PART III: DEFERRED COMPENSATION

Funded Deferred Compensation (Annuities and Trusts)

3523. What are the tax consequences of a Section 83 funded deferred compensation agreement for the employee?

Under IRC Section 83, as a general rule, an employee is currently taxed on a contribution to a trust or a premium paid for an annuity contract (paid after August 1, 1969) to the extent that the interest is substantially vested when the payment is made.

An interest is substantially vested if it is transferable or not subject to a Section 83 substantial risk of forfeiture. An interest is transferable if it can be transferred free of a substantial risk of forfeiture (Q 3530).[1] On May 29, 2012, the IRS released proposed regulations clarifying the definition of "substantial risk of forfeiture" under Section 83, and incorporating its ruling in Rev. Rul. 2005-48 as to Section 83 equity plans (for details on the changes see Q 3530). On February 25, 2014, the IRS issued final regulations that are substantially similar to the proposed regulations. These regulations will apply to all transfers of property on or after January 1, 2013, and the proposed regulations may be relied on as to transfers after May 30, 2012.[2]

A partner is immediately taxable on the partner's distributive share of contributions made to a trust in which the partnership has a substantially vested interest even if the partner's right is not substantially vested.[3]

If an employee's rights change from substantially nonvested to substantially vested, the value of the employee's interest in the trust or the value of the annuity contract on the date of change (to the extent such value is attributable to contributions made after August 1, 1969) must be included in the employee's gross income for the taxable year in which the change occurs. The value on the date of change also probably constitutes "wages" for the purposes of withholding[4] and for purposes of FICA and FUTA (Q 3562). The value of an annuity contract is its cash surrender value.[5]

If only part of an employee's interest in a trust or an annuity contract changes from substantially nonvested to substantially vested during any taxable year, then only that corresponding part is includable in gross income for the year.[6]

An employee is not taxed on the value of a vested interest in a trust attributable to contributions made while the trust was exempt under IRC Section 501(a).[7]

1. IRC Secs. 402(b)(1), 403(c), 83(a); Treas. Regs. §§1.402(b)-1(a)(1), 1.403(c)-1(a), 1.83-1(a)(1), 1.83-3(b), 1.83-3(d).
2. Proposed Treas. Reg. §1.83-3, 5-29-2012.
3. *U.S. v. Basye*, 410 U.S. 441 (1973).
4. Temp. Treas. Reg. §35.3405-1T, A-18; Let. Rul. 9417013.
5. IRC Secs. 402(b)(1), 403(c), 83(a); Treas. Regs. §§1.402(b)-1(b), 1.403(c)-1(b).
6. Treas. Regs. §§1.402(b)-1(b)(4), 1.403(c)-1(b)(3).
7. Treas. Reg. §1.402(b)-1(b)(1).

Special rules apply to trusts that lose their tax qualification because of a failure to satisfy the applicable minimum participation or minimum coverage tests.[1] The IRS has taken the controversial position that these special rules apply to non-exempt trusts that were never intended to be tax qualified. As a result, the IRS would tax highly compensated employees ("HCEs") (Q 3825) participating in trust-funded nonqualified plans that fail the minimum participation or minimum coverage tests applicable to qualified plans (Q 3764 through Q 3777), which most nonqualified plans will fail (Q 3526).

There is no tax liability when an employee's rights in the value of a trust or annuity (attributable to contributions or premiums paid on or before August 1, 1969) change from forfeitable to nonforfeitable. Prior to August 1, 1969, an employee was not taxed when payments were made to a nonqualified trust or as premiums to a nonqualified annuity plan if the employee's rights at the time were forfeitable.[2] Thus, the employee did not incur tax liability when the employee's forfeitable rights later became nonforfeitable. This old law still applies to trust and annuity values attributable to payments made on or before August 1, 1969.[3]

Where an employer amended its Section 451 "unfunded" nonqualified deferred compensation plan (one subject to the claims of the employer's general creditors in bankruptcy) to provide those participants with a choice between a lump sum payment of the present value of their future benefits or an annuity contract securing their rights to the remaining payments under the plan (with a corresponding tax gross-up payment from the employer), any participant who chose the annuity contract would be required to include the purchase price for such participant's benefits under the contract in gross income (as well as the tax gross-up payment) in the year paid or made available, if earlier.[4]

For taxation of annuity payments to an employee, see Q 3531.

3524. What are the tax consequences of a Section 83 funded deferred compensation agreement for the employer?

Whether a cash or accrual basis taxpayer, an employer can take a deduction for a contribution or premium paid in the year in which an amount attributable thereto is includable in an employee's gross income.[5] This deduction cannot be more than the amount of the contribution and it cannot include any earnings on the contribution before they are included in the employee's income.[6] If more than one employee participates in a funded deferred compensation plan, the deduction will be allowed only if separate accounts are maintained for each employee.[7] The employer is not allowed a deduction at any time for contributions made or premiums paid on or before August 1, 1969, if the employee's rights were forfeitable at the time.[8] Contributions or premiums paid or accrued on behalf of an independent contractor may be deducted only in

1. IRC Sec. 402(b)(4).
2. IRC Secs. 402(b) and 403(b), prior to amendment by P.L. 91-172 (TRA '69).
3. Treas. Regs. §§1.402(b)-1(d), 1.403(c)-1(d).
4. Let. Rul. 9713006.
5. IRC Sec. 404(a)(5); Treas. Regs.§§1.404(a)-1(c).
6. Treas. Reg. §1.404(a)-12(b)(1).
7. Treas. Reg. §1.404(a)-12(b)(3).
8. Treas. Reg. §1.404(a)-12(c).

the year in which amounts attributable thereto are includable in the independent contractor's gross income.[1]

With respect to contributions made after February 28, 1986 to annuity contracts held by a corporation, partnership, or trust (i.e., a nonnatural person), the "income on the contract" for the tax year of the policyholder generally is treated as ordinary income received or accrued by the contract owner during such taxable year (Q 439).[2]

Corporate ownership of life insurance also may result in exposure to the corporate alternative minimum tax (Q 300).

The IRS has taken the position that a nonexempt employee's Section 83 funded trust deferred compensation agreement cannot be considered an employer-grantor trust. As a result, the employer will not be taxed on the trust's income, but it also cannot claim the trust's deductions and credits.[3] Proposed regulations have affirmed the position of the IRS (Q 3526).[4]

Funded deferred compensation may take the form of either a salary continuation or pure deferred compensation plan (Q 3532).

The fact that a trust to fund a previously unfunded deferred compensation agreement was established as part of a nontaxable[5] corporate liquidation did not alter its treatment as an employee trust.[6]

A nonqualified deferred compensation plan funded by a trust or annuity other than an "excess benefit plan" (Q 3590) must provide for minimum vesting generally comparable to that required in qualified retirement plans (Q 3785).[7] Government plans and many church plans, however, are exempt from ERISA.

The above rules do not apply to nonqualified annuities purchased by tax-exempt organizations and public schools (Q 3907 to Q 3961) or to individual retirement accounts and annuities (Q 3602 to Q 3648).

IRC Section 404(a)(11)

If vacation pay is paid to an employee within 2½ months after the end of the applicable tax year, it generally is deductible for the tax year in which it is earned (vested) and is not treated as deferred compensation.[8] Employers may not deduct accrued vacation or severance pay unless it actually is received by employees.[9]

1. IRC Sec. 404(d); Temp. Treas. Reg. §1.404(d)-1T.
2. IRC Sec. 72(u). See also H.R. Rep. 99-426 (TRA '86), *reprinted in* 1986-3 CB (vol. 2) 703, 704; the General Explanation of TRA '86, at 658.
3. Let. Rul. 9302017.
4. Prop. Treas. Reg. §1.671-1(g).
5. IRC Sec. 337.
6. *Teget v. U.S.*, 552 F.2d 236, 77-1 USTC ¶9315 (8th Cir. 1977).
7. ERISA Sec. 201.
8. Temp. Treas. Reg. §1.404(b)-1T, A-2.
9. IRC Sec. 404(a)(11).

Actual receipt is not:

(1) a note or letter evidencing the employer's indebtedness (whether or not guaranteed by an instrument or third party);

(2) a promise to provide future service or property (whether or not evidenced by written agreement);

(3) an amount transferred by a loan, refundable deposit, or contingent payment; or

(4) amounts set aside in a trust for an employee.[1]

The IRS provided settlement options for taxpayers who had accelerated the deduction of accrued employee benefits (primarily vacation pay, disability pay, and sick pay) secured by a letter of credit, bond, or similar financial instrument, in reliance on *Schmidt Baking Co., Inc. v. Comm.*[2], which Section 404(a)(11) expressly overturned for years ending after July 22, 1998.[3] The IRS also has published guidance explaining the automatic accounting method change necessary to comply with IRC Section 404(a)(11).[4]

IRC Section 409A

Section 409A covers "inclusion in gross income of deferred compensation under nonqualified deferred compensation plans."[5] This definition of "nonqualified deferred compensation plans" is so expansive that it generally applies to most arrangements of deferred fringe benefits, including funded arrangements covered by Section 83, and is not limited to cash payments, unless the arrangement is outside certain statutory exemptions or regulatory exceptions to Section 409A. Plan sponsors should routinely seek to design their fringe benefit arrangements covered by Section 83 to fall within these Section 409A exemptions and exceptions whenever possible.

3525. What are the tax consequences of a Section 83 funded deferred compensation agreement for the employer?

Whether a cash or accrual basis taxpayer, an employer can take a deduction for a contribution or premium paid in the year in which an amount attributable thereto is includable in an employee's gross income.[6] This deduction cannot be more than the amount of the contribution and it cannot include any earnings on the contribution before they are included in the employee's income.[7] If more than one employee participates in a funded deferred compensation plan, the deduction will be allowed only if separate accounts are maintained for each

1. IRSRRA '98, Sec. 7001, H.R. Conf. Rep. No. 105-599.
2. 107 TC 271 (1996) (employer allowed to deduct accrued vacation liabilities because it had obtained an irrevocable letter of credit guaranteeing such obligation within 2½ months of the year of deduction).
3. Rev. Proc. 99-26, 1999-1 CB 1244.
4. Notice 99-16, 1999-1 CB 501.
5. See generally Treas. Reg. Sec. 1.409A-1(b)(9)(v) and 1.409A-3(i)(1)(iv); see also Notice 2007-34, 2007-17 IRB 996 governing split dollar life insurance as to the limited types of split dollar arrangements excepted from Section 409A.
6. IRC Sec. 404(a)(5); Treas. Regs.§§1.404(a)-1(c).
7. Treas. Reg. §1.404(a)-12(b)(1).

employee.[1] The employer is not allowed a deduction at any time for contributions made or premiums paid on or before August 1, 1969, if the employee's rights were forfeitable at the time.[2] Contributions or premiums paid or accrued on behalf of an independent contractor may be deducted only in the year in which amounts attributable thereto are includable in the independent contractor's gross income.[3]

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The IRS has taken the position that a nonexempt employee's Section 83 funded trust deferred compensation agreement cannot be considered an employer-grantor trust. As a result, the employer will not be taxed on the trust's income, but it also cannot claim the trust's deductions and credits.[5] Proposed regulations have affirmed the position of the IRS (Q 3526).[6]

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If vacation pay is paid to an employee within 2½ months after the end of the applicable tax year, it generally is deductible for the tax year in which it is earned (vested) and is not treated

1. Treas. Reg. §1.404(a)-12(b)(3).
2. Treas. Reg. §1.404(a)-12(c).
3. IRC Sec. 404(d); Temp. Treas. Reg. §1.404(d)-1T.
4. IRC Sec. 72(u). See also H.R. Rep. 99-426 (TRA '86), *reprinted in* 1986-3 CB (vol. 2) 703, 704; the General Explanation of TRA '86, at 658.
5. Let. Rul. 9302017.
6. Prop. Treas. Reg. §1.671-1(g).
7. IRC Sec. 337.
8. *Teget v. U.S.*, 552 F.2d 236, 77-1 USTC ¶9315 (8th Cir. 1977).
9. ERISA Sec. 201.

as deferred compensation.[1] Employers may not deduct accrued vacation or severance pay unless it actually is received by employees.[2]

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The IRS provided settlement options for taxpayers who had accelerated the deduction of accrued employee benefits (primarily vacation pay, disability pay, and sick pay) secured by a letter of credit, bond, or similar financial instrument, in reliance on *Schmidt Baking Co., Inc. v. Comm.*[4], which Section 404(a)(11) expressly overturned for years ending after July 22, 1998.[5] The IRS also has published guidance explaining the automatic accounting method change necessary to comply with IRC Section 404(a)(11).[6]

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3526. What is a "secular trust" and how is it taxed?

A secular trust is an irrevocable trust established to formally fund and secure nonqualified deferred compensation benefits and is referred to as a secular trust to distinguish it from a grantor rabbi trust (Q 3556). Funds placed in a secular trust are not subject to the claims of the employer's creditors. Thus, unlike a rabbi trust, a secular trust can protect its participants against both the employer's future unwillingness to pay promised benefits and the employer's future inability to pay promised benefits, including sponsor insolvency or bankruptcy situations.

1. Temp. Treas. Reg. §1.404(b)-1T, A-2.
2. IRC Sec. 404(a)(11).
3. IRSRRA '98, Sec. 7001, H.R. Conf. Rep. No. 105-599.
4. 107 TC 271 (1996) (employer allowed to deduct accrued vacation liabilities because it had obtained an irrevocable letter of credit guaranteeing such obligation within 2½ months of the year of deduction).
5. Rev. Proc. 99-26, 1999-1 CB 1244.
6. Notice 99-16, 1999-1 CB 501.
7. See generally Treas. Reg. Sec. 1.409A-1(b)(9)(v) and 1.409A-3(i)(1)(iv); see also Notice 2007-34, 2007-17 IRB 996 governing split dollar life insurance as to the limited types of split dollar arrangements excepted from Section 409A.

Secular trusts have not been as popular as rabbi trusts, in part because of questions surrounding their taxation (see Q 3527 to Q 3529), but they have received more consideration during recent severe economic downturns when companies are more at risk to fail, or the future for success of an industry appears unclear or highly volatile (such as the airline industry during the first part of the 21st century).

ERISA Implications

Use of a secular trust (at least other than an employee-grantor trust) probably will cause a deferred compensation plan subject to ERISA to be funded for ERISA purposes.[1] Funded plans generally are required to meet ERISA's Title I requirements.

Section 409A Inapplicable

Section 409A generally is inapplicable to a secular trust arrangement because the contributions and earnings are made subject to current annual income taxation to a plan participant and thus the plan is eligible to claim the Section 409A short term deferral exception for current compensation (Q 3533). In effect, the plan is an after-tax plan that involves current compensation, not Section 409A nonqualified deferred compensation. Whether this is entirely true as to a plan participant when a non-taxable investment vehicle is used inside the trust to shelter any earnings growth taxation as to the plan sponsor is not entirely clear as of the date of this publication.

3527. What are the tax consequences to an employee when a secular trust is used to provide deferred compensation?

The IRS takes the position that IRC Section 402(b)(1) through IRC Section 402(b)(4) govern the taxation of employee-participants in an employer-funded secular trust.[2] Under the general timing rule of IRC Section 402(b)(1), contributions to a secular trust are immediately included in the income of the employee to the extent that they are substantially vested.[3] Further, in any tax year in which any part of an employee's interest in the trust changes from substantially non-vested to substantially vested, the employee will be required to include that portion in income as of the date of the change.[4]

An interest is substantially vested if it is transferable or not subject to a substantial risk of forfeiture (Q 3530).[5]

With respect to the taxation of distributions from an employer-funded secular trust, the IRS previously has indicated that the rules of IRC Section 72 (except IRC Section 72(e)(5)) apply (Q 3531). Under this approach, distributions would be taxable except to the extent that they represent amounts previously taxed. Consequently, it would seem that a highly compensated

1. See, e.g., *Dependahl v. Falstaff Brewing Corp.*, 653 F.2d 1208 (8th Cir. 1981) (plan is funded when employee can look to property separate from employer's ordinary assets for satisfaction of benefit obligations), *aff'g in part* 491 F. Supp. 1188 (E.D. Mo. 1980), *cert. denied*, 454 U.S. 968 (1981) and 454 U.S. 1084 (1981).
2. Let. Ruls. 9502030, 9302017, 9212024, 9212019, 9207010, 9206009.
3. Treas. Reg. §1.402(b)-1(a)(1).
4. IRC Sec. 402(b)(1); Treas. Regs. §§1.402(b)-1(b)(1), 1.402(b)-1(b)(4).
5. Treas. Regs. §§1.402(b)-1(a)(1), 1.83-3(b).

employee who has been taxed on his or her entire "vested accrued benefit" would not be taxed again on receipt of a lump sum distribution.

The IRS has questioned the applicability of IRC Section 72 to distributions from employer-funded secular trusts to highly compensated employees ("HCEs") as defined in IRC Section 414(q) (Q 3827) participating in plans that fail the minimum participation or the minimum coverage tests applicable to qualified retirement plans (which most nonqualified plans will fail). The IRS has adopted the controversial position that a special rule under IRC Section 402(b)(4) should be applied to tax HCEs each year on their "vested accrued benefit" in the trust (minus amounts previously taxed). Thus, HCEs will be taxed on vested contributions and on vested earnings on those contributions. Apparently, the IRS would tax HCEs on their vested earnings even where they consist of unrealized appreciation of capital assets or nominally tax-free or tax deferred income (e.g., from municipal bonds or life insurance). Further, the IRS believes that any right to receive trust payments in compensation for these taxes also will be taxable as part of the vested accrued benefit.[1]

The IRS believes that as long as a failure to satisfy the minimum participation test or the minimum coverage test is not the only feature of the plan that keeps the secular trust from being treated as a tax-qualified trust (and it generally will not be so treated), then any participants who are not highly compensated will be taxed under the general rules of IRC Section 402(b)(1), described above.

The 10 percent penalty for certain early (premature) annuity distributions under IRC Section 72(q) may apply to distributions from employer-funded secular trusts if the deferred compensation plan behind the trust is considered to be an annuity (i.e., if it provides for the payment of benefits in a series of periodic payments over a fixed period of time, or over a lifetime).[2]

Employee-funded secular trusts (where the employee establishes the trust, but the employer administers it and contributes to it) are analyzed differently. The employee generally has a choice between currently receiving cash or its equivalent, e.g., an immediately surrenderable annuity or life insurance policy, or a cash contribution to the trust. Sometimes the employee has the choice between withdrawing contributions from the trust or leaving them in. In these situations, the IRS generally has ruled that the employee constructively received the employer-contributed cash and then assigned it to the trust. Thus, the IRS generally has held the employee to be currently taxable on employer contributions to the trust.[3]

An employee who establishes and is considered to be the owner of an employee-funded secular trust under the grantor-trust rules should not have to include the income on annuity contracts held by the trust in income each year (Q 439).[4]

1. Let. Ruls. 9502030, 9417013, 9302017, 9212024, 9212019, 9207010.
2. Let. Ruls. 9502030, 9212024, 9212019.
3. See Let. Ruls. 9548015, 9548014. See also Let. Rul. 9450004 (employee who could keep or contribute cash to trust was currently taxable on amounts contributed, although keeping cash would jeopardize future contributions and benefits).
4. Let. Ruls. 9322011, 9316018.

3528. What are the tax consequences to an employer that uses a secular trust to fund a deferred compensation plan for employees?

It is the position of the IRS that an employer can take a deduction for a contribution to an employer-funded secular trust in the year in which it is includable in employee income.[1] The rules of IRC Section 404(a)(5) limit the employer's deduction to the amount of the contribution; it never can include "earnings" on that amount between contribution and inclusion in the employee's income.[2] Moreover, these deductions potentially may be subject to certain limitations based on aggregations of defined "nonqualified deferred compensation," depending on the type of sponsor (Q 3515).

An employer cannot increase its "contributions" and thus its deductions by drafting the trust agreement to require that the trust distribute its earnings to the employer and that the trustee retain those earnings as "re-contributions" to the trust. The IRS has indicated that it will not recognize such deemed distributions and re-contributions.[3]

If a secular trust covers more than one employee, the employer will be able to take a deduction for contributions only if the trust maintains separate accounts for the various employees. According to the IRS, the separate account rule is satisfied only if the trust document requires that the income earned on participants' accounts be allocated to the accounts.[4]

The IRS also has granted employers immediate deductions for trust contributions where participants could choose between receiving current compensation outright or having it contributed to a trust, and where trust participants could choose between withdrawing contributions from the trust or leaving them in the trust. The IRS regarded these situations as employee-funded trusts and gave the employers deductions for the payment of compensation.[5] Moreover, these deductions potentially may be subject to certain limitations based on aggregations of defined "nonqualified deferred compensation" depending on the type of sponsor (Q 3515).

3529. If a secular trust is used to fund employer-provided deferred compensation, is the trust itself subject to taxation?

The IRS believes that a secular trust can never be an employer-grantor trust. Thus, an employer-funded secular trust is a separate, taxable entity. Unless secular trust earnings are distributable or are distributed annually, the trust will be taxed on those earnings.[6]

Proposed regulations have affirmed this position.[7]

1. Let. Ruls. 9502030, 9417013, 9302017, 9212024, 9212019.
2. Treas. Reg. §1.404(a)-12(b)(1); Let. Ruls. 9502030, 9417013, 9302017, 9212024, 9212019.
3. Let. Rul. 9302017.
4. Treas. Reg. §1.404(a)-12(b)(3); Let. Ruls. 9502030, 9302017, 9212024.
5. Let. Ruls. 9548015, 9548014. See also Let. Rul. 9450004 (employer allowed immediate deduction where employee could keep or contribute cash to employee-funded trust). See also Treas. Reg. §1.404(a)-12(b)(1); Let. Ruls. 9502030, 9417013, 9302017, 9212024, 9212019.
6. Let. Ruls. 9502030, 9417013, 9302017, 9212024.
7. Prop. Treas. Reg. §1.671-1(g) (employer not treated as an owner of any portion of a domestic, nonexempt employees' trust under IRC Sec. 402(b) if part of a deferred compensation plan, regardless of whether the employer has power of interest described in IRC Sec. 673 through IRC Sec. 677).

Because the IRS generally would tax HCEs each year on vested trust earnings (and generally would tax other employees on at least some trust earnings when a substantially nonvested interest becomes substantially vested), double taxation of trust earnings is a very real possibility. Funding secular trusts with life insurance may eliminate this by eliminating taxation of the trust. The IRS has not considered the use of life insurance in secular trusts, but under generally applicable tax rules, the inside build-up (or "earnings") on life insurance should not be taxed to the trust while it holds the policies. The use of life insurance probably will not save employees from taxation on trust earnings, however.

It also is possible to avoid trust (and therefore double) taxation by using employee-funded secular trusts. Employee-funded trusts generally are treated as employee-grantor trusts, because the trust income generally is held solely for the employee's benefit. As a result, the trust income generally is taxed to the employee only.[1]

3530. What is "a substantial risk of forfeiture" under IRC Section 83?

A person's rights in a Section 83 funded plan, where there has been a "transfer of property," are subject to a substantial risk of forfeiture[2] requirement under IRC Section 83. Full enjoyment of the property must be conditioned on the future performance (or the refraining from performance) of substantial services by any individual.[3]

On February 25, 2014, the IRS issued final regulations[4] clarifying the Section 83 definition of "substantial risk of forfeiture" (which are substantially similar to the proposed regulations released on May 29, 2012) as follows:

- A risk of forfeiture may be established only through a service condition or a condition related to the purpose of the transfer.
- Both the likelihood of a forfeiture event and the likelihood the forfeiture will be enforced must be considered in evaluating whether a service condition is related to a purpose of the transfer in establishing whether there is a substantial risk of forfeiture.
- Property is *not* transferred subject to a substantial risk of forfeiture to the extent that an employer is required to pay the fair market value of a portion of such property to the employee if the employee returns the property. In other words, the risk that the value of the property will decline during a period of time is not a substantial risk of forfeiture.
- A nonlapse restriction, by itself, will not result in a substantial risk of forfeiture.

1. See Let. Ruls. 9548015, 9548014, 9450004. Compare Let. Rul. 9620005 (group of secular trusts, each with a separate employee grantor, pooled investment resources together to form a master trust, will be taxed as a partnership, thereby avoiding double taxation applicable to corporations).
2. Note that there are currently six definitions of "substantial risk of forfeiture" and "substantial limitation" (which is usually referred to a substantial risk of forfeiture) contained in the Internal Revenue Code and that they are not all the same. This can be very confusing to planners and attorneys alike. They are in IRC Sections: a.) 409A, b.) 83, c.) 457(f), d.) 457A, e.) 312, and f.) 61. "Substantial limitation," commonly referred to as a "substantial risk of forfeiture," applicable to unfunded unsecured plans and the least burdensome standard of the six.
3. IRC Sec. 83(c)(1); Treas. Reg. §1.83-3(c)(1).
4. Treas. Reg. 1.83-3.

- In the case of equity compensation primarily, transfer restrictions mandated under the securities laws, including lock-up agreement restrictions, and restrictions related to insider trading under Rule 10b-5 under the Securities Exchange Act of 1934 [except as specifically outlined in Treasury Regulation Sections 1.83-3(j) and (k)] do NOT create a substantial risk of forfeiture.

These final regulations apply to property transferred on or after January 1, 2013. The proposed regulations can be relied upon for property transferred after May 30, 2012.

Planning Point: Planners should review the final regulations for the final guidelines that must be followed in order to create a valid "substantial risk of forfeiture" for a Section 83 plan after January 1, 2013. For transfers made prior to this date, they may rely on the proposed regulations. It should be noted that the regulations appear to be an attempt by the IRS to better integrate the definitions of "substantial risk of forfeiture" under Sections 83 and 409A. In doing so, the clarifications do potentially have special implications for plans involving majority or sole shareholders of closely-held companies as noted herein.

Even with this clarification, however, whether there is a risk of forfeiture and whether it is substantial still largely depends on the facts and circumstances.[1]

Because the inquiry remains so fact-based, little definitive guidance as to the sorts of services considered substantial existed prior to the release of the proposed regulations, and even this guidance may now need to be considered in light of the new final regulations. The regularity of performance and the time spent in performing the required services tend to indicate whether they are substantial.[2] Furthermore, it is not clear how far into the future an arrangement must require substantial services to require adequate "future performance." Nonetheless, the regulations' examples describe arrangements requiring employees to work for periods as short as one or two years as imposing substantial risks of forfeiture.[3]

Some things are clear. Requiring that property be returned if the employee is discharged for cause or for committing a crime will not create a substantial risk of forfeiture.[4] The IRS has indicated that benefits would be taxable once a participant has met age and service requirements under an IRC Section 457 governmental plan (Q 3568), although the benefits remained forfeitable if participants were fired for cause; the IRS noted that forfeiture on termination for cause was not sufficient to constitute a substantial risk of forfeiture.[5]

A covenant not to compete will not ordinarily result in a substantial risk of forfeiture unless the particular facts and circumstances indicate otherwise.[6]

1. Treas. Reg. §1.83-3(c)(1).
2. Treas. Reg. §1.83-3(c)(2).
3. See Treas. Reg. §1.83-3(c)(4), Ex. 1 and Ex. 3. For examples of service requirements that have constituted a substantial risk of forfeiture in the context of Section 457(f) plans (Q 3586), see generally Letter Rulings 9642046, 9642038, 9628020, 9627007, 9623027. However, these older rulings must now be considered in light of Notice 2007-62 or the regulations.
4. Treas. Reg. §1.83-3(c)(2).
5. TAM 199902032.
6. Treas. Reg. §1.83-3(c)(2); see also Let. Ruls. 9548015, 9548014.

Similarly, the requirement that a retiring employee render consulting services on the request of his or her former employer does not result in a substantial risk of forfeiture, unless the employee is, in fact, expected to perform substantial consulting services.[1]

Special scrutiny will be applied in determining whether the risk of forfeiture is substantial concerning a property transfer from a corporation to a controlling shareholder-employee. In such situations, a restriction that would otherwise be considered to impose a substantial risk of forfeiture will be considered to impose such a risk only if the chance that the corporation will enforce the restriction is substantial.[2]

Planning Point: To the extent these new regulations are drawing down Section 409A concepts into the Section 83 definition of substantial risk of forfeiture with regard to the likelihood whether forfeiture conditions will be enforced, sole or majority shareholders (and perhaps even the relatives of such persons) in closely-held companies may have a difficult time creating plans for themselves under Section 83. This is because the control they exercise over such a plan raises the issue of whether any forfeiture provision is likely to be enforced, as in the Ludden case.

In addition, under Section 409A, a noncompete and a consulting agreement can never constitute a substantial risk of forfeiture. However, the more stringent definition of "substantial risk of forfeiture" in Section 409A is used only to define the scope of the short term deferral exception under Section 409A to define the scope of the application of Section 409A coverage (and not the incidence of taxation) under the current regulations. In contrast, the phrase is used to determine incidence of deferral or taxation under Section 83. This could mean a substantive transfer of the narrower 409A definition down into Section 83 broadly.

Lack of a substantial risk of forfeiture under Section 409A means only that a plan cannot escape 409A coverage and must comply fully with 409A to achieve deferral and avoid taxation, which then largely controls the incidence of taxation. Under Section 83, it governs the incidence of deferral or taxation in the first place. This situation may cause great confusion for planners and attorneys.

Imposing a sufficient condition on the full enjoyment of the property is not in itself enough to create a substantial risk of forfeiture; the possibility of forfeiture if the condition is not satisfied must be substantial. This possibility may be substantial even if there are circumstances under which the failure to satisfy the condition will not result in forfeiture of the property. For example, the possibility of forfeiture is substantial where an employee would generally lose his or her deferred compensation on termination of employment before completing the required services, but would not forfeit those benefits if his or her early termination were due to death or permanent disability.[3] The possibility that a forfeiture might not be enforced in the event of normal or early retirement before the satisfaction of the condition might not undermine the substantial risk of forfeiture.

The risk that property will decline in value over time does not create a substantial risk of forfeiture. The example below, taken from the final regulations, illustrates.

1. Treas. Reg. §1.83-3(c)(2).
2. See Treas. Reg. §1.83-3(c)(3). Compare *Ludden v. Comm.*, 68 TC 826 (1977) (possibility of forfeiture did not amount to a substantial risk of forfeiture because there was too little chance that the shareholder-employees would cause themselves to be fired), aff'd on other grounds, 620 F.2d 700, 45 AFTR 2d 80-1068 (9th Cir. 1980).
3. Rev. Rul. 75-448, 1975-2 CB 55.

Example: Employer, ABC Corp., gives its employee, in connection with his performance of services for ABC Corp., a bonus of 100 shares of ABC Corp. stock. Under the terms of the agreement, employee is required to return the stock to ABC Corp. if he terminates his employment for any reason. However, for each year occurring after January 1, 2010, during which employee remains employed with ABC Corp., employee ceases to be obligated to return 10 shares of stock. Employee's rights in 10 shares each year for 10 years cease to be subject to a substantial risk of forfeiture in each year he remains employed.

Example 2: Same facts as above, except for each year that employee remains employed after January 1, 2010, ABC Corp. agrees to pay, in redemption of the bonus shares given to the employee if he terminates employment for any reason, 10 percent of the fair market value of each share of stock on the date of termination. Since ABC Corp. will pay employee 10 percent of the value of his bonus stock for each year (up to 10 years when the stock becomes 100 percent vested) he remains employed with ABC Corp., and the risk of decline in value is not a substantial risk of forfeiture, employee's interest in 10 percent of the bonus stock becomes substantially vested in each of those years.[1]

It is not clear whether one can effectively extend a substantial risk of forfeiture. One letter ruling has concluded that as long as the future services required of the employee were and would continue to be substantial, an agreement between the employer and the employee postponing the vesting date of restricted stock would not in itself trigger taxation of the stock.[2] The ruling has generated controversy, particularly with respect to efforts to extend it's reasoning to ineligible Section 457(f) plans. To the extent that the narrower Section 409A definition of substantial risk of forfeiture is being substituted for the one in 457(f) by Notice 2007-62, it cannot necessarily be used, because Section 409A prohibits extensions of the risk of forfeiture. (Q 3586).[3]

3531. How is an employee taxed on the payments he or she receives from a nonqualified annuity or nonexempt trust?

Annuity payments are taxable to employees under the general rules in IRC Section 72 relating to the taxation of annuities (see Q 450 as to payments in annuitization phase, Q 441 as to payments in accumulation phase).[4] An employee's investment in the contract, for purposes of figuring the exclusion ratio, consists of all amounts attributable to employer contributions that were taxed to the employee and premiums paid by the employee, if any. Investment in the contract includes the value of the annuity taxed to the employee when the employee's interest changed from nonvested to vested.[5]

Payments under a nonexempt trust are also generally taxed under the same rules relating to annuities, except that distributions of trust income before the annuity starting date are subject to inclusion in income under the generally applicable "interest first" rule without regard to

1. Treas. Reg. §1.83-3(c)(4), Ex. 3 and 4.
2. Let. Rul. 9431021.
3. Coming proposed regulations intended to integrate Section 409A with 457(f) are expected to largely confirm Notice 2007-62 which substitutes the 409A definition of substantial risk of forfeiture for the one in 457(f) as to ineligible plans.
4. IRC Sec. 403(c).
5. Let. Rul. 7728042.

the "cost recovery" rule retained (for certain cases) by IRC Section 72(e)(5) (Q 450, Q 441).[1] Furthermore, a distribution from the trust before the "annuity starting date" for the periodic payments will be treated as distributed in the following order.

(1) Income earned on employee contributions made after August 1, 1969

(2) Other amounts attributable to employee contributions

(3) Amounts attributable to employer contributions (made after August 1, 1969 and not previously includable in employee's gross income)

(4) Amounts attributable to employer contributions made on or before August 1, 1969

(5) The remaining interest in the trust attributable to employer contributions[2]

The IRS has privately questioned whether the annuity rules of IRC Section 72 are applicable to distributions to highly compensated employees from an employer-funded nonexempt trust under a plan that fails the minimum participation or the minimum coverage tests applicable to qualified plans (Q 3761, Q 3762); the taxation of such distributions is unclear (Q 3526).[3]

If a distribution consists of an annuity contract, the entire value of the annuity, less the investment in the contract, is included in gross income.[4]

For applications of FICA and FUTA to deferred compensation payments, see Q 3562.

Unfunded Deferred Compensation

3532. What are the tax benefits for a participant of an unfunded deferred compensation agreement with an employer?

A properly constructed unfunded[5] nonqualified deferred compensation agreement can postpone payment of compensation for currently rendered services until a future date, with the intended objective of postponing the taxation of such compensation until it is actually received. Since the enactment of IRC Section 409A (generally effective as to contributions/deferrals to plans as of January 1, 2005), such an agreement, at least with respect to vested compensation, likely will create a plan that is covered by the additional tax law requirements of Section 409A, unless the plan is either specifically exempted by the statute or can claim an exception under the regulations.

Section 409A also creates an entirely new and greatly expanded group of compensation plan types that may be covered by Section 409A under the law's broad definition of a "nonqualified

1. IRC Sec. 402(b)(2).
2. Treas. Reg. §1.402(b)-1(c)(2).
3. Let. Ruls. 9502030, 9417013.
4. Treas. Reg. §1.402(b)-1(c)(1).
5. "Unfunded" does not mean that assets may not be set aside in a sponsor's general asset reserve for a plan; just that they may not be escrowed from sponsor's general creditors or constitute "plan assets' under ERISA. It also means that the plan is an unsecured promise-to-pay subject to Sections 61 and 451, and not a "transfer of property" plan under Section 83.

deferred compensation plan" (see the nine plan types that follow). This definition constitutes an expansion beyond what historically was considered a deferred compensation plan and now pulls in almost all executive compensation plans and some employee benefit plans.

Under Section 409A, a nonqualified deferred compensation plan is one involving a deferral of compensation that is legally binding in the present tax year and not payable until a future tax year (beyond the current tax year plus 2½ months), and is not specifically statutorily exempted or regulatorily excepted.

As noted, under the current Section 409A regulations, there are nine types or categories of nonqualified deferred compensation plans, per the so-called "aggregation rule," as follows.

(1) Employee account balance plans (voluntary salary, bonus, commission deferral plans)

(2) Employer account balance plans (defined contribution, "phantom stock" plans)

(3) Employer nonaccount balance plans (defined benefit plans)

(4) Split dollar life insurance plans

(5) Stock equity plans

(6) Severance/separation plans

(7) Reimbursement or fringe benefit plans

(8) Foreign plans

(9) Other miscellaneous plans

Under a typical "pension" type deferred compensation agreement (primarily employee and employer account balance plans and employer nonaccount balance plans using 409A language), an employer promises to pay an employee fixed or variable amounts for life or for a guaranteed number of years or to pay out an account containing pre-tax contributions plus credited gains and losses. The employer can make this promise to an employee without creating current taxation, subject to compliance with IRC Section 409A, when applicable.

When the deferred amount is received, the employee may be in a lower income tax bracket, but at least has another future income source (Q 3561). Additionally, many employers use the employer-paid types (account or nonaccount balance) of plans to provide benefits in excess of the limitations placed on qualified plan benefits. For example, a Supplemental Executive Retirement Plan ("SERP"), in either an account balance or nonaccount balance design, for a selected group of executives generally provides extra retirement benefits. An "excess benefit plan" is a special kind of supplemental plan that addresses only the benefits lost under qualified plan limits and caps (Q 3590).

Nonqualified deferred compensation plans have been divided into two broad categories: (1) voluntary employee deferred compensation plans and (2) employer-paid supplemental plans. Both unfunded deferred compensation plans (governed by IRC Sections 61 and 451) and funded deferred compensation plans (governed by IRC Section 83) may be divided into these categories (Q 3523). Under prior law, taxation of these two plan categories was the same based on whether the plan was an unfunded plan (one that was merely an "unsecured promise-to-pay") or a funded plan (one that involved the "transfer of property").

The enactment of Section 409A, however, has added a new additional categorization: whether the plan (unfunded or unfunded) is covered or excepted from coverage from the additional Section 409A requirement. That is because Section 409A is additive tax law and only changes prior income tax law applicable to nonqualified deferred compensation to the extent specifically indicated. The term "nonqualified deferred compensation plans" should be understood to refer to both voluntary employee deferred compensation plans and employer-paid supplemental plans that are covered by Section 409A requirements, as well as all the other plan types now covered by Section 409A.

A "voluntary employee deferred compensation plan" involves an agreement between the employer and employee, whereby the employee defers receipt of some portion of present compensation (or a raise or bonus, or a portion thereof) in exchange for the employer's promise to pay a deferred benefit in the future. This has been referred to as an "in lieu of" plan. As noted, under Section 409A, these plans are employee account balance plans.

An "employer-paid supplemental plan" is a compensation benefit provided by the employer to an employee in the future in addition to all other forms of compensation; the employer promises to pay a deferred benefit, but there is no corresponding reduction in the employee's present compensation, raise, or bonus. Under Section 409A, these plans are employer account balance or non-account balance plans.

3533. What requirements must be met by a private nonqualified deferred compensation plan?

An unfunded private nonqualified deferred compensation plan is a plan entered into with any employer other than:

(1) a state;

(2) a political subdivision of a state (e.g., a local government);

(3) an agency or instrumentality of (1) or (2); or

(4) an organization exempt from tax under IRC Section 501.

Although private nonqualified deferred compensation agreements most frequently are entered into with employees of corporations, they also may be entered into with employees of other business organizations and with independent contractors.[1] For example, a director's fees can be deferred through an unfunded deferred compensation agreement with the corporation.[2]

1. Rev. Rul. 60-31, 1960-1 CB 174, as modified by Rev. Rul. 70-435, 1970-2 CB 100.
2. Rev. Rul. 71-419, 1971-2 CB 220.

This remains true for plans covered by IRC Section 409A. If an employer or service recipient transfers its payment obligation to a third party, efforts to defer payments from the third party may not be effective.[1]

For rules concerning nonqualified deferred compensation plans sponsored by governmental or private tax-exempt not-for-profit employers, see Q 3567 through Q 3586.

General Taxation Rules for Unfunded Plans

IRC Section 409A is *additive law* that further defines the income tax doctrine of constructive receipt. Therefore, prior income tax law and theories (for example, the economic benefit theory) continue to apply, unless specifically replaced by Section 409A. This means that a plan subject to Section 409A must comply with both prior income tax law (except as specifically changed) as well as Section 409A requirements. Plans that are statutorily exempted or excepted by regulations from the Section 409A requirements (such as amounts grandfathered from 409A coverage) must continue to comply with prior income tax law only.

Pre-409A Income Tax Law Requirements

1. An employer may contractually agree to pay deferred amounts as additional compensation, or employees may voluntarily agree pursuant to contract to reduce current salary.[2]

2. The plan must provide that participants only have the status of general unsecured creditors of the employer in bankruptcy and that the plan constitutes a mere unsecured promise-to-pay benefits by the employer in the future.

3. The plan also should state that it is the intention of the parties that it is unfunded for tax (and ERISA) purposes; that is without ERISA "plan assets".

4. The plan should prohibit and void the anticipatory assignment of the benefits by a participating employee.

5. The plan should define the time and form for paying deferred compensation for each event (e.g., retirement) that would entitle a participant to a distribution of benefits.

6. The plan should include any provisions necessary to designate and comply with controlling state law requirements.

7. These requirements continue after the enactment of Section 409A, and are the primary requirements for portions of plans that are grandfathered from 409A coverage or excepted from 409A coverage, such as plans that can claim the "short term deferral exception."

1. Rev. Rul. 69-50, 1969-1 CB 140, as amplified in Rev. Rul. 77-420, 1977-2 CB 172 (deferral of physicians' payments from Blue Shield type organization ineffective); TAM 9336001 (deferral of plaintiffs' attorney's fees under structured settlement with defendants' liability insurers ineffective); *contra Childs v. Comm.*, 103 TC 634 (1994), *aff'd*, 89 F.3d 856 (11th Cir. 1996) (deferral of plaintiffs' attorneys' fees under structured settlement with defendant's liability insurers effective).
2. Rev. Rul. 69-650, 1969-2 CB 106.

If the plan refers to a trust or other informal funding mechanism, additional rules must be satisfied (Q 3554, Q 3556).

3534. What is the doctrine of constructive receipt and how does it apply in the context of nonqualified deferred compensation plans?

Under pre-409A income tax law, tax deferment is not achieved if, prior to the actual receipt of payments, the employee is in constructive receipt of the income under the agreement. Income is constructively received if the employee can draw upon it at any time. Income is not constructively received if the employee's control of its receipt is subject to substantial limitations or restrictions. Some agreements contain contingencies that may cause the employee to forfeit future payments. So long as the employee's rights are forfeitable, there can be no constructive receipt.[1] The IRS has ruled, however, that the employee will not be in constructive receipt of income even though his or her rights are nonforfeitable if the agreement is entered into before the compensation is earned and the employer's promise to pay is not secured in any way.[2]

IRC Section 409A created new requirements for elections to defer compensation for covered nonqualified deferred compensation plans.[3] Under pre-IRC Section 409A income tax law (which is still applicable to amounts grandfathered and plans excepted from Section 409A coverage), there was some conflict between the IRS and the courts with respect to the consequences of an election to defer compensation after the earning period commences. The IRS always has seemed to believe that a deferral election after the earning period commences will result in constructive receipt of the deferred amounts, even if made before the deferred amounts are payable.

For example, in TAM 8632003, the IRS found constructive receipt where a participant in a shadow stock plan elected, just prior to surrendering his shares, to take the value of his shares in ten installment payments rather than in one lump sum. The IRS refused to permit further deferral of amounts already earned and determinable, believing that the fact that the benefits were not yet payable at the time of the election was an insufficient restriction on the availability of the money.[4] A plan allowing elections to defer bonus payments on or before May 31 of the year for which the deferral was effective did not cause constructive receipt. There was no express consideration of the effect of the election provision, however.[5]

In another ruling, contributions to a rabbi trust did not result in income to participants or beneficiaries until benefits would be paid or made available in the context of the plan allowing an election to further defer compensation through choice of the payout method after termination of services; there was no express consideration of the effect of the election provision.[6]

Pre-section 409A, courts looked more favorably on elections to defer compensation after the earning period commenced but before the compensation was payable. For example, the

1. Treas. Regs. §§1.451-1, 1.451-2.
2. Rev. Rul. 60-31, 1960-1 CB 174, as modified by Rev. Rul. 70-435, 1970-2 CB 100.
3. IRC Sec. 409A(a)(4).
4. See also Let. Rul. 9336001 (election to defer must be made before earning compensation to avoid constructive receipt); Rev. Proc. 71-19, 1971-1 CB 698, as amplified by Rev. Proc. 92-65, 1992-2 CB 428.
5. See Let. Rul. 9506008.
6. See also Let. Rul. 9525031.

Tax Court considered the same plan addressed in TAM 8632003, above, and reaffirmed its position that an election to further defer compensation not yet due under the original deferred compensation agreement does not necessarily result in constructive receipt.[1] Although the IRS did acquiesce in *Oates* and in the first *Veit* case, it tried to distinguish those cases and the second *Veit* case in TAM 8632003.

The 409A general rule requires an election prior to the tax year in which the compensation is to be earned, which is the historic position of the IRS. Because the IRS was charged by Congress in the Congressional Commentary to Section 409A to pursue plans not conforming to Section 409A, it could be expected that the IRS likely will challenge plans excepted from Section 409A, and perhaps even grandfathered plans, that generally do not follow the income tax guidelines established by Section 409A, especially this one governing fundamental tax deferral.

Planning Point: It appears that the IRS currently has its hands full with its audit for general 409A compliance. Perhaps we will see some pre-409A grandfathered plans challenged as part of this audit process.

Whether Section 409A is applicable or not, special concerns are present if compensation is deferred for a controlling shareholder-employee, typically in the closely-held corporate situation. If a controlling shareholder-employee can (through control of the corporation) effectively remove any restrictions on his or her immediate receipt of the money, the IRS can argue that he or she is in constructive receipt because nothing really stands between the shareholder-employee and the money.[2] It is hard to eliminate these concerns in advance, because the IRS continues to refuse to issue advance rulings on the tax consequences of a controlling shareholder-employee's participation in a nonqualified deferred compensation plan.[3] Courts seemed to be less willing to impose constructive receipt in such situations prior to Section 409A.[4]

Under Section 409A, the definition of "substantial risk of forfeiture" in the regulations embedded this IRS argument into law. The regulations to Section 409A prevent such a shareholder-employee from using the short term deferral exception to escape the coverage of Section 409A, even on a "vest and pay lump sum" Supplemental Executive Retirement Plan ("SERP"). However, they do not seem to prohibit such a nonqualified deferred compensation plan for such a shareholder-employee if the plan thereby fully complies with the documentary and operational requirements of the law. Such a plan could not claim the short term deferral exception to escape Section 409A coverage, even as to a SERP. Under the Section 409A regulations the shareholder's control causes a loss of the substantial risk of forfeiture needed to claim the short term deferral exception. Even then, the IRS still might attempt to attack a plan for such a shareholder-employee, even if the plan is otherwise fully complying with the form and

1. See *Martin v. Comm.*, 96 TC 814 (1991). See also *Childs v. Comm.*, 103 TC 634 (1994), *aff'd*, 89 F.3d 856 (11th Cir. 1996); *Oates v. Comm.*, 18 TC 570 (1952), *aff'd*, 207 F.2d 711 (7th Cir. 1953), *acq.*, 1960-1 CB 5; *Veit v. Comm.*, 8 TCM 919 (1949); *Veit v. Comm.*, 8 TC 809 (1947), *acq.*, 1947-2 CB 4.
2. See, e.g., TAM 8828004.
3. See Rev. Proc. 2008-3, Sec. 3.01(43), 2008-1 IRB 110.
4. See, e.g., *Carnahan v. Comm.*, TC Memo 1994-163 (controlling shareholder's power to withdraw corporate funds is not sufficient to cause constructive receipt), *aff'd without opinion*, 95-2 USTC ¶50,592 (D.C. Cir. 1995).

operational requirements of Section 409A. Therefore, special consideration and review must be applied to such a situation before implementing any plan, whether a voluntary deferral or employer-paid supplemental design.

Finally, a nonqualified deferred compensation plan that is subject to registration as a security with the Securities and Exchange Commission ("SEC"), but that fails to register, may suffer adverse tax consequences. In such a case, a participant may be able to rescind the deferral of his or her compensation under SEC rules. A right to rescind could cause the participant to be in constructive receipt of the deferred amounts. Currently though, the IRS has not resolved either the nature or extent of any tax implications arising from a failure to register a plan with the SEC, and this is further complicated by the enactment of Section 409A. Further complicating matters, the SEC has not formally clarified in detail the nonqualified deferred compensation plans that are subject to the "security" registration requirements and has provided little useable informal guidance in this area, except to suggest that contemporary voluntary multi-account deferral designs might require registration.

3535. What requirements must be met by a private nonqualified deferred compensation plan under IRC Section 409A?

Congress imposed additional requirements in IRC Section 409A to avoid a current constructive receipt on a "nonqualified deferred compensation plan" at inception and during the life of a covered plan. Many of these new requirements actually are those that the IRS formerly required to receive a favorable private letter ruling on income tax deferral under a plan and so are not really new.

Section 409A imposes requirements on plans in four primary areas.

1. Minimum plan documentation
2. Permissible Distributions
3. Elections to defer
4. Prohibited Accelerations

See Q 3536 to Q 3539 for a detailed discussion of each of these requirements.

Planning Point: Planners should assume that any compensation plan is covered by Section 409A and plan to comply until and unless they have satisfied themselves that the plan (which may be for only a single person) is either specifically statutorily exempted – such as a 457(b) plan – or meets (or can be designed to claim) a regulatory exception – such as the short term deferral exception).

3536. What are the minimum plan documentation requirements that must be met by a private nonqualified deferred compensation plan under IRC Section 409A?

Under Section 409A, a plan must be compliant both in form (documentation) and operation (administration). Therefore, there are certain minimum requirements for plan documentation to comply with Section 409A at the outset. In general, any plan subject to Section 409A must meet the following minimum requirements:

As to Section 409A:

1. The plan must be in writing, but there are no IRS prototype plans available as is the case for qualified plans. In effect, a plan is in violation of Section 409A if it is a covered arrangement but not in writing. However, the plan may be in more than one document, such as a plan and joinder agreement.

   This also suggests that plans claiming exception from 409A ought to be in writing to make the exception from coverage clear if audited. There are indications that the IRS is asking for an identification of those plans that are covered and those claiming a 409A coverage exception to include the relevant exception and justification in pre-audit requests.[1]

2. The plan must state either the amount of the deferred compensation or the method for calculating the amount and the plan also must state the time and form of payment distribution, which would include:

   a. all of the Section 409A rules for elections to defer on salary, commissions, performance-based compensation bonuses, and non-performance-based compensation bonuses, and newly eligible participants as applicable (see Permissible Distributions and Elections to Defer), and

   b. all of the Section 409A permissible distributions, "earlier of" sequencing, and a prohibition against all other non-Section 409A distributions and accelerations (see Prohibited and Permissible Accelerations).

3. The plan must contain all the unique definitions (e.g., "separation from service") and key terminology (e.g., "leave of absence") from Section 409A that apply to the plan, including the special plan termination rules.

4. The plan should contain a "Section 409A interpretation clause" defining undefined, ambiguous, or missing plan definitions and other language consistent with Section 409A.

5. The plan should include the Section 409A compliant timing for distribution following a permissible distribution event.

6. The plan should state the inclusion or prohibition of permitted Section 409A acceleration events (e.g., domestic relations orders).

7. The plan should state the requirements for a voluntary plan termination by the employer.

1. Several counsel have shared pre-audit IRS written requests on-line at various tax blogs in the past several years, and they generally suggest the wisdom of a written plan, even if claiming an exception to 409A coverage.

8. The plan should include an indemnification provision that either accepts or refuses the responsibility of the employer for any Section 409A violations and the adverse tax consequences that may result.

9. The plan should state whether it will allow subsequent elections and whether a series of installment payments shall be treated as a single distribution or a series of individual distributions for purposes of the plan, and subsequent elections to extend deferral.

10. The plan should include a provision for a delay of the payment start date for six calendar months when there is a separation from service of "specified employees," including the desired optional "catch-up" treatment (the provision is required if the plan is sponsored by a publicly-traded company; the provision is conditional (or unnecessary) if the sponsor is a closely-held company or tax-exempt organization).

11. The plan should include a prohibition provision against crediting interest on any participant accounts during any period that the plan sponsor is not in compliance with the minimum funding requirements for any qualified defined benefit pension plan.

12. The plan optionally may include a provision for:

    a. the very limited Section 409A right of the employer to offset participant liabilities to the employer against a participant's account, unless extended in the normal course of business as outlined in Section 409A, which should be clearly documented if this very narrow exception to the rule will be relied upon,

    b. accelerated cash-outs for certain allowed small amounts (those amounts less than the annual 402(g)(1)(b) amount) upon a separation from service, and

    c. automatic cancellation of a participant's deferral election for the balance of the plan year upon a request for an "unforeseeable emergency" request.

As to continuing prior law:

1. The plan should contain a provision in which the employer contractually agrees to pay deferred amounts at a future date as additional compensation, or employees contractually voluntarily agree with the employer to reduce current salary.[1]

2. The plan must provide that participants only have the status of general unsecured creditors of the employer in bankruptcy and that the plan constitutes mere promise-to-pay benefits by the employer in the future.

3. The plan also should state that it is the intention of the parties that it be unfunded for tax (and ERISA) purposes.

1. Rev. Rul. 69-650, 1969-2 CB 106.

4. The plan should prohibit and void the anticipatory assignment of the benefits by a participating employee.

5. The plan should include any provisions necessary to designate and comply with controlling state law requirements.

3537. When can a participant in a private nonqualified deferred compensation plan receive a distribution of previously deferred compensation under IRC Section 409A?

Under Section 409A, a participant only may receive a distribution of previously deferred compensation upon the occurrence of one of six primary events.

- Separation from service
- Date the participant becomes disabled
- Death
- A fixed date or time (or pursuant to a fixed scheduled) specified in the plan at the date of the deferral
- A change in the ownership or effective control of the corporation or assets of the corporation, to the extent provided in regulations (but an equity investment by the federal government under the Troubled Asset Relief Program ("TARP") is not considered a change in ownership or control)[1]
- The occurrence of an unforeseeable emergency[2]

Most of these events have definitions unique to Section 409A and must be used in covered plans. Generally speaking, the definitions are narrower than one might suppose, and have special rules.

Under 409A, "specified employees" ("key employees" as defined under IRC Section 416(i)) of publicly-traded corporations may not take distributions until six calendar months after a separation from service (or the date of death of the employee, if earlier).[3] In general, plan distribution in other situations is prohibited under Section 409A (see below).

Under final regulations, a change in ownership occurs when an individual or persons acting as a group acquires more than 50 percent of the total fair market value or total voting power of the corporation. Ownership under these rules is subject to attribution under IRC Section 318(a). A change in effective control occurs when (1) an individual or persons acting as a group acquires 35 percent or more of the total voting power of the stock of the corporation within a twelve month period or (2) where there is an adversarial change in a majority of the membership of the board of directors within a twelve month period. A change in the

1. Notice 2009-49, 2009-25 IRB 1093.
2. IRC Sec. 409A(a)(2)(A); Treas. Reg. §1.409A-3.
3. IRC Sec. 409A(a)(2)(B)(i).

ownership of a substantial portion of the assets of the corporation occurs when an individual or persons acting as a group acquire assets equal to or greater than 40 percent of the total gross fair market value of the corporation.[1]

An "unforeseeable emergency" under Section 409A means "a severe financial hardship to the participant resulting from an illness or accident" of the participant, the participant's spouse, or a dependent (as defined in IRC Section 152(a) of the participant, loss of the participant's property due to casualty, or other similar "extraordinary and unforeseeable circumstances" arising as a result of events beyond the control of the participant.[2] A nonqualified deferred compensation plan financial hardship withdrawal under this provision may be taken without taking a financial hardship distribution from any qualified 401(k) plan balance of the employee, and the plan may require that the balance of remaining voluntary employee deferral elections for the plan year be cancelled if a financial hardship distribution is taken from an employee's 401(k) plan balance (to comply with 401(k) plan financial hardship requirements).[3]

3538. When must a participant in a private nonqualified deferred compensation plan make the election to defer compensation under IRC Section 409A?

IRC Section 409A imposes timing requirements for participants making elections to defer compensation. The general rule is that participants now generally must make deferral elections prior to the end of the preceding taxable year (December 31 in most cases).[4] There are two major exceptions to the general rule.

1. In the first year of a plan, a participant can make a pro rata election on compensation, based upon the number of days remaining in the year.

2. In the case of any "performance-based compensation," as defined in the regulations to Section 409A, a participant must make an election to defer not later than six months before the end of the covered period (June 30 for a calendar year performance period). The compensation must meet this unique Section 409A definition, which includes (among other important requirements) a twelve month performance period.[5] This rule changes the common practice on bonus compensation under prior law, especially as to new plans, by making it essential to start and enroll a deferral plan prior to the six month deadline to maximize the deferral opportunity.

Newly eligible participants must make an election within thirty days after the date of eligibility, but only with respect to services to be performed subsequent to the election. In addition, elections to defer on plans of the same Section 409A plan type (for example, all employee account balance plans) under the "aggregation rule," if there is more than one, must occur at the same time.

1. Treas. Reg. §1.409A-3(i)(5).
2. Treas. Reg. §1.409A-3(i)(3).
3. Treas. Reg. Section 1.409A-3(j)(4)(viii); Preamble Section VII.D., Section 409A Proposed Treas. Regulations, 9-23-2005.
4. IRC Sec. 409A(a)(4)(B)(i).
5. IRC Sec. 409A(a)(4)(B); Treas. Reg. §1.409A-2.

Planning Point: Employers with more than one plan of the same Section 409A type (e.g., employee account balance plans) only should allow enrollment in plans, including the newly eligible employees, during perhaps a mid-year and end-of year enrollment window to comply with the requirement of a common enrollment period for similar Section 409A plans.

Section 409A also requires a plan to specify whether any elected series of installment payments shall be treated as a single distribution or a series of individual distributions.

Using this rule, Section 409A allows participants to elect to make a "subsequent election" to delay the timing of a distribution or change the form of a distribution from a plan so long as the plan provides for such subsequent election right. To make such a subsequent election, the plan document and the administration must require the subsequent election to be made at least twelve months in advance of the original distribution date, and the subsequent election must delay the timing of the distribution at least five years from the date of the original distribution (unless made on account of disability, death, or an unforeseeable emergency).

In addition, there is a twelve month period requirement after the subsequent election and prior to the original date during which the old election must be applied if a separation from service occurs. An election related to a scheduled series of installment payments made pursuant to a fixed schedule and treated as a single distribution must be made at least twelve months in advance of the first such scheduled installment payment.[1] In general, it is usually preferable to create more flexibility for a participant in a plan by designating that a series of installment payments be treated as a series of individual distributions. It is necessary to have a plan administrator who can manage this complex flexibility and thereby comply with Section 409A to include it in a plan.

Current regulations generally also provide that a separately identified amount of an installment (either by percentage or fixed dollar amounts) that an employee is entitled to receive on a determinable date may be deferred subject to the subsequent election rules.[2] In effect, a portion of an installment, if a series of installment payments are treated as a series of individual distributions, may be subsequently deferred.

3539. When do prohibited (and permissible) acceleration of payment requirements apply to private nonqualified deferred compensation plans under IRC Section 409A?

Accelerations of plan distributions outside the six primary permissible listed distributions are prohibited. Final regulations, however, define specified circumstances under which a plan may permit the acceleration of plan payments and, in effect, widen permissible plan distributions, as follows:

1. To comply with a domestic relations order (a DRO, not a QDRO since there are no "plan assets" in a promise-to-pay nonqualified deferred compensation plan to levy against).

1. IRC Sec. 409A(a)(4)(C); Treas. Reg. §1.409A-2(b).
2. Treas. Reg. §1.409A-2(b)(2).

2. To comply with a conflict-of-interest divestiture requirement.[1]

3. To pay income taxes due on a vesting event under a plan subject to IRC Section 457(f).

4. To pay FICA or other employment taxes imposed on compensation deferred under the plan.

5. To pay any amount included in income under IRC Section 409A.

6. To pay only the proper amount due, based on a valid unforeseeable emergency request.

7. To terminate a participant's entire interest in a plan:

   a. after a separation from service where the payment is not greater than the IRC Section 402(g)(1)(B) amount ($17,500 for 2013 and 2014, up from $17,000 in 2012), or

   b. in the calendar month prior to or twelve months following a Section 409A change in control event date.

8. To terminate the plan entirely at the employer's discretion (and distribute) so long as:

   a. all the plans of the same section 409A type are terminated,

   b. all plan termination distributions will be made no earlier than twelve months, but not later than twenty-four months, following the date of termination, and

   c. no new plan of the same Section 409A type is established for at least three years following the termination (or a retroactive violation occurs).

9. To terminate a plan pursuant to an IRC Section 331 corporate dissolution with the approval of a bankruptcy court judge.[2]

The IRS has informally advised[3] that a "salary advance" plan that allows an employer to offset any unpaid compensation advances against an employee's balance under a Section 409A non-qualified deferred compensation plan violates the Section 409A prohibition against acceleration of payments, and requires the amendment of the salary advance plan to prevent a violation of Section 409A for the deferred compensation plan (the terms of the two plans would be combined to determine a Section 409A violation).

Offsets and substitutions of plans to achieve an earlier distribution of compensation deferred under Section 409A generally are prohibited, except for a narrow exception that

1. IRC Sec. 1043.
2. Treas. Reg. §1.409A-3(A).
3. CCA 200935029, Released 8-28-2009.

allows "debt incurred in the normal course of the service relationship" to be offset in the year debt is due up to $5,000".[1]

3540. What is a "short term deferral exception" under Section 409A regulations?

The "short term deferral exception" in the regulations to Section 409A is perhaps the most important exception to coverage by Section 409A for many compensation plans.

Its name is a misnomer because this regulatory exception actually can be claimed for plan benefit distributions far in the future so long as (1) the benefit is subject to a Section 409A "substantial risk of forfeiture," which is the most stringent definition of the five definitions of "substantial risk of forfeiture" currently in the IRC, and (2) the plan distribution essentially is made in a lump sum on the lapse of the 409A substantial risk of forfeiture. Both of these requirements must be met to claim the Section 409A short term deferral exception.

For example, an employer-paid supplemental executive retirement plan (SERP) for a 45 year-old key employee might provide for payment upon vesting at age 62, but it might also provide for a forfeiture of the entire benefit if the executive terminates employment prior to age 62. If that promised benefit is also payable in a lump sum in that year of vesting (resulting in lapse of the substantial risk of forfeiture) or within 2½ months following that year, the plan might qualify as a so-called "vest-and-pay lump sum" plan to claim an exception from Section 409A coverage, even though the plan defers payment for 17 years. Under the short term deferral exception, no Section 409A "deferral of compensation" occurs if amounts are paid within 2½ months after the end of the tax year in which the employee obtains a legally-binding right to the amounts or any Section 409A substantial risk of forfeiture lapses. Under this rule, many multi-year bonus arrangements, including bonus life insurance or bonus annuity arrangements and "vest-and-pay lump sum" SERPs that require payments in lump sum promptly after the amounts "vest" (under Section 409A substantial risk of forfeiture requirements), as in our example, will not be subject to coverage under Section 409A.[2]

3541. What penalties can be imposed under Section 409A?

IRC Section 409A imposes substantial penalties for failing to meet either the Section 409A form (documentation) or operational (administration) requirements at inception and during the life of a covered plan. One of the peculiarities of Section 409A is that the tax falls on the participant and not the employer. In the worst case situation, any violation of the Section 409A documentary or operational requirements results in retroactive constructive receipt, with the vested portion of the deferred compensation being taxable to the participant back to the date of the violation, which might be the date of the intended deferral.[3]

In addition to the normal income tax on the compensation, the participant must pay an additional 20 percent tax, as well as interest at a "premium" penalty rate 1 percent higher than

1. Treas. Reg. §1.409A-3(j)(4)(D)(xiii).
2. Treas. Reg. §1.409A-1(b)(4).
3. IRC Sec. 409A(a)(1)(A)(i); Prop. Treas. Reg. Section 1.409A-4 as to valuation when worst-case taxation is required.

the normal AFR underpayment rate.[1] Fortunately, there now are methods under Notices 2008-113 (in the case of operational errors), Notice 2010-6 (in the case of documentation error), and Notice 2010-80 (updating both prior Notices) for correcting many common documentary and operational errors that may avoid the full impact of taxation under Section 409A.

Planning Point: With regard to penalties for violations of Section 409A, at least one state – California – currently adds its own 20 percent excise state income tax penalty when the federal penalty is imposed for a Section 409A error. It is understood that California does not add the penalty interest tax. Planners should therefore check the relevant applicable state rules at the time any voluntary deferral plan is created, to determine the additional state income tax exposure for likely eligible participants. If the sponsor and its participants are substantially all located (and likely to remain) in a state(s) that also imposes its own penalty excise tax, a discussion of other potential approaches to a 409A nonqualified deferred compensation plan may be in order. If the plan desired is an employer-paid SERP, the 409A penalty state income tax possibility may be less of an issue.

3542. What is a "substantial risk of forfeiture" for Section 409A purposes?

The definition of "substantial risk of forfeiture" for purposes of Section 409A ("409A SROF") is uniquely used and more stringent than any of the other definitions under the IRC (Q 3530, footnote 1), especially as to closely-held companies and tax-exempt organizations. The 409A definition starts with the language from the Section 83 definition that there is a substantial risk of forfeiture if compensation is conditioned on the performance of substantial future services, the occurrence of a condition related to the purpose of the compensation, and the possibility of forfeiture is substantial. Whether there is a 409A SROF is based on the likelihood of enforcement, given all the facts and circumstances.

On May 29, 2012, the IRS released proposed Section 83 regulations clarifying "substantial risk of forfeiture" as to *funded* Section 83 "transfer of property plans" and it has drawn some language from Section 409A in doing so (Q 3530). On February 25, 2014, the IRS released final regulations that are substantially similar to the proposed regulations. It appears that the IRS may be trying to better integrate Section 83 with 409A by dropping 409A concepts into these Section 83 regulations. However, in doing so, it may be making substantive changes to "substantial risk of forfeiture" requirements for Section 83 plans by adopting the more stringent 409A requirements. Of course these changes to Section 83 impact only funded "transfer of property" plans and not unfunded promise-to-pay plans that are specifically exempt from Section 83 coverage.

For example, the final Section 409A regulations note the following as to certain specific circumstances that do not constitute a 409A SROF.

- Voluntary salary deferrals (because the deferrals are fully vested and so such a plan is covered and must comply with Section 409A requirements)
- A covenant not to compete, even if the compensation is forfeitable based on a breach

1. IRC Sec. 409A(a)(1)(B); Prop. Treas. Reg. Section 1.409A-4 as to valuation when worst-case taxation is required.

- Compensation following an extension or modification of an existing 409A SROF (hence rolling vesting dates do not create a 409A SROF and, unless there is new consideration for the extension or modification, the amount will be treated as vested and subject to 409A compliance requirements)

- Compensation beyond the time at which the employee could have otherwise received it, *unless the present value of the amount subject to the 409A SROF is materially greater than the present value of the amount the employee could have elected to receive in the absence of the 409A SROF*

Planning Point: These rules primarily create a problem for 457(f) voluntary deferral plans operating under the guidance of IRS Notice 2007-62 and the proposed 457/409A integration regulations that are expected to follow the Notice.[1] This is because, in the Notice, the IRS proposed to substitute the 409A SROF definition for the definition found in 457(f).

In addition, the IRS has indicated that it does not believe any risks of forfeiture are real in a Section 457(f) voluntary deferral unless there is a significant employer match that would provide a substantial benefit to the employee for deferring and placing otherwise vested compensation back at risk.

Therefore, it appears that the IRS is driving planners toward Section 457(b) "eligible" plans as the only alternative for voluntary deferral plans under Section 457 when no employer match is contemplated. Even when a match is contemplated, a "materially greater" safe harbor match is required for a 457(f) "ineligible" voluntary deferral plan, and there is currently no guidance in Notice 2002-62 on what level of match would be "materially greater" so as to satisfy the requirement. Hopefully, the forthcoming 457/409A regulations will clarify this safe harbor match issue in a useful way for planners.

- Payments based on attainment of a prescribed level of earnings, unless there is a substantial risk that this level may not be achieved;

- Payments based on an initial IPO unless the risk there will be no initial IPO is substantial from the beginning; or

- Stock options immediately exercisable in exchange for substantially vested stock, even if the ability to exercise on the stock would terminate on a separation from service.

Where individuals have significant voting power in the employing entity paying the nonqualified deferred compensation, the following relevant factors must be considered to determine if there is a 409A SROF:

- The employee-shareholders relationship to the other shareholders and the extent of their control and potential control over the decision, and possible loss of control of the employee;

1. Proposed regulations integrating Section 457 (especially 457(f) plans) with Section 409A closely following Notice 2007-62 were expected in the fall of 2012, so planners should check to determine if they are available for guidance as to new 457(f) plans under consideration. As of the date of this publication, however, these proposed regulations have yet to be released.

- The position of the employee at the employer and the extent to which the employee-shareholder is subordinate to the other employees, especially other employee shareholders;
- The relationship of the employee to the employer's officers and directors (i.e., whether they are family);
- The person or persons who would approve the employee's discharge; and
- The past actions of the employer in enforcing any restrictions on employees, especially employee-shareholders.[1]

Of course, this means that majority or controlling shareholders in for-profit entities may find it difficult, if not impossible, to establish that there is a 409A SROF.[2] The failure to establish a 409A SROF in such situations apparently does not mean that a nonqualified deferred compensation plan cannot be created for such an employee-shareholder, or so it has been thought to date. This is because the 409A SROF definition is used for a special purpose under Section 409A, rather than to establish whether there is current taxation. Except in the case of 457(f) plans, based on IRS Notice 2007-62, the 409A definition is used to determine access to the short term deferral exception that allows the plan to entirely avoid compliance with the so-called 409A "detail" requirements. If a plan has no 409A SROF and cannot claim the short term deferral exception under the final 409A regulations, it must comply with all the form and operational requirements of Section 409A. Because Section 409A is additive income tax law, the plan would then also have to comply with the other applicable pre-409A IRC income tax sections (for example, Section 61/451 substantial limitation or risk requirements in the case of an unfunded deferred compensation plan) in order to achieve income tax deferral for the plan.

In the first reported Section 409A case (whose facts occurred during the transition period in 2005 when there were no regulations and only the bare statute and IRS Notice 2005-1 to review), the Tax Court held in a summary opinion (meaning it is not legal precedent) that a surrender charge on an annuity was not a substantial risk of forfeiture. The case is confusing at best because the taxpayer was arguing that the situation was covered by Section 409A and a deferral existed, while the IRS argued only that there was a constructive receipt of income under Section 61 and made no 409A violation arguments at all.[3]

3543. What are the reporting and withholding requirements under Section 409A?

Section 409A requires both informational annual tax reporting and tax reporting of amounts in violation of Section 409A (to determine the special taxes). Under IRC Section 409A, employers are required to make an informational tax report on all employee deferrals for a year on a Form W-2 or a Form 1099-MISC, regardless of whether such deferred

1. *See generally*, Treas. Reg. Section 1.409A-1(d).
2. It is less clear how these factors would be applied to 457(f) plans for employees in tax-exempt organizations that have no shareholders. Perhaps forthcoming 457/409A integration regulations will clarify this situation as well.
3. *Slater v. Comm'r*, T.C. Summary Opinion 2010-1, 1-11-2010.

compensation currently is includable in gross income. These amounts are reportable for informational purposes, whether or not they are treated as wages under IRC Section 3401(a).[1] The IRS temporarily waived the informational reporting obligations of employers for 2005-2010.[2] The IRS has since indicated that no informational reporting will be required until the proposed regulations on income taxation under Section 409A are made final.[3] Employers should annually check with their administrator to determine if informational reporting will be required for the coming tax year.

Employers also must annually report amounts includable in gross taxable income under IRC Section 409A on a Form W-2 or a Form 1099 MISC for any documentary or operational violations of Section 409A. This includes violations that require "worst case" tax reporting for a violation, or amounts includible under the documentary and operational correction procedures allowed under current IRS Notices 2008-113, 2010-6, and 2010-80.

Amounts reportable for violations of Section 409A should be reported as wages on line 2 in Form 941 and then in Box 12 of Form W-2 using a "Z" code. *No code is added on Box 12 if the compensation is taxable but not subject to the penalties of Section 409A.* The amounts for an independent contractor should be reported as non-employee compensation in Box 7 and Box 15b of Form 1099-MISC. This includible income is treated as supplemental wages subject to withholding, but there is no requirement for an employer to withhold on the 20 percent excise penalty and late interest tax penalty amounts.[4]

3544. What are the correction procedures under Section 409A?

With respect to nonqualified deferred compensation plans, it is important to note that the EPCS and the SCP correction procedures applying to qualified plans[5] *do not* apply to nonqualified deferred compensation plans, whether subject to Section 409A or not.

Fortunately, it is not always necessary to suffer worst case taxation under Section 409A for an unintentional error in either plan documentation or operation. The IRS has released three notices, one that addresses Section 409A documentation errors, Notice 2010-6,[6], one that addresses Section 409A operational administrative errors, Notice 2008-113,[7] and Notice 2010-80 that updates both on certain select issues.[8] All notices require that certain preconditions be met to take advantage of the special correction processes made available. In general, the notice correction procedures allow for corrections based on the timing of the correction of the error, the party involved (whether an "insider" or another employee), and in some cases the magnitude of the error.

The general remedy under the notices is to include in an employee's income only the amount in error, in the case of operational errors, or some specified portion of the amount, such as

1. IRC Secs. 6041, 6051.
2. Notices 2005-1; 2005-94; 2006-100; 2007-89, 2008-115 and 2010-80
3. Proposed Treas. Reg. 1.409A-4.
4. Notice 2008-115.
5. See generally, Rev. Proc. 2008-50 effective for qualified plan errors after 1-1-2009, as modified and superseded in part by Rev. Proc. 2013-12.
6. Notice 2010-6, 2010-3 IRB, 1-6-2010.
7. 2008-51, 12-23-2008
8. Notice 2010-80, 2010-51 IRB 853.

50 percent or 25 percent in the case of documentation errors. The 20 percent excise tax and premium penalty tax is often avoided, unless the affected participant is an "insider" (applying SEC Section 16-b named officer standards, including those in closely-held companies by analogy). Both the employer and the employee have to report the correction of the error on tax returns to the IRS to claim the benefit of these correction procedures, unless caught and corrected in the year of error. In that case, reporting is not required.

Some commentators think that it also may be possible to correct some documentary and operational errors in covered plans outside the parameters of these three notices under correction concepts applicable prior to the enactment of Section 409A. However, it should be recognized that the IRS takes a strict constructionist view of errors and error correction under Section 409A, and is unlikely to agree with these alternative procedures, even though 409A is additive law and arguably historic contract and tax bookkeeping correction procedures should remain available. However, plans excepted from 409A coverage and grandfathered portions of plans would remain covered by these pre-409A correction procedures and not the formal correction procedures provided in the Notices.[1]

Notices 2009-113 and 2010-6 were expanded in late 2010 under Notice 2010-80. Notice 2010-80 modified Notice 2008-113, governing operational errors, to eliminate employer and employee reporting when an operational error correction is made within the same year as the error. It also modified Notice 2010-6, governing documentation errors, to allow correction of severance/separation plans with an incorrect release of claims provisions if completed by December 31, 2012, and to allow nonqualified plans "linked" to other nonqualified plans (e.g., excessive benefit plans) and stock plans to use Notice 2010-6 to make corrections for document failures prior to that date. However, this last opportunity to correct the errors outlined in Notice 2010-80 expired on December 31, 2012.

Documentary Error Correction

In the case of documentation errors, there are some errors that may be corrected without an amendment or paying any tax or penalties at all. Notice 2010-6 provides an extensive digest of various (but not all possible) documentation errors and the remedies that permit the employee to report less than the amount that would be required in the worst case Section 409A taxation situation and avoid the full Section 409A 20 percent excise and premium interest penalty taxes in many cases. Notice 2010-6 highlights specific documentation errors, with corrective procedures and costs.

Because it is focused on language and structures that create errors under Section 409A, it also provides a useful checklist for plan drafting to avoid common Section 409A drafting errors for various types of Section 409A-covered plans. Notice 2010-6 also gives new plans a grace period of twelve months from the effective date to correct errors found in the plan documentation.

1. See for example, Olshan, Regina & Schohn, Erica, Expert Q&A on Correcting Section 409A Documentary Violations, Practicallaw.com, October, 2010; Baker, Rosina, 409A Failures: Correcting Outside of the IRS's Formal Correction Programs, Presentation at DC Bar Luncheon Program, February 25, 2010, available at ipbtax.com; and Barker, Rosina & O'Brien, Kevin, Document Failures in the Section 409A Plan: Correcting With and Without Notice 2010-6, **Pension & Benefits Daily**, BNA, April 12, 2010.

Operational Error Correction

In the case of operational errors, Notice 2008-113 defines operational errors based on Section 409A requirements. It organizes them into useful categories of Section 409A operational violations, such as distributions made before the six month delay period for highly compensated employees. It outlines the Notice 2008-113 special corrective procedure required to correct that category of error without having to incur the worst case tax event. In general, full relief is available when operational errors involving any employee are discovered and corrected in the same tax year, and by the second tax year in the case of employees that are not "insiders," as defined under Section 16(b) of the federal securities laws notwithstanding whether the employer is a public or private corporation. In other words, the "insider" rule for 409A correction purposes applies to public companies and also to private, closely-held for-profit and tax-exempt organizations by analogy.

Planning Point: Notice 2010-6 allowed a final opportunity to correct documentation errors in plans not later than December 31, 2010, and to have these corrections apply retroactively back to the January 1, 2009, effective date for actual document compliance. As of January 1, 2011, this opportunity passed, and sponsors now must use Notice 2010-6, as modified by Notice 2010-80 to make formal corrections. In addition, all errors in plans, whether of a documentary or operational nature, usually can be corrected in order to minimize the negative tax impact on an employee if the error is identified and corrected sooner rather than later, especially if caught and corrected in the same tax year. Therefore, plan sponsors should routinely audit their plans in the late fall to discover and correct any operational or documentation errors before the end of the current tax year. They should also build in a review audit in the first year of a plan in order to catch initial plan drafting errors and then correct them during the correction grace period provided for new plans that do not generally constitute an error or require formal correction under Notice 2010-6.

409A Tax Calculation

If it is necessary to compute the worst case scenario, the directions for completing the calculations, including the calculation of the late premium penalty interest, as applicable, can be found in Proposed Treasury Regulation Section 1.409A-4. This proposed regulation for calculation of the tax under Section 409A was issued in December 2008 and is still not final as of the date of this publication. One of the positive elements in the calculations under the proposed regulations is that the calculation applies only to vested benefit amounts unless there is an indication that vesting is being used as a subterfuge just to avoid the application of Section 409A. It is not clear how this calculation rule would apply to plans with long vesting periods.

Planning Point: In theory, under this rule, corrections could be made on a SERP design with vesting delayed until nearly retirement (as many SERPs for key employees in closely-held companies are structured), and still be able to make corrections to the plan for errors during nearly the entire period of the plan without worrying about imposition of a tax under Section 409A. This is because the benefits would remain unvested, and therefore not includible in any calculations for an error. Of course, such plans might be better designed as a plan excepted from 409A coverage entirely, so as to entirely avoid IRS questions concerning whether the exclusion of unvested amounts will be recognized. Presumably, the IRS would ignore this rule if the plan is drafted totally ignoring the requirements of Section 409A, or if there appears to be a pattern of ignoring Section 409A with regard to the plan.

Planning Point: On May 9, 2014, in a subcommittee meeting at the America Bar Association's annual conference, the IRS announced that it was launching a new, limited CIP 409A audit. Although the audit is to impact only 50 public companies that are also targeted for an audit on employment taxes, the audit will be used to sharpen IRS future audit practice on 409A plans for broader audits that will surely follow.

This new IRS 409A audit initiative suggests the wisdom of periodic "self-audits" of both the required documentary and operational compliance. A periodic self-audit makes sense anyway, since the special correction programs, which provide a less than worse-case result under the penalty provisions of 409A, are NOT available for companies once they are in an IRS audit. Moreover, the IRS currently applies a strict application of 409A penalties when they are discovered in audit. Therefore, it is recommended that companies routinely self-audit their 409A plans annually for operational compliance. Documents can be reviewed less frequently, but certainly should be reviewed any time they are amended or restated. However, compliant plan documentation and operation should always be in sync at all times.

3545. What rules apply to correction of errors in nonqualified deferred compensation plans excepted from Section 409A?

The IRS procedures for the voluntary correction of errors in qualified pension plans do not apply to the correction of errors in nonqualified deferred compensation plans. Moreover, the correction of errors in connection with nonqualified deferred compensation plans was not the subject of much discussion prior to the enactment of Section 409A. There were legal theories for the correction of both documentation and operational administrative errors in connection with nonqualified deferred compensation plans that existed prior to Section 409A (Q 3544).

Most documentary errors, in general, were corrected under various legal theories for the reformation of contracts (such as correction of "scrivener errors") because nonqualified deferred compensation plans are contracts. Likewise, longstanding tax bookkeeping theories and principles were applied to correct operation plan administration errors (Q 3544).

Where plans can claim a regulatory exception from Section 409A coverage or are grandfathered from Section 409A coverage, these pre-409A legal theories remain the appropriate methods for correcting both documentary and operational plan administration errors. Some believe these pre-409A legal theories still can be used to correct errors not covered by Notices 2008-113 and 2010-6 (as modified by Notice 2010-80), even as to errors specifically covered by these notices. The fact that Section 409A is additive law would seem to support this position. The IRS takes a strict view as to the correction of errors in 409A covered plans and is unlikely to agree with corrections made outside the notices at this stage, except as to grandfathered and 409A-excepted plans, and plans that fall under the short term deferral exception (Q 3540).

3546. Does Section 409A apply to independent contractors?

IRC Section 409A generally does not apply to amounts deferred under an arrangement between an employer and either an accrual-based independent contractor or an unrelated independent contractor. If both the employer and the independent contractor are accrual-based taxpayers, the agreement is not a nonqualified deferred compensation plan covered by Section 409A.

In addition, if, during a contractor's taxable year in which an amount is deferred, the contractor provides significant services to each of two or more service recipients that are unrelated, both to each other and to the independent contractor, the arrangement does not involve a deferral of compensation under Section 409A; the plan is not covered by Section 409A. For this exception, a safe harbor rule provides that an independent contractor will be treated as providing significant services to more than one service recipient where not more than 70 percent of the total revenue of the trade or business is derived from any particular service recipient or group of related service recipients. Unfortunately, there is no three-of-five or similar multi-year feature in this safe harbor rule.[1]

3547. What are Section 409A's effective dates, compliance deadlines, and grandfathering rules?

The requirements of Section 409A generally apply to amounts deferred (or prior unvested amounts) after December 31, 2004. The requirements also apply to amounts deferred prior to January 1, 2005, if the plan under which the deferral is made is materially modified after October 3, 2004. There is an exception for material modifications made pursuant to IRS guidance. The IRS deferred the date to comply in both form and operation with the final regulations under Section 409A until December 31, 2008, and actual compliance began as of January 1, 2009.[2] Prior to January 1, 2009, plans were required to operate in "good faith" compliance with Section 409A documentary and operational requirements.[3]

It should be noted that, under IRS Notice 2010-6, addressing documentation errors, sponsors were given until not later than December 31, 2010, to make corrections to documents not made compliant by December 31, 2008, and to have these corrections deemed retroactively in compliance as of the January 1, 2009 actual compliance deadline under Section 409A (see prior discussion on correction of documentation and operational plan errors)(Q 3544). This deadline has passed and generally has not been extended except for certain specific corrections outlined in Notice 2010-80 that expired after December 31, 2012.

Finally, corrections on certain assets in offshore rabbi trusts were given only until December 31, 2007 to disconnect or terminate the trust so as to comply with the 409A(b) funding requirements. Notice 2008-33 provided temporary guidance on complying with these requirements. There are currently no regulations yet on Section 409A(b) so future guidance as to the structuring of assets in such rabbi trusts is not yet available. A plan is materially modified if a new benefit or right is added or if a benefit or right existing as of October 3, 2004 is materially enhanced and such addition or enhancement affects amounts earned and vested before January 1, 2005. The reduction of an existing benefit is not a material modification.[4] Adding a participant right to a grandfathered plan that it did not possess, even though it was technically permissible under Section 409A, will be considered to be a material modification (for example, an "unforeseeable emergency" distribution right).

1. Treas. Reg. §1.409A-1(f)(2)(C)(iii).
2. Notice 2007-86, 2007-46 IRB 990; Notice 2006-79, 2006-43 IRB 763.
3. IRS Notice 2005-1.
4. Treas. Reg. §1.409A-6(a)(4).

Planning Point: Employers should use great care in making any modifications to existing pre-409A deferred compensation arrangements until they are paid out to avoid the application of IRC Section 409A. According to the final regulations, a "material modification" that causes loss of grandfathering may be considered to be a formal plan amendment and may occur simply by virtue of an employer's exercise of administrative discretion in the plan participant's favor. Any amendment effected by form or practice that adds a beneficial right to a plan, even if it were allowed prior to the enactment of Section 409A and remained permissible after enactment (for example, a financial hardship provision), can cause loss of grandfather protection.

3548. What elements of an unfunded arrangement met regulatory requirements before the enactment of Section 409A?

Prior to the enactment of Section 409A, the IRS generally would issue advance rulings concerning the tax consequences of an unfunded arrangement if the arrangement met the requirements outlined below. Some of the requirements parallel those now required in IRC Section 409A.[1] The IRS generally will not issue a letter ruling to a plan sponsor on the income tax consequences of a plan under Section 409A and does not plan to issue any prototype documents under Section 409A (there were no prototype documents prior to the enactment of Section 409A either).[2]

Any initial election to defer compensation generally had to be made before the beginning of the period of service for which the compensation was payable, regardless of the existence of forfeiture provisions. If any election other than the initial election to defer compensation could be made after the beginning of the period of service, the plan had to set forth substantial forfeiture provisions that had to remain in effect throughout the entire period of the deferral. The plan had to define the time and method for paying deferred compensation for each event (such as retirement) entitling a participant to benefits. The plan could specify the date of payment or provide that payments would begin within thirty days after a triggering event.

If the plan provided for the early payment of benefits in the case of an "unforeseeable emergency," that term was defined as an unanticipated emergency caused by an event beyond the control of the participant or beneficiary that would cause severe financial hardship if early withdrawal were not permitted. The plan also had to provide that any early withdrawal would be limited to the amount necessary to meet the emergency. Language similar to that in Treasury Regulations Sections 1.457-2(h)(4) and 1.457-2(h)(5) could be used. The plan had to provide that participants had the status of general unsecured creditors of the employer and that the plan constituted a mere promise by the employer to pay benefits in the future. The plan also had to state that it was the intention of the parties that it be unfunded for tax and ERISA purposes. The plan had to provide that a participant's rights to benefits could not be anticipated, alienated, sold, transferred, assigned, pledged, encumbered, attached, or garnished by the participant's or the participant's beneficiary's creditors.[3]

1. Rev. Proc. 2009-3, 2009-1 IRB 107, 2008-1 IRB 110.
2. Rev. Proc. 2008-61, 2008-42 IRB, 10-20-2008, amplifying Rev. Proc. 2008-3, 2008-1 IRB 110
3. Rev. Proc. 2009-3, Sec. 3.01(42), 2009-1 IRB 107; Rev. Proc. 71-19, 1971-1 CB 698, as amplified by Rev. Proc. 92-65, 1992-2 CB 428.

3549. What are the deferred compensation rules applicable to foreign nonqualified entities under Section 457A?

In the Emergency Economic Stabilization Act of 2008, Congress created new IRC Section 457A to impose immediate taxation on deferred compensation where the employer is a foreign "nonqualified entity" (as defined in the law) that is not subject to U.S. taxation. This section is comparable to Section 409A, which potentially applies to nonqualified deferred compensation paid by any entity, U.S. domestic or foreign. In addition, 457A applies to both cash and accrual method taxpayers while Section 409A applies to just cash method taxpayers.

Under IRC Section 457A, all compensation deferred under a nonqualified deferred compensation plan of a nonqualified entity is includable in gross income of a plan participant when there is no substantial risk of forfeiture of the rights to such compensation. IRC Section 457A defines a substantial risk of forfeiture as applicable "only if" a person's rights are conditioned on the future performance of substantial services.[1] This definition is not exactly the same as that in Section 409A but is generally consistent. For instance, Section 409A includes attainment of performance goals in addition to performance of substantial services.

IRC Section 457A defines a nonqualified entity as (1) any foreign corporation, unless substantially all of its income is "effectively connected with the conduct of a trade or business in the United States" or is "subject to a comprehensive foreign income tax," or (2) any partnership, unless substantially all of its income is allocated to persons other than "foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax" and "organizations which are exempt from tax under this title."[2] (IRC Section 457A provides a limited exception for deferred compensation payable by foreign corporations that have "effectively connected income" under IRC Section 882).

A "comprehensive foreign income tax" is the income tax of a foreign country if there is an applicable comprehensive income tax treaty between that country and the United States or the Secretary of the Treasury is otherwise satisfied that it is a comprehensive foreign income tax.[3]

IRC Section 457A generally applies to nonqualified deferred compensation within the same broad scope as IRC Section 409A. IRC Section 457A explicitly applies to all stock options and stock appreciation rights, even those issued with the option price or measurement price at fair market value.[4] IRC Section 457A also extends the 2½ month short term deferral exemption in IRC Section 409A to twelve months, meaning that IRC Section 457A does not apply to compensation received during the taxable year following that in which the compensation is no longer subject to a substantial risk of forfeiture.[5]

If the amount of any deferred compensation taxable under IRC Section 457A is not determinable at the time it is otherwise includable under that section, it is subject to a penalty and

1. IRC Sec. 457A(d)(1)(A).
2. IRC Sec. 457A(b).
3. IRC Sec. 457A(d)(2).
4. IRC Sec. 457A(d)(3)(A).
5. IRC Sec. 457A(d)(3)(B).

interest when so determinable. In addition to the normal tax, the amount includable is subject to a 20 percent penalty tax and interest on the underpayment of taxes at the normal underpayment rate plus 1 percent.[1]

IRC Section 457A applies to deferred amounts attributable to services performed after December 31, 2008. Congress also directed the IRS to provide guidance within 120 days on amending plans to conform to IRC Section 457A and providing a limited period of time to do so without violating IRC Section 409A.

3550. What are the tax consequences of a transfer to a qualified plan?

In a private letter ruling, the IRS determined that employees that elect to cancel their interests in an unfunded nonqualified deferred compensation plan in exchange for substitute interests in a qualified plan would be taxable on the present value of their accrued benefits in the qualified plan upon the funding of those new interests. They would have to include the value of future benefits attributable to future compensation when the cash, which otherwise would have been received under the nonqualified plan, would have been includable.[2]

Planning Point: This ruling is largely consistent with Section 409A, which broadly prohibits "substitutions" of benefits, and deems them a prohibited acceleration that results in immediate taxation and the application of penalty taxes. This prohibition does not apply to an annual transfer from a nonqualified plan to a qualified 401(k) plan that occurs within the framework of a wrap nonqualified plan, which remains possible under Section 409A. Nor does Section 409A apply to the process of using alternative qualified nondiscrimination testing rules to determine and then allocate the largest possible benefit into the qualified plan as between the excess benefit nonqualified plan and the qualified plan.

3551. What ERISA requirements are imposed on deferred compensation plans?

Deferred compensation plans may be required to meet various requirements under ERISA, including funding and vesting requirements, unless they can find an exemption from coverage and meet those ERISA exemption requirements.[3]

Certain plans, including "top hat" plans for a "select group," "excess benefit plans" (Q 3590), and plans that provide payments to a retired partner or a deceased partner's successor in interest under IRC Section 736, are exempt from some or all of these more onerous ERISA requirements.[4]

3552. What rules govern "Top Hat" plans?

Under ERISA, a "top hat" plan is an unfunded plan maintained primarily to provide deferred compensation for a select group of management or highly compensated employees.[5] The determination of whether a plan is offered to a "select group" is a facts and circumstance

1. IRC Sec. 457A(c).
2. Let. Rul. 9436051.
3. See, generally, ERISA, Titles I and IV.
4. ERISA Secs. 4(b), 201, 301, 401, 4021.
5. ERISA Sec. 201(2), 301(a)(3),4021(b)(6).; also see DOL Reg. Section 2520.104-23 providing an alternative, one-time short-form of reporting.

determination.[1] Where all management employees were eligible for a plan, the plan did not meet the select group requirement.[2]

Top hat plans are subject to a different standard of review from other ERISA plans, because they are exempt from most of ERISA's substantive rules. They are subject to a de novo review unless the plan documents expressly grant deference to the plan administrator, rather than to the "arbitrary and capricious"[3] standard of *Firestone v. Bruch*.[4]

There is another ERISA exemption available for "excess benefit plans" that make up the difference between what the qualified plan pays and what it would have paid but for the caps on qualified plan benefits to the highly compensated. This type of plan is also commonly referred to as a "top hat" plan since by its definitional terms it applies only to the highly compensated.[5]

As to income taxation, top hat plans will generally be "nonqualified deferred compensation plans" and thereby be covered by additive Section 409A (and prior income tax law), unless an exception to coverage can be claimed (example, short term deferral exception for SERPs).

3553. What is the "economic benefit" theory?

Under the economic benefit income tax theory, an employee is taxed when he or she receives something other than cash that has a determinable, present economic value. The danger, in the nonqualified deferred compensation context, is that an arrangement for providing future benefits will be considered to provide the employee with a current economic benefit capable of valuation. Current taxation arises when assets are unconditionally and irrevocably paid into a fund or trust to be used for the employee's sole benefit.[6]

An employer can establish a reserve for satisfying its future deferred compensation obligations while preserving the "unfunded and unsecured" nature of its promise, provided that the reserve is wholly owned by the employer and remains subject to the claims of its general creditors. A mere promise to pay, not represented by notes or secured in any way, is not regarded as a receipt of income.[7] Unfunded plans do not confer a present, taxable economic benefit.[8] An unfunded and unsecured promise of future payment is not taxable under IRC Section 83, which codifies the economic benefit theory.[9]

It generally has been accepted that deferred compensation benefits can be backed by life insurance or annuities (or other assets) in a general asset reserve of the employer without creating a currently taxable economic benefit to a participant.[10]

1. See, e.g., *Demery v. Extebank*, 216 F.3d 283 (2d Cir. 2000) ("select group" requirement was met where plan was offered to 15.34 percent of employees, since they were all either management or highly compensated employees).
2. *Carrabba v. Randalls Food Mkts, Inc.*, 252 F.3d 721 (5th Cir. 2001), *cert. denied*, 26 EBC 2920 (US Sup. Ct. 2001).
3. *Goldstein v. Johnson & Johnson*, 251 F.3d. 433 (3d Cir. 2001).
4. 489 U.S. 101 (1989).
5. ERISA Sections 4(b)(5), 201(7),301(a)(9),4021(b)(6)
6. *Sproull v. Comm.*, 16 TC 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952); Rev. Rul. 60-31, sit. 4, 1960-1 CB 174.
7. Rev. Rul. 60-31, 1960-1 CB 174, 177; Rev. Rul. 70-435, 1970-2 CB 100.
8. *Minor v. U.S.*, 772 F.2d 1472, 85-2 USTC ¶9717 (9th Cir. 1985).
9. Cf. Treas. Reg. §1.83-3(e).
10. See, e.g., *Casale v. Comm.*, 247 F.2d 440 (2d Cir. 1957) (the IRS has said it will follow this decision, Rev. Rul. 59-184, 1959-1 CB 65); Rev. Rul. 72-25, 1972-1 CB 127; Rev. Rul. 68-99, 1968-1 CB 193; TAM 8828004; Rev. Rul. 60-31, 1960-1 CB 174.

In the *Goldsmith* case,[1] the court found that the promises of pre-retirement death and disability benefits provided the employee with a current economic benefit – current life insurance and disability insurance protection – even though the corporation was the owner and beneficiary of the policy, which was subject to the claims of its general creditors. The court did not find constructive receipt of the promised future payments, but ruled that the portion of the premium attributable to life, accidental death, and disability benefits was taxable as a current economic benefit to the employee. The *Goldsmith* case appears to be anomalous. Since it was decided, the IRS has not treated pre-retirement death or disability benefits paid out as ordinary income under a nonqualified deferred compensation plan as creating a currently taxable economic benefit.[2] This income tax treatment can be compared with that intended by Congress for deferred compensation plans under IRC Section 457 (Q 3584).

It should be noted that the economic benefit tax theory has not been eliminated by the enactment of Section 409A, because Section 409A is *additive* law and actually further defines constructive receipt. Therefore, the IRS still can apply this theory when it believes it is supported by the facts of any nonqualified deferred compensation arrangement situation covered by, grandfathered, or excepted from Section 409A coverage.

3554. How does an informal funding affect a private IRC Section 451 unfunded nonqualified deferred compensation account balance or nonaccount balance plan?

An IRC Section 451 unfunded deferred compensation account balance or nonaccount balance arrangement cannot be formally funded. That is, the employee cannot be given any secured interest in any trust or escrowed fund or in any asset, such as an annuity or life insurance contract, without adverse tax consequences. If a secured interest is given, the arrangement is treated as a funded arrangement under IRC Section 83 and must be handled according to its tax deferral requirements (Q 3523 to Q 3531).

A nonqualified deferred compensation account balance or nonaccount balance arrangement can be informally funded without jeopardizing tax deferral, even after enactment of Section 409A. For example, even after the enactment of IRC Section 409A, it would appear that an employer can still set aside assets as a general reserve in a rabbi trust (Q 3556) to provide funds for payment of deferred compensation obligations, as long as the following requirements are met:

(1) the plan participants have no interest in those assets and they remain the employer's property, subject to the claims of the employer's general creditors in bankruptcy,

(2) the trust or assets supporting the plan are not placed offshore (in light of IRC Section 409A(d),

(3) the trust does not receive assets or pay out deferred compensation to participants during the period of an employer's declining economic circumstances, and

1. *Goldsmith v. U.S.*, 586 F.2d 810, 78-2 USTC ¶9804 (Ct. Cl. 1978).
2. See, e.g., Let. Ruls. 9517019, 9510009, 9505012, 9504006, 9427018, 9403016, 9347012, 9323025, 9309017, 9142020.

(4) there is no transfer of assets to a trust during a period the sponsor's qualified defined benefit pension plan, if any, is "at risk" or underfunded.[1]

Rabbi trusts remain very popular devices for reserving assets acquired to support the liabilities of a nonqualified deferred compensation account balance or nonaccount balance arrangement. Currently, however, there are no proposed regulations for the so-called "funding" rules under Section 409A; there is only the bare language of the law. Practitioners should watch for these regulations, which are likely to further clarify these "funding" prohibition requirements in connection with the use of such a trust.

The IRS historically has not considered a plan that sets aside assets in an escrow account to be "formally funded" if the assets are subject to the claims of the employer's general creditors.[2] Of course, the Section 409A prohibition on use of offshore trusts to hold assets intended to hold general company assets changes adds a new requirement to the use of such a trust.

It generally has been accepted for some time that an employer may informally fund its obligation by setting aside a fund composed of life insurance contracts, annuities, mutual funds, securities, etc., without adverse tax consequences to the employee so long as the fund remains the unrestricted asset of the employer and the employee has no interest in it.[3] Thus, a deferred compensation plan should not be regarded as "funded" for income tax purposes (although there is another issue of funding for ERISA purposes) merely because the employer purchases a life insurance policy or an annuity contract to ensure that funds will be available when needed. The Tax Court stretched these rules a bit in ruling that payment obligations to attorneys under a structured settlement were unfunded even though the attorneys were annuitants under the annuities financing the obligations; it is not clear if this decision can be extended to more traditional nonqualified deferred account balance and nonaccount balance plans.[4] In general, the sponsoring company must be the owner and recipient of all benefits from any insurance contracts in the general reserve for the arrangement to be treated as unsecured and thereby unfunded for income tax purposes.

Since the enactment of Section 409A, securing or distributing deferred compensation on the employer's falling net worth or other financial events unacceptably secures the payment of the promised benefits.[5] This now includes hybrid rabbi/secular trust arrangements that distribute assets from nominal rabbi trusts to secular trusts on the occurrence of triggering events based on the employer's financial difficulty. Under any such arrangement, compensation otherwise successfully deferred is immediately taxable as a violation of Section 409A, and is subject to its 20 percent excise tax, plus premium penalty interest on the underpayment of taxes (the normal underpayment AFR rate plus 1 percent).[6]

1. *Minor v. U.S.*, 772 F.2d 1472, 85-2 USTC ¶9717 (9th Cir. 1985); see also *McAllister v. Resolution Trust Corp.*, 201 F.3d 570 (5th Cir. 2000); *Goodman v. Resolution Trust Corp.*, 7 F.3d 1123 (4th Cir. 1993).
2. Let. Ruls. 8901041, 8509023.
3. Rev. Rul. 72-25, 1972-1 CB 127 (annuity contract); Rev. Rul. 68-99, 1968-1 CB 193 (life insurance).
4. *Childs v. Comm.*, 103 TC 634 (1994), *aff'd*, 89 F.3d 856 (11th Cir. 1996).
5. IRC Sec. 409A(b)(2); Notice 2006-33, 2006-15 IRB 754.
6. IRC Sec. 409A(b)(5).

As noted, setting aside assets in an offshore trust to directly or indirectly fund deferred compensation now also unacceptably secures the payment of the promised benefits under the funding provisions of Section 409A.[1] Under any such arrangement, the compensation otherwise successfully deferred is immediately taxable and subject to a 20 percent excise tax, and premium penalty interest is due at the normal underpayment AFR rate plus 1 percent.[2]

It must be pointed out that both the Section 409A prohibition on financial triggers and on offshore trusts apply even to deferrals of compensation earned and vested on or before December 31, 2004 (and thus not generally subject to the requirements of Section 409A). The IRS provided transition relief through December 31, 2007, for amounts otherwise subject to Section 409A(b), if those assets relate to compensation deferred on or before December 31, 2004, and if those assets were set aside, transferred, or restricted on or before March 21, 2006.[3] This relief was not extended to coincide with the extension of compliance relief under Section 409A to December 31, 2008. Compliance with the Section 409A funding requirements needed to be completed by December 31, 2007.

In addition, the Section 409A funding requirements also prohibits top executives – individuals described in IRC Section 162(m)(3) or subject to Section 16(a) of the Securities Exchange Act of 1934 – from setting aside assets in a rabbi trust or other informal funding device during a "restricted period." The restricted period is any period during which the employer is in bankruptcy, during which a company's qualified defined benefit plan is in "at-risk" status (underfunded per the statutory requirements), or during the six months before or after an insufficient plan termination. The restrictions apply to any transfers or reservations after August 17, 2006. If any Section 409A prohibited transfer occurs, compensation otherwise successfully deferred is immediately taxable and subject to a 20 percent excise tax and premium penalty interest on the underpayment of taxes is due at the normal underpayment AFR rate plus 1 percent.[4]

Pre-409A, one court had ruled that a "death benefit only" plan backed by corporate-owned life insurance was "funded" for ERISA purposes.[5] The decision has been criticized, but the result, if ever accepted by other courts, could have far reaching tax implications.

If a plan is "funded" for ERISA purposes (meaning that assets are ERISA "plan assets"), it generally is required to satisfy ERISA's exclusive purpose rule and to meet certain minimum vesting and funding standards. Once these requirements are met, the plan may no longer be considered "informally funded" for tax purposes as well, and adverse income tax consequences may follow. In 1987, the same court that decided *Dependahl* distinguished it and concluded that a nonqualified deferred compensation plan informally funded with life insurance contracts was not funded for ERISA purposes and thus was not subject to minimum vesting and funding standards.[6] The court distinguished this case from *Dependahl*, in part, by noting that the *Belsky*

1. IRC Sec. 409A(b)(1); Notice 2006-33, 2006-15 IRB 754.
2. IRC Sec. 409A(b)(5).
3. Notice 2006-33, 2006-15 IRB 754.
4. IRC Secs. 409A(b)(3), 409A(b)(5).
5. See *Dependahl v. Falstaff Brewing Corp.*, 491 F. Supp. 1188 (E.D. Mo. 1980), *aff'd in part*, 653 F.2d 1208 (8th Cir. 1981), *cert. denied*, 454 U.S. 968 (1981) and 454 U.S. 1084 (1981).
6. *Belsky v. First Nat'l Life Ins. Co.*, 818 F.2d 661 (8th Cir. 1987).

agreement stated specifically that the employee's only right against the employer was that of an unsecured creditor.[1]

Over the years, the Department of Labor ("DOL") has issued various advisory opinions permitting the use of an employer-owned asset to finance different types of plans while the plans maintained their "unfunded" status under ERISA.[2] The DOL has stated that plan assets include any property, tangible or intangible, in which the plan has a beneficial ownership interest.[3] According to footnote three in Advisory Opinion 94-31A, the "beneficial ownership interest" analysis is not relevant in the context of excess benefit and top hat plans.[4] The DOL reasoned that its position was supported by the special nature of these plans, the participating employees' ability to affect or substantially influence the design and operation of the plan, and the rulings of the IRS surrounding the tax consequences of using rabbi trusts with these plans. The kind of plan asset analysis relevant in that context is not clear, although the DOL does have a working premise that rabbi trusts meeting with IRS approval will not cause excess benefit or top hat plans to be funded for ERISA purposes.[5] The impact on the ERISA treatment of assets after application of the Section 409A funding rules is yet to be determined. The basic concept of the prior DOL position that a plan is "unfunded" for ERISA purposes if it is "unfunded" for income tax purposes still would seem to work.

Pre-409A, a key associate insurance policy used to informally fund a plan should be held by the employer (as owner) and not distributed to the employee at any time; otherwise, the employee would be taxed on the value of the contract when he or she receives it.[6] This result would not change under Section 409A since a key associate policy, as an informal funding device, generally would not be subject to Section 409A when set up correctly (Q 282). The employer cannot deduct its premium payments, but the employer receives the death proceeds tax-free.[7] Proceeds paid to a corporation may be includable, at least in part, in the corporation's income for alternative minimum tax purposes (Q 300).[8] For tax results on the surrender of a policy, see Q 51, Q 52. For a discussion of accumulated earnings tax, see Q 293.

Even after Section 409A, an employee generally is not taxable on the premiums paid by the employer or on any portion of the value of the policy or annuity, provided that the employer applies for, owns, is beneficiary of, and pays for the policy or annuity contract and uses it merely

1. For courts finding plans backed by life insurance or annuities to be unfunded, see *Reliable Home Health Care Inc. v. Union Central Ins. Co.*, 295 F.3d 505 (5th Cir. 2002); *Miller v. Heller*, 915 F. Supp. 651 (S.D.N.Y. 1996); *The Northwestern Mut. Ins. Co. v. Resolution Trust Corp.*, 848 F. Supp. 1515 (N.D. Ala. 1994); *Darden v. Nationwide Mut. Life Ins. Co.*, 717 F. Supp. 388 (E.D.N.C. 1989), *aff'd*, 922 F.2d 203 (4th Cir.), *cert. denied*, 502 U.S. 906 (1991); *Belka v. Rowe Furniture Corp.*, 571 F. Supp. 1249 (D. Md. 1983).
2. See DOL Adv. 92-22A (cash value element of split dollar life insurance policy under death benefit plan is not a plan asset); DOL Adv. Op. 92-02A (stop-loss insurance policy backing medical expense plan obligations is not plan asset of death benefit plan); DOL Adv. Op. 81-11A (corporate-owned life insurance is not plan asset of death benefit plan).
3. DOL Adv. Op. 94-31A.
4. But see *Miller v. Heller*, 915 F. Supp. 651 (S.D.N.Y. 1996) (in holding that a deferred compensation plan is an unfunded top hat plan, the court interpreted footnote three in Advisory Opinion 94-31A to mean that the DOL's *entire* analysis for determining whether assets are plan assets is not relevant to the issue of whether the plan is funded).
5. See, e.g., DOL Adv. Op. 92-13A. See also DOL Adv. Op. 90-14A (great deference is given to the position of the IRS regarding deferred compensation plans when determining, for ERISA purposes, whether a top hat plan is funded).
6. *Centre v. Comm.*, 55 TC 16 (1970); *Morse v. Comm.*, 17 TC 1244 (1952), *aff'd*, 202 F.2d 69 (2nd Cir. 1953). See Treas. Reg. §1.83-3(e).
7. IRC Sec. 264(a)(1).
8. IRC Secs. 56-59.

as a reserve for the employer's obligations under the deferred compensation agreement.[1] Properly structured funding arrangements should not be treated as a nonqualified deferred compensation subject to Section 409A.

Where an employee receives a basic vested right in cash values of a policy, or basic life insurance protection and a vested right in the cash surrender values of a policy, the policy becomes a split dollar arrangement. A split dollar arrangement also can be subject to Section 409A, unless it is one of the two excepted variations under IRS Notice 2007-34.

Premiums for a split dollar policy should be taxable to the employee under split dollar and Section 409A rules (making it subject to the Section 409A penalty taxes and interest if the arrangement does not comply with Section 409A requirements in both form and operation). The Tax Court has held that employer-paid life insurance premiums on an employee's life, where the annual increase in the cash surrender value benefits the employee and the employee also receives annual insurance protection for both the employee and his or her family, will be includable in the employee's gross income.[2] Only an endorsement split dollar (where the participant receives only an interest in a portion of the policy death benefits and pays only an economic benefit tax cost) seems to escape additional taxation under both split dollar and Section 409A tax rules.

With respect to contributions made after February 28, 1986 to annuity contracts held by a corporation, partnership, or trust (i.e., a nonnatural person), "the income on the contract" for the tax year of the policyholder generally is treated as ordinary income received or accrued by the contract owner during such taxable year (Q 439).[3] Corporate ownership of life insurance may result in exposure to the corporate alternative minimum tax (Q 300).

3555. How does a surety bond, indemnification insurance or a third party guarantee affect a private IRC Section 451 unfunded nonqualified deferred compensation account balance or non-account balance plan?

The IRS has privately ruled that an employee's purchase of a surety bond (with no reimbursement from his or her employer) as protection against nonpayment of unfunded deferred compensation benefits would not, by itself, cause deferred amounts to be includable in income prior to receipt.[4] The IRS also warned, however, that an employer-paid surety bond would cause current taxation. A later letter ruling has blurred the line between employee-provided and employer-provided surety bonds; the IRS hinted, without clearly distinguishing between employee-paid and employer-paid surety bonds, that the use of a surety bond to protect deferred compensation could cause the promise to be secured, resulting in taxation under IRC Section 83 when the deferred compensation is substantially vested (that is, either not subject to a substantial

1. *Casale v. Comm.*, 247 F.2d 440 (2nd Cir. 1957) (the IRS has said it will follow this decision, Rev. Rul. 59-184, 1959-1 CB 65); Rev. Rul. 72-25, 1972-1 CB 127; Rev. Rul. 68-99, 1968-1 CB 193; Let. Ruls. 8607032, 8607031; TAM 8828004. See also Let. Rul. 9122019. But see Goldsmith v. U.S., 586 F.2d 810, 78-2 USTC ¶9804 (Ct. Cl. 1978) discussed in Q 3553.
2. *Frost v. Comm.*, 52 TC 89 (1969).
3. IRC Sec. 72(u).
4. Let. Rul. 8406012.

risk of forfeiture or transferable to a third party free of such a risk).[1] Whether the IRS meant to question both employer-provided and employee-provided surety bonds is not clear.

The IRS has privately ruled that an employee can buy indemnification insurance to protect his or her deferred benefits without causing immediate taxation. This result holds even if the employer reimburses the employee for the premium payments as long as the employer has no other involvement in the arrangement (the employee's premium payments must be treated as nondeductible personal expenses, and any premium reimbursements must be included in the employee's income).[2] The ERISA consequences of such an arrangement are not clear.

On occasion, third party guarantees of benefit promises have received favorable treatment. For example, a parent corporation's guarantee of its subsidiary's deferred compensation obligations did not accelerate the taxation of the benefits.[3] The conclusion that the plaintiffs' promise to pay their attorney was funded and secured and subject to IRC Section 83 where they irrevocably ordered the defendants' insurers to pay the plaintiffs' attorney his fees out of the plaintiffs' recovery and the defendants' insurers paid the attorney by purchasing annuities for him was "strengthened" by the fact that a defendant and the defendants' insurers guaranteed to make the annuity payments should the annuity issuer default.[4]

The current value of protection provided by an employer-paid surety bond or other guarantee arrangement constitutes a taxable economic benefit;[5] protecting deferred compensation benefits by giving employees certificates of participation secured by irrevocable standby letters of credit secured the promise and triggered application of IRC Section 83.[6] Further, an employer's purchase of irrevocable standby letters of credit that were beyond the reach of its general creditors to back its promise to pay accrued vacation benefits secured the promise and triggered taxation under IRC Section 83.[7]

There is some controversy between the IRS and the Tax Court over whether a promise to pay will be "funded" for tax purposes if the benefit obligation is transferred to a third party. The IRS is likely to think that the employer's promise is funded, even if the third party pays the transferred obligations out of general revenues or sets aside a fund that remains its general asset and to which the employee has no special claim.[8] The Tax Court does not seem to think that the transfer will automatically result in funding; rather, the Tax Court is more likely to examine whether any property is specially set aside (secured) by the new obligor for the employee.[9]

1. Let. Rul. 9241006.
2. Let. Rul. 9344038.
3. Let. Ruls. 8906022, 8741078. See also *Berry v. U.S.*, 593 F. Supp. 80 (M.D.N.C. 1984), *aff'd per curiam*, 760 F.2d 85 (4th Cir. 1985) (a guarantee does not make a promise secured, because the guarantee is itself a mere promise to pay); *Childs v. Comm.*, 103 TC 634 (1994) (same), *aff'd*, 89 F.3d 856 (11th Cir. 1996).
4. TAM 9336001.
5. Let. Rul. 8406012.
6. Let. Rul. 9331006.
7. Let. Rul. 9443006.
8. Rev. Rul. 69-50, 1969-1 CB 140, as amplified in Rev. Rul. 77-420, 1977-2 CB 172; TAM 9336001.
9. *Childs v. Comm.*, 103 TC 634 (1994), *aff'd*, 89 F.3d 856 (11th Cir. 1996).

3556. What is a "rabbi" trust?

A rabbi trust is a trust vehicle for accumulating assets to support an employer's unfunded deferred compensation plan obligations. Under the IRC, this trust is considered an IRC Section 671 "grantor" trust. Established by the employer with an independent trustee, a rabbi trust is designed to provide employees with some assurance that their promised benefits will be paid while preserving the tax deferral that is at the heart of unfunded deferred compensation plans. To accomplish these ends, a rabbi trust is generally irrevocable.

The use of such trusts with nonqualified deferred compensation plans has been affirmed under Section 409A(b). However, plans must meet the funding rules contained in 409A(b) that include prohibitions against funding or distribution while in declining financial circumstances, placing them offshore,[1] and placing assets into one during the "restricted period" when a sponsor is underfunded on any qualified defined benefit plan.[2] There are currently no regulations covering these 409A(b) funding rules but they are expected to be released in the coming months.

Planning Point: Planners need to watch for the proposed regulations covering these funding rules under Section 409A(b). Although Section 409A(b) now statutorily confirms use of rabbi trusts in connection with nonqualified plans, these regulations are likely to make substantive changes in the requirements for a 409A(b) compliant rabbi trust. They will likely revoke or replace the current rabbi trust model trust in Rev. Proc. 92-64[3] (Q 3558).

In addition to the new funding requirements of Section 409A(b), the key characteristic of a rabbi trust is that it must provide that its assets remain subject to the claims of the employer's general creditors in the event of the employer's insolvency or bankruptcy.[4] This result has been affirmed even when there was a delay in making a distribution of account, based on a legitimate participant request under the plan, until a bankruptcy filing prevented any distribution.[5]

These trusts are called "rabbi" trusts because the first such trust approved by the IRS was set up by a synagogue for a rabbi.[6] Historically, the combination of security (albeit imperfect; a rabbi trust can protect an employee against the employer's future unwillingness to pay promised benefits, but it cannot protect an employee against the employer's future inability to pay) and the tax deferral offered to participants in a nonqualified deferred compensation plan supported by a rabbi trust has made such trusts very popular, even though the new Section 409A(b) funding rules have reduced the ability to use the trust device to provide security for the payment of benefits (for example, placing it offshore).

3557. What is the impact of Section 409A(b) on a "rabbi" trust?

IRC Section 409A has statutorily codified the use of rabbi trusts subject to certain limitations on their use. Since enactment of the Section 409A(b) funding rules, there have been three funding prohibitions on the use of a rabbi trust.

1. 26 USC Section 409A(b)(2) as amended by the Gulf Opportunity Zone Act of 2005 ("GOZA")
2. 27 USC Section 409A(b)(3) in the Pension Protection Act of 2006.
3. 1992-2 C.B. 422.
4. See *McAllister v. Resolution Trust Corp*. 201 F.3d 570 (5th Cir. 2000); *Goodman v. Resolution Trust Corp*. 7 F.3d 1123 (4th Cir. 1993) (both underscoring that beneficiaries of rabbi trusts take the risk of trust assets being subject to the claims of the employer's general creditors for the benefit of favorable tax treatment).
5. *In re Washington Mutual Inc*., 450 B.R. 490 (June 1, 2011) (denying motion for "constructive trust" for payments).
6. Let. Rul. 8113017.

(1) The securing or distribution of deferred compensation during a period when the employer's net worth is falling or during other financial events that unacceptably secure the payment of the promised benefits is treated as a violation of Section 409A.[1] This includes hybrid rabbi/secular trust arrangements that distribute assets from nominal rabbi trusts to secular trusts on the occurrence of triggering events indicating the employer's financial difficulty. Under any such arrangement, otherwise deferred compensation is immediately taxable and subject to a 20 percent additional tax, plus premium interest on the underpayment of taxes (at the normal underpayment AFR rate plus 1 percent).[2]

(2) Also, under the Section 409A(b) funding rules, setting aside assets in an offshore trust (one outside the United States) to directly or indirectly fund deferred compensation also unacceptably secures the payment of the promised benefits.[3] Under any such arrangement, the otherwise deferred compensation is immediately taxable and subject to a 20 percent additional tax, plus premium interest on the underpayment of taxes (at the normal underpayment AFR rate plus 1 percent).[4]

Both the Section 409A funding rules prohibition on financial triggers and on offshore trusts apply even to deferrals of compensation earned and vested on or before December 31, 2004 (and thus not generally subject to the requirements of IRC Section 409A). The IRS provided transition relief through December 31, 2007, for amounts otherwise subject to IRC Section 409A(b), if those assets relate to compensation deferred on or before December 31, 2004, and if those assets were set aside, transferred, or restricted on or before March 21, 2006.[5] *Note: the IRS did not further extend the deadline for compliance on the funding rules to December 31, 2008, as it did for other documentary and operational compliance with Section 409A. December 31, 2007, was the deadline for compliance with the Section 409A(b) funding requirements*. All existing trusts out of compliance with the Section 409A funding requirements should have been terminated and assets distributed or the trust amended as of December 31, 2007. A trust that has not done so is in violation of Section 409A.

(3) Finally, a trust is in violation of the funding requirements of Section 409A if it makes contributions or a transfer of assets to a trust during the period that any qualified defined benefit pension plan is "at risk" (below the required percentage statutory funding levels) under the qualified pension funding rules enacted in the Pension Reform Act of 2006, or during the period of any reorganizational bankruptcy.

1. IRC Sec. 409A(b)(2); Notice 2006-33, 2006-15 IRB 754. As of the date of this publication, there are still no regulations covering the funding rules of Section 409A.
2. IRC Sec. 409A(b)(4).
3. IRC Sec. 409A(b)(1); Notice 2006-33, 2006-15 IRB 754.
4. IRC Sec. 409A(b)(4).
5. Notice 2006-33, 2006-15 IRB 754.

Planning Point: IRC Section 409A has called into question many prior decisions and rulings in the deferred compensation arena, and there are no detailed regulations on the new funding rules of Section 409A(b). Moreover, there has been no IRS update on the model trust in light of the enactment of Section 409A. Employers and employees therefore should exercise caution in structuring deferred compensation when using rabbi trusts and any other informal funding mechanisms. There currently are not even proposed regulations for Section 409A(b) requirements, so much detail for guidance in trust construction, especially in the absence of a revised model trust, and in operation is missing. Using the model trust document modified to add the current three funding prohibitions of Section 409A(b) should be acceptable. However, the planner needs to watch for the release of Section 409A proposed regulations. These regulations will likely make substantive changes in the requirements under these new rules governing rabbi trusts that will impact documentation and operation. The fate of Rev. Proc. 92-64 governing the model rabbi trust document should also be part of this proposed regulation release. Ideally, a new prototype rabbi trust document will be part of the release.

3558. What pre-409A issues were raised by the IRS model rabbi trust?

The rabbi trust has been so popular historically that the IRS released a model rabbi trust instrument in 1992 to aid taxpayers and to relieve the processing of requests on the IRS for advance rulings on these arrangements.[1] The IRS model trust was intended to serve as a safe harbor document construction for employers. Used properly, pre-409A, the model trust assured employers that plan participants either were not in constructive receipt of income or that they incurred no economic benefit because of the trust. Of course, whether an unfunded deferred compensation plan using the model rabbi trust effectively deferred taxation depended on whether the underlying plan effectively deferred compensation.

Pre-Section 409A, the IRS would issue advance rulings on the tax treatment of unfunded deferred compensation plans that did not use a trust and unfunded deferred compensation plans that used the model trust in Rev. Proc. 92-64. The IRS announced at that time that it would not issue advance rulings on unfunded nonqualified deferred compensation arrangements *that use a trust* other than the model trust.[2] With the enactment of Section 409A, the IRS announced that it would not issue any advance letter rulings on the income tax consequences of nonqualified deferred compensation plans, but would continue to advise on peripheral tax issues, such as gift tax issues. It also declined to issue prototype plans, although it did not indicate that this pronouncement also includes a revision of its model rabbi trust under the existing revenue procedure. The status of the model trust as provided in the revenue procedure has remained in limbo pending Section 409A regulations, and the funding portion of the law that include rules on trusts.[3]

The current model trust language contains all the pre-409A provisions necessary for operation of a trust separate from the underlying plan except provisions describing the trustee's investment powers. The parties involved still needed to provide language describing the investment powers of the trustee, and those powers must include some investment discretion. Proper use of the model trust requires that its language be adopted verbatim, except where substitute language is

1. 1992-2 C.B. 422.
2. See Rev. Proc. 92-64, 1992-2 CB 422, 423.
3. See Rev. Proc. 2008-61, 2008-42 IRB, 934 and Rev. Proc. 2009-3, 2009-1 IRB 107, Section 3.01(42).

expressly permitted. Although it is somewhat puzzling in light of the claim by the IRS that it will not rule on plans that do not use the model trust, the employer may add additional text to the model trust language, as long as such text is "not inconsistent with" the model trust language.[1] The enactment of Section 409A, and specifically the new funding rules (see Q 3557) that impact trusts used in connection with such plans, places the use of the model rabbi trust requirements at issue, even if the grantor adds language incorporating the essential language contained in Section 409A(b), including all the amendments since the enactment of Section 409A.

Under the pre-409A model trust, the rights of plan participants to trust assets had to be merely the rights of unsecured creditors. Participants' rights could not be alienable or assignable. The assets of the trust were required to remain subject to the claims of the employer's general creditors in the event of insolvency or bankruptcy.[2]

In at least one older pre-409A letter ruling, the IRS held that the use of a third party guarantee as an additional security measure did not undermine the tax-effectiveness of a rabbi trust.[3]

Under the pre-409A process, the board of directors and the highest ranking officer of the employer were required to notify the trustee of the employer's insolvency or bankruptcy, and the trustee must be required to cease benefit payments on the company's insolvency or bankruptcy.[4]

Under pre-409A process, if the model trust was used properly, it should not cause a plan to lose its status as "unfunded." In other words, contributions to a rabbi trust should not cause immediate taxation to employees; employees should not have income until the deferred benefits are received or otherwise made available.[5] Contributions to a rabbi trust for the benefit of a corporation's directors have been treated similarly.[6] Likewise, contributions to a rabbi trust should not be considered "wages" subject to income tax withholding until benefits are actually or constructively received.[7]

Pre-409A, a proper rabbi trust would not be considered an IRC Section 402(b) nonexempt employees' trust. Contributions to a proper rabbi trust would not be subject to IRC Section 83.[8]

Pre-409A, the employer should receive no deduction for amounts contributed to the trust, but should receive a deduction when benefit payments are includable in the employee's income (Q 3560). In pre-409A and pre-model trust days, the employer generally was considered the owner of the trust under IRC Section 677 and was required to include the income, deductions, and credits generated by the trust in computing the employer's taxable income.[9] This is normal grantor trust tax treatment.

1. Rev. Proc. 92-64, 1992-2 CB 422, 423, Secs. 4.01 and 5.01.
2. Sections 1(d) and 13(b) of the model trust, at 1992-2 CB 424 and 427; but see *Goodman v. Resolution Trust Corp.*, 7 F.3d 1123 (4th Cir. 1993) (assets in a rabbi trust must be subject to the claims of creditors at all times).
3. See Let. Rul. 8906022 (employer established a rabbi trust and its corporate parent also guaranteed the obligations).
4. See section 3(b)(1) of the model trust, at 1992-2 CB 425.
5. Rev. Proc. 92-64, Sec. 3, 1992-2 CB 422, 423; Let. Ruls. 9732008, 9723013, 9601036.
6. Let. Ruls. 9525031, 9505012, 9452035.
7. Let. Rul. 9525031.
8. Let. Ruls. 9732006, 9548015, 9542032, 9536027.
9. Let. Ruls. 9314005, 9242007, 9214035.

Pre-409A, the IRS generally would issue advance rulings on the grantor trust status of trusts following the model trust.[1] Those pre-409A model trust rulings seem entirely consistent with earlier rulings.[2] In pre-409A and pre-model trust rulings, the IRS generally conditioned favorable tax treatment upon the satisfaction of two additional requirements: that creation of the trust did not cause the plan to be other than unfunded for ERISA purposes, and that trust provisions requiring that the trust's assets be available to satisfy the claims of general creditors in the event of insolvency or bankruptcy were enforceable under state and federal law.[3] The same conditions were imposed in earlier model trust rulings.[4]

Pre-409A, the concern of the IRS with respect to ERISA seems to have been that if the DOL took the position that the use of a rabbi trust causes the underlying plan to be other than unfunded for ERISA purposes, then this would cause the plan to be funded for tax purposes and require the accelerated taxation of contributions to the rabbi trust. The DOL's position has been that rabbi trusts maintained in connection with excess benefit or top hat plans will not cause the underlying plans to be funded for ERISA purposes so long as the IRS maintains they are not taxable because they are unsecured (hence not funded for tax purposes).[5]

Also, at least one court prior to the enactment of Section 409A noted that the use of a rabbi trust will not cause a top hat plan to lose its ERISA exemption as long as the trust assets remain subject to the claims of the employer's creditors in the event of insolvency, and the participants' interests are inalienable and unassignable.[6] Nonetheless, pre-Section 409A rulings on plans using the model trust are supposed to state that the IRS expresses no opinion on the ERISA consequences of using a rabbi trust.[7]

In earlier pre-409A private letter rulings, the IRS had allowed the use of a rabbi trust in conjunction with a deferred compensation plan that permitted hardship withdrawals, ruling that the hardship withdrawal provision did not cause amounts deferred to be taxable before they are paid or made available. In these letter rulings, "hardship" generally was defined as an unforeseeable financial emergency caused by events beyond the participant's control. The amount that could be withdrawn generally was limited to the amount needed to satisfy the emergency need.[8]

Pre-409A IRS guidelines for giving advanced rulings on unfunded deferred compensation plans expressly permitted the use of certain hardship withdrawal provisions (Q 3533).[9] Therefore, pre-409A, it seemed that a rabbi trust conforming to the model trust could be used in conjunction with a deferred compensation plan permitting an acceptable hardship withdrawal.[10]

1. Rev. Proc. 92-64, Sec. 3, 1992-2 CB 422, 423.
2. Let. Ruls. 9542032, 9536027, 9443016.
3. Let. Ruls. 9314005, 9242007, 9214035, 8634031.
4. See, e.g., Let. Ruls. 9548015, 9517019, 9504006; see also Rev. Proc. 92-64, Sec. 4.02, 1992-2 CB 422, 423; sections 1(d), 1(e) and 3(b) of the model trust, at 1992-2 CB 424, 425.
5. See DOL Adv. Op. 94-31A, fn.3; DOL Adv. Op. 92-13A.
6. See *Nagy v. Riblet Prod. Corp.*, 13 EBC 1743 (N.D. Ind. 1990), *amended on other grounds and reconsideration denied*, 1991 U.S. Dist. Lexis 11739 (N.D. Ind. 1991).
7. See Rev. Proc. 92-64, Sec. 3, 1992-2 CB 422, 423.
8. See Let. Ruls. 9242007, 9121069.
9. Rev. Proc. 92-65, Sec. 3.01(c), 1992-2 CB 428.
10. Let. Rul. 9505012.

Pre-409A, an appropriate hardship withdrawal provision was not expected to trigger taxation before deferred amounts are paid or made available. Such a provision might have triggered constructive receipt; however, at the time a qualifying emergency arises.[1]

Pre-409A, the trustee could be given the power to invest in the employer's securities. If the trustee was given that power, the trust had to be revocable or include a provision that the employer could substitute assets of equal value for any assets held by the trust.[2]

Where presumably model trusts separately serving a parent and affiliates could invest in the parent's stock, it was ruled that:

(1) dividends paid on the parent's stock held by the parent's trusts would not be includable in the parent's income in the year paid,

(2) no gain or loss would be recognized by the parent on transfer of its stock from its trusts to its participants or their beneficiaries, and

(3) no gain or loss would be recognized by the affiliates on the direct transfer of the parent's stock to the affiliates' participants or their beneficiaries if that stock was transferred directly by the parent to the participants or beneficiaries and neither the affiliates nor their trusts were the legal or beneficial owners of parent's stock.[3]

Regulations under IRC Section 1032 (Q 292) generally permit nonrecognition treatment for transfers of stock from an issuing corporation to an acquiring corporation if the acquiring corporation immediately disposes of such stock. A transfer of a parent corporation's stock to a rabbi trust for the benefit of a subsidiary's employee would not qualify for this nonrecognition treatment because the stock is not immediately distributed to the participant. The IRS has announced that nonrecognition treatment is available for such transfers, albeit under a different theory. The IRS treated the parent corporation, rather than the subsidiary corporation, as the grantor and owner of the rabbi trust, so long as the trust provided that stock not transferred to the subsidiary's employees reverts to the parent and the parent's creditors can reach the stock.[4] Pre-409A, the IRS had indicated that it would rule on model rabbi trusts that have been modified to comply with this notice.

Pre-409A, the trust had to provide that, if life insurance would be held by the trust, the trustee would have no power to name any entity other than the trust as beneficiary, assign the policy to any entity other than a successor trustee, or loan to any entity the proceeds of any borrowing against the policy (but an optional provision permits the loan of such borrowings to the employer).[5]

Pre-409A, taxpayers that wanted to adopt the model trust and wished to obtain an advance ruling on the underlying deferred compensation plan had to follow not only the standard

1. Let. Rul. 9501032.
2. See IRS Model Trust, section 5(a), Rev. Proc. 92-64, 1992-2 CB 425.
3. Let. Rul. 9505012.
4. Notice 2000-56, 2000-43 IRB 393.
5. See IRS Model Trust, sections 8(e) and 8(f), Rev. Proc. 92-64, 1992-2 CB 426.

guidelines for obtaining a ruling on an unfunded deferred compensation plan (Q 3533) but had to also follow other guidelines unique to plans using a trust.

First, the plan had to provide that the trust and any assets would be held to conform to the terms of the model trust.

Second, taxpayers had to generally include a representation that the plan was not inconsistent with the terms of the trust with the letter ruling request.

Third, the language of the trust had to conform generally with the model text, and taxpayers generally had to include a representation that the trust conformed to the model trust language (including the order in which the provisions appear) and that the trust did not contain any inconsistent language (in substituted portions or elsewhere) that conflicted with the model trust language. Provisions were permitted to be renumbered if appropriate, any bracketed model trust language could be omitted, and blanks could be filled in.

Fourth, the request for a letter ruling generally had to include a copy of the trust document on which all substituted or added language was clearly marked and on which the required investment authority text was indicated.

Fifth, the request for a ruling generally had to contain a representation that the trust was a valid trust under state law, and that all of the material terms and provisions of the trust, including the creditors' rights clause, were enforceable under the appropriate state laws.

Finally, the trustee generally had to be an independent third party that could be granted corporate trustee powers under state law, such as a bank trust department or a similar party.[1]

Pre-409A, the IRS issued several private letter rulings addressing the deductibility of interest paid on life insurance policy loans after the policies were transferred to a rabbi trust (Q 30).

Planning Point: Until proposed regulations under Section 409A(b) are released, the model trust will need to be amended to comply with all the new Section 409A(b) funding requirements if it is to be used with a Section 409A plan and remain 409A compliant under Section 409A(b). These forthcoming regulations under Section 409A(b) will be important in determining what will happen to Rev. Proc. 94-64 and the model trust contained in it, as well as the details that may be required to draft such trust provisions and guide trust operations. Planners need to watch for these proposed regulations and rely on legal counsel's expert guidance in the meantime.

3559. Can a private IRC Section 451 unfunded nonqualified deferred compensation employee account balance plan be used in connection with a qualified 401(k) elective deferral plan to maximize the annual deferrals into the qualified 401(k) and also to receive employee contributions that cannot go into the qualified plan because of nondiscrimination testing issues?

Yes. However, 409A income tax and ERISA developments governing participant deposits have raised questions about the technique.

1. Rev. Proc. 2003-3, Secs. 3.01(35), 4.01(33), 2003-1 IRB 113; Rev. Proc. 92-64, Secs. 3 and 4, 1992-2 CB 422, 423.

A 1995 private letter ruling approved a particular nonqualified/401(k) "wrap-around" "spill-over" or "pour-over" plan.[1] Since then, more rulings approving the use of wrap-around plans have been issued.[2] Wrap-around plans have been primarily used to maximize elective deferrals under both an IRC Section 401(k) plan and a nonqualified voluntary employee account balance plan, which generally is subject to IRS Section 409A. These plans are referred to as "linked" plans by the IRS for purposes of Section 409A, as are "excess benefit" plans. Such a nonqualified arrangement may be unnecessary due to the method by which the actual deferral percentage test for 401(k) plans now is administered (Q 3731).

For employers that continue to elect to use the current year testing method on their qualified plans, use of a wrap-around nonqualified employee account balance plan will continue to provide planning opportunities and any employer, regardless of method, may desire a nonqualified employee account balance plan to permit highly compensated employees to voluntarily defer more than that permitted under a qualified plan.

Section 409A Impact

Under final regulations to IRC Section 409A, the IRS advised that such a wrap-around nonqualified plan is still possible under IRC Section 409A if it meets certain requirements.

(1) The plan must follow the structure provided in the favorable IRS letter rulings (contributions must all go first into the nonqualified employee account balance plan and then spill into the qualified 401(k) as it becomes clear the qualified plan may receive them, based on discrimination testing).

(2) Such a linkage may not result in a decrease in deferrals in the nonqualified arrangement in excess of the deferral limits under IRC Section 402(g)(1)(b) ($17,500 in 2013 and 2014, up from $17,000 in 2012).[3] For existing nonqualified wrap-around arrangements, the IRS offered transition relief through December 31, 2008. For these plans, elections as to the timing and form of payment under the nonqualified plan that are controlled by the qualified plan were permitted through December 31, 2008. Elections had to be made in accordance with the terms of the nonqualified plan as of October 3, 2004.[4] In Notice 2010-80, the IRS modified Notice 2010-6 governing plan documentation correction to allow "linked" plan documentation under the notice's guidance so long as certain prerequisites are met.

DOL Guidance Potentially Impacting Wrap Plans

Although Section 409A does not seem to preclude a nonqualified wrap-around plan based upon income tax considerations after Section 409A, the DOL's recently released guidance on

1. See Let. Rul. 9530038.
2. Let. Ruls. 200116046, 200012083, 199924067, 9752018, 9752017.
3. Treas. Regs. §§1.409A-2(a)(9), 1.409A-3(j)(5).
4. Notice 2006-79, 2006-43 IRB 763.

the timeliness of qualified plan deposits and the required deadlines raises ERISA issues for wrap-around plans that need to be discussed with legal counsel, if a wrap design is to be used. This discussion is necessary because the currently approved wrap plan structure does not conform to these more recent timely deposit rules.

Approved Wrap Plan Structure

An employer seeking to maximize highly compensated employees' ("HCEs") elective deferrals to its 401(k) plan established an unfunded, nonqualified salary reduction plan (employee account balance plan) to temporarily hold elective deferrals until the maximum amount of 401(k) elective deferrals could be determined for the tax year. Employees could defer compensation into the proposed nonqualified plan by entering into salary reduction agreements by December 31 of the prior year. These employees then would receive "matching" contributions under the nonqualified plan equal to their matching contributions under the 401(k) plan. The employer would determine the maximum amount of elective contributions that the HCEs could make to the 401(k) plan for the current year as soon as practicable each year, but no later than January 31 of the next year.

Then, the lesser of the maximum allowable amount or the amount actually deferred under the nonqualified plan would be distributed in cash to the HCEs by March 15 of the following year unless they irrevocably elected to have such amounts contributed as elective deferrals to the 401(k) plan at the same time they elected to defer compensation into the nonqualified plan. Where such election was made, the "elective deferrals" and the appropriate "matching" contributions made under the nonqualified plan would be contributed directly to the 401(k) plan. Earnings under the nonqualified plan would not be contributed to the 401(k) plan. Presumably, any balance in the nonqualified plan would remain in the nonqualified plan.

In a pre-409A ruling, the IRS determined that amounts initially held in the nonqualified employee account balance plan would be treated as made to the 401(k) plan in the year of deferral under the nonqualified plan, and would be excluded from income under IRC Section 402(e)(3). Amounts distributed to an employee that the employee did not elect to contribute to the 401(k) plan would be taxable in the year the compensation was earned. This is the linked plan design structure for a nonqualified wrap-around plan approved under Section 409A.

Apparently, the key to the success of this wrap-around arrangement was the requirement that the election to transfer amounts to the 401(k) plan had to be made at the same time as the election to initially defer compensation into the nonqualified plan, before the beginning of the year in which the compensation was earned. The IRS earlier had approved, and then revoked in 1995, its approval of a similar arrangement where the election to transfer excess amounts flowed from a 401(k) plan into a nonqualified plan, even after the close of the year in which the amounts were earned.[1] Apparently, the IRS was concerned that this arrangement raised the specter of constructive receipt and violated qualified 401(k) plan law (Q 3533).

1. See Let. Ruls. 9423034 and 9414051, revoking Let. Rul. 9317037.

Another pre-409A private letter ruling approved a similar arrangement utilizing a rabbi trust (Q 3556) in connection with the nonqualified plan.[1] One ruling (involving a top hat plan, Q 3533) specifically indicated that amounts must be transferred from the nonqualified plan to the 401(k) plan no later than March 15th.[2]

A 401(k) plan will be disqualified if any employer-provided benefit (other than matching contributions) is contingent on the employee's elective deferrals under the 401(k) plan (Q 3698). The 401(k) regulations provide that participation in a nonqualified deferred compensation plan is treated as contingent only to the extent that the employee may receive additional deferred compensation under the nonqualified deferred compensation plan based on whether he or she makes elective deferrals under the 401(k) plan. These regulations explicitly state that a provision under a nonqualified deferred compensation plan requiring an employee to have made the maximum permissible elective deferral under the 401(k) plan is not treated as contingent (deferrals under a nonqualified plan permitting deferral up to 15 percent of compensation if participants have made maximum allowable 401(k) elective deferrals were not impermissibly conditioned on elective deferrals).[3]

So, how does this structure stack up against the final regulations published by the DOL (as finalized on January 14, 2010)? The written rule provides that employers have a fiduciary duty to remit employee contributions to the qualified plan as soon as they can be reasonably segregated from the employer's general assets, but not later than the 15th business day of the month following the month in which the participant contributions are withheld or received.[4] Unfortunately, the DOL has taken the position that the "reasonable segregation" language takes precedence over the "no later than the 15th day of the month following the month" language.

The 2010 regulations do provided a safe harbor for retirement and health and welfare plans with fewer than 100 participants (often referred to as "small plans"). The DOL has said that "… employee contributions are deemed to be timely if the amounts are deposited with the plan no later than the 7th business day following the date the contributions (including loan repayments) are received by the employer."

The DOL has declined to extend the same or similar safe harbor to large plans. The rule for large plans is a facts-and-circumstances determination, which is no rule at all. But, in either case, the rule for timely deposits to the qualified plan, and many versions of the wrap design, especially those that need to wait until the following year to determine and move deposits to the qualified plan, do NOT meet these DOL timely deposit rule requirements. There are some qualified plan systems that may facilitate the approved wrap plan design by functionally being able to move the money virtually in real time from the nonqualified plan to the qualified plan almost instantly as it comes in on a timely deposit basis until the qualified plan caps out and thereafter leaves the balance of the deposits in the nonqualified plan. If the qualified plan system cannot do this, then the timely deposit rules are an issue for use of a wrap design.

1. See Let. Rul. 9752018.
2. Let. Rul. 200116046.
3. See, e.g., Let. Rul. 199902002.
4. DOL Reg. 2510.3-102(b).

Planning Point: Of interest is the fact that the DOL timely deposit rules have always been an issue since the wrap design first appeared in the mid-1990s. What has changed is the DOL's heavy focus on timely deposit compliance, and the emphasis on the shortest period possible for remission of employee contributions to the qualified plan. The IRS, for its part, has apparently given the wrap design basic approval, even under Section 409A, so long as certain nominal requirements discussed heretofore are met.

It is important, however, not to overlook the ERISA issue concerning the timeliness of contributions to the qualified 401(k) plan under such a wrap plan linked to the employer's qualified 401(k) plan, and to determine the measure of the risk. Obtaining clearance from the DOL for the design may be in order, based upon the ability of the qualified plan recordkeeping and nondiscrimination testing capabilities system to take deposits on a timely basis. If it cannot meet or approach the timely deposit requirements, counsel must help the sponsor understand the measure of the risk involved if the design is to be implemented.

3560. When are deferred amounts under an unfunded nonqualified account and nonaccount balance plan deductible by the employer?

An employer can take an income tax expense deduction for nonqualified deferred compensation when it is includable in the employee's income, regardless of whether the employer is on a cash or accrual basis of accounting.[1] Likewise, deduction of amounts deferred for an independent contractor can be taken only when they are includable in the independent contractor's gross income.[2] Section 409A has not changed the income tax deduction timing; only the potential timing of income tax inclusion by a participant.

The IRS has confirmed that payments made under an executive compensation plan within 2½ months of the end of the year in which employees vest do not constitute deferred compensation and thus may be deducted in the year in which employees vest, rather than the year in which the employees actually receive the payments.[3] Previously, there was some controversy over the proper timing of an accrual basis employer's deduction for amounts credited as "interest" to employee accounts under a nonqualified deferred compensation plan. The weight of authority currently holds that IRC Section 404(a)(5) governs the deduction for such amounts, which must be postponed until such amounts are includable in employee income. Amounts representing "interest" cannot be currently deducted by an accrual basis employer under IRC Section 163.[4]

To be deductible, deferred compensation payments must represent reasonable compensation for the employee's services when added to current compensation. The question of what is reasonable is question of fact in each case. One factor considered in determining the reasonableness of compensation is whether amounts paid are intended to compensate for past, under-compensated services (Q 3515). Thus, deferred compensation for past services may be deductible, even if the total of such compensation and other compensation for the current year is in excess of reasonable compensation for services performed in the current year, as long as

1. IRC Sec. 404(a)(5); Treas. Regs. §§1.404(a)-1(c), 1.404(a)-12(b)(2). See also *Lundy Packing Co. v. U.S.*, 302 F. Supp. 182 (E.D.N.C. 1969), *aff'd per curiam*, 421 F.2d 850 (4th Cir. 1970); *Springfield Prod., Inc. v. Comm.*, TC Memo 1979-23.
2. IRC Sec. 404(d).
3. Let. Rul. 199923045.
4. *Albertson's, Inc. v. Comm.*, 42 F.3d 537 (9th Cir. 1994), *vacating in part* 12 F.3d 1529 (9th Cir. 1993), *aff'g in part* 95 TC 415 (1990) (divided court), *en banc reh'g denied*, (9th Cir. 1995), *cert. denied*, 516 U.S. 807 (1995); Notice 94-38, 1994-1 CB 350; Let. Rul. 9201019; TAM 8619006.

that total, plus all compensation paid to the employee in prior years, is reasonable for all of the services performed through the current year.[1]

Planning Point: Substantiating the rationale behind the deferred compensation can be particularly important in a plan that is implemented for the benefit of an owner-operator nearing retirement in a closely-held company, because this substantiation can make the difference between whether the post-retirement payments are considered tax deductible compensation, rather than a nondeductible dividend. This is especially true in light of the increases in dividend tax rates for clients in the highest income tax bracket, which took effect beginning January 1, 2013.

Best practice dictates documenting that the deferred compensation is partial compensation to make up for past "under compensation" in board resolutions and supporting materials, as well as the plan document itself (if written as a separate individual agreement) in order to support it as reasonable compensation. This also suggests the wisdom of creating such a plan for an owner-operator as far in advance of retirement as possible, so as to make the deferred compensation part of compensation for as many tax years as possible, thereby helping establish its long-term reasonableness, even if resources to initially fund it are not readily available.

Reasonableness of compensation is usually not an issue as to non-shareholder or minority shareholder employees. A finding of unreasonableness in the case of a controlling shareholder is more likely. In one case, benefits paid to a surviving spouse of a controlling shareholder of a closely-held corporation were held not reasonable compensation where:

(1) the controlling shareholder had not been under-compensated in previous years,

(2) the controlling shareholder's compensation exceeded the amounts paid by comparable companies,

(3) the payments were not part of a pattern of benefits provided to employees, and

(4) there was an absence of dividends.[2]

In a second case, deferred compensation payments were held to be reasonable where the controlling shareholder was inadequately paid during the controlling shareholder's life and the surviving spouse, to whom payments were made, did not inherit a controlling stock ownership.[3] Proper documentation (e.g., board of directors' minutes) is important to help substantiate the reasonableness of the compensation.

Publicly-traded corporations generally do not run into the reasonable compensation issue. This is because public companies are not permitted to deduct compensation in excess of $1 million per tax year to certain top-level employees unless it is performance-based incentive compensation (Q 3515).[4]

1. Treas. Reg. §1.404(a)-1(b).
2. See, e.g., *Nelson Bros., Inc. v. Comm.* TC Memo 1992-726.
3. *Andrews Distrib. Co., Inc. v. Comm.*, TC Memo 1972-146.
4. IRC Sec. 162(m).

Golden parachute rules may limit the amount of the deduction for deferred compensation payments that are contingent upon a change in ownership or control of a corporation or made under an agreement that violates a generally enforced securities law or regulation (Q 3521).[1]

3561. How are deferred compensation account balance and nonaccount balance payments taxed when they are received by the employee or the beneficiary?

Plans Subject to Section 409A

Section 409A is a refinement of the constructive receipt doctrine. Plans that are "nonqualified deferred compensation plans," as defined in Section 409A, have additional requirements added to the prior tax law, unless specifically replaced by Section 409A, that are now necessary to achieve and maintain income tax deferral as to plan participants. Under Section 409A, its regulations, and guidance, a participant will be taxed on deferred compensation immediately upon violation of Section 409A either in form (documentation) or operation (administration). These additional 409A plan requirements (for plans not involving a trust) are primarily:

(1) minimum required plan documentation;

(2) limited permissible distributions;

(3) prohibited accelerations of these distributions; and

(4) required timing of elections to defer.

Plans Excepted or Grandfathered from Section 409A Coverage (Residual Rules for 409A Plans)

When deferred compensation payments are actually or constructively received, they are taxed as ordinary income. Deferred compensation payments are "wages" subject to regular income tax withholding (and not the special withholding rules that apply to pensions, etc.) when actually or constructively received.[2] Section 409A greatly expands the existing definition of constructive receipt so that violations of Section 409A requirements in either form documentation or administrative operation cause immediate taxation.

In the worst case taxation situation, deferred compensation that is subject to constructive receipt not only is immediately taxed under IRC Section 409A, but it is also subject to a 20 percent excise tax in addition to the normal tax on all vested amounts (Q 3533, Q 3554). Interest on the underpayment of taxes is retroactively imposed to the date of error and is also due at the normal underpayment AFR rate plus 1 percent.[3] The IRS has provided for certain corrections of documentation and operational errors that may entirely or substantially avoid the worst case

1. IRC Sec. 280G.
2. See IRC Sec. 3401(a); Rev. Rul. 82-176, 1982-2 CB 223; Rev. Rul. 77-25, 1977-1 CB 301; Temp. Treas. Reg. §35.3405-1T, A-18; cf. Let. Rul. 9525031 (contributions to rabbi trust were not subject to income tax withholding because they were not the actual or constructive payment of wages).
3. IRC Sec. 409A(b)(4).

taxation situation under Section 409A. The tax outcome under these correction procedures depends largely on the nature of the error, when the error occurred and is corrected, and the specific participant involved (an "insider" or not, regardless whether the company is publicly-traded or privately-held).

Certain Foreign Plans of "Nonqualified Entities" under IRC Section 457A

A nonqualified deferred compensation plan of a uniquely defined "nonqualified entity" (offshore fund or partnership located in a tax indifferent situs) is subject to IRC Section 457A. This is a different IRC section than Section 409A, which covers the "nonqualified deferred compensation" plans of all entities, except to the extent they are exempted or excepted from coverage. Deferred compensation provided by such 457A nonqualified entities is taxable at the time any 457A "substantial risk of forfeiture" lapses. (Q 3533). If the deferred compensation is deferred beyond the year in which the risk of forfeiture lapses, the participant is subject to a 20 percent excise tax and premium penalty interest on the underpayment of taxes at the normal underpayment AFR rate plus 1 percent on the amount.[1]

Annuity Payout

Where an unfunded plan paid deferred compensation benefits in the form of a commercial single premium annuity at the termination of the participant's employment, the IRS privately ruled that the full value of the contract would be includable in the recipient's income at the time of distribution, in accordance with IRC Section 83.[2] Unless the payment was due to be paid in a lump sum rather than in installments, this technique would now also violate Section 409A as an impermissible acceleration of the benefits.

Beneficiary Payments

Payments made to a beneficiary from an unfunded plan are "income in respect of a decedent" for income tax purposes and, as such, are taxed as they would have been to the employee. It is not clear whether the same withholding rules apply. For treatment of death benefits under deferred compensation agreements, see Q 3599.

Divorce

This area remains complicated. Prior to Section 409A (but continuing for excepted and grandfathered plans), benefits assigned by an employee to an ex-spouse in a divorce agreement can be split and, if so, are taxed to the employee and the ex-spouse according to their split. The employee retains the tax liability for FICA/FUTA purposes. Pre-409A, generally speaking, there was no framework for the assignment of nonqualified deferred compensation for any reason, other than for eligible Section 457 plans (Q 3568), which is similar to the framework for the assignment of qualified plan benefits through a qualified domestic relations order ("QDRO").[3] In fact, plans frequently prohibited such assignments (as well as all others) to avoid a constructive receipt issue

1. IRC Sec. 457A(c). There are no regulations for this new IRC section as of the date of this publication.
2. Let. Rul. 9521029.
3. See Let. Rul. 9340032.

for plan participants. They sometimes did allow splitting of the nonqualified account, but prohibited accelerated distribution of the ex-spouse's portion granted in a divorce until it was due.

Section 409A final regulations specifically permit the accelerated distribution of a nonqualified account balance or nonaccount balance benefit to an ex-spouse under a Domestic Relations Order ("DRO"). Note that this is not a QDRO, and the DRO form, which generally should parallel a QDRO, cannot actually do so in all respects because a nonqualified plan has no "plan assets" (to which the standard QDRO attaches). Under Section 409A, a plan still does not have to provide for this divorce participant right if the employer does not want to include it in the plan. Moreover, it is not clear if the prior rulings (involving the responsible party for income tax and FICA purposes) continue to apply in the case of a 409A plan divorce distribution to an ex-spouse.

3562. Are contributions to, and postretirement payments from, a deferred compensation account balance or nonaccount balance plan subject to FICA and FUTA taxes?

Yes.

There are two timing rules for the treatment of deferred compensation amounts under the Federal Insurance Contributions Act ("FICA") and the Federal Unemployment Tax Act ("FUTA"): (1) the "general timing rule," and (2) the "special timing rule."

The general timing rule provides that amounts taxable as wages generally are taxed when paid or "constructively received" (Q 3533).

The special timing rule applies to amounts deferred by an employee under any deferred compensation plan of an employer covered by FICA. The special timing rule applies to voluntary salary, commission and bonus reduction plans, employer-paid supplemental plans, funded and unfunded plans, private plans, and eligible or ineligible Section 457 plans. It does not apply to excess (golden) parachute payments.

Section 409A has not changed the application or calculation of employment taxes. Under these rules, vested nonqualified plan contributions (and the earnings on them) generally are taxable for employment tax purposes (compared with income tax purposes) when they are contributed (as in the case of most voluntary salary/bonus deferral plans) or when they are vested (as in the case of an employer-paid supplemental plan with risks of forfeiture on the benefits).

General Timing Rule

Under the general timing rule, an employee's "amount deferred" is considered to be "wages" for FICA purposes at the later of the date when the services are performed or the employee's rights to such amount are no longer subject to a Section 3121 "substantial risk of forfeiture" governing the timing of the imposition of FICA taxes on compensation.[1] This definition of substantial

1. See IRC Secs. 3121(v)(2)(A), 3121(v)(2)(C); Treas. Reg. §31.3121(v)(2)-1(a)(2); *Buffalo Bills, Inc. v. U.S.*, 31 Fed. Cl. 794 (1994), *appeal dismissed without opinion*, 56 F.3d 84, 1995 U.S. App. Lexis 27184 (Fed. Cir. 1995); *Hoerl & Assoc., P.C. v. U.S.*, 996 F.2d 226 (10th Cir. 1993), *aff'g in part, rev'g in part, and remanding* 785 F. Supp. 1430 (D. Colo. 1992); Let. Ruls. 9443006 (fn. 1), 9442012, 9417013; 9347006, 9024069 *as revised by* Let. Rul. 9025067; TAMs 9051003, 9050006.

risk of forfeiture or limitation should not be confused with the six others discussed in Q 3530 and Q 3533; it is similar but not the same as the others and should be reviewed separately for FICA inclusion questions.

Similar rules apply for FUTA (federal unemployment tax) purposes, although the taxable wage base for FUTA purposes is substantially smaller ($7,000).[1]

Where an amount deferred cannot be readily calculated by the last day of the year, employers may choose between two alternative methods: the estimated method and the lag method.

Under the estimated method, the employer treats a reasonably estimated amount as wages paid on the last day of the calendar year. If the employer underestimates, it may treat the shortfall as wages in the first year (or in the first quarter of the second year). If the employer overestimates, it may claim a refund or credit.

Under the lag method, the employer may calculate the end-of-year amount deferred on any date in the first quarter of the next calendar year. The amount deferred will be treated as wages paid and received on that date, and the amount deferred that otherwise would have been taken into account on the last day of the year must be increased by income through the date on which the amount is taken into account.[2]

Special Timing (Nonduplication) Rule

The "special timing" (nonduplication) rule is designed to prevent double taxation once an amount is treated as wages. Under this rule, any amount (and any income attributable to it) will not again be treated as wages for FICA or FUTA purposes in any later year.[3] A deferred amount is treated as taken into account for FICA and FUTA purposes when it is included in computing the amount of wages, but only to the extent that any additional tax for the year resulting from the inclusion actually is paid before the expiration of the period of limitation for the year. A failure to take a deferred amount into account subjects it (and any income attributable thereto) to inclusion when actually or constructively paid.[4]

3563. When is a nonqualified deferred compensation plan excluded for purposes of determining FICA and FUTA taxes?

The following plans and benefits are not considered deferred compensation for FICA and FUTA purposes (but may well be a "nonqualified deferred compensation plan" for 409A purposes):

(1) Stock options, stock appreciation rights, and other stock value rights, but not phantom stock plans or other arrangements under which an employee is awarded the right to receive a fixed payment equal to the value of a specified number of shares of employer stock;

(2) Some restricted property received in connection with the performance of services;

1. See IRC Secs. 3306(r)(2), 3306(b)(1).
2. Treas. Regs. §§31.3121(v)(2)-1(f), 31.3306(r)(2)-1(a).
3. IRC Secs. 3121(v)(2)(B), 3306(r)(2)(B).
4. Treas. Regs. §§31.3121(v)(2)-1(a)(2)(iii), 31.3306(r)(2)-1(a).

(3) Compensatory time, disability pay, severance pay, and death benefits;

(4) Certain benefits provided in connection with impending termination, including window benefits;

(5) Excess (golden) parachute payments;

(6) Benefits established twelve months before an employee's termination, if there was an indication that benefits were provided in contemplation of termination;

(7) Benefits established after termination of employment; and

(8) Compensation paid for current services.[1]

3564. Is the manner of determining the amount deferred for employment tax purposes impacted by whether the account is an account balance plan or a nonaccount balance plan?

The manner of determining the amount deferred for employment tax purposes under Section 3121 for a given period depends on whether the deferred compensation plan is an account balance plan or a nonaccount balance plan.[2]

Account Balance Plan

A plan is an account balance plan only if, under its terms, a principal amount is credited to an employee's individual account, the income attributable to each principal amount is credited or debited to the individual account, and the benefits payable to the employee are based solely on the balance credited to his or her individual account.[3] This is the typical voluntary top hat salary/bonus deferral plan and the defined contribution version of an employer-paid supplemental plan.

If the plan is an account balance plan, the amount deferred for a period equals the principal amount credited to the employee's account for the period, increased or decreased by any income or loss attributable thereto through the date when the principal amount must be taken into account as wages for FICA and FUTA purposes.

The regulations explain that "income attributable to the amount taken into account" means any amount that, under the terms of the plan, is credited on behalf of an employee and attributable to an amount previously taken into account, but only if the income is based on a rate of return that does not exceed either the actual rate of return on a predetermined actual investment or a reasonable rate of interest, if no predetermined actual investment has been specified.

Nonaccount Balance Plan

If the plan is a nonaccount balance plan, the amount deferred for a given period equals the present value of the additional future payment or payments to which the employee has obtained a legally binding right under the plan during that period. The present value must be determined

1. Treas. Regs. §§31.3121(v)(2)-1(b)(4), 31.3306(r)(2)-1(a).
2. Treas. Regs. §§31.3121(v)(2)-1(c)(1), 31.3306(r)(2)-1(a).
3. Treas. Regs. §§31.3121(v)(2)-1(c)(1), 31.3306(r)(2)-1(a).

as of the date when the amount deferred must be taken into account as wages, using actuarial assumptions and methods that are reasonable as of that date.[1]

With respect to these defined-benefit-type plans, the IRS has ruled privately that when a deferred compensation plan promises to pay a fixed amount in the future, the "amount deferred" is the present value of the expected benefits at the time when the benefits are considered wages for FICA purposes. The discount (that is, the income attributable to the amount deferred) is not treated as wages in that or any later year.[2] Thus, if the deferred compensation payments under such a plan vest (i.e., become non-forfeitable) on retirement, then the present value of the expected payments will be treated as wages for FICA purposes in the year of retirement.

An employer may treat a portion of a nonaccount balance plan as a separate account balance plan if that portion satisfies the definition of an account balance plan and the amount payable under that portion is determined independently of the amount payable under the other portion of the plan.[3]

The "income attributable to the amount taken into account" means the increase, due solely to the passage of time, in the present value of the future payments to which the employee has obtained a legally binding right, the present value of which constitutes the amount taken into account, but only if determined using reasonable actuarial methods.[4]

Final Section 3121 regulations provide that an amount deferred under a nonaccount balance plan need not be taken into account as wages under the special timing rule (See Q 3563) until the earliest date on which the amount deferred is reasonably ascertainable. An amount deferred is reasonably ascertainable when there are no actuarial (or other assumptions) needed to determine the amount deferred other than interest, mortality, or cost-of-living assumptions.[5] For example, the IRS ruled that a participant's benefits under an IRC Section 457 plan (Q 3568) would not be subject to FICA tax simply because the plan's age and service requirements had been met, because benefits were not "reasonably ascertainable" at that time. Similarly, the benefits would not be subject to income tax withholding at that time, because they are not treated as constructively received until actually received for income tax withholding.[6]

Planning Point: It usually is better not to vest an employee in employer amounts subject to forfeiture until immediately before payment is scheduled to start, because there is no refund or credit ability for FICA taxes paid if the employee should leave the employer and forfeit the benefit under the plan. It usually is desirable to vest it in the final year the employee is actively at work so as to avoid FICA/FUTA taxation on each payment following retirement.

No amount deferred under a deferred compensation plan may be taken into account as FICA or FUTA wages before the plan is established.[7]

1. Treas. Regs. §§31.3121(v)(2)-1(c)(2), 31.3306(r)(2)-1(a).
2. TAMs 9051003, 9050006.
3. Treas. Regs. §§31.3121(v)(2)-1(c)(1)(iii)(B), 31.3306(r)(2)-1(a).
4. Treas. Regs. §§31.3121(v)(2)-1(d)(2), 31.3306(r)(2)-1(a).
5. Treas. Regs. §§31.3121(v)(2)-1(e)(4)(i), 31.3306(r)(2)-1(a).
6. TAM 199902032.
7. Treas. Regs. §§31.3121(v)(2)-1(e)(1), 31.3306(r)(2)-1(a).

3565. Are self-employed individuals and corporate directors subject to FICA and FUTA taxes for deferred compensation arrangements?

Self-employed individuals pay Social Security taxes through self-employment ("SECA") taxes rather than FICA taxes. Deferred compensation of self-employed individuals is usually counted for SECA tax purposes when it is includable in income for income tax purposes.[1] Deferred compensation of self-employed individuals generally is counted for SECA purposes when paid, or when it is constructively received, if earlier.[2]

Likewise, corporate directors who defer their fees generally count those fees for SECA purposes when paid or constructively received (Q 3533).[3]

For a discussion of the SECA taxation of deferred commission payments to self-employed life insurance agents, see Q 571.

3566. What is the wage base subject to FICA and FUTA taxes for deferred compensation arrangements?

The wage base for the old age, survivors, and disability insurance ("OASDI") portion of the FICA tax and the taxable earnings base for the OASDI portion of the SECA tax are both $117,000 for 2014 (up from $113,700 in 2013).

Medicare Hospital Insurance Portion and Health Care Reform Changes

There is no taxable wage base cap for the Medicare hospital insurance portion of the FICA tax, so all deferred compensation counted as wages for FICA purposes is subject to at least the hospital portion of the FICA tax without limit.[4]There also is no earnings base cap for the hospital insurance portion of the SECA tax.[5]

As of 2014, the Medicare payroll tax on all wages is 2.9 percent, with the employer and employee each paying 1.45 percent. The Medicare payroll tax rate for the employee was raised to 2.35 percent beginning January 1, 2013 for individuals making more than $200,000 and couples making more than $250,000 annually. Also, a new 3.8 percent Medicare tax on the lesser of "investment income" or the amount of adjusted gross income in excess of the income breakpoints became effective January 1, 2013 on individuals making more than $200,000 of specially defined adjusted gross income concerning investment and other income, and couples making $250,000 ($125,000 for married couples filing separately).[6]

On June 28, 2012, the Supreme Court, in *National Federation of Independent Business v. Sebelius*, upheld the constitutionality of the *Patient Protection and Affordable Care Act*, with only minor change to certain Medicaid provisions[7].

1. See IRC Sec. 1402(a); Treas. Reg. §1.1402(a)-1(c).
2. See, e.g., Let. Ruls. 9609011, 9540003.
3. IRC Secs. 1402(a), 5123(a); Treas. Reg. §1.1402(a)-1(c); Let. Rul. 8819012.
4. IRC Sec. 3121(a)(1).
5. IRC Sec. 1402(b)(1).
6. Health Care Reform Act of 2010, PL 111-148.
7. 132 S. Ct. 2566 (2012)

3567. Are the tax benefits of a nonqualified deferred compensation account balance or nonaccount balance plan available through an agreement with a state or local government or other tax-exempt employer?

Yes.

Such plans generally are available under and covered by IRC Section 457 (but see Q 3589). It should be noted that governmental plans have slightly different rules under Section 457 than those of private tax-exempt organizations, such as charities and private colleges. For both types of tax-exempt organizations – governmental or private - there are two kinds of plans under IRC Section 457: 1.) "eligible" plans under Section 457(b), and 2.) "ineligible" plans under Section 457(f). Receipt and taxation of compensation for services performed for a state or local government may be deferred under a Section 457 plan.

For this purpose, a state or local government includes a state, a political subdivision of a state, or any agency or instrumentality of either of them. A plan of a tax-exempt rural electric cooperative and its tax-exempt affiliates is included under these same rules. Deferred compensation plans covering state judges may not be governed under these rules (Q 3589). Although the IRC does not appear to provide for tax-exempt employers and governmental entities to maintain SIMPLE IRA plans (Q 3654), the IRS has stated that they may do so.[1] (SIMPLE IRA plans of tax-exempt employers and governmental entities are not subject to the limits of IRC Section 457). IRC Section 409A specifically exempts 457(b) eligible plans from coverage by Section 409A, but specifically applies Section 409A to so-called 457(f) ineligible top hat plans.

IRC Section 457 also generally applies to deferred compensation agreements entered into with private, nongovernmental organizations exempt from tax under IRC Section 501 (for the most part, nonprofit organizations serving some public or charitable purpose). Amounts deferred under agreements with such tax-exempt organizations (other than tax-exempt rural electric cooperatives) in taxable years prior to December 31, 1986, do not fall within the rules applicable to Section 457 plans (see "Grandfather Rule," below).

Churches fit into their own unique category within tax-exempt organizations. Neither a church (as defined in IRC Section 3121(w)(3)(A)), nor a church-controlled organization (as defined in IRC Section 3121(w)(3)(B)) is an eligible employer for purposes of IRC Section 457.[2] The plan of such a church employer, however, is subject to Section 409A unless the plan can claim one of the exceptions to coverage, such as the "short term deferral exception" (Q 3540). Such a church plan generally is not subject to ERISA requirements as well, unless so elected.

In Notice 2005-58,[3] the IRS determined that a federal credit union was not covered by Section 457 because of its federal chartering, reversing a decision from a 2004 private letter ruling.[4] The notice said that a federally chartered credit union was not an eligible employer

1. Notice 97-6, 1997-1 CB 353. See also *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCT-12-96), n. 130, p. 140 (the 1996 Blue Book).
2. IRC Sec. 457(e)(13); Treas. Reg. §1.457-2(e).
3. 2005-33 IRB 295.
4. Let. Rul. 200430013.

under IRC Section 457 because it was a federal instrumentality under IRC Section 501(c)(1). Under this Notice, a federal credit union that consistently claimed the status of a non-governmental tax-exempt organization for employee benefit plan purposes was permitted to maintain an "eligible" or "ineligible" plan under IRC Section 457 if implemented on or before the August 2005 cutoff date provided in the notice. The Notice did not offer an interim solution for the creation of nonqualified plans pending resolution of the federal instrumentality issue, which was incorporated into a bigger project primarily dealing with Indian tribe agency units.

The guidance in this Notice was the only guidance on this issue until 2012, when the IRS issued proposed regulations defining a federal instrumentality, and determined that a federal credit union was, in fact, a federal instrumentality. However, the IRS still concluded that, for purposes of available retirement plan authority, federal credit unions will look to Section 457 for construction of nonqualified plans, just like their state chartered peers. This means that federal credit unions are authorized to have 457(b) eligible and 457(f) ineligible nonqualified plans, thus ending the eight year mystery of their proper authority for nonqualified plans. As to plans created by federal credit unions during the intervening period of no guidance, plans created pursuant to 457(b) and 457(f) would seem to be safe from attack. However, a plan created during that period that complied with both Sections 409A and Section 83 (which is used by reference in Section 457(f)) would seemly satisfy the most stringent income tax hurdles and avoid taxation. However, sponsors of such plans would need to consider modifications necessary to fit their plan entirely within the bounds of 457(f) as the most likely target. Designs that used other Code sections for plans are less certain and will probably require special process with the IRS in light of the proposed regulations.

An "eligible" Section 457 plan is one that meets the annual deferral limits and other requirements of IRC Section 457 (Q 3568).[1] Plans that do not meet these limits are referred to as 457(f) "ineligible" plans and generally are top hat plans because of the ability to impose vesting on the benefits (and generally can be provided only to a select group of management or highly compensated employees for ERISA purposes) (Q 3586).[2]

Plans Not Subject to IRC Section 457

Bona fide vacation leave, sick leave, compensatory time, severance pay (including certain voluntary early retirement incentive plans), disability pay, and death benefit plans generally are not considered to be plans providing for the deferral of compensation and, thus, are not subject to IRC Section 457. The IRS has issued interim guidance for certain broad-based, nonelective severance pay plans of a state or local government in existence before 1999 with respect to the timing of reporting payments.[3]

Length of service awards that accrue to bona fide volunteers (or their beneficiaries) due to "qualified services" after December 31, 1996 are also excluded from coverage.[4] "Qualified

1. Treas. Reg. §1.457-2(f).
2. Treas. Reg. §1.457-2(h).
3. Ann. 2000-1, 2000-2 IRB 294.
4. IRC Sec. 457(e)(11)(A)(ii).

services," for this purpose, means firefighting and prevention services, emergency medical services, and ambulance services.[1] This exclusion does not apply when the accrued aggregate amount of the award in any year of service exceeds $3,000.[2]

IRC Section 457 also does not apply to nonelective deferred compensation attributable to services not performed as an employee. Deferred compensation is treated as nonelective for this purpose if all individuals with the same relationship to the employer are covered under the same plan, with no individual variations or options under the plan.[3]

Pre-409A Grandfather Rule – Nongovernmental Tax-Exempt Organizations

Amounts deferred under plans of nongovernmental tax-exempt organizations for taxable years beginning after December 31, 1986 are not subject to IRC Section 457 if made pursuant to an agreement that was in writing on August 16, 1986, and provides for yearly deferrals of a fixed amount or an amount determined by a fixed formula.[4] This grandfather provision is available only to those individuals covered under a plan on August 16, 1986.[5]

Any modification to a written plan that directly or indirectly alters the fixed amount or the fixed formula will subject the plan to the limitations of IRC Section 457.[6] Modifications that reduce benefits apparently will not.[7]

Where promised retirement benefits provided (as a matter of practice) solely through a grandfathered nonqualified plan were offset by benefits from a qualified plan without altering the fixed formula determining the total amount of promised benefits, the grandfathered status of the nonqualified plan was not affected.[8] Similarly, an amendment to allow for the diversification into different mutual funds for the deemed investment of a participant's account and not limiting such participant to his or her original mutual fund investment options was found not to modify the basic formula and not to affect the grandfather status of the plan.[9]

Where, in the context of a parent-subsidiary structure established before August 16, 1986, a participant in the subsidiary's plan became an employee of the parent and was paid by the parent but retained his positions and responsibilities with, but not his compensation from, the subsidiary, a proposal to amend the subsidiary's plan to cover the participant's employment with the parent did not modify the plan's fixed formula and did not affect the grandfathered status of the plan.[10]

The IRS has indicated that amendments providing for selection of investment alternatives and an election to receive an annual cash payment did not adversely affect the plan's

1. IRC Sec. 457(e)(11)(C).
2. IRC Sec. 457(e)(11)(B).
3. IRC Sec. 457(e)(12).
4. TRA '86, Sec. 1107(c)(3)(B).
5. TAMRA '88, Sec. 1011(e)(6).
6. Notice 87-13, 1987-1 CB 432, Notice 98-49, 1998-2 CB 365.
7. See TAMRA '88, Sec. 6064(d)(3); Let. Ruls. 9538021, 9334021, 9250008.
8. Let. Rul. 9549003.
9. Let. Rul. 9721012.
10. Let. Rul. 9548006.

grandfathered status under the Tax Reform Act of 1986.[1] In addition, the IRS has ruled that amendments to make such a pre-August 16, 1986 plan compliant with Section 409A (these old plans were not included in the Section 409A exemptions or exceptions) does not cause loss of the plan's grandfathering against coverage by Section 457.[2]

Code Section 409A and Section 457

As noted, Section 409A does not apply to Section 457(b) "eligible" plans but does apply to Section 457(f) "ineligible" top hat plans. Unfortunately, the requirements of the two IRC sections do not mesh together easily. In an attempt to reconcile the requirements of Section 457(f) with Section 409A, the IRS released Notice 2007-62.[3] There, the IRS redefined certain terms for Section 457(f) purposes. Of significance, the IRS made the Section 409A definition of a "substantial risk of forfeiture" the 457(f) definition. The 409A definition of substantial risk of forfeiture is the most stringent and is more of a timing rule (it governs the availability of the short term deferral exception) than a taxation rule. The result of this proposed change and guidance is that many pure deferral plans cannot now achieve a substantial risk of forfeiture for 457(f) purposes because the 409A definition precludes there being a risk of forfeiture unless there is currently a substantial employer contribution required (ill defined). Therefore, a plan without an employer match or a small one may not satisfy the 457(f) requirement because of the required use of the 409A definition in 457(f).

Before the notice, a plan might have independently satisfied the old 457(f) SROF requirements (as presently understood) and also the individual "detail" requirements (i.e., minimum documentation, permissible distributions, prohibitions against accelerations, and the timing of elections) of Section 409A. This use of the Section 409A definition in Section 457(f) also has the result of eliminating the possibility of installment payments that are taxable as received. That is because the Section 409A definition (made the 457(f) definition) does not treat covenants not to compete and consulting agreements, which often are used to support the position that installment payments are taxable as received, as a substantial risk of forfeiture.

The IRS in Notice 2007-62 also redefined the definition of "severance plans" as to a voluntary and involuntary separation from service for purposes of Section 457(f) to use the 409A definition. As of the date of this publication, the IRS has yet to release new 457(f) regulations based upon Notice 2007-62, so it is not clear how the IRS intends to proceed with this confusing situation. It is clear that 457(f) plans are covered by Section 409A, and must comply with both Sections 457(f) and 409A.

Planning Point: In summary, after Notice 2007-62, employer-paid supplemental plans (account balance or nonaccount balance), are left unhindered, but even here the payments must be made in a lump sum (or risk Section 72 taxation). Unless a voluntary deferral plan will involve a significant employer match, a voluntary deferred compensation plan account balance plan is unlikely to satisfy the revised standard for income deferral under Section 457(f). The IRS is expected to finally release proposed regulations in the coming months. It currently appears

1. Let. Rul. 9822038.
2. Let. Rul. 201117001
3. *See generally*, Notice 2007-62, 2007-31 IRB 311.

that the IRS will substantially follow the major items of guidance originally provided in Notice 2007-62 in these proposed regulations.[1] Moreover, it is unclear as of the date of publication how the IRS will reconcile the many differences between the requirements and exemptions, regarding plans in 457 and those covered by 409A in the forthcoming proposed regulations integrating 457 and 409A. There are indications that the IRS may stretch the reach of 409A into various types of plans under 457. Planners therefore should check for forthcoming proposed regulations for more detail.

3568. What are the requirements for a Section 457(b) "eligible" nonqualified deferred compensation plan?

There are two types of retirement-oriented nonqualified deferred compensation plans under Section 457: (1) the 457(b) "eligible plan, and (2) the 457(f) "ineligible" plan. A deferred compensation plan under IRC Section 457(b) must meet certain requirements as set forth below. These requirements do not contain a prohibition against discrimination among employees. A Section 457 plan that is not administered in accordance with these requirements will be treated as "ineligible," and must meet certain extra requirements (Q 3586).[2] Plans paying benefit awards based solely on length of service to bona fide volunteers or their beneficiaries on account of such volunteers' qualified services are exempt from Section 457.[3]

It should be noted that the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA 2001) made many changes in the rules applicable to Section 457 plans. In addition, final regulations were issued in 2003 and were generally effective for taxable years beginning after December 31, 2001.[4] In addition, IRC Section 409A, enacted in 2004, specifically excludes 457(b) "eligible" plans from Section 409A coverage, but specifically includes 457 (f) "ineligible" plans. The balance of this discussion covers only so-called 457(b) "eligible" deferred compensation plans.

Governmental Versus Private Tax-Exempt Organizations

In general, 457(b) "eligible" plans separate into two different categories: (1) plans for governmental plans, and (2) plans for private tax-exempt organizations. The tax and ERISA rules for an eligible plan will vary according to the category the plan. See Q 3569 to Q 3586 for details.

3569. What are the rules regarding permissible participants in a Section 457(b) "eligible" nonqualified deferred compensation plan?

Under "eligible" plans, only individuals may participate, but they may be either employees or independent contractors. Partnerships and corporations cannot be participants.[5] Where local government employees were hired by a water company as part of privatization, they could no longer participate in the local government's Section 457 plan.[6]

1. IRC Sec. 457(e)(11). Note the definitions of these terms are generally different for 457 and 409A purposes.
2. IRC Sec. 457(b)(6).
3. IRC Sec. 457(e)(11)(A)(ii).
4. Treas. Reg. §1.457-12.
5. Sen. Rep. 95-1263 (Revenue Act of 1978), *reprinted in* 1978-3 CB (vol. 1) 364.)
6. IRS Information Letter 2000-0300.

It should be noted that nongovernmental private tax-exempt employers must structure their plans to take advantage of a top hat ERISA exemption (e.g., by allowing only a select group of management or highly compensated employees to participate). Otherwise, the plan would be subject to the exclusive purpose and funding requirements of Title I of ERISA, and a nongovernmental tax-exempt Section 457 plan cannot, by definition, meet those requirements.[1]

3570. What are the timing requirements for deferred compensation under a Section 457(b) "eligible" nonqualified deferred compensation plan?

Generally, compensation may be deferred for any calendar month, but only if a deferral agreement has been entered into *before* the beginning of that month.[2] But a Section 457 plan may permit a newly hired employee to enter into an agreement before his first day of employment, under which deferrals will be made for the first month in which he is employed. Non-elective employer contributions are treated as being made under an agreement entered into before the first day of the calendar month.[3] This timing of elections to defer should be contrasted with that required for 457(f) "ineligible" plans, which are subject to Section 409A.

A Section 457 plan may permit deferrals pursuant to an automatic election, under which a fixed percentage of an employee's compensation is deferred unless he affirmatively elects to receive it in cash.[4]

3571. What are the rules regarding the availability of the amounts payable under a Section 457(b) "eligible" nonqualified deferred compensation plan?

A Section 457 plan generally cannot provide that amounts will be made available before (1) the calendar year in which the participant attains age 70½, (2) the date when the participant has a severance from employment (see Q 3573), or (3) the date when the participant is faced with "an unforeseeable emergency" (see Q 3574).[5] Here again the difference in the rules for a permissible distribution for 457(b) "eligible" plan and a 457(f) "ineligible" plan should be contrasted.

A participant in an eligible nongovernmental private tax-exempt Section 457 plan may make a one-time election, *after* amounts are available and *before* commencement of distributions, to defer commencement of distributions (Q 3586).[6]

The early distribution penalty applicable to qualified retirement plans generally does not apply to distributions from a Section 457 plan, except to the extent that the distribution is attributable to rollovers from a qualified retirement plan or a Section 403(b) plan, for which Section 457 plans are required to separately account (see Q 3574).[7]

1. See Let. Rul. 8950056.
2. IRC Sec. 457(b)(4).
3. Treas. Reg. §1.457-4(b).
4. Rev. Rul. 2000-33, 2000-2 CB 142.
5. IRC Sec. 457(d)(1)(A).
6. IRC Sec. 457(e)(9)(B).
7. IRC Sec. 72(t)(9).

3572. When does a "severance from employment" occur under a Section 457(b) "eligible" nonqualified deferred compensation plan?

A severance from employment occurs when a participant ceases to be employed by the employer sponsoring the plan.[1] An employee will not experience a severance from employment merely because any portion of his benefit is transferred (other than by a rollover or elective transfer) from his former employer's plan to the plan of his new employer.[2]

Under the regulations, an independent contractor is considered to have separated from service upon an expiration of all contracts under which services are performed, if such expiration is considered a good faith and complete termination of the contractual relationship. Good faith is lacking where a renewal of the contractual relationship or the independent contractor becoming an employee is anticipated.[3] Note the similarity of the definition used here and for a 457(f) plan, which are subject to the rules covering a separation from service distribution under Section 409A.

3573. Is a Section 457(b) "eligible" nonqualified deferred compensation plan required to include provisions regarding unforeseeable emergency situations?

An unforeseeable emergency must be defined in the plan as a severe financial hardship of participants or beneficiaries resulting from illnesses or accidents of the participants or beneficiaries or of their spouses or dependents, the loss of the participants' or beneficiaries' property due to casualty, or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond their control. It should be noted that 457 uses very similar terminology as used in Section 409A, and it now appears that the IRS may intend to treat the definitions as the same in both Code sections.[4]

Examples of valid emergencies in the 457 regulations and in Rev. Rul. 2010-27 include the imminent foreclosure of or eviction from a primary residence; the need to pay for medical or funeral expenses, including funeral expenses for an adult child who is not a dependent; and significant water damage to a principal residence. However, the most recent ruling indicates that paying off high credit card debt is not unforeseeable and therefore does not qualify.

Whether an event is an unforeseeable emergency will depend upon the relevant facts and circumstances of each case. But a distribution on account of an unforeseeable emergency may not be made where the emergency may be relieved through reimbursement or compensation from insurance or otherwise, by liquidation of a participant's assets if liquidation in itself would not cause severe financial hardship, or cessation of deferrals under the plan. In addition, the distribution must be limited to the amount reasonably necessary to satisfy the emergency need (including amounts necessary to pay taxes or penalties reasonably expected to result from the distribution).[5]

1. IRC Sec. 457(d)(1)(A)(ii); Treas. Reg. §1.457-6(b).
2. EGTRRA 2001 Conf. Rep., *reprinted in* the General Explanation of EGTRRA 2001, p. 161.
3. Treas. Reg. §1.457-6(b)(2).
4. Rev. Rul. 2010-27.
5. Treas. Reg. §1.457-6(c)(2).

Distributions made at any time on or after August 25, 2005 and before January 1, 2007 by an individual whose principal place of abode on August 28, 2005 was located in the Hurricane Katrina disaster area and who sustained an economic loss by reason of Hurricane Katrina are treated as permissible distributions under IRC Section 457(d)(1)(A). Total distributions under this provision may not exceed $100,000.[1]

A court *did* find a severe financial hardship where the participant's spouse gave birth to a severely ill child and had to cease working in order to care for such child.[2]

3574. How are loans treated under a Section 457(b) "eligible" nonqualified deferred compensation plan?

Any amount received as a loan from an eligible nongovernmental Section 457(b) plan is treated as a distribution in violation of the distribution requirements.[3] But a facts and circumstances standard is applied to amounts received as loans from an eligible governmental Section 457 plan to determine whether the loan is bona fide and for the exclusive purpose of benefitting participants and beneficiaries. Factors considered include whether the loan has a fixed repayment schedule, a reasonable rate of interest, and repayment safeguards.[4] Such loans are taxed under the rules of IRC Section 72(p) (Q 3848).[5] Contrast this with the treatment of loans under 457(f) "ineligible" plans covered by Section 409A where loans are prohibited (Q 3533).

3575. How are domestic relations orders treated in conjunction with Section 457(b) "eligible" nonqualified deferred compensation plans?

The qualified domestic relations order (QDRO) rules applicable to qualified plans (Q 3816) also apply to eligible Section 457 plans, so that the IRC Section 457(d) distribution rules are not violated if an eligible Section 457 plan makes a distribution to an alternate payee pursuant to a QDRO.[6] Contrast this with a 457(f) plan where a DRO outlined by Section 409A regulations applies (Q 3533).

3576. What required minimum distribution ("RMD") requirements are imposed with regard to Section 457(b) "eligible" nonqualified deferred compensation plans?

The Worker, Retiree, and Employer Recovery Act of 2008 (WRERA 2008) provided that RMDs from governmental Section 457 (b) defined contribution plans for calendar year 2009 were waived. Also, the five year rule was to be determined without regard to 2009.

For distributions *after December 31, 2001*, an eligible Section 457(b) plan is generally subject only to the same required minimum distribution rules as apply to qualified retirement plans.[7] These rules generally require a plan to begin distribution of an employee's interest no later

1. KETRA 2005 Sec. 101; Notice 2005-92, 2005-51 IRB 1165.
2. *Sanchez v. City of Hartford*, 89 F. Supp. 2d 210 (DC 2000).
3. Treas. Reg. §1.457-6(f)(1).
4. Treas. Reg. §1.457-6(f)(2).
5. Treas. Reg. §1.457-7(b)(3).
6. IRC Secs. 414(p)(10), 414(p)(11).
7. IRC Sec. 457(d)(2).

than his required beginning date.[1] For a detailed discussion of the rules that apply to qualified retirement plans, see Q 3802 through Q 3813.

"Required beginning date" generally means April 1 of the calendar year following the *later* of (1) the year in which the employee attains age 70½ or (2) the year in which he retires.[2] A special rule applies to a "5 percent owner" (as defined in IRC Section 416 (Q 3828), for whom "required beginning date" means April 1 of the calendar year following the year in which he attains age 70½.[3] Although this rule technically applies to Section 457 (b) plans maintained by tax-exempt employers (and not to governmental or church plans), as a practical matter, tax-exempt employers are as unlikely as governments and churches to have 5 percent owners. A Section 457 (b) plan may provide that the required beginning date for *all employees* is April 1 of the calendar year following the calendar year in which the employee attains age 70½.[4]

Penalty. An excise tax of 50 percent of the amount by which the required minimum distribution for the year exceeds the amount actually distributed is imposed on the payee (Q 3814).[5]

3577. What requirements involving the treatment of plan assets are imposed upon Section 457(b) "eligible" nonqualified deferred compensation plans?

Governmental plans. An eligible Section 457 plan of a governmental employer must hold all plan assets and income thereon in a trust, custodial account, or annuity contract for the exclusive benefit of participants and their beneficiaries. This account is exempt from tax under IRC Section 501(a).[6]

Nongovernmental tax-exempt plans. A Section 457 plan of a nongovernmental tax-exempt employer must provide that amounts deferred, all property purchased with those amounts, and the income thereon remain the property of the employer sponsoring the plan, and subject to the claims of its general creditors.[7] The participants may not have a secured interest in property held under such a Section 457 plan. A rabbi trust (Q 3556) may be established without causing such a Section 457 plan to violate this requirement.[8] Section 457(f) "ineligible" plans impose an additional more stringent requirement (Q 3586).

3578. What limitations on the amount of deferrals apply to Section 457(b) "eligible" nonqualified deferred compensation plans?

A Section 457(b) plan must provide that the annual deferral amount may not exceed the lesser of (1) 100 percent of includable compensation or (2) the applicable dollar limit. The dollar limit is $17,500 in 2013 and 2014.[9] The limit was $17,000 in 2012. In tax years beginning after

1. IRC Sec. 401(a)(9)(A).
2. IRC Sec. 401(a)(9)(C).
3. IRC Sec. 401(a)(9)(C)(ii)(I).
4. Treas. Reg. §1.401(a)(9)-2, A-2(e).
5. IRC Sec. 4974.
6. IRC Sec. 457(g); Treas. Reg. §1.457-8(a).
7. IRC Sec. 457(b)(6); Treas. Reg. §1.457-8(b).
8. Let. Ruls. 9517026, 9436015.
9. IR-2013-86 (Oct. 31, 2013).

2006, annual cost-of-living adjustments are made in $500 increments.[1] "Annual deferral" is defined to include not only elective salary deferral contributions, but also non-elective employer contributions.[2] The annual deferral amount does not include any rollover amounts received by the plan on behalf of the participant.[3]

Any amount deferred in excess of the Section 457(b) plan's deferral limits is considered an excess deferral. Likewise, where an individual participates in more than one Section 457 plan, amounts deferred not in excess of the applicable plan's deferral limits, but that nevertheless exceeds the individual participant's deferral limit, are also considered excess deferrals.[4] Amounts that exceed a governmental Section 457 plan's deferral limits must be distributed to the participant, along with allocable net income, as soon as administratively practicable after the plan determines that the amount constitutes an excess deferral.[5] If a nongovernmental tax-exempt Section 457(b) plan's deferral limits are exceeded, the plan will be treated as an ineligible plan.[6] For these purposes, all plans in which the individual participates as a result of his relationship with a single employer are treated as a single plan.[7] Where excess deferrals have arisen out of a failure to satisfy the individual deferral limitation, a Section 457(b) plan may provide that the excess deferral will be distributed as soon as administratively practicable after the plan determines that the amount constitutes an excess deferral. If the Section 457(b) plan does not distribute the excess deferral, it will not lose its status as an eligible plan, but the participant must include the excess amount in income for the later of (1) the taxable year in which it was deferred or (2) the first taxable year in which there is no longer a substantial risk of forfeiture.[8]

The contribution limits under IRC Section 457(b) are not coordinated with the IRC Section 402(g) limits on elective deferrals under IRC Section 401(k) plans and IRC Section 403(b) plans.[9]

> *Example*: In 2014, an employee works for a not-for-profit organization sponsoring a Section 457(b) plan, and "moonlights" as a sales representative for a business sponsoring a 401(k) plan. The employee can defer up to $17,500 under the Section 457(b) plan *and* up to $17,500 under the 401(k) plan (prior to 2002, the employee was limited to the maximum deferral amount under the Section 457(b) plan).

These limitations do not apply to qualified governmental excess benefit arrangements under IRC Section 415(m)(3).[10]

Some employers have avoided the deferral limitations by deliberately failing to satisfy the trust requirements under IRC Section 457(g) – so that the IRS would rule the plan to be an *ineligible* plan (Q 3586) – while maintaining a Section 457 (f) "substantial risk of forfeiture" (Q 3530) in order to avoid current taxation.[11]

1. IRC Sec. 457(b)(2).
2. Treas. Reg. §1.457-2(b).
3. Treas. Reg. §1.457-4(c)(1)(iii).
4. Treas. Regs. §§1.457-4(e)(1), 1.457-5.
5. Treas. Reg. §1.457-4(e)(2).
6. Treas. Reg. §1.457-4(e)(3).
7. Treas. Regs. §§1.457-4(e)(2), 1.457-4(e)(3).
8. Treas. Reg. §1.457-4(e)(4).
9. IRC Sec. 457(c).
10. IRC Sec. 457(e)(14).
11. See, e.g., Let. Rul. 9823014.

Compensation. "Includable compensation" has the meaning given to "participant's compensation" by IRC Section 415(c)(3) (Q 3783). Includable compensation is determined without regard to community property laws. Compensation is taken into account at its present value in the plan year in which it is deferred (or, if the compensation deferred is subject to a Section 457(f) substantial risk of forfeiture, at its present value in the plan year in which such risk is first eliminated).[1]

3579. Can participants in a Section 457(b) "eligible" nonqualified deferred compensation plan make catch-up contributions?

IRC Section 457(b) Catch-up Rules. An eligible Section 457(b) plan can provide for catch-up contributions in one or more of a participant's last three taxable years ending before he attains normal retirement age under the plan. For those years, in addition to the normal limits, a participant may defer a catch-up amount equal to the portions of normal deferral limits unused in prior taxable years for which the participant was eligible to participate in the plan.[2] During those years, the limit on deferrals is increased to the lesser of (1) twice the amount of the regularly applicable dollar limit (2 × $17,500 in 2014); or (2) the underutilized limitation.[3] Note that the IRC Section 457(b) catch-up rules cannot be used for the year in which the participant attains normal retirement age.[4] The underutilized limitation is the sum of (1) the otherwise applicable limit for the year; plus (2) the amount by which the applicable limit in preceding years exceeded the participant's actual deferral for those years.[5]

For purposes of determining the underutilized limitation for pre-2002 years, participants remain subject to the rules in effect for those prior years (e.g., includable compensation is reduced by all pre-tax contributions and the previous coordination rules apply.).[6] A participant cannot elect to have the IRC Section 457(b) catch-up rules apply more than once, even if he failed to use it in all three years before he reached retirement age, and even if he rejoined the plan or participated in another plan after retirement.

For purposes of the IRC Section 457(b) catch-up rules, the Section 457(b) plan must generally specify the plan's normal retirement age. Under the regulations, a Section 457(b) plan may define normal retirement age as any age on or after the earlier of (1) age 65 or (2) the age when participants may retire and receive immediate retirement benefits (without actuarial or other reduction) under the basic defined benefit plan of the government or tax-exempt entity, but in any event, no later than age 70½. A special rule provides that Section 457(b) plans may permit participants to designate a normal retirement age within these ages instead of designating a normal retirement age. A participant may not have more than one normal retirement age under different plans sponsored by the employer sponsoring the Section 457(b) plan for purposes of the IRC Section 457(b) catch-up rules. Plans that include among their participants qualified

1. IRC Secs. 457(e)(5), 457(e)(6), 457(e)(7).
2. IRC Sec. 457(b)(3); Treas. Reg. §1.457-4(c)(3).
3. Treas. Reg. §1.457-4(c)(3)(i).
4. See, e.g., Treas. Reg. §1.457-4(c)(3)(D)(vi), Ex. 3.
5. Treas. Reg. §1.457-4(c)(3)(ii).
6. Treas. Regs. §1.457-4(c)(3)(iii), 1.457-4(c)(iv).

police or firefighters may designate an earlier normal retirement age for such qualified police and firefighters.[1]

Age 50 Catch-up Rules. An additional catch-up rule applies for eligible Section 457(b) plans of governmental employers.[2] Additional contributions are allowed for participants who have attained age 50 by the end of the taxable year.[3] (See also Q 3706.) All eligible IRC Section 457(b) governmental plans of an employer are treated as a single plan.[4] The additional amount is the lesser of (1) the applicable dollar amount; or (2) the participant's compensation, reduced by the amount of any other elective deferrals that the participant made for that year.[5]

The applicable dollar amount for eligible IRC Section 457(b) governmental plans is $5,500 in 2014.[6] The applicable dollar amount was also $5,500 for 2009-2014. The $5,500 limit is indexed for inflation in $500 increments for years beginning after 2006.[7] An individual participating in more than one plan is subject to one annual dollar limit for all catch-up contributions during the taxable year.[8] Catch-up contributions by participants age 50 or over, made under the provisions of IRC Section 414(v), are not subject to any otherwise-applicable limitation of IRC Section 457(b)(2) (determined without regard to IRC Section 457(b)(3)).[9] See Q 3706 for additional details on the requirements for the new catch-up contributions.

During the last three years before a participant reaches normal retirement age, the age 50 catch-up rules do not apply if a higher catch-up amount would be permitted under the IRC Section 457(b) catch-up rules referenced above. Thus, an individual who is eligible for additional deferrals under both the age 50 catch-up and the IRC Section 457(b) catch-up rules is entitled to the greater of (1) the applicable dollar limit in effect for the plan year plus the age 50 catch-up contribution amount, disregarding the IRC Section 457(b) catch-up rules or (2) the applicable dollar limit in effect for the plan year plus the contribution amount under the IRC Section 457(b) catch-up rules, disregarding the age 50 catch-up rules.[10]

For the taxation of amounts deferred under a Section 457(b) plan, see Q 3586.

3580. Do any special rules regarding small distributions and transfers apply to Section 457(b) "eligible" nonqualified deferred compensation plans?

Yes. If a participant's total distribution is $5,000 or less, the participant may elect to receive such amount (or the Section 457(b) plan may provide for an involuntary cashout of such amount) if (1) no amount has been deferred by the participant during the 2-year period ending on the date of distribution; and (2) there has been no prior distribution under this provision.[11]

1. Treas. Reg. §1.457-4(c)(3)(v).
2. IRC Sec. 414(v)(6)(A)(iii); Treas. Reg. §1.414(v)-1(a)(1).
3. IRC Sec. 414(v)(5).
4. IRC Sec. 414(v)(2)(D).
5. Treas. Reg. §1.457-4(c)(2)(i).
6. IR-2009-94 (Oct. 15, 2009), IR-2013-86 (Oct. 31, 2013).
7. IRC Sec. 457(e)(15); Treas. Reg. §1.457-4(c)(2)(i).
8. Treas. Reg. §1.414(v)-1(f)(1).
9. IRC Sec. 414(v)(3)(A).
10. Treas. Reg. §1.457-4(c)(2)(ii).
11. IRC Sec. 457(e)(9); Notice 98-8, 1998-4 IRB 6.

Participants are permitted to make tax-free transfers between eligible Section 457(b) plans as long as the amounts transferred are not actually or constructively received prior to the transfer.[1] But according to the regulations, plan-to-plan transfers must meet certain requirements and are permitted only from one governmental plan to another, or from one nongovernmental tax-exempt plan to another, not between a governmental plan and a nongovernmental tax-exempt plan. In addition, no direct transfer may be made from a governmental plan to a qualified retirement plan except in the context of a service credit purchase, discussed in Q 3583. A tax-exempt plan may not directly transfer assets to a qualified retirement plan, and a qualified retirement plan may not directly transfer assets to either a governmental plan or a nongovernmental tax-exempt plan.[2]

Employees that deferred amounts to a Section 457(b) plan in which they were ineligible to participate cannot transfer such amounts, under IRC Section 457(e)(10), to a Section 457(b) plan in which they *are* eligible to participate.[3]

3581. Are rollover distributions permitted in the context of Section 457(b) "eligible" nonqualified deferred compensation plans?

Yes. Distributions may be rolled over to and from eligible Section 457(b) plans of governmental employers under rules similar to those for qualified retirement plans and tax-sheltered annuities.[4] If an eligible Section 457(b) plan of a governmental employer receives a rollover from a qualified retirement plan or a TSA, it must separately account for such rollover amounts thereafter.[5]

The following rules applicable to rollovers from qualified retirement plans (Q 3882) are also applicable to rollovers to and from eligible Section 457(b) plans of governmental employers.

(1) Maximum amount of rollover

(2) 60-day limitation

(3) Definition of eligible rollover distribution

(4) Sales of distributed property

(5) Frozen deposits

(6) Surviving spouse rollovers

(7) For distributions after December 31, 2006, non-spouse beneficiary rollovers[6]

The direct rollover rules, automatic rollover option, and withholding rules applicable to qualified retirement plans (Q 3884) also apply.[7]

1. See IRC Sec. 457(e)(10); Let. Ruls. 199923010, 8946019, 8906066.
2. Treas. Reg. §1.457-10(b)(1).
3. Let. Rul. 9540057.
4. IRC Sec. 457(d)(1)(C); Treas. Reg. §1.457-7(b)(2).
5. IRC Secs. 402(c)(8)(B), 403(b)(8)(A)(ii).
6. IRC Sec. 457(e)(16).
7. IRC Secs. 457(d)(1)(C), 3401(a)(12)(E).

Transfers between eligible Section 457(b) plans remain the only option for eligible Section 457(b) plans of *nongovernmental tax-exempt organizations*.[1] A 457(f) ineligible plan may not be rolled over into another qualified retirement plan or an IRA at all, but is taxable upon vesting.

3582. What is a service credit purchase in the context of Section 457(b) "eligible" nonqualified deferred compensation plans?

In many states, participants may use "permissive service credits" to increase their retirement benefits under the state's defined benefit retirement plan(s). For this purpose, permissive service credit means credit for a period of service that a plan recognizes only if the employee contributes an amount, determined by the plan, that does not exceed the amount necessary to fund the benefit attributable to such period of service. Such contributions must be voluntary and made in addition to regular employee contributions, and are generally subject to the limits of IRC Section 415.[2]

Participants may exclude from income amounts directly transferred (i.e., from trustee to trustee) from a Section 457(b) plan of a governmental employer to a governmental defined benefit plan in order to purchase permissive service credits. Likewise, a participant may use such directly transferred amounts to repay contributions or earnings that were previously refunded because of a forfeiture of service credit, under either the transferee plan or another Section 457(b) plan maintained by a governmental employer in the same state.[3]

3583. Will the IRS issue advance rulings on the tax consequences of Section 457(b) "eligible" nonqualified deferred compensation plans?

Since the enactment of IRC Section 409A, the IRS has refused to issue advance rulings on the tax consequences of nonqualified deferred compensation plans as it did prior to Section 409A (Q 3533). The availability and requirements for favorable letter rulings for plans under Section 457(b) were not clear even before the enactment of Section 409A and the IRS's release of guidance refusing to issue letter rulings on such plans.

It was clear, though, that prior to the enactment of Section 409A, the IRS would not issue an advance ruling on the tax consequences of a Section 457(b) plan covering independent contractors, unless all such independent contractors were identified.[4] Now that 457(b) "eligible" plans are specifically exempted from, and 457(f) "ineligible" plans are specifically covered by, Section 409A statutorily, perhaps the IRS will begin to provide letter rulings on 457(b) "eligible" plans. The IRS specifically will not issue letter rulings on the income tax consequences of 457(f) "ineligible" plans covered by Section 409A (see Q 3533).

1. IRC Sec. 457(d)(1)(C).
2. EGTRRA 2001 Conf. Rep., *reprinted in* the General Explanation of EGTRRA 2001, pp. 161, 162.
3. IRC Sec. 457(e)(17).
4. Rev. Proc. 2003-3, Sec. 3.01(36), 2003-1 CB 113, as modified by Rev. Proc. 2011-56.

3584. Is the cost of current life insurance protection under a Section 457 plan taxable to participants?

If life insurance is purchased with amounts deferred under a Section 457 plan, whether a 457(b) "eligible" or 457(f) "ineligible" plan, the cost of current life insurance protection is not taxed to the participant, as long as the employer retains all the incidents of ownership in the policy, is the sole beneficiary under the policy, and is under no obligation to transfer the policy or pass through the proceeds of the policy. To have an "eligible" plan, under a private tax-exempt entity, the plan must be unfunded and the plan assets cannot be set aside (escrowed) for any participants or their beneficiaries (Q 3567).[1]

3585. Are death benefits under a Section 457 plan excludable from gross income?

If a death benefit is provided by a Section 457 plan, whether a 457(b) "eligible" or 457(f) "ineligible" plan, any such death benefit will not qualify for exclusion from gross income as life insurance proceeds under IRC Section 101(a) because the life insurance proceeds are "washed" through the employing entity and lose their tax-free character.[2] Prior to the enactment of Section 409A, both 457 "eligible" and "ineligible" plans would have to be treated under the deferred compensation rules of Section 457.[3]

Since the enactment of Section 409A, however, an eligible plan would be subject only to Section 457 treatment on the deferred compensation death benefit, while a Section 457(f) ineligible plan would have to comply with both Sections 457 and 409A. The outcome is still the same, however, because a death benefit paid from the employer rather than from the life insurance carrier (e.g., as in the case of endorsement split dollar) will be treated as deferred compensation and thereby as ordinary income, income in respect of a decedent, etc. (Q 3586). It is not expected that forthcoming proposed 457/409A integration regulations will change this result.

3586. How are the participants in a Section 457(b) "eligible" plan taxed?

Amounts deferred under an eligible governmental Section 457 plan, and any income attributable to such amounts, are includable in the participant's gross income for the taxable year in which they are paid to the participant (or to the beneficiary).[4]

Unless a taxpayer elects otherwise, any amount of a qualified Hurricane Katrina distribution required to be included in gross income shall be so included ratably over the three year taxable period beginning with such year. Qualified Hurricane Katrina distributions are distributions not exceeding $100,000 in the aggregate from qualified retirement plans, individual retirement plans, Section 403(b) tax-sheltered annuities, or eligible governmental Section 457 plans made at any time on or after August 25, 2005, and before January 1, 2007, by an individual whose

1. Treas. Reg. §1.457-8(b)(1).
2. Treas. Reg. §1.457-10(d).
3. Let. Rul. 9008043.
4. IRC Sec. 457(a)(1)(A); Treas. Reg. §1.457-7(b)(1).

principal place of abode on August 28, 2005, was located in the Hurricane Katrina disaster area and who sustained an economic loss by reason of Hurricane Katrina.[1]

Nongovernmental (Private) Tax-Exempt Section 457(b) Eligible Plan

Distributions of amounts deferred under Section 457 eligible plans sponsored by nongovernmental tax-exempt organizations (private charitable organizations) are includable in the participant's gross income for the taxable year in which they are made available to the participant (or to the beneficiary), without regard to whether they actually have been distributed.[2] These amounts are not considered to be available simply because the participant or beneficiary is permitted to direct the investment of amounts deferred under the plan.[3]

Amounts generally are considered made available and, hence, includable in income as of the earliest date on which the plan permits distributions to be made on or after the severance of employment, but not later than the date on which the required minimum distribution rules of IRC Section 401(a)(9) would require commencement of distributions.[4]

Plans may provide a period during which participants are permitted to elect to defer the payment of all or a portion of amounts deferred until a fixed or determinable date in the future. This election period must expire before the first time when any amounts deferred are considered made available to the participant.[5] If the participant fails to make this election, the amounts deferred generally would be includable in income when made available as discussed above. Plans may provide, however, for a "default payment schedule" to be used if no election is made, in which case amounts deferred are includable in income for the year in which such amounts first are made available under the default payment schedule.[6] In addition, a plan may provide for a second, one-time election to further defer payment of amounts deferred beyond the initial distribution deferral.

Participants may not elect to accelerate commencement of such distributions, however. Amounts deferred are not treated as available merely because the participant may elect this second deferral. Participants may be permitted to make this second deferral election even if they:

(1) have previously received a distribution on account of an unforeseeable emergency;

(2) have previously received a cash-out distribution of an amount of $5,000 or less;

(3) have previously made (or revoked) other elections regarding deferral or mode of payment; or

(4) are subject to a default payment schedule deferring the commencement of benefit distribution.[7]

1. Section 101(e), KETRA 2005; Notice 2005-92, 2005-51 I.R.B. 1165.
2. IRC Sec. 457(a)(1)(B); Treas. Reg. §1.457-7(c)(1).
3. Treas. Reg. §1.457-7(c)(1).
4. Treas. Reg. §1.457-7(c)(2)(i).
5. Treas. Reg. §1.457-7(c)(2)(ii)(A).
6. Treas. Reg. §1.457-7(c)(2)(ii)(B).
7. Treas. Reg. §1.457-7(c)(2)(iii).

A plan may provide participants with an opportunity to elect among methods of payment, provided such election is made before the amounts deferred are to be distributed according to the participant's (or beneficiary's) initial or additional distribution deferral election. If the participant does not make an election regarding the mode of payment, the amounts deferred are included in the participant's gross income when they become available pursuant to either the participant's initial or additional election, unless such amounts are subject to, and includable in income according to, a default payment schedule.[1]

In addition, amounts are not considered made available to a participant or beneficiary solely because a participant or beneficiary may elect to receive a distribution on account of an unforeseeable emergency or a cash-out distribution of $5,000 or less.[2]

The use of a rabbi trust in connection with a nongovernmental private tax-exempt Section 457 eligible plan should not affect the tax treatment of participants or their beneficiaries.[3]

3587. How are the participants in a Section 457(f) "ineligible" plan taxed?

Prior to the enactment of Section 409A, the general income tax rule was that compensation deferred under an ineligible Section 457(f) plan was includable in gross income in the first taxable year during which it is not subject to a Section 457(f) "substantial risk of forfeiture" (Q 3530).[4] Where no 457 substantial risk of forfeiture existed in the initial year of deferral, all compensation deferred under the plan had to be included in the participant's gross income for that year. This rule still applies to any 457(f) plan amounts that may be eligible to be grandfathered, if any; or to amounts in a plan if it can claim the short term deferral exception to Section 409A coverage.

Since the enactment of Section 409A, which specifically included 457(f) ineligible plans under Section 409A coverage, such ineligible plans have become obligated to comply with both the requirements under Section 457(f) and Section 409A. Unfortunately, the two IRC sections do not integrate smoothly, although the IRS tried to reconcile them in IRS Notice 2007-62 shortly after the final regulations to Section 409A were issued in 2007. Many see significant problems in the notice's proposed solutions, at least as to the substantial risk of forfeiture requirement that proposes to substitute the 409A definition of substantial risk of forfeiture for the one in 457(f), which has been less onerous. The issue remains outstanding and confused because the IRS has not issued proposed regulations following Notice 2007-62. Even issues regarding the ability to grandfather portions of plans remain open at this late date. These proposed 457/409A integration regulations are expected to be released in the near future and planners should determine if they are available for review on the many important compliance details.

Prior to the enactment of Section 409A, a participant's right to deferred compensation under an ineligible Section 457 plan was subject to a 457(f) substantial risk of forfeiture if it was conditioned on the future performance of substantial services by any individual.[5] Because this is

1. Treas. Reg. §1.457-7(c)(2)(iv).
2. Treas. Reg. §1.457-7(c)(2)(i).
3. Let. Ruls. 9517026, 9436015.
4. IRC Sec. 457(f)(1)(A); Treas. Reg. §1.457-11(a)(1).
5. IRC Sec. 457(f)(3)(B); Treas. Reg. §1.83-3(c).

the same language as used in IRC Section 83, governing transfers of property as compensation, it generally was believed that Section 83 concepts governed this definition for 457(f) purposes. Hence, distributions would become taxable when no longer subject to a Section 457(f) substantial risk of forfeiture, which might be as late as the date of each payment by the proper use of covenants not to compete, consulting agreements, and similar devices to continue the risk of forfeiture until payment actually was made.[1]

If the risk were to lapse before or at the time payments began, however, distributions from an ineligible plan would be taxable according to the annuity rules.[2] Property (including an insurance contract or annuity) distributed from an ineligible plan is includable in gross income at its fair market value.[3] Once the annuity contract has been distributed, payments or withdrawals from that contract may be subject to the "interest first" rule (Q 10, Q 441).

Prior to the enactment of Section 409A and the 457 final regulations, it was not entirely clear when earnings on compensation deferred under an ineligible plan would be includable in gross income. The 457 final regulations currently provide that if amounts deferred are subject to a 457(f) substantial risk of forfeiture, then the amount includable in gross income for the first taxable year in which there is no 457(f) substantial risk of forfeiture includes earnings up to the date of the lapse. Earnings accruing after the date of the lapse are not includable in gross income until paid or otherwise made available, provided that the participant's (or the beneficiary's) interest in any assets of the employer is not senior to that of the employer's general creditors.[4] Based upon Notice 2007-62 (and the likely proposed regulations), the substantial risk of forfeiture applied for this purpose would become the more stringent 409A substantial risk of forfeiture definition, which for example, specifically excludes non-competes and consulting services as valid risks of forfeiture.

After enactment and release of IRS Notice 2007-62, the IRS proposed to use the Section 409A definition of substantial risk of forfeiture in place of that in Section 457(f) in an attempt to reconcile the sections. The impact of this proposed definition substitution is severely detrimental to 457(f) plans, especially 457(f) voluntary deferral plans.

Before the notice, it would have been possible for a 457(f) plan (whether a voluntary deferral or employer-paid supplemental plan) to have complied with the requirements under 457(f) as to substantial risk of forfeiture and then to have complied with the detailed coverage requirements of Section 409A separately, and avoided current income taxation under both sections.

After Notice 2007-62, this is impossible. Moreover, the Section 409A definition is the most severe definition of substantial risk of forfeiture of all the six definitions currently in the IRC because it is used primarily to limit the availability of the short term deferral exception

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1. Note that the IRS released proposed regulations, clarifying the Section 83 definition of "substantial risk of forfeiture" on May 29, 2012. Final regulations that are substantially similar to these proposed regulations were released February 25, 2014. These regulations appear to be an attempt to better reconcile the definition in Section 83 with the more stringent definition of "substantial risk of forfeiture" in Section 409A, and may be in anticipation of the coming clarifications in the forthcoming 457/409A proposed regulations expected in the near future.
2. IRC Sec. 457(f)(1)(B); Treas. Reg. §1.457-11(a)(4).
3. H. Rep. 95-1445 (Revenue Act of 1978), *reprinted in* 1978-3 CB (vol. 1) 227; Sen. Rep. 95-1263 (Revenue Act of 1978), *reprinted in* 1978-3 CB (vol. 1) 364.
4. Treas. Reg. §1.457-11(a).

(Q 3540) that would allow plans to escape Section 409A coverage. Hence, this most stringent Section 409A rule now governs taxation under Section 457(f) plans, so that a 457(f) ineligible plan is now taxable (for 457(f) purposes) when any 409A substantial risk of forfeiture lapses. This means that a plan could be fully compliant with the Section 409A detail form and operation requirements and yet fail the 457(f) substantial risk of forfeiture requirement because of the IRS's proposed move in 457(f) to the Section 409A definition.

Note that under the Section 409A definition, devices such as covenants not to compete do not constitute a valid substantial risk of forfeiture. This means that 457(f) distributions can only be paid either as a lump sum, or under Section 72 annuity treatment if paid in installments, based on Notice 2007-62 guidance. Moreover, the IRS requires a voluntary employee or director deferral plan to have an employer contribution such that it creates an amount, on a present value basis, that would make the amount of the benefit "materially greater" than the benefit without it, before it considers that a 457(f) ineligible plan has the necessary substantial risk of forfeiture (for 457(f) purposes) to permit a deferral of income taxation.

Planning Point: The IRS has not yet provided any safe harbor guidance for the level of employer contribution that would be required to create this "materially greater" benefit in the case of a 457(f) voluntary deferral plan. A plan without any employer contribution apparently would not achieve income tax deferral because of the substitution of the 409A definition for the 457(f) definition proposed by Notice 2007-62. In light of the notice and until further guidance in the form of proposed regulations is available, practitioners must proceed carefully with 457(f) voluntary deferral plans involving little or no employer contribution. It appears that the IRS is driving deferral designs to 457(b), and away from 457(f), unless the necessary employer contribution is made. Moreover, based upon Notice 2007-62, both 457(f) deferral and SERP plans need to be paid in lump sum (or incur annuity taxation if paid in installments).

The IRS was to have issued proposed regulations incorporating these proposed modifications to 457 regulations before the date of this publication, however, no modifications have been released. Although it currently appears that the IRS will follow the major guidance provided in Notice 2007-62, readers should check to confirm how the IRS has finally resolved this integration in any proposed regulations. The one clear summary statement that can be made about this area of necessary compliance with both Sections 457(f) and 409A after Notice 2007-62, but in the absence of proposed regulations, is that it is both complex and confusing!

Additional 457 (not 409A) final rules still pertaining to the tax treatment of ineligible Section 457 plans do not extend these rules to any of the following: (1) any plan qualified under IRC Section 401, IRC Section 403, or IRC Section 415(m), (2) that portion of any plan that consists of a nonexempt trust to which IRC Section 402(b) applies, and (3) any transfer of property to which IRC Section 83 applies.[1]

The 457 regulations also clarify that these provisions do not apply if the IRC Section 83 transfer occurs before the lapse of a 457(f) substantial risk of forfeiture applicable to amounts deferred under an ineligible plan. If, on the other hand, the IRC Section 83 transfer occurs after the lapse of a 457(f) substantial risk of forfeiture, the provisions do apply. If such property is includable

1. IRC Sec. 457(f)(2); Treas. Reg. §1.457-11(b).

in income under IRC Section 457(f) on the lapse of a substantial risk of forfeiture, then when the property is later made available to the participant, the amount includable is the excess of the value of the property when made available over the amount previously included in income on the lapse.[1] This section does not apply to an option that has no readily ascertainable fair market value (as defined in IRC Section 83(e)(3)) and that was granted on or before May 8, 2002.[2]

If a plan ceases to be an eligible governmental plan, amounts subsequently deferred by participants will be includable in income when deferred, or, if later, when the amounts deferred cease to be subject to a substantial risk of forfeiture. Amounts deferred before the date on which the plan ceases to be an eligible governmental plan, and any earnings thereon, will be treated as if the plan continues to be an eligible governmental plan and, thus, will not be includable in income until paid to the participant or beneficiary.[3]

Rulings on Ineligible Plans

Prior to the enactment of Section 409A, the creation of a rabbi trust in connection with an ineligible Section 457 plan to hold employer assets in connection with the plan did not affect the tax treatment of amounts deferred thereunder.[4] Since the enactment of Section 409A, use of a rabbi trust is still possible so long as the requirements under the Section 409A(b) funding rules (e.g., the trust may not be placed offshore) are met (Q 3556).

The right to designate "deemed" investments in an ineligible Section 457 plan will not result in current taxation under the constructive receipt doctrine (Q 3533), the economic benefit doctrine (Q 3553), or on account of a transfer of property under IRC Section 83.[5] Section 409A has not changed this rule.

A Section 457 plan created prior to the enactment of Section 409A and established to provide additional benefits for an employee on an extended leave of absence was an ineligible plan rather than an eligible plan because it was unfunded and no trust was established (as would otherwise be required by IRC Section 457(g)), and because a settlement agreement called for deferrals in excess of the IRC Section 457(b) maximum amount. The IRS found, however, that a plan provision requiring service of the participant (then age 44) until age 50 was a 457(f) substantial risk of forfeiture.[6]

3588. What are the reporting and withholding requirements for a Section 457(b) plan?

Deferrals under an eligible Section 457(b) plan (and earnings thereon) are not subject to withholding when deferred, but they must be reported annually on a participant's Form W-2 (according to the Form W-2 instructions).[7]

1. Treas. Reg. §1.457-11(d)(1).
2. Treas. Reg. §1.457-12.
3. Treas. Reg. §1.457-9.
4. See, e.g., Let. Ruls. 200009051, 9713014, 9701024, 9444028, 9430013, 9422038.
5. Let. Ruls. 9815039, 9805030.
6. Let. Rul. 9835017.
7. Notice 2000-38, 2000-33 IRB 174.

Payments from Section 457(b) plans are wages subject to regular income tax withholding, not under the withholding rules that apply to pensions.[1]

Employers generally are liable for withholding from Section 457(b) plan distributions. If a trustee (or custodian or insurance carrier treated as a trustee) of a governmental plan makes distributions from such plan's trust or custodial account, then that person is responsible for withholding income tax and reporting the distributions.[2]

Amounts deferred under both eligible and ineligible 457 plans generally are subject to Social Security taxes under the Federal Insurance Contributions Act ("FICA") and federal unemployment taxes under the Federal Unemployment Tax Act ("FUTA") at the later of the date when the services are performed or the date when the employee's right to such amounts is no longer subject to a substantial risk of forfeiture (Q 3530).[3] For more detail on the application of FICA and FUTA taxes to deferred compensation, see Q 3562.

Service performed in the employ of a state or political subdivision is exempt from FUTA, and also may be exempt from FICA.[4]

Length of service awards from an eligible employer accruing to bona fide volunteers (or their beneficiaries) due to "qualified services" after December 31, 1996, which are exempted from the Section 457 plan requirements (Q 3567, Q 3568) and which are maintained by an eligible employer are not considered "wages" for FICA purposes.[5]

Deferrals under a Section 457(f) "ineligible" plan (and earnings thereon) are not subject to taxation or withholding when deferred, but they must be reported annually on the participant's Form W-2 (according to the Form W-2 instructions). As of the date of this publication, this informational reporting requirement has been waived. Plan sponsors should check with their administrators at the end of each year to determine if they must report and to obtain the necessary information for current tax year W-2s (Q 3533).

Income Tax Informational and 409A Violation Reporting

Employees: Same as for other plans covered by Section 409A (Q 3533)

Independent Contractor: Same as for other plans covered by Section 409A (Q 3533)

Income Tax Withholding: Same as for other plans covered by Section 409A (Q 3533)

FICA and FUTA: Section 409A has not changed the application of FICA to 457(f) plans. For more detail on the application of FICA and FUTA taxes to deferred compensation, see Q 3562.

1. Rev. Rul. 82-46, 1982-1 CB 158; Temp. Treas. Reg. §35.3405-1, A-23.
2. Notice 2000-38, 2000-33 IRB 174, Notice 2003-20, 2003-1 CB 894.
3. See IRC Secs. 3121(a)(5), 3121(v)(2), 3306(b)(5), 3306(r)(2). See also Let. Rul. 9024069, as modified by Let. Rul. 9025067; compare SSA Inf. Rel. No. 112 (Dec. 1993).
4. IRC Secs. 3306(c)(7), 3121(b)(7).
5. IRC Sec. 3121(a)(5)(I).

3589. What tax rules apply to nonqualified deferred compensation plans covering state judges?

A nonqualified deferred compensation plan covering state judges is taxed under the rules applicable to funded and unfunded nonqualified deferred compensation plans (and is not subject to the extra requirements under 457(f) for "ineligible" plans) if:

(1) the plan has been continuously in existence since December 31, 1978;

(2) the plan requires all eligible judges to participate and contribute the same fixed percentage of their basic or regular compensation;

(3) the plan provides no judge with an option as to contributions or benefits, which, if exercised, would affect the amount of his or her includable compensation;

(4) retirement benefits under the plan are a percentage of the compensation of judges holding similar positions in the state; and

(5) benefits paid to any participant in any year do not exceed the limitation of IRC Section 415(b) (Q 3784).[1]

Plans that do not meet these conditions must comply with requirements of Section 457(b) or 457(f), as applicable.

3590. What is an excess benefit pension plan? How is it taxed?

ERISA Section 3(36) defines an "excess benefit" plan as a nonqualified employee pension benefit plan maintained by an employer solely for the purpose of providing benefits for certain select employees in excess of the limitations on contributions and benefits imposed by IRC Section 415 (Q 3784). ERISA Section 3(36) has never been amended to include the limitations on covered compensation imposed by IRC Section 401(a)(17) ($260,000 in 2014, up from $255,000 for 2013).[2] If an excess benefit plan cannot restore these benefits, its usefulness is limited.

One case seems to indicate that an excess benefit plan can replace benefits limited by IRC Section 401(a)(17), provided that the plan was never amended to take the 401(a)(17) limits into account.[3] On the other hand, in another case, a Supplemental Executive Retirement Plan (Q 3532) intended as an excess benefit plan was held to be a "top hat" plan (Q 3533), rather than an excess benefit plan, because it was not specifically limited to restoring benefits lost under IRC Section 415.[4] Until ERISA is amended to add the IRC Section 401(a)(17) limits to the excess benefit plan exemption, this area of ERISA law is likely to remain muddled.

An excess benefit plan can be funded or unfunded as compared to a top hat plan that must be unfunded. If the excess benefit plan is unfunded (as defined for ERISA purposes), it apparently need

1. Rev. Act of 1978 Sec. 131 (as amended by TEFRA 1982 Sec. 252); TRA 1986 Sec. 1107(c)(4); PL 97-514 (TEFRA), Section 252. See also *Foil v. Comm.*, 91-1 USTC ¶50,016 (5th Cir. 1990); *Yegan v. Comm.*, TC Memo 1989-291.
2. IRC Sec. 401(a)(17).
3. *Gamble v. Group Hospitalization*, 38 F.3d 126 (4th Cir. 1994).
4. *Garratt v. Knowles*, 245 F.3d 941 (7th Cir. 2001).

not comply with any of ERISA's requirements. Even if it is funded, an excess benefit plan is exempt from ERISA's minimum participation, vesting, funding, and plan termination insurance provisions.[1]

As noted, the alternative ERISA exemption is the so-called ERISA "top hat" exemption of ERISA Section 201(2) for a select group of management and highly compensated employees. However, as noted, the plan must not be limited to only a select group, but be unfunded to claim this exemption.

Tax Implications

In contrast to the special treatment afforded by ERISA, excess benefit plans remain subject to the tax rules applicable to nonqualified deferred compensation plans, which includes the full range of Section 409A form and operational requirements, unless the plan can claim an exception from Section 409A coverage, such as the "short term deferral exception" (Q 3540). The employer's deduction is deferred until amounts are includable in the employee's gross income, and the employee generally is taxed on payments when they are received (Q 3523, Q 3560).

Planning Point: Funding the plan for ERISA "excess benefit" plan exemption purposes (as compared to the "select group" ERISA exemption) is permitted, and does not present ERISA "plan asset" problems. However, it would change the applicable income tax consequences if the amounts do not remain subject to the claims of the sponsor's general creditors in bankruptcy. Funding the plan would subject the amounts to the Section 83 tax rules applicable to "transfers of property" and vested amounts would be taxable. Therefore, an excess benefit plan should generally always be unfunded to assure the desired income tax consequences, in spite of the ERISA rules. Moreover, pre- 409A, it was common for the qualified plan distribution events to control the distribution of the nonqualified excess benefit plan benefits. Under Section 409A, these "excess benefit" plans are described as "linked" plans, and, if form and timing of distributions from the nonqualified plan are governed by the qualified plan (and deferral stop-and-start timing as well for DC plans), the nonqualified plan is in violation of Section 409A. In effect, distributions and deferral timing rules under any qualified plan cannot control the nonqualified excess benefit/linked plan distribution or deferral timing. This is because the qualified distribution rules are different and incompatible to those under Section 409A. In general, qualified plan provisions may govern only the calculation of the benefit amount due under the nonqualified plan.

As a consequence, post-409A, the nonqualified plan documentation must be written to calculate the benefit in an excess benefit/linked *defined benefit* plan using a single pre-established benefit form, like lump sum (even if a different form is selected by a participant under the DB qualified plan at separation of service, and even if that benefit form is not available under the qualified DB plan). As noted, this is because the distribution form and timing in the nonqualified plan must generally be selected in advance under Section 409A and not at the time of distribution as is the case with a qualified plan. Therefore, one form must be established.

Of course, these 409A "linked" plan rules mean that existing linked qualified and nonqualified "excess benefit" nonqualified plans should already be delinked as to distribution timing and the timing of deferrals (stop and start) in the case of DC plans. Moreover, the IRS has applied similar logic to multiple nonqualified plans linked together. Movement of benefit amounts between one nonqualified plan linked to another can impermissibly delay or accelerate distribution of benefits under Section 409A. The IRS has thus required that they also be delinked so one nonqualified plan cannot control the distribution of benefits from another.

1. ERISA Secs. 4(b)(5), 201(7), 301(a)(9), 4021(b)(8).

Qualified Governmental Excess Benefit Arrangements

"Qualified governmental excess benefit arrangements" are excess benefit plans maintained by state and local governmental employers. The requirements for such plans are set forth in IRC Section 415(m).[1] For a discussion of the interaction between IRC Section 415(m) and IRC Section 457, see Q 3568.

3591. What are employee stock options and how are they taxed?

An employee stock option gives an employee the right to buy a certain number of shares in the employer's corporation at a fixed price within a specified period of time. The price at which the option is offered is called the "grant" price and usually is at or below the stock's current market value. It is assumed that the stock will increase in value, allowing the employee to profit by the difference. Should the stock price decrease below the grant price, the option is "underwater" and the employee simply does not "exercise" the option to purchase the stock; the employee is not at risk for out-of-pocket losses.

There are two principal kinds of stock option programs, each with unique rules and tax consequences: (1) "qualified" or "incentive stock options" ("ISOs"), sometimes also referred to as "statutory stock options," (see Q 3592) and (2) non-qualified stock options ("NQSOs"), sometimes also referred to as "nonstatutory stock options" (see Q 3593).

Some executive plans use performance-based options, which provide that the option holder will not realize any value from the option unless specified conditions are met, such as the share price exceeding a certain value above the grant price or the company outperforming the industry. Performance-based plans can require special plan accounting.

3592. What are ISOs and how are they taxed?

For a stock option to qualify as an ISO (and thus receive special tax treatment under IRC Section 421(a)), it must meet the requirements of IRC Section 422 when granted and at all times from the grant until its exercise. The key requirements are that an ISO have an exercise price not less than the fair market value of the stock at the time of the grant, expire within no more than ten years, and be generally nontransferable and exercisable only by the grantee.[2]

Planning Point: Although technically ISOs are exempt from Section 409A, they are required to be issued at fair market value at the date of grant in order to qualify as an ISO. If they are not issued at fair market value at the date of grant, they become an NQSO that has not been issued at fair market value and thereby subject to Section 409A, because they fail to meet the requirements for exemption. Therefore, the planner must make certain that the ISO, like an NQSO, is issued at fair market value at the date of grant in order to avoid the application of Section 409A to the stock.

Tax Implications for Employees

An employee receiving an ISO realizes no income upon its receipt or exercise.[3] Instead, the employee is taxed when he or she disposes of the stock acquired with the ISO.

1. See, e.g., Let. Rul. 199923056.
2. IRC Sec. 422; Treas. Reg. §1.422-2.
3. See IRC Sec. 422(a) (incorporating by reference the nonrecognition provisions of IRC Sec. 421(a)(1)).

Disposition generally means any sale, exchange, gift, or transfer of legal title of stock. It does not include a transfer from a decedent to his or her estate, a transfer by a bequest or inheritance, or any transfer of ISO stock between spouses or incident to a divorce.[1]

The tax treatment of the disposition of ISO stock depends on whether it was disposed of within the statutory holding period for ISO stock. The ISO statutory holding period is the later of two years from the date of the grant or one year from the date when the shares were transferred to the employee upon exercise.[2]

If the employee disposes of the stock within the holding period, the employee first recognizes ordinary income, measured by the difference between the option price and the fair market value of the stock at the time of exercise, and second, capital gain measured by the difference between the fair market value of the stock at exercise and the proceeds of the sale.[3] When an employee disposes of ISO stock after the holding period, all of the gain is capital gain, measured by the difference between the option price and the sale proceeds.[4]

Although the exercise of an ISO does not result in an immediate taxable event, any deferred gain is includable as an adjustment in calculating the Alternative Minimum Tax ("AMT").

Tax Implications for Employers

An employer granting an ISO is not entitled to a deduction with respect to the option on its grant or its exercise.[5] The amount received by the employer as the exercise price will be considered the amount received by the employer for the transfer of the ISO stock.[6] If the employee disposes of the stock prior to the end of the requisite holding period, the employer generally may take a deduction for the amount that the employee recognized as ordinary income in the same year in which the employee recognizes the income.[7]

Reporting and Withholding

The employer has no obligation to pay FICA or FUTA taxes, or to withhold federal income taxes, when an option is granted. Pending further guidance from the IRS, employers also are not obligated to pay or withhold FICA and FUTA taxes on the exercise of ISOs.[8] The IRS has announced that any rule imposing FICA or FUTA on the exercise of ISOs will not take effect before January 1 following the second anniversary of the announcement.

IRC Section 6039 requires employers to provide a written statement to each employee regarding any exercise of an ISO and, beginning for transfers occurring in 2009 or later, to file a similar information return with the IRS by January 31 of the year following the transfer.[9]

1. IRC Secs. 424(c)(1), 424(c)(4).
2. IRC Sec. 422(a)(1).
3. IRC Secs. 421(b), 422(c)(2).
4. IRC Sec. 1001(a).
5. IRC Sec. 421(a)(2).
6. IRC Sec. 421(a)(3).
7. IRC Sec. 421(b).
8. Notice 2002-47, 2002-28 IRB 97.
9. Prop. Treas. Regs. §§1.6039-1, 1.6039-2.

Under proposed regulations, the information return must identify the parties and provide the following information:

- The date the option was granted;
- The exercise price per share;
- The date the option was exercised;
- The fair market value of a share on the date of exercise; and
- The number of shares transferred pursuant to the exercise.

3593. What are NQSOs and how are they taxed?

A non-qualified stock option ("NQSO") is generally an option to purchase employer stock that does not satisfy the legal requirements of an ISO (Q 3592).

Tax Implications for Employees

The tax implications of an NQSO are governed by IRC Section 83, and potentially by Section 409A, because they give a participant a legally binding right to compensation that will be realized in a later taxable year. Final regulations to Section 409A allow an NQSO to be structured to claim the equity plan exception and avoid Section 409A coverage. The requirements to claim the regulatory exception from Section 409A coverage are:

- the option stock must be Section 409A "service recipient stock";
- the exercise price must be at fair market value on the option grant date;
- the option share total must be fixed on the grant date;
- the option stock must be subject to taxation under Section 83 and Treasury Regulation Section 1.83-7; and
- the option cannot provide for any additional deferral of compensation features.

If an option does not meet these preconditions, and is issued below fair market value, it must comply with Section 409A, which usually destroys the intended objective and subjects the award to immediate taxation. Fortunately, the IRS has provided for a correction method for such failures that allow the participants to avoid experiencing the taxation scenario if the error is discovered early and corrected quickly (Q 3533).

Under Section 83, an employee generally is not taxed on an NQSO at grant unless it has a readily ascertainable fair market value and is not subject to a substantial risk of forfeiture.[1] Options generally do not have a readily ascertainable fair market value unless they are publicly traded.[2] If an NQSO does not have a readily ascertainable fair market

1. IRC Secs. 83(a), 83(e)(3).
2. Treas. Reg. §1.83-7(b)(1).

value at grant, it is taxed at the time of exercise.[1] If an NQSO with a readily ascertainable fair market value is subject to a Section 83 substantial risk of forfeiture, it is taxed when the risk of forfeiture lapses. When taxed, the employee will recognize the excess of the market value of shares receivable over the grant price as ordinary income subject to FICA, FUTA, and federal income tax.[2]

On May 29, 2012, the IRS released proposed regulations clarifying the key definition of "substantial risk of forfeiture" for purposes of Section 83. On February 25, 2014, the IRS released final regulations that are substantially similar to the proposed regulations. (for details, see Q 3530).[3] These clarifications incorporate the IRS's position in Rev. Rul. 2005-48, in which it rejected the extension of the court's logic in the case of *Robinson v. Comm.* that implied that restrictions other than those related to the purpose of the transfer, such as lock-up agreement restrictions and Rule 10b-5 trading restrictions mandated by U.S. securities law, could result in the deferral of taxation. It also ruled that Section 16(b) of the Securities & Exchange Act of 1934 is the ONLY securities law provision that will defer taxation under Section 83. The regulations apply to property transferred on or after January 1, 2013. The proposed regulations can be relied upon for transfers after May 30, 2012.

Planning Point: These regulations would seem to clarify that federally mandated clawback requirements as in Dodd-Frank, TARP, and Sarbanes-Oxley will NOT defer taxation on stock options post exercise, or restricted stock awards post vesting, even if the stock is potentially subject to forfeiture or disgorgement upon triggering of such a clawback. They might even limit use of non-compete agreements and consulting agreements to defer taxation, given that the IRS has drawn language from Section 409A, and Section 409A specifically provides that non-competes and consulting agreements will not constitute a substantial risk of forfeiture, although this is less clear at the date of publication. Time will tell if these regulations are only "clarifications" or substantive change, so planners must follow the progress of the IRS's administration of these regulations, now that they are finally effective.

Within 30 days of the grant of an NQSO subject to a substantial risk of forfeiture, an employee may elect under IRC Section 83(b) to be taxed currently on the fair market value of the option. Any appreciation after the election is taxable as a capital gain. If the NQSO is ultimately forfeited, no deduction is allowed for that forfeiture.[4]

Tax Implications for Employers

An employer has a corresponding deduction (in the same amount and at the same time) as the ordinary income recognized by the employee.[5] Compensation paid in the form of stock options normally triggers the receipt of wages for the purpose of employment tax and withholding provisions in the amount of the income generated under IRC Section 83(a).[6]

1. Treas. Reg. §1.83-7(a).
2. IRC Sec. 83(a).
3. Prop. Treas. Reg, §1.83-3, Treas. Reg. §1.83-3.
4. IRC Sec. 83(b)(1).
5. IRC Sec. 83(h).
6. See Rev. Rul. 79-305, 1979-2 CB 550; Rev. Rul. 78-185, 1978-1 CB 304.

Deferred Compensation

NQSOs that are exercisable at less than their fair market value at the date of grant, or where there are additional deferral features in the NQSO, will be subject to the rules governing deferred compensation plans under IRC Section 409A (Q 3533). Where the exercise price can never be less than the fair market value of the underlying stock at the date of grant, and where there is no other feature for the deferral of compensation, a stock option will not constitute deferred compensation subject to IRC Section 409A.[1] Plans generally could substitute non-discounted stock options and stock appreciation rights for discounted options and rights until December 31, 2007.[2] See Q 3533 for exceptions to this rule.

Under a pre-409A ruling, stock options could be "converted" to a deferred compensation plan free of tax under limited circumstances. Where employees could choose to retain or surrender both ISOs and NQSOs in exchange for an initial deferral amount under a nonqualified deferred compensation plan, the IRS indicated that neither the opportunity to surrender the options, nor their actual surrender, would create taxable income for participants under either the constructive receipt or economic benefit doctrines.[3] For a discussion of the theories of constructive receipt and economic benefit, see Q 3533 and Q 3553, respectively.

Reporting and Withholding

An employer has no obligation to pay employment taxes or to withhold federal income taxes upon the grant of NQSOs, unless the plan fails to place itself in the desired exception to Section 409A. In that case, Section 409A taxation, reporting, and withholding would be required. Under Section 83 (assuming exception from Section 409A coverage), on exercise, the employer must treat the excess of the market value of shares received over the grant price as wages subject to FICA, FUTA, and federal income tax withholding in the pay period in which the income arises. The employer has no obligation to withhold or pay federal income or employment taxes on the sale of shares purchased by option.

Employers are to use code "V" in Box 12 on Form W-2 to identify the amount of compensation to be included in an employee's wages in connection with the exercise of an employer-provided NQSO. Completion of code V is addressed in the instructions for Forms W-2 and W-3. Employers must report the excess of the fair market value of the stock received on exercise of the option over the amount paid for that stock on Form W-2 in boxes 1, 3 (up to the Social Security wage base), 5, and 12 (using code V) when an employee (or former employee) exercises his or her options.[4] If an employer were to fail to claim the exception to 409A and violate Section 409A, it would follow reporting and withholding required for Section 409A plans (Q 3533).

Department of Labor Issues

An ISO generally is not subject to ERISA's reporting requirements and a summary plan description need not be distributed to participants. An employer must furnish a statement to an

1. Treas. Reg. §1.409A-1(b)(5).
2. Notice 2006-79, 2006-43 IRB 763.
3. Let. Rul. 199901006.
4. Ann. 2000-97, 2000-48 IRB 557; Ann. 2001-7, 2001-3 IRB 357.

employee on or before January 31 of the year following the year in which the employee exercises the ISO, stating details about the options granted.[1]

3594. What is restricted stock?

A restricted stock award is an outright grant of shares by a company to an individual, usually an employee, without any payment by the recipient (or for only a nominal payment). The shares of stock generally are subject to a contractual provision under which the granting company has the right (but not the obligation) to repurchase or reacquire the shares from the recipient on the occurrence of a specified event (e.g., termination of employment). This right of repurchase or reacquisition expires after a specified period of time, either all at once or in increments (for example, a grant of 1,000 shares with 200 shares vesting annually over a five year period). The expiration of this right is referred to as "vesting." During the period that the shares of stock may be repurchased or reacquired, the recipient is prohibited from selling (or otherwise transferring) the shares. This is why the shares are called "restricted stock." The passage of time typically serves as the primary restriction for such stock and is the normal substantial risk of forfeiture in the grant necessary to prevent current taxation under IRC Section 83 and to claim the "short term deferral exception" to avoid Section 409A coverage. Restricted stock vesting may depend on restrictions other than time (e.g., satisfying corporate performance goals, such as reaching a specified level of profitability) that also might satisfy these requirements.

On May 29, 2012, the IRS released proposed regulations clarifying the definition of "substantial risk of forfeiture" under Section 83, and incorporating its ruling in Rev. Rul. 2005-48 (for details on the changes see Q 3591 and Q 3530). On February 25, 2014, the IRS released final regulations that are substantially similar to the proposed regulations. These regulations apply to all transfers of property on or after January 1, 2013, though the final regulations may be relied on as to transfers after May 30, 2012.[2]

For the tax treatment of restricted stock, including the taxability of dividends on restricted stock, see Q 3595.

3595. How is restricted stock taxed?

The tax implications of restricted stock are governed by IRC Section 83, even after the enactment of Section 409A, if done properly. This is because restricted stock is issued subject to a Section 409A substantial risk of forfeiture that makes it eligible to claim the Section 409A "short term deferral exception" to escape Section 409A coverage requirements. The distribution must be made during the exception safe harbor time period to claim this exception to Section 409A (Q 3533).

Section 83 restricted stock generally does not constitute taxable income to the employee at the time it is granted (unless at the time of the grant it is "substantially vested," see below). An employee who receives restricted stock must include the fair market value of that stock in his or

1. IRC Sec. 6039(a).
2. Prop. Treas. Reg. §1.83-3, Treas. Reg. §1.83-3.

her income in the year the stock becomes "substantially vested."The amount the employee paid for the restricted stock, if any, must be subtracted from this amount. Restricted stock becomes substantially vested in the year in which the stock becomes transferable or the stock is no longer subject to a Section 83 substantial risk of forfeiture.[1]

Within thirty days of receiving the restricted stock, an employee may elect under IRC Section 83(b) to be taxed on the fair market value of the stock currently rather than the year the stock becomes substantially vested. Any appreciation after the election is taxable as a capital gain. If the restricted stock is ultimately forfeited, no deduction is allowed for that forfeiture.[2]

Where restricted stock that is substantially vested is subjected to new restrictions that cause it to become substantially nonvested, the stock is not subject to IRC Section 83(b) in the absence of an exchange of stock. Where substantially vested stock is exchanged for substantially nonvested stock, the new restricted stock is subject to IRC Section 83(b).[3]

An employer has a corresponding deduction in the same amount and at the same time as the ordinary income recognized by the employee.[4] Compensation paid in the form of restricted stock normally triggers the receipt of wages for the purpose of employment tax and withholding provisions in the amount of the income generated under IRC Section 83(a).[5]

On May 29, 2012, the IRS released proposed regulations clarifying the definition of "substantial risk of forfeiture" under Section 83, and incorporating its ruling in Rev. Rul. 2005-48 (for details on the changes see Q 3594, Q 3591, and especially Q 3530). On February 25, 2014, the IRS released final regulations that are substantially similar to the proposed regulations. These regulations will apply to all transfers of property on or after January 1, 2013, though the final regulations may be relied on as to transfers after May 30, 2012.[6]

3596. How are dividends on restricted stock taxed?

Dividends received on restricted stock are extra compensation to an employee that must be included on the employee's Form W-2. Dividends received on restricted stock that the employee chooses to include in his or her income in the year transferred are treated the same as any other dividends. The employee should receive a Form 1099-DIV showing these dividends. These dividends should not be included in the employee's wages on his or her income tax return; instead, the employee should report them as dividends.

1. IRC Sec. 83(a).
2. IRC Sec. 83(b).
3. Rev. Ruling 2007-49, 2007-31 IRB 237.
4. IRC Sec. 83(h).
5. See Rev. Rul. 79-305, 1979-2 CB 350.
6. Proposed Treas. Reg. 1.83-3, 5-29-2012.