

Section 409A and the Impact on Nonqualified Retirement Plans



On April 10, 2007 the Internal Revenue Service issued final regulations under Section 409A. These regulations implement the rules for unfunded, non-qualified deferred compensation plans that were enacted as part of the American Jobs Creation Act of 2004. The regulations are effective as of January 1, 2008.

IRC Section 409A provides rules governing elective deferrals of compensation, the form and timing of distributions and the use of rabbi trusts as funding vehicles. If a deferred compensation plan complies with all of the applicable requirements, its tax treatment is the same as in the past, in which deferred amounts were taxed on actual or constructive receipt if the services were performed for a taxable entity; or upon vesting if the services were performed for a tax-exempt entity.

Plans that do not comply in form or operation will be subject to immediate taxation on all current and previously deferred amounts, plus an additional 20% penalty and underpayment of interest on previously deferred amounts.

Section 409A imposes four broad conditions on plans that fall within its scope:

1. Deferral elections by service providers must be made before the beginning of the year in which the services related to the deferred compensation are performed. There is an exception for performance based compensation, where the deadline is six months before the end of the performance period.
2. The time and manner in which deferred compensation will be distributed must be specified at the time of deferral.
3. The distribution must begin on a date fixed in advance or be triggered by one of five specified events:
 - separation from service,
 - death,
 - disability,
 - change of control of the service provider, or
 - unforeseeable emergency.

Accelerated distributions are no longer permissible.

1. No amount may be set aside in an offshore rabbi trust for the purpose of making distributions.

It is imperative that your clients involved in deferred compensation plans be aware of the regulations and obtain appropriate guidance from legal and tax counsel regarding the effect that these rules have on deferred compensation plans.