
Election and Distribution Rules under the Final Section 409A Regulations

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Overview

The IRS recently issued final regulations under Section 409A of the Internal Revenue Code (the Code) related to nonqualified deferred compensation. While the final regulations include many clarifications, small wording changes and new examples, the new rules retain the same general approach taken by the proposed Section 409A regulations with respect to the timing of deferral elections and the distribution of deferred amounts. In particular, the final regulations provide that:

- an election to defer compensation must be made in the year before the services with respect to such compensation are performed, unless a specific exception applies;
- compensation that is deferred may only be distributed on a specified payment date; a separation from service; death; disability; a change in control; or an unforeseeable emergency; and such event must be designated at the time the deferral election is made; and
- once compensation has been deferred, its payment may not be accelerated (unless a specific exception applies) or subsequently deferred (unless strict second election rules are obeyed).

This alert focuses on the rules in the final regulations related to the timing of deferral elections and the time and form of payment of deferred compensation, and provides our recommendations for bringing your arrangements into compliance with the new rules.

Background

The American Jobs Creation Act of 2004 (the Act) added Section 409A to the Code, which provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in income, unless strict timing and documentary requirements are satisfied. A violation of Section 409A results in the assessment of a 20% tax and interest on the employee or service provider, in addition to regular income and employment taxes.

The final regulations are scheduled to become effective on January 1, 2008, by which date all

nonqualified deferred compensation arrangements must be in documentary compliance with the final regulations. Until that date, all such arrangements must be operated in good faith compliance with the final regulations, the proposed regulations or other guidance issued under Section 409A.

Timing of Elections – Initial Deferral Election Rules

The final regulations retain the general rule that an initial deferral election with respect to compensation must be made in the year before the services with respect to such compensation are performed. Moreover, service recipients may not retain any right to override a deferral election made by a service provider. There are some special situations that vary the time at which deferral elections must be made. These exceptions are discussed below.

Initial eligibility. Section 409A provides that a deferral election may be made within 30 days following the date that a service provider is first eligible to participate in the plan, provided that the election may only apply to compensation earned following the date of the election. The final regulations continue to apply rules requiring that all similar plans be aggregated (the plan aggregation rules) to determine a service provider's first date of eligibility. However, the plan aggregation rules have been modified so that the exception for initial eligibility is more likely to be available than it was under the proposed regulations. The final regulations also provide relief to service providers who become newly eligible to participate in excess benefit plans and to certain service providers who are rehired.

Deferral of forfeitable rights. The final regulations allow a service provider to defer receipt of a payment within 30 days of the date the service provider acquires a legally binding right to such payment, provided that the right to the payment is conditioned on the continued services for a period of at least 12 months from the date the service provider acquires the legally binding right to the payment. For example, an employer grants an employee a bonus on January 1, 2008, which is to be paid on January 1, 2010, provided that the employee continues to be employed through such date. The employee may elect to defer the compensation on or before January 31, 2008 (30 days from the date the service provider acquires the legally binding right to the payment).

Nonelective deferrals. In the case of payment arrangements that do not permit the service provider to elect the time and form of payment, the final regulations provide greater flexibility for service recipients to satisfy the requirement to designate a time and form of payment for compensation. The final regulations now permit such designations to be made by the service recipient before the later of (i) the latest date that the service provider could have made an election (if an election had been provided to the service provider), and (ii) the date that the service recipient grants the legally binding right to the compensation.

Deferral of short-term deferral awards prior to vesting. The final regulations allow a service provider to defer payments that would qualify as short-term deferrals, provided that the election to defer is made at least 12 months before the date the substantial risk of forfeiture lapses, and the deferral election designates a payment date that is at least five years after that date. For example, an employer grants an employee a bonus on January 1, 2008, which is to be paid on January 1, 2010, provided that the employee continues to be employed through such date. The employee may elect to defer the compensation on or before January 1, 2009, provided that the election delays the

payment to a date on or after January 1, 2015 (five years from the date the substantial risk of forfeiture lapses).

Performance-based compensation. In general, deferral elections with respect to performance-based compensation determined over a 12-month period must be made no later than six months before the end of the performance period, provided that (i) the service provider performs services continuously from the later of the beginning of the performance period and the date the performance criteria are established through the date of the election, and (ii) in no event may the deferral election be made after the amount of the compensation is readily ascertainable. The final regulations allow an award to be bifurcated (part performance-based compensation, part non-performance-based compensation), as long as the performance-based compensation portion is separately identified or designated and determined separately under the plan. The final regulations also provide that an award will not fail to qualify as performance-based compensation merely because it allows for automatic payment in the event of death, disability or a change in control. However, it should be noted that an award could fail to qualify as performance based if it provides for automatic payment on termination of employment irrespective of performance.

Fiscal year compensation. Compensation that is payable based on a service recipient's fiscal year, which varies from the service provider's taxable year, may be deferred, provided the deferral election is made before the end of the service recipient's fiscal year immediately preceding the year before the services are performed. This election is only available for compensation based on the service recipient's fiscal year, and is not available for amounts paid during the fiscal year, such as salary.

Distributions of Compensation – Time and Form of Payment Rules

In general, a specific time and form of payment must be established with respect to payments of deferred compensation when the deferral is made. The "time" refers to the date that distributions of the compensation commence—alternatives include a specified payment date; separation from service; disability; death; change in ownership or control of a corporation; and unforeseeable emergency. Although these alternatives may appear to be self-explanatory, each (except death) has a special meaning set forth in the regulations, coupled with complex rules regarding its usage. The final regulations permit payments to be made in connection with the dates and events listed above, provided the payments are made by the later of (i) the end of the calendar year in which the payment date occurs, or (ii) the 15th day of the third month following the end of the year in which the payment date occurs. (However, it should be noted that payments on account of a separation from service to certain key employees of a public company are subject to a six-month delay.) As in the proposed regulations, the final regulations allow an entire taxable year to be considered a "specified payment date." The "form" of the payment refers to whether the amount is paid in a lump sum or over a period of time.

Delay in payment by the service recipient. In certain cases, delays in payment by the service recipient are permitted. For example, the final regulations permit a payment to be delayed due to certain business concerns, provided that the business concern (such as cash flow issues) is articulated by means of an objective, nondiscretionary formula. Also, the final regulations include a "going concern" test so that if the making of a scheduled payment is delayed because making the

payment “would jeopardize the ability of the service recipient to continue as a going concern,” then the payment would still be considered to have been made on the scheduled payment date, provided the payment is made in the first year in which the concern is eliminated. Delay in payment is also allowed to avoid the compensation deduction limitation under Section 162(m).

Prohibition of accelerated payments. Acceleration of payments is generally prohibited under Section 409A, unless a specific exception is available under the regulations (e.g., pursuant to a domestic relations order; for payments of employment taxes or state, local or foreign taxes; or for payments upon income inclusion under Section 409A). A payment made to a service provider to substitute for a payment of deferred compensation may be viewed as an accelerated payment of the deferred compensation. Similarly, if a payment of compensation is made in exchange for the forfeiture of a future payment of deferred compensation, the payment in substitution may be considered a payment of the deferred compensation.

Subsequent changes in time and form of payment. The final regulations allow service providers and service recipients (together or alone) to make changes to the time and form of payment, provided that certain requirements are met. Any such changes must be made at least 12 months before the payment is to be made. The deferral period must be at least five years where the deferred payment is to be made upon separation from service, change in control or with respect to a specific payment date or schedule.

Recommendations

Clients should review or have reviewed all plan documents and deferral election forms to ensure compliance with the rules regarding designation of time and form of payment. Documentary compliance must occur no later than December 31, 2007. Additionally, clients should consider whether to give service providers a final opportunity to change existing payment distribution elections prior to December 31, 2007, to the extent permitted by the Section 409A transition rules. And finally, clients should consider whether certain payments made to service providers could be connected to forfeitures or future payments of deferred compensation, as such payments could be considered as impermissible accelerations under Section 409A.

For more information on this or other tax matters, please see our [tax publications](#), or contact:

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