

PEBA
Section 409A Final Regulations:
Actions for 2007

SERPs, Restoration Plans, Salary Deferrals, and Separation Pay

May 17, 2007

Agenda

- Background
- Types of arrangements covered
- Initial deferral elections
- Time and form of payment
- Key employees/delayed payments
- Subsequent changes in time or form of payment
- Coordination of amounts between qualified and nonqualified plans
- Coordination of amounts between 401(k) plan and nonqualified plan
- Transition relief applicable to all plans – 2007 required action
- DB restoration plans and DB SERPs – 2007 required action
- 401(k) restoration plans and DC SERPs – 2007 required action
- Exempt and non-exempt separation pay
- Closing thoughts

Background

- Section 409A was added to the Internal Revenue Code by the American Jobs Creation Act of 2004 and is generally effective for deferrals after 2004
 - Deferrals earned and vested before 2005 not subject to 409A
 - Vested deferrals prior to 2005 subject to 409A if materially modified
- Key elements of section 409A restrictions:
 - Scope – what is deferred compensation
 - Initial elections on deferral amount, time and form of payment
 - Time of payment (i.e., payment triggers)
 - Subsequent changes in time and form of payments
- Final regulations issued April 10, 2007 and become effective January 1, 2008
 - Both plan documents and plan operations must comply by this date

Background (continued)

- Before 2008 employers must operate plans in accordance with reasonable, good faith compliance standard
 - Must satisfy terms of statute and Notice 2005-1
 - May satisfy terms of proposed regulations or final regulations as good faith safe harbor
- Special transition rules apply to facilitate changes needed to comply with final regulations
 - Most recently described in Notice 2006-79 (see memo 9869)
 - Centerpiece is ability to change time and form of payment without normal 409A restrictions
 - Cannot bring payments into 2007 or defer 2007 payments to later

Background (continued)

- Section 409A says that all monies deferred under a nonqualified deferred compensation plan that are not subject to a “substantial risk of forfeiture” are taxable immediately unless they follow the rules and requirements of Section 409A
- Nonqualified deferred compensation defined very broadly
 - Any time an individual acquires a “legally binding right” to compensation payable in a subsequent tax year
- Section 409A does not explicitly limit the amount of compensation an individual may defer

Types of arrangements covered

- Arrangements covered by Section 409A
 - Deferrals of salary, bonus and other incentive compensation
 - Defined benefit and defined contribution SERPS (including nonelective arrangements)
 - Defined benefit and defined contribution restoration plans (including nonelective arrangements)
 - Some equity-based compensation; e.g., stock units
 - Discounted nonqualified stock options or those with a “deferral feature”
 - Arrangements providing for the deferral of equity gain
 - Change in control agreements
 - Severance plans
 - Individual agreements that involve the deferral of compensation
 - Deferred payment arrangements for outside directors

Types of arrangements not covered

- Arrangements not covered by Section 409A
 - Nonqualified stock options that are not discounted and do not have a deferral feature
 - Stock appreciation rights
 - Restricted stock (but not stock units) that does not have a deferral feature
 - Incentive stock options
 - Stock purchase rights under 423 plans (i.e., broad-based employee stock purchase plans)
 - Annual bonuses or other annual compensation paid within 2 ½ months after close of year services performed
 - Severance and other post termination payments paid within 2 ½ months after close of year when severance or payment right event occurs
 - Tax-qualified plans (e.g., 401(k), broad-based pension plans)

Initial deferral elections

- The deadline by which the deferral and/or the time and the form of eventual payment first must be “irrevocably” established
 - Most relevant to plans that give participants choices
 - E.g., election whether to defer salary under 401(k) restoration plan
 - E.g., election among optional forms of payment under DB SERP
- Requirement also applies to plan without participant election as to time or form
 - Payment terms must be established at time obligation to pay arises or, if later, deadline for participant election had one been provided under the plan
- Participant election generally required before start of first calendar year the compensation to be deferred is earned
 - For compensation based on employer fiscal year, may be made before start of relevant fiscal year
 - Fiscal year compensation must relate to period coextensive with one or more fiscal years
 - This rule not available for bonuses based on a calendar year or salary

Initial deferral elections (continued)

- Exception for “performance-based” compensation that satisfies certain conditions
 - Elect at least 6 months before end of performance period
- Participant election within 30 days after obtain legally binding right provided at least 12 months of service still required to vest when election made
- Newly eligible participants have 30 days to elect
 - Plan aggregation rules apply for purposes of determining if newly eligible
 - Elective and non-elective account balance plans not aggregated under final rules
 - Election can only apply with respect to compensation paid for services performed subsequent to the election (special rule for bonus pay)

Initial deferral elections (continued)

- Plan terms dictate eligibility
 - Occurs at time when first eligible to accrue an amount without employer action
 - Ignore lack of employee election to accrue (or election not to accrue)
- Special rule for nonelective excess benefit (i.e., restoration) plans
 - Deadline is 30 days after start of calendar year after calendar year accruals commence
 - Election applies to prior accruals as well as future accruals
- For arrangements that are elective or not pure restoration plans under which individual elects time and/or form of payment
 - Obtain election before start of calendar year from individuals who are likely to become participants in upcoming year
 - Apply default terms subject to election to further defer by participant or among actuarially equivalent life annuities
 - Apply 30 day/12 month forfeitability rule if plan imposes vesting conditions
 - Apply default election for first 30 days of accruals and then apply individual's election to future accruals (but may be difficult to administer)

Time and form of payment

- 409A restricts when payments may commence
 - Payment prohibited before fixed calendar date or limited list of events
 - Separation, death, disability, change in control or unforeseeable emergency
 - “Key employees” of publicly traded companies subject to added six-month delay for separation payments
- Detailed standards provided in regulations to determine a separation from service
- Must designate event-based payments at objectively determinable:
 - date(s) (e.g., first day of third month commencing after separation)
 - calendar year(s) (e.g., first three years following a separation)
 - Period(s) within designated calendar year(s) or not more than 90 days
- Payment permitted on “earlier of” or “later of” permissible triggers

Time and form of payment (continued)

- Payment considered timely if occurs:
 - later in same calendar year or, if later, within 2½ months after specified payment date
 - No more than 30 days before specified date (except for key employee subject to six-month delay on separation)
 - During first calendar year calculation is administratively practicable
 - Under conditions specified under special rule for refusals to pay (which now covers unintentional failures to pay as well as affirmative disputes)
- Generally, event-based payments must have same timing and form regardless of nature of event or when it occurs
 - Example: all payments upon separation must be same without distinction between “retirement” and other types of separations (except death or 409A disability)

Time and form of payment (continued)

- Plan can provide different payment schedule for each different event
- A plan may provide for alternative payment schedule depending on occurrence of event before or after a **single** date
 - For example, a lump sum is paid if the participant separates from employment before age 55 and a lifetime annuity is provided if separation occurs on or after age 55
- For separation-based payments only, may provide for alternative schedule:
 - For separation within two years after a CIC and
 - For separation before or after one (but not both) of the following:
 - A specified date (as described above)
 - A specified combination of a date (age) and service
 - Service must be determined under objective formula or under qualified plan
- Will age-based distinctions raise ADEA concerns?

Key employees/delayed payments

- A key employee is determined on a 12-month look back period ending on December 31 unless employer designates another date
- Must use same determination period for all 409A arrangements
- Key employees are generally top-50 officers with 2005 compensation greater than \$135,000 (2006 figure is \$140,000; 2007 figure is \$145,000)
 - Can use any available definition of compensation under section 415 for this purpose
- A participant who meets the key employee standards during twelve month look back period will be a key employee for the twelve months beginning on the first day of the fourth month following the end of the look back period
 - For example, a plan uses calendar year as the look-back period. For the 12-month period of April 1, 2007 through March 31, 2008, the look back period is the 2006 calendar year. Any participant who meets the key employee standard during the 2006 calendar year will be a key employee and subject to the six month distribution delay if such participant separates from employment from April 1, 2007 through March 31, 2008
 - Employer can designate earlier (but not later) effective date after each 12-month period – and must be consistent for all 409A arrangements

Key employees/delayed payments (continued)

- Employer can use either of two alternative definitions of key employees:
 - designate all employees as key employees OR
 - Use another objective definition that:
 - Is reasonably designed to include all key employee (determined under normal definition) and (per preamble) must actually do so in operation AND
 - Covers no more than 200 employees
- Plan may implement the delay as a complete delay in the actual commencement of any and all benefits or provide for a catch up of the missed payments in the seventh month
 - The plan must specify how the delay will be implemented
- Publicly traded on an “established securities market”
 - Includes foreign national securities exchange which is officially recognized, sanctioned, or supervised by governmental authority
- Employer can choose whether to include non US income
- Special simplified rules are provided for key employee determination after corporate transactions

Subsequent changes in time and form

- Accelerated payments generally prohibited, with limited exceptions (e.g., small cash-out below 402(g) dollar limit)
- Re-deferral (i.e., change in time or form of payment) allowed subject to conditions:
 - Election doesn't take effect for at least 1 year
 - Payments (except due to death, disability or unforeseeable emergency) with respect to election must be deferred for at least 5 years from date payment would otherwise have been made
 - If payment is at a specified calendar date, election must be made at least one year before date of first scheduled payment

Subsequent changes in time and form (continued)

- Re-deferral rules don't apply to actuarially equivalent life (and J&S) annuities
 - Life annuity is series of substantially equal periodic payments for life or joint lives
 - Ignore following features to determine whether a life annuity: (i) term certain, (ii) pop-up, (iii) cash refund, (iv) social security leveling feature, (v) COLA feature
 - Must take these into account to determine actuarial equivalence
 - Can use any reasonable actuarial assumptions, applied consistently to all life annuities
 - Subsidized joint & survivor annuities also qualify if periodic payments to participant and survivor not more than periodic payments under SLA
 - Election can be made any time before payments begin subject to constructive receipt rule
- Special definition of “payment”
 - Series of substantially equal installments treated as single payment or, if specified in plan, multiple separate payments
 - Life annuity must be treated as single payment

Subsequent changes in time and form (continued)

- Can change installments (treated as single payment) or life annuity into lump sum, subject to 1/5 year rule, without application of “no acceleration” rule. For example:
 - Participant who elected a life annuity payable at age 65 can elect to redefer payment to a lump sum payable at age 70 (but can't offer choice between a lump sum and an annuity both at same commencement date)
 - Five year installment payable commencing in 2008 could be redeferred as a lump sum payable in 2013 if plan treats as a single payment
 - Five year installment payable in 2008 through 2012 designated to consist of five separate payments cannot be redeferred to a lump sum payable in 2013 since installments 2009 through 2012 will not be redeferred five years but the 2008 installment only could be redeferred to be payable in 2013
 - Exception cannot be used to accelerate commencement date, only payment schedule

Coordination of amounts between qualified and nonqualified plans

- Increases or decreases in tax qualified plan benefits that affect benefit amounts in SERPs and restoration plans generally are not deemed to constitute impermissible deferrals or accelerations of SERP or restoration plan benefits
 - Plan amendments that freeze or increase tax qualified plan benefits and SERP switches appear permissible
 - Changing subsidized or ancillary benefits under tax qualified plan permissible
 - Participant choices on subsidized benefits under tax qualified plan also do not create 409A concerns
- In the case of an unforeseeable emergency distribution from nonqualified plan or a hardship distribution from a qualified 401(k) plan, the nonqualified plan can provide for the cancellation of the individual's deferral election

Coordination of amounts between 401(k) plan and nonqualified plan

- A direct link between contributions under qualified 401(k) plan and nonqualified plan is subject to limits
- A participant's increasing, decreasing or suspending pre or post tax deferrals under a tax qualified 401(k) plan will not constitute a deferral or acceleration of a payment under a coordinated 401(k) restoration plan provided:
 - Maximum impact on change in amounts electively deferred under restoration plan cannot exceed the annual tax qualified 401(k) plan elective deferral limit (e.g., \$15,500 in 2007)
 - The time or form of payment under the restoration plan are not affected
- Maximum impact on change in any matching contributions cannot exceed 100% of the match that would be provided under the qualified plan absent IRC limits
 - Matching contributions are either forfeited or never credited under the restoration plan if no participant deferrals were made
 - Is possible this will be revised to provide for separate 402(g) limit, if greater
 - Can this be used by DB SERP to offset qualified plan matching balances?

Coordination of amounts between 401(k) plan and nonqualified plan (continued)

- 409A restrictions in conjunction with the contingent benefit (i.e., anti-conditioning) rule will likely make it difficult to coordinate a 401(k) restoration plan that includes employee deferrals with participant-specific qualified plan elections
 - One approach would be the wrap-around 401(k) restoration plan described in example in proposed regulations
 - All deferrals initially go into the restoration plan
 - At year end, maximum amounts are transferred back into qualified plan
 - Other approaches seem problematic or too limited
- It appears that restoration plans that provide a match only (i.e., no employee deferrals) can remain linked with actual 401(k) plan match as long as the match does not exceed the qualified plan match determined without limits
 - But need to condition any NQ match on 401(k) participation at maximum level

Coordination of amounts between 401(k) plan and nonqualified plan (continued)

- Many sponsors may conclude that the difficulty and risk of including employee deferrals in a linked 401(k) restoration plan are not worth the benefit. Options to address include:
 - Match only in restoration plan, subject to anti-conditioning requirement
 - Allow unlinked employee deferrals and provide a match that is offset by the maximum amount possible (rather than the actual amount made) under the qualified plan

Transition relief applicable to all plans – 2007 required action

- Determine arrangements subject to 409A
- During 2007 may continue to operate any plan subject to 409A in good faith compliance with new rules, subject to transition relief
 - Not required to document good faith compliance or all actions taken
- Make final design decisions needed to comply with or be exempt from 409A effective January 1, 2008
- Establish and execute plan for communicating changes to employees
 - Includes obtaining elections, if appropriate
- Changes in time or form of payments to be made after 2007 can be made through December 31, 2007 without 409A restrictions
 - Depending on terms of plan, payment terms may be elective or established by employer
 - Constructive receipt principles still apply to extent participants given choice
 - In many plans this may actually be initial election of time and form of payment
 - Relief not available with respect to payments required in 2007
 - Cannot accelerate post 2007 payments into 2007

Transition relief applicable to all plans – 2007 required action (continued)

- Time and form of payment can continue to be coordinated with tax qualified plan payments through 2007 if nonqualified plan provided for linkage on October 3, 2004
 - Plans that use linked elections with qualified plans can apparently make distributions to key employees through 2007 without applying six-month delay
 - Will need independent payment terms for payments in 2008 and later
 - Independent election timing needs to be sensitive to constructive receipt issues for payments that first commence shortly after 2007
- Review administrative procedures and systems
 - Very limited tolerance under 409A for operational defects
- Decide how key employees will be determined (must be consistent for all plans)

Transition relief applicable to all plans – 2007 required action (continued)

- Compliance amendments are required by December 31, 2007
 - Material terms must be in writing in one or more documents and must address:
 - The amount deferred (or method or formula to determine amount)
 - The time and form of payment
 - Initial deferral election provisions (if any)
 - Subsequent deferral election provisions (if any)
 - Six-month delay in key employee payments (if applicable)
 - Good practice to document key employee determination and required if you don't use default rules
 - In future years, material terms of new plans must be written by end of calendar year in which legally binding rights arises, although extra 2½ months are available in some cases
 - Acceleration exceptions (e.g., for QDRO) generally don't need to be incorporated into document in advance of actual use
 - Plan aggregation rules not applicable to plan document failures

Transition relief applicable to all plans – 2007 required action (continued)

- Regulations offer limited ability to terminate and pay-out any plan benefits
 - A number of conditions apply:
 - Discretionary termination/liquidation cannot be proximate to downturn in financial health
 - Required to terminate all plans that would be aggregated under 409A
 - Benefits can generally be paid only within the 13th and 24th month period following termination (except benefits that would otherwise be paid)
 - Must wait three years before establishing another plan of the same type
 - More favorable rule applies to termination/liquidation in connection with a CIC, dissolution or bankruptcy

Transition relief applicable to all plans – 2007 required action (continued)

- Transition rules can be used during 2007 to achieve similar effect
 - Modify payment terms to require full payment of all benefits in lump sum at specified date in 2008
 - Must continue scheduled payments through 2007
 - Note, this will not avoid need for some 409A compliance
 - Plan document must be amended to reflect 409A material terms
 - Time/form of payment in 2008 (or later) must satisfy 409A
- If changing time of payment on an event basis, do not make effective until January 1, 2008 to avoid impermissible acceleration into 2007

DB restoration plans and DB SERPs – 2007 required action

- Continue to operate any plan subject to 409A in good faith compliance with new rules subject to transition relief
- Remember that 409A doesn't apply to grandfather amounts
 - Equals the vested, present value as of December 31, 2004 of the amount available to participant if voluntarily terminated on December 31, 2004 and received benefits with the maximum value on the earliest possible date allowed under plan following termination of service
 - Increased for passage of time based on December 31, 2004 interest rates
 - Can reflect option elected and, likely, subsidies aged into (but not serviced into)
- Use transition rules by December 31, 2007 to make (or offer) one last change in time and form of payment without 409A restrictions with respect to any distributions scheduled or anticipated to be paid in 2008 or later
 - Constructive receipt principles still apply to extent participants given choice
 - Plans that have previously solicited and received participants elections under the transition rules in 2005 and 2006 can do so again in 2007

DB restoration plans and DB SERPs – 2007 required action (continued)

- For non-elective restoration plan, for the period beginning in 2008, decide whether to give new participants an election as to form (or time)
 - Can new participants be identified within 30 days after start of first calendar year after year in which benefits accrue?
- Decide on default terms for form (or time) of payment
 - Decide whether to alter form based on separation before or after a fixed date (e.g. age) or fixed date (age) and service combination
- Decide whether to offer participants subsequent right to change form (or time)
 - Subject to 12-month/5-year general rule (e.g., life annuity at separation can be changed to lump sum payable 5 years after separation) OR
 - Among actuarially equivalent life annuities (or subsidized J&S)

401(k) restoration plans and DC SERPs – 2007 required action

- Continue to operate any plan subject to 409A in good faith compliance with new rules subject to transition relief
 - For example, do not permit penalty or haircut voluntary withdrawals of deferred amounts not grandfathered
 - Elective deferrals of compensation to be earned in 2008 generally must be made by December 31, 2007 (other than items subject to delayed deadline such as performance-based pay)
- Remember that 409A doesn't apply to grandfather amounts (i.e., vested account balance as of December 31, 2004 plus earnings)
- Use transition rules by December 31, 2007 to make (or offer) one last change in time and form of payment without 409A restrictions with respect to any distributions scheduled or anticipated to be paid in 2008 or later
 - Constructive receipt principles still apply to extent participants given choice
 - Plans that have solicited participants elections under the transition rules can do so again in 2007
- Delayed distribution election deadline for new participants is available in a non-elective excess plan

401(k) restoration plans and DC SERPs – 2007 required action (continued)

- Decide whether allocations under a 401(k) restoration plan should be directly linked to contributions under the 401(k) plan
 - Need to require maximum employee contributions to 401(k) plan before contributions may be made to restoration plan
 - Alternative is to reduce restoration plan benefit by hypothetical match available under 401(k) plan without regard to actual match allocated to participant
- Decide on default terms for form (or time) of payment
 - Decide whether to alter form based on separation before fixed date (e.g., age) or date (age) and service combination
 - Decide whether to treat any installments as a “single” payment or separate payments
 - Decide whether to offer different distribution form or time for distinct portion of account balance
- Decide whether to offer participants subsequent right to change form (or time)
 - Subject to 12-month/5-year general rule; e.g., 10 annual installments at separation (treated as single payment) can be changed to lump sum 5 years after separation

Exempt separation pay

- Involuntary severance paid in lump sum or otherwise within the limited time required for short-term deferral (i.e., within 2 ½ months after end of year in which separation occurs) is exempt from 409A
- Collectively bargained severance plans covering involuntary terminations or terminations pursuant to window program exempt
- Involuntary termination and window programs for non-represented employees are exempt in amount up to two times the lesser of individual's total annual compensation or 401(a)(17) pay limit as adjusted for inflation (\$450,000 in 2007) provided this amount is paid within two calendar years starting after the year separation from service occurs
 - Exemption applies to first \$450,000 even if total exceeds dollar limit
 - Can choose (carefully) what items to apply against \$450,000 exemption

Exempt separation pay (continued)

- Deferred compensation does not include outplacement and moving expenses or reimbursement of deductible expenses to the extent that these amounts are incurred before the end of the second calendar year following termination and reimbursed by employer before the third such calendar year
- Reimbursement of taxable medical expenses to the extent incurred during COBRA period
- Any nontaxable benefits; e.g., non-taxable post-employment medical benefits
- Aggregate severance payments not exceeding basic 402(g) limit (\$15,500 in 2007) automatically exempt from 409A under a de minimis exception

Non-exempt separation pay

- Must comply with 409A requirements (e.g., six-month delay in payments to key employees, W-2 reporting, etc.)
- In the case of voluntary or involuntary termination, where separation pay is the subject of bona fide, arm's length negotiations, initial deferral election may be made at any time up to the time individual obtains a legally binding right to the payment
- In the case of window program, initial deferral election may be made at any time up to the time the election to participate in the program becomes irrevocable
- Taxable reimbursements of non-exempt medical or other expenses deemed paid on fixed date(s) if:
 - Plan provides objectively, determinable definition of eligible expenses
 - Plan specifies period during which reimbursable expense must be incurred (e.g., for life)
 - Reimbursement made by close of calendar year after the year in which incurred
 - Reimbursement right not subject to liquidation or exchange
 - Amount eligible for reimbursement in one year cannot affect amount eligible in another year
 - Multi-year limit (e.g., lifetime cap) on medical expense reimbursements is acceptable

Closing thoughts

- There is much work to be done on virtually every non-qualified retirement plan
 - Any plan that offers the choice between an annuity and a lump sum
 - Any plan that offers a choice between current and deferred payment
 - Any plan that links to a qualified plan
- The regulations appear to have little tolerance for non-compliance and/or operational defects
 - Issues with respect to 2005-2007 improper payments may be identified
 - Currently no means of addressing these other than paying appropriate taxes
 - Some discussion of VCP type program but does not seem likely
 - Simplified designs may be preferable to minimize operational defects
- All actions must be completed by December 31, 2007
 - Make decisions/gain management approvals
 - Amend plans
 - Communicate/ gather elections
 - Modify administrative practices and systems
- You can not afford to wait to address these issues