer compensation must be made not later than the close of the tax year preceding the year in which the compensation is earned, it allows an employee to elect deferral of "performance-based compensation" (if based on services performed over a period of at least 12 months) not later than six months before the end of the service period. "Performance-based compensation" is defined by the regulation as "compensation based on the satisfaction of criteria" established in writing no more than 90 days after the beginning of the period, where the performance outcome is substantially uncertain when the criteria is established.

Separation from Service. An employee is considered to have separated from service if the employee dies, retires, or is otherwise terminated. This does not include bona fide leaves of absence, such as military leave, sick leave, etc., if (1) the leave is no longer than six months or (2) the employee has a contractual or statutory right to reemployment upon return. An independent contractor, however, is considered to have separated from service upon expiration of the contract under which the services were performed.

Initial Deferral Elections. The general rule of Section 409A is that compensation for services performed during a taxable year must be deferred by the close of the preceding tax year with two main exceptions: (1) in the first year of eligibility, an election can be made within 30 days after a participant becomes eligible to participate, and (2) for performance-based compensation, i.e., bonuses, based on performance based on a service period of at least 12 months, the deferral election can be made up to 6 months before the end of the service period. The final regulation expands on the general rule for deferrals by stating that a deferral election will not be considered to be made "until such election becomes irrevocable" under the terms of the plan, i.e., when the election can no longer be amended.

Offshore Trusts. Amounts set aside in offshore trusts to pay NQDC would generally be taxed when they are set aside or transferred to offshore trusts. The IRS issued Notice 2006-33 in March 2006 to provide transitional guidance on the use of offshore trusts or triggers based on the employer's financial health.[2]

Triggers Based on Employer's Financial Health. Deferred compensation would be taxable if the NQDC plan restricts payment of benefits in the event of a change in the employer's financial health. This provision effectively means that rabbi trusts can be used with NQDC plans, but rabbicular trusts and secular trusts, which allow payments upon a "trigger" for the change in the employer's financial health will not be able to defer additional income.

Permissible Payments/Distributions. In order for a plan to be compliant with Section 409A, an NQDC plan should generally allow distributions only upon one of the following events, as outlined below. A plan may provide for payment upon the earliest or latest of more than one event and may also allow for an alternative payment schedule if the event occurs on or before one specified date.

1. **Specified Time/Date –** the dates and amounts of payments must be "objectively determinable" at the time of deferral.

2. **Separation from Service –** Key employees of publicly owned corporations (as defined under Section 416 of the tax code) may not receive a distribution until six months after separation from service, unless death occurs earlier. The plan must provide how the 6-month delay will be implemented. This does not include military or sick leave but may include the expiration of a contract for an independent contractor.

3. **Unforeseeable Emergency –** this provision includes emergencies that result in a "severe financial hardship" of the service provider or beneficiary or a spouse or dependent of the service provider or beneficiary. Examples include the need to pay medical or funeral expenses, or an imminent foreclosure or eviction. Distributions must be limited to the amount "reasonably necessary to satisfy the emergency need" and must be made from a plan that provides for payment upon an unforeseeable emergency.

4. **Disability –** The service provider is disabled if: a) he/she is not be able to engage in any "substantial gainful activity" for at least 12 months, or b) he/she meets requirement a) and is receiving income replacement benefits for at least 3 months under an employer's accident and health plan.[3]

5. **Change in Control/Ownership of a Corporation –** Section 409A allows an NQDC plan to make payments to an employee following a change in the ownership of a corporation, a change in the effective control of the corporation or a change in the ownership of a substantial portion of the assets of the corporation. These terms are defined in the final regulations as follows:

   - **Change in ownership of the corporation –** any one person or group obtains more than 50% of the stock of a corporation (and did not own more than 50% of the stock of the corporation before the acquisition of stock). A group may include owners of a corporation that enter into a merger, acquisition or other transaction with a corporation.

   - **Change in the effective control of the corporation –** any one person or group obtains 20% or more of the total voting power of the stock of a corporation or a majority of the board of directors is replaced during a 12 month period by directors who are not endorsed by a majority of the board of directors. If a change of control event does occur, only the plans covering the employees of the acquired company need to be terminated, not the plans of the acquiring company. A service recipient may recommence a new plan after terminating and liquidating a nonqualified deferred compensation plan three years after a change in control.

   - **Change in the ownership of a substantial portion of a corporation's assets –** any one person or group acquires 40% or more of the total gross fair market value of the assets of the corporation.[4]

Acceleration of Payments – Section 409A does not permit the acceleration of payments under any NQDC plan except under the following situations.

1. **Domestic relations order –** acceleration will be permitted to fulfill a domestic relations order.

2. **Conflicts of interest –** acceleration will be permitted to comply with a certificate of divestiture (as defined in Section 1043(b)(2)). Notice 2006-64 has indicated that the acceleration of payment may be permitted as necessary to satisfy federal conflict of interest requirements pursuant to a written determination by the Office of Government Ethics.[5]

3. **Section 457(f) plans –** a Section 457(f) plan may permit an acceleration of a payment to pay federal, state and local income taxes due upon a vesting event as long as the payment is not more than the income tax that would have been withheld if all of the deferred compensation had been paid at the time of vesting.
4. **De minimis and specified amounts –** an arrangement may be amended to allow acceleration of payments as long as the payment coincides with the termination of a participant's interest in the NQDC plan, the payment is made by the later of the end of the calendar year when separation from service occurs or within 2½ months after separation from service, the payment is not greater than $10,000 and the participant is not given an election with respect to the payment.
5. **Payment of employment (FICA) taxes –** a plan may allow acceleration of a payment to pay FICA tax on deferred compensation, and the income tax withholding related to a FICA amount, as long as the total payment does not exceed the aggregate of the FICA amount and the income tax withholding.
6. **Income Inclusion under 409A –** a plan may allow the acceleration of a payment to a service provider if the arrangement fails to meet the requirements of Section 409A and the regulations, and as a result is subject to income tax (the amount may not exceed the amount required to be included in income).
7. **Arrangement Terminations –** an arrangement may permit acceleration if there is a termination of the arrangement due to a corporate dissolution or bankruptcy filing, a change in control, or the service recipient's discretion, provided that all aggregated arrangements are terminated and all payments are made within 24 months of the termination of the arrangement.
8. **Distributions to avoid a Nonallocation Year –** a plan may provide for payment acceleration to prevent the occurrence of a nonallocation year (within the meaning of Section 409(p)(3)) in the employee stock ownership plan.
9. **Nonqualified Deferred Compensation arrangements linked to qualified plans –** For NQDC plans that are linked to qualified plans, changes in qualified plan contributions amounts will not constitute an acceleration of payment. However, the final regulations do provide additional rules applicable to "linked" deferred compensation plans.

Other Changes to the Time and Form of Payments:

- **Cancellation of Deferrals.** Cancellation of deferrals may be allowed due to an unforeseeable emergency or hardship distribution (must be cancelled, cannot be postponed or otherwise delayed).
- **Re-Deferral of Income.** Re-deferral of income must be made at least 12 months prior to the payment date, deferral of the payments must be for at least 5 years, and the election may not take effect until 12 months after the date of election.

Effective Date of Section 409A and final regulations. Section 409A applies to all amounts deferred (and earnings on those amounts) after December 31, 2004. An amount would be considered deferred (and grandfathered) before January 1, 2005 if ***the amount was fully vested by that date and the employer had a binding legal obligation to pay that amount*** (earnings on those amounts deferred before January 1, 2005 are also grandfathered). Section 409A also applies to amounts deferred before January 1, 2005 if the plan under which the deferral is made is materially modified after October 3, 2004. The effective date of the final regulations is January 1, 2008, and the deadline for bringing written plan documents into compliance with Section 409A is December 31, 2007.

Material Modifications. Material modifications under Section 409A do not include: amendments to comply with the provisions of AJCA, reduction of an existing benefit (such as a "haircut provision"), exercising a discretionary right in place on October 3, 2004, changing or adding an investment measure, or amending a plan by December 31, 2004 to stop future deferrals or terminate the arrangement. Material modifications do include adding a new benefit or right or materially enhancing an existing benefit or right under the plan, or exercising discretion to accelerate vesting of a benefit on or before December 31, 2004. Suspension or termination of a plan is not considered a material modification.

Written Documentation Compliance with Section 409A. The final regulations have set the deadline for written plan documents to be in compliance with the new rules to December 31, 2007. In order to comply with the documentation requirement of Section 409A, the plan documents must provide for the following items: (1) the amount that the employee/service provider has a right to be paid, (2) the schedule or triggering events that will result in a payment of that amount, (3) the six-month delay requirement for payments to certain employees of publicly-traded companies upon separation of service (only public companies would need to include this requirement), and (4) the permissible conditions under which a deferral election may be made (for employee deferral plans). Although the written plan does not need to specify when amounts may be accelerated under Section 409A, the taxpayer does need to show that the plan was operated in compliance with the acceleration rules or transitional guidance under Section 409A, as applicable.

Anti-Abuse Rule. The IRS added an anti-abuse rule to address corporate transactions, structures or stock right grants, where a principal purpose of the transaction is to avoid Section 409A for a deferred compensation arrangement.

Employer Reporting Requirements. The AJCA also added IRC Sections 6041(g)(1) and 6051(a)(13) to the tax code, which require that employers report all deferrals for the year on a Form 1099 or a Form W-2 (assuming such form is required to be filed for the employee), regardless of whether the compensation is includible in income, for all amounts deferred in calendar years beginning after December 31, 2004. The IRS indicated in Notice 2005-94 that it would temporarily suspend employer's reporting and withholding obligations for calendar year 2005 under Section 409A until further guidance is issued in 2006. However, it appears that employers will need to withhold and report for 409A deferrals in 2006, and may also need to file corrected returns for 2005.

Potential Impact. Because the terms under Section 409A are broadly defined, these rules can potentially impact many existing deferred compensation and employee benefit plans. Employers should be very careful to make sure that affected plans meet the requirements of 409A.

Split-Dollar Arrangements and Section 409A

IRS Notice 2007-34

On April 10, 2007, the Internal Revenue Service issued IRS Notice 2007-34 (2007-17 IRB) (the "Notice") to provide "guidance regarding the application of Section 409A to split-dollar life insurance arrangements. This summary will outline the content of the Notice. The preamble to the proposed regulations under IRC §409A, released September 29, 2005, stated that some split-dollar arrangements may be subject to the provisions of the section. Generally speaking, the Notice follows the treatment offered by the preamble to the proposed §409A regulations.

Following the preamble to the proposed §409A regulations, the Notice excludes the following types of split-dollar arrangements from the reach of Section 409A: 1) some endorsement split-dollar arrangements, which qualify for an exception to 409A, such as short-term deferrals; 2) collateral assignment split-dollar arrangements (except if all or a portion of the repayments on the loans are waived, cancelled or forgiven); and 3) loan arrangement split-dollar plans (non-equity arrangements).

Application of Section 409A to Endorsement Split-Dollar Arrangements. Many endorsement split-dollar arrangements will be subject to Section 409A, if, under the terms of the arrangement and the relevant facts and circumstances, the employee has a legally enforceable right to compensation that will (or may be) includible in the income of the employee in a later tax year. This describes a so-called equity endorsement arrangement, under which an employer would own a life insurance policy on the life of an employee, and the employer would (1) endorse all or part of the death benefit of the policy to the employ and (2) provide the employee with access to all or part of the cash surrender value of the policy. The Notice provides that the access to the cash surrender value, but not the endorsement of the death benefit, is subject to IRC §409A.

Arrangements Grandfathered Under the Final Split-Dollar Regulations: Equity Collateral Assignment Arrangements. A big question that has arisen is how the IRS would apply the new §409A to split-dollar arrangements "grandfathered" under the split-dollar regulations, specifically the so-called "equity collateral assignment" arrangements. The Notice begins to address this question by stating that such an arrangement could provide for deferred compensation under IRC §409A if "the employee has a legally binding right during a taxable year to compensation that pursuant to the terms of the arrangement is payable to (or on behalf of) the employee in a later year (for example, upon termination of the split-dollar arrangement)" and does not qualify for any exception under IRC §409A.

However, the Notice repeats the assurance that it provided in IRS Notice 2002-8, that "in cases where the value of current life insurance protection is treated as an economic benefit provided by a sponsor to a benefited person under a split-dollar life insurance arrangement [such as a grandfathered equity collateral assignment arrangement], the IRS will not treat the arrangement as having been terminated for so long as the parties to the arrangement continue to treat and report the value of the life insurance protection as an economic benefit provided to the benefited person." The Notice also provides that for purposes of IRC §409A, the IRS will not consider a transfer to have been made upon termination of such an arrangement (thus no deferral of income) nor will it treat the provision of life insurance coverage during the term of the arrangement to be deferred compensation.

Proportional Allocation Rules. For those split-dollar arrangements that are both subject to §409A and which contain a component that is 409A grandfathered and a component that is not 409A grandfathered, the Notice provides that any reasonable method for proportionally allocating the earnings subject to IRC §409A can be used. The Notice also provides a method that may be considered reasonable: the grandfathered component, including earnings is equal to the greater of (1) vested policy cash value of the policy as of December 31, 2004 (net of security for loans to the employer) and (2) the portion of the policy cash value equal to the proportion of pre-2005 premiums divided by total premiums paid.

Material Modifications to Split-dollar Arrangements. Finally, the Notice provides that for purposes of IRS Reg. 1.61-22(j) (which applies the final split-dollar regulations to arrangements entered into or materially modified after September 17, 2003), split-dollar arrangements determined by taxpayers to be subject to IRC §409A that are modified solely to be brought into compliance with IRC §409A will not be treated as materially modified. However, because the Notice does not generally subject grandfathered equity collateral assignment or pure death benefit endorsement arrangements to Section 409A, this transitional protection would appear to benefit only equity endorsement arrangements.

1. See Notice 2005-1.
2. See Section 409A(b) of the tax code. Under Notice 2006-33, the IRS provided relief for assets set aside or transferred on or before March 21, 2006, if the plan comes into conformity with Section 409A(b) and any other guidance issued by December 31, 2007.
3. Alternatively, the plan may also provide that an employee is disabled if determined to be disabled by the Social Security Administration or in accordance with a disability insurance program.
4. The regulations also define the following terms related to change of ownership/control of a corporation:
   Corporation – 1) a corporation for whom the employee is providing services at the time of the change of control, 2) a corporation (or corporations) that is liable for the payment of the deferred compensation, or 3) a corporation that is a majority shareholder of a corporation defined in 1) or 2).
   Majority Shareholder – a shareholder that owns more than 50% of the total fair market value and voting power of a corporation.
   Gross fair market value – the fair market value of the assets of the corporation being disposed of without regard to any liabilities.
   Attribution rules – The family attribution rules of Section 318(a) also apply to determine stock ownership.
5. Acceleration may be permitted if the determination indicates that: 1) divestiture of the financial interest or termination of the financial arrangement is reasonably necessary to comply with any federal conflict of interest statute, regulation, rule or executive order, or is requested by a congressional committee as a condition of confirmation; and 2) specifies the financial interest to be divested or terminated.
6. Under Notice 2005-94, amounts currently includible in income (as opposed to deferrals) may need to be reported on a corrected tax return for 2005 in accordance with future published guidance.

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