

**Nonqualified Plans of Non-Profit Employers
and
New Code Section 409A**

by

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The Senate and the House recently approved the American Jobs Creation Act of 2004 (the "Act"). The Act makes significant changes in the federal tax laws that apply to nonqualified deferred compensation plans ("NQDC plans"). This legislation has been sent to the President and is expected to be signed into law before the end of October 2004. The Internal Revenue Service ("IRS") is expected to issue initial guidance on the new legislation prior to year end.

The Act adds a new section 409A to the Internal Revenue Code of 1986, as amended ("Code"). Plans covered by new Code section 409A are subject to a variety of new requirements, including rules on the timing of deferrals, distributable events and elections to change the timing or form of distributions. If NQDC plans do not meet these new statutory requirements, then all the compensation deferred under the plans will become includible in the employee's gross income to the extent that it is not subject to a substantial risk of forfeiture. Interest at the underpayment rate in effect for the year of deferral plus one percentage point and an additional 20% tax will be assessed.

Note: This summary only addresses the provisions in new Code section 409A that are of interest to non-profit employers. Additional rules and provisions apply to for-profit employers, but these additional rules are not discussed in this summary.

Background on NQDC Plans of Non-Profit Employers

Before analyzing the applicability of new Code section 409A to NQDC plans maintained by non-profit employers, it is important to review the application of Code section 457 to such employers. The Tax Reform Act of 1986 subjected the NQDC plans of all tax-exempt employers to Code section 457. In 1988, the Technical and Miscellaneous Revenue Act exempted NQDC plans maintained by certain employers, including churches and qualified church-controlled organizations, or "QCCOs," from the application of Code section 457. NQDC plans of these employers could be maintained under the more favorable, traditional rules governing such plans instead of the more restrictive Code section 457 rules. However, NQDC plans maintained by most non-profit employers, including those maintained by "non-QCCOs" (e.g., church-affiliated hospitals, colleges, universities and nursing homes) have been subject to Code section 457 since 1986 and continue to be subject to its requirements.

There are two types of section 457 plans – "eligible" 457 plans meeting the requirements of Code section 457(b) and "ineligible" 457 plans described in Code section 457(f). Eligible 457(b) plans are subject to a number of requirements, including contribution limits, minimum required distribution rules, and distribution event restrictions. Ineligible 457(f) plans are not subject to any such limitations. These plans

more closely resemble traditional NQDC plans, except that amounts deferred under such plans must be subject to a substantial risk of forfeiture in order to escape current taxation. With that background, we move to a consideration of new Code section 409A.

Scope of Section 409A Coverage

Code section 409A is broadly written so that it applies to any plan, agreement or arrangement that provides for deferral of compensation. It is important to note that this new provision is not limited to employer-employee plans or agreements, but also covers agreements or arrangements with independent contractors. Certain “qualified plans” are exempt from coverage by the new statutory provisions. This exemption applies to plans covered under Code sections 401(a) (which includes 401(k) cash or deferred arrangements), 403(b) and 457(b).¹

There are several other limited exemptions from coverage under Code section 409A. Code section 409A does not apply to the payment of annual bonuses or other annual compensation amounts paid within 2½ months after the close of the taxable year in which the relevant services required for payment have been performed. In addition, Code section 409A exempts bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plans from coverage. Severance pay plans, whether or not bona fide, are not, however, excluded.

Section 409A and 457 Plans

As noted above, section 457(b) plans are not subject to new Code section 409A.² Thus, the rules for eligible 457(b) plans maintained by tax-exempt employers (including non-QCCOs) have not been changed. However, any NQDC plan maintained by a non-profit employer which is exempt from coverage under Code section 457 (e.g., those maintained by churches and QCCOs) is subject to the new Code section 409A rules, described below.³

But what about Code section 457(f) plans? May non-profit employers, including non-QCCOs, maintain these so-called “ineligible” 457 plans outside of Code section 409A? The impact of the new Code section 409A rules on Code section 457(f) plans is

¹ In addition to these plans, the Act also exempts Simplified Employee Pension Plans (also known as “SEPs”) and SIMPLE IRA plans from coverage under Code section 409A.

² The House’s version of the NQDC legislation did cover Code section 457(b) plans, but the Conference agreement excluded these plans from coverage under Code section 409A.

³ Certain nonelective deferred compensation plans described in Code section 457(e)(12) and benefiting only independent contractors are also exempt from the new Code section 409A rules, if the plan was in existence as of May 1, 2004. However, if such a plan has a material change in the class of individuals eligible to participate after May 1, 2004, new Code section 409A will apply to deferrals made after the date of that change.

unclear. The Conference Report accompanying the Act makes it clear that Code section 457(f) plans are subject to the Code section 409A requirements. However, as noted above, to avoid current taxation, benefits under ineligible 457(f) plans are normally subjected to a substantial risk of forfeiture. But benefits under NQDC plans that do not meet the new Code section 409A requirements are not taxed immediately if the benefits are subject to a substantial risk of forfeiture. On first blush, it would therefore seem that 457(f) plans would not be affected by section 409A, even if they do not comply with the new section 409A rules. However, as noted above, current taxation of deferred benefits is not the only consequence applicable to the lapse of a substantial risk of forfeiture with respect to benefits paid under an NQDC plan subject to Code section 409A. Interest is imposed on taxes due with respect to prior year deferrals, along with a 20% additional tax. Code section 409A can be read to impose that same interest and additional tax on benefits paid under an ineligible 457(f) plan that does not comply with the new Code section 409A requirements.

Informal discussions with Congressional and Treasury staff initially indicated that, while this may be the result that Congress intended for some Code section 457(f) plans, the section 409A requirements may not be applied to a 457(f) plan with a straight-forward vesting schedule under which amounts become payable only after the completion of a specified period of service. However, subsequent conversations with staff indicate that the new section 409A rules may be applicable to 457(f) plans across the board. We hope that this issue will be addressed in any initial 409A guidance.

Initial Deferral Elections

Section 409A generally requires that an election to defer compensation earned during a taxable year must be made “during the preceding taxable year.” The time and form of distribution must be specified at the time of the initial deferral election. The Conference Report accompanying the Act states that an NQDC plan can either specify the time or form of payments, or it can allow the participant to elect the time and form of payment at the time of the initial election to defer. In either event, this determination must be made in advance of the deferral.

There are two limited exceptions to this basic requirement:

- *Newly Eligible Participants.* A newly eligible participant can make an election to defer compensation within the first 30 days of becoming eligible.
- *Certain Incentive Payments.* In the case of an election to defer the payment of “performance-based compensation” earned over a period of at least twelve months, the election must be made at least six months prior to the end of the period during which the performance-based compensation is earned. In order to be eligible for this exception, the performance-based compensation must meet two requirements: 1) it must be variable and based on preestablished

performance criteria;⁴ and 2) it must not be readily ascertainable at the time of the election to defer.⁵ Thus, an employee who is entitled to receive performance-based compensation for work performed from January through December of 2004 would need to have made an election to defer the payment of this compensation prior to June 30, 2004, unless the incentive compensation is both earned and vested before the end of 2004.⁶

The Conference Report indicates that multiple payout events are permissible. Thus, a participant could elect to receive 25 percent of their account balance at age 60 and the rest at age 65. Further, a participant could elect different forms of payment for different distribution events. For example, a participant could elect to receive a lump-sum distribution in the event of death or disability, but an annuity payment upon attaining age 65.

Subsequent Deferral Elections

A core provision in section 409A is the limitation on the ability of a participant to make changes in the time and form of distribution. Thus, section 409A contemplates that, subject to the limited exceptions described below, when and how deferred amounts will be paid from the plan must be clear at the time the amounts are deferred.

NQDC plans may allow a subsequent election to delay the timing or form of distribution only if the following requirements are met:

- The plan must provide that such an election cannot take effect until at least 12 months after the date of the election;
- The plan must require that any additional deferral be for a period of at least five years from the date the payment would otherwise have been made, except in the case of elections relating to distributions on death, disability, or unforeseeable emergency; and
- The plan must provide that any deferral election related to a payment to be made at a specified time or pursuant to a fixed schedule must be made at least 12 months prior to the date of the first scheduled payment.

Distributable Events

⁴ According to the Conference Report accompanying the Act, the performance criteria will be considered to be “preestablished” if they are set out in writing no later than 90 days after the commencement of the service period.

⁵ Any performance-based compensation that does not meet both of these requirements is subject to the less favorable rules which require that the election to defer payment must be made prior to the beginning of the taxable year in which the compensation is earned.

⁶ As discussed later in this summary, any amount earned and vested prior to the end of 2004 (whether or not it is performance-based compensation) generally is not subject to Code section 409A.

Amounts deferred under NQDC plans can be distributed only upon one of the following events:

- *Separation from service.* “Separation from service” is not defined in the statute, but Code section 409A directs Treasury to issue guidance on what constitutes a separation from service. Controlled-group aggregation rules are to be applied in connection with separation from service determinations. The Conference Report does not address the question of how controlled groups will be determined for non-profit employers.
- *Death.*
- *Disability.* “Disability” for purposes of section 409A is limited to the participant’s being disabled within the meaning of the Social Security Act, or the participant’s receiving income replacement benefits for at least three months under the employer’s accident or health plan due to a disability which can be expected to result in death or last for a continuous period of at least 12 months.
- *At a specified time or pursuant to a fixed schedule.* The specified time or fixed schedule must be specified at the time of the deferral election. The Conference Report accompanying the Act makes a distinction between amounts payable upon the occurrence of an event, which is not permissible, and amounts payable at a specified time, which is permissible. For example, the Conference Report states that an amount payable when a person reaches age 65 is payable at a specified time. In contrast, amounts payable when a person’s child begins college are payable upon the occurrence of an event.
- *An unforeseeable emergency.* Unforeseeable emergency under Code section 409A is modeled on a similar provision in Code section 457(b). It is not the same as the hardship distribution provisions applicable to Code section 401(k) plans or Code section 403(b) plans.
- *A change in ownership or effective control of the employer.*

Prohibition on Acceleration of Payments

Section 409A generally prohibits participants from accelerating payments under an NQDC plan. This prohibition includes any change in the form of payment that would result in an acceleration of payments. Thus, if the participant had elected to receive benefits in the form of an annuity payment, he or she could not later decide to take all or a portion of those annuity benefits in the form of a lump sum.

However, the Conference Report indicates that Congress expects Treasury to allow acceleration under very limited circumstances. The Report suggests the following possible exceptions that Treasury could consider:

- Acceleration required for reasons beyond the control of the participant and when the distribution is not elective (e.g., in the case of a court-approved divorce settlement).
- Situations involving choices between different forms of actuarially equivalent life annuity payments.
- Cash-outs of minimal amounts for purposes of administrative convenience (e.g., automatic distribution to a terminated employee if the account balance is less than \$10,000).
- Distributions to a participant to pay income taxes due upon a vesting event under a section 457(f) plan.

None of these exceptions are specifically provided in the statutory language. Thus, it will be up to Treasury to determine the circumstances in which accelerations will be permitted.

Effect of Violations

If the requirements of Code section 409A are violated, all amounts deferred for the participant under the NQDC plan (including any earnings) for all taxable years are taxed immediately, except to the extent that the amounts are subject to a substantial risk of forfeiture.⁷ In addition, the participant will have to pay interest at the underpayment rate plus one percent for all tax underpayments which have occurred, along with a 20 percent additional tax on any compensation which is required to be included in that participant's income. Significantly, these tax consequences apply to all earnings on deferrals, whether actual or notional, and can affect multiple tax years of deferrals.

Reporting and Withholding

Amounts deferred under an NQDC plan are subject to reporting and federal income tax withholding requirements at the time they are included in the participants income. In addition, however, all deferred amounts (presumably both elective and nonelective) must be reported to the IRS on Form W-2 (or Form 1099, for independent contractors) for the year in which the amount was deferred, even if the amounts are not yet includible in income. However, Treasury has been authorized to issue guidance establishing some *de minimis* amounts for which reporting would not be required.

Effective Dates and Treasury Guidance

Section 409A applies to amounts deferred after 2004, and to any earnings on such amounts. The requirements of this new section do not apply to either amounts deferred

⁷ Earlier versions of the legislation provided that a violation with respect to any participant would result in taxation for all participants in the same plan. However, this provision was eliminated and the tax, interest and additional tax now are payable only by the participant with respect to whom a violation occurs.

prior to 2005 or earnings on pre-2005 deferrals, unless the plan is “materially modified” after October 3, 2004. For purposes of the effective date, this “grandfather” rule only applies to amounts deferred before January 1, 2005, if the amount is also “earned” and “vested” before such date.

Treasury has been directed to issue guidance to permit plans to be amended to add the new rules for post-2004 deferrals without jeopardizing the grandfathered status of pre-2005 deferrals. Treasury staff have indicated that they expect to issue guidance prior to year end on some key section 409A issues, including what constitutes a material modification to an NQDC plan for purposes of Code section 409A. They have also indicated that this guidance will provide a form of model amendments that employers can adopt to bring their NQDC plans into compliance, with such amendments not creating a material modification to the NQDC plans. Treasury and the IRS are interested in hearing from employers and other interested parties about what key issues should be addressed in their initial 409A guidance.