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Limitations on Terminating and Otherwise Changing Nonqualified Deferred Compensation Arrangements Subject to Code Section 409A

For various reasons, the current economic downturn is causing many employers and executives to reconsider their nonqualified deferred compensation arrangements. To the extent those arrangements are subject to Revenue Code section 409A, there are significant limitations on an employer's ability to terminate and liquidate such arrangements. In addition, in many, if not most, cases there may be no viable options for terminating and liquidating a 409A arrangement either: (i) because the parties cannot or do not want to satisfy all of the requirements (e.g., terminating all arrangements of the same type) or (ii) because of uncertainties about whether all of the conditions can actually be satisfied (e.g., whether a termination or liquidation is not proximate to a downturn in the financial health of the employer). If all of the conditions are not satisfied, any liquidating distributions would be in violation of 409A and all arrangements that are required to be aggregated would be treated as violating 409A, which generally would result in significant adverse tax consequences to the participants. This Washington Report describes those limitations and discusses the options that may be available for terminating and making other changes to such arrangements.

Background

In most cases, nonqualified deferred compensation arrangements are merely unfunded and unsecured promises by an employer to pay compensation to an executive in the future. The key advantage of these arrangements to the executives is that they generally do not have to pay taxes on the compensation until it is actually paid (i.e., deferred taxes on the compensation). However, the key disadvantage to the executives is that the deferred compensation generally must remain subject to the claims of the employer's general creditors in the event the employer goes bankrupt or otherwise becomes insolvent.

With the economic downturn and corresponding increase in bankruptcies, many executives are becoming concerned about their employers' ability to pay the deferred compensation when it becomes due under the terms of the arrangement. In addition, because of reduced levels of executive compensation, many executives are looking for sources of additional cash, and in many cases, nonqualified deferred compensation arrangements represent a significant portion of an executive's total accumulated wealth.

Employers are also considering changes to their nonqualified deferred compensation arrangements. For instance, in response to the economic downturn, many employers would like to reduce the total of executive compensation, including the level of deferred compensation. In this regard, the employers are considering options for terminating existing nonqualified deferred compensation arrangements. However, because the termination of an arrangement may require the employer to pay the deferred compensation out of general assets earlier than expected, and at a time when cash flow may be significantly reduced, employers are also considering options that may be available to delay the distributions or replace the existing arrangements with new arrangements.

Code Section 409A

Section 409A, which was enacted in 2004, and generally applies to amounts deferred on or after January 1, 2005, imposes new rules on nonqualified deferred compensation arrangements. There are essentially three new requirements, which must be satisfied both in form and operation: (1) election restrictions, (2) distribution restrictions, and (3) acceleration restrictions.

The election restrictions impose requirements with respect to both the timing of a participant's initial deferral election as well as the designation of the time and form of

distributions. The distribution restrictions provide that deferred compensation cannot be distributed any earlier than one of six specified events: (1) separation from service (for specified employees of publicly traded companies, the deferred compensation must not be distributed for at least six months after separation from service); (2) disability (as narrowly defined in the Revenue Code); (3) death; (4) a specified time (or fixed schedule specified under the arrangement as of the date of deferral), but not an event; (5) a change in the ownership or effective control of the corporation or in the ownership of a substantial portion of the assets of the corporation; or (6) the occurrence of an unforeseeable emergency (as narrowly defined in the Code). The acceleration restrictions provide that the deferred compensation cannot be accelerated except as otherwise provided in regulations.

There are significant adverse tax consequences if the new requirements are not satisfied: (1) all deferred compensation must be included in income in the current taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in income (including deferrals in prior years), (2) an additional tax is imposed equal to the interest, using the IRS' underpayment rate plus 1 percent, that would have been imposed during the deferral period if the deferred compensation had been includible in income when first deferred (or, if later, not subject to a substantial risk of forfeiture), and (3) an additional tax is imposed equal to 20% of the deferred compensation.

Limited Options for Terminating Arrangements

Deferred compensation that is subject to section 409A generally can be distributed only upon the occurrence of one of six events (as discussed above). Noticeably absent from this list of distributable events is the termination of the nonqualified deferred compensation arrangement. However, the final regulations issued under section 409A in April 2007 (see our Bulletins Nos. 07-50, 07-48, 07-44, 07-41 and 07-38) include the following three exceptions to this general prohibition; provided certain specific conditions are satisfied:

(1) Termination In Connection with a Corporate Dissolution: The first exception applies with respect to an employer's termination and liquidation of a plan within 12 months of a corporate dissolution taxed under section 331 or, with the approval of a bankruptcy court, pursuant to 11 U.S.C. section 503(b)(1)(A). This exception is only available if the amounts deferred under the arrangement are included in the participants' gross incomes in the latest of the following years (or, if earlier, the taxable year in which the amount is actually or constructively received): (a) the calendar year in which the plan termination and liquidation occurs; (b) the first calendar year in which the amount is no longer subject to a substantial risk of forfeiture; or (c) the first calendar year in which the payment is administratively practicable.

(2) Termination in Connection with a Change in Control: The second exception applies to an employer's termination and liquidation of a plan pursuant to irrevocable action taken by the employer within 30 days preceding or the 12 months following a change in control event (as defined for purposes of section 409A), provided that all arrangements that are treated as a single plan under the plan aggregation rules (discussed below) are terminated and liquidated with respect to each participant who experienced the change in control event. In addition, all such participants are required to receive all amounts under the terminated arrangements within 12 months of the date the employer irrevocably takes all necessary action to terminate and liquidate the arrangements.

The final regulations provide that the requirements of section 409A generally are applied as if a separate plan is maintained for each employee and all arrangements of the same type in which the employee participates are aggregated and treated as a single plan. For this purpose, the final regulations aggregate the following nine categories of plans separately:

(a) elective account balance plans;
(b) nonelective account balance plans;
(c) nonaccount balance plans;
(d) separation pay arrangements (but only to the extent payable solely upon an involuntary separation from service or as a result of participation in a window program);
(e) split-dollar life insurance arrangements;
(f) reimbursement plans;
(g) stock rights;
(h) foreign plans; and
(i) all other plans.

Thus, for example, if a participant participates in two nonelective account balance plans maintained by his or her employer, the participant will be treated as participating in a single plan that includes the amounts deferred under the two separate plans. In addition, if the employer wants to terminate one of the two separate nonelective account balance plans in connection with a change in control event, the employer would have to terminate both of the plans with respect to all participants in those plans who experienced the change in control event and any other nonelective account balance plans in which one or more of such participants also participates.

(3) Other Termination That Satisfies Certain Conditions: The third exception applies to an employer's termination and liquidation of a plan if all of the following conditions are satisfied:

(a) the termination and liquidation does not occur proximate to a downturn in the financial health of the employer;

(b) the employer also terminates and liquidates all plans that would be aggregated with the plan under the plan aggregation rules;

(c) no payments in liquidation of the plan are made within 12 months of the date the employer takes all necessary action to irrevocably terminate and liquidate the plan other than payments that would be payable under the terms of the plan if the action to terminate and liquidate the plan had not occurred;

(d) all payments are made within 24 months of the date the employer takes all necessary action to irrevocably terminate and liquidate the plan; and

(e) the employer does not adopt a plan of the same type under the plan aggregation rules at any time within 3 years following the date the employer takes all necessary action to irrevocably terminate and liquidate the plan.

The final regulations are not clear on a number of the conditions that must be satisfied. To begin with, there is the language used to describe the arrangements that must be terminated. The language is different from that used under the exception for terminations in connection with a change in control event as described in subsection (2) above, which provides that all plans of the same type under the plan aggregation rules must be terminated. In contrast, the language in the final regulations with respect to this third exception is different and some have argued could be interpreted to require only the termination of a portion of a plan on a participant-by-participant basis and not the entire plan. However, based on informal discussions with a Treasury representative, AALU understands that the drafters of the final regulations intended that the entire plan (and any aggregated plans) must be terminated. In addition, this interpretation is consistent with language in the preamble to the proposed 409A regulations which provided that all plans of the same type, with respect to all participants, must be terminated under this exception. The language in the final 409A regulations with respect to this requirement is not substantively different from the language in the proposed 409A regulations.

The final regulations are also not clear on when a termination and liquidation is not proximate to a downturn in the financial health of the employer, one of the conditions that must be satisfied. This issue has become even more difficult with the current economic downturn. Many employers are experiencing downturns in their financial health because of the current economic conditions. It is not clear what level of downturn in the financial health of the employer must exist before a termination would no longer be permissible under this third exception. It is also not clear whether the analysis looks solely to the financial health of the employer and/or the general financial health of the economy. Based on a literal interpretation of the final regulatory language, it appears that the analysis should consider only the financial health of the employer.

In addition, it is not certain whether the financial health of the employer must be considered at one time or at two different points in time. The employer must take action to terminate the plan and then cannot distribute any plan benefits until at least 12 months following the plan's termination. The final regulations, which reference both the termination and liquidation of the plan, seem to suggest that the financial condition of the employer must be considered at both points in time (i.e., when the plan is formally terminated and then at the time of the liquidation, which must occur at least 12 months after the formal plan termination, but no more than 24 months following such date). For example, if an employer takes action to terminate a plan formally when the financial health of the employer is fine, but at the time the liquidation distributions are scheduled to be made (e.g., on the one-year anniversary of the termination), there has been a downturn in the financial health of the company, it is not clear whether the liquidation distributions can be made.

Because of these uncertainties, employers and executives may be reluctant to terminate and liquidate an arrangement under this alternative. If all of the conditions are not satisfied, any liquidating distributions would be in violation of section

409A and all aggregated plans would be treated as violating that section. The adverse consequences of violating the section primarily fall on the participants (i.e., additional interest tax and additional 20% tax). The employer has certain withholding and reporting obligations if a plan or plans fail to comply with section 409A, but the consequences of not meeting those obligations can be relatively insignificant when compared to the potential adverse consequences that may fall on the participants.

In addition, the other two options for terminating and liquidating a 409A arrangement only apply in limited circumstances (i.e., in connection with certain corporate dissolutions and changes in control). Thus, in many cases, there may be no viable options for terminating and liquidating 409A arrangements.

Terminating Split-Dollar Arrangements

To the extent a split-dollar arrangement is subject to section 409A (see our Bulletins Nos. 07-41; 07-48 and 07-50), the same limitations discussed above regarding terminating 409A arrangements generally should apply. Thus, if an employer or executive would like to terminate a split-dollar arrangement under the third alternative discussed above ("Other Termination That Satisfies Certain Conditions"), all other split-dollar arrangements that are required to be aggregated and treated as a single 409A plan must be terminated as well. Note that split-dollar arrangements are a separate type of plan for purposes of the 409A plan aggregation rules. Any payments in "liquidation" of the terminated split-dollar arrangement would also have to be made during the period beginning 12 months after the termination and ending 24 months after the termination. However, it is not necessarily clear what payments in liquidation would be required upon a termination of a split-dollar arrangement (which may depend on the particular terms and structure of each such arrangement). In addition, the employer could not establish a new split-dollar arrangement (that is subject to section 409A) within 3 years of the date the existing arrangements were terminated and liquidated.

The final 409A regulations do not contain any special rules regarding the application of section 409A to split-dollar arrangements, other than treating them as a separate category for purposes of the plan aggregation rules. However, in conjunction with the issuance of the final regulations in April 2007, the IRS issued Notice 2007-34 to provide additional guidance for purposes of applying the general rules under the final 409A regulations to split-dollar arrangements (see our Bulletins Nos. 07-38, 07-41, 07-44, 07-48 and 07-50). Notice 2007-34 does not, however, expressly address the termination of split-dollar arrangements under the final 409A regulations.

The guidance in Notice 2007-34 does indicate that many split-dollar arrangements may not be subject to section 409A, including the following (unless they include certain features):

(1) death-benefit only arrangements (i.e., non-equity);
(2) collateral assignment method arrangements that are taxed as loans under Regs. section 1.7872-15;
(3) arrangements that are not subject to the final split-dollar regulations (i.e., entered into before September 18, 2003 and not materially modified thereafter) and that are taxed as loans under IRS Notice 2002-8; and
(4) arrangements that are excepted as short-term deferrals under the general 409A guidance (i.e., paid no later than 2-1/2 months following the end of the taxable year in which the executive vests under the arrangement).

Although these types of split-dollar arrangements generally may not be subject to section 409A, Notice 2007-34 indicates that they may become subject to 409A if the obligation to repay the employer's interest (i.e., the "loan") is waived, cancelled or otherwise forgiven. Similarly, these arrangements may become subject to the section if the employer makes a cash payment or provides another benefit in lieu of forgiveness.

Notice 2007-34 also addresses certain types of split-dollar arrangements that may be subject to 409A. They include, but are not necessarily limited to: (a) endorsement method arrangements that are taxed under the economic benefit regime of Regs. section 1.61-22(d); and (b) arrangements that are not subject to the final split-dollar regulations (i.e., entered into before September 18, 2003 and not materially modified thereafter) and that are taxed under the modified economic benefit regime of IRS Notice 2002-8. However, it should be emphasized that because the rules are not clear, there are a number of theories that may support the position that one or more of these types of arrangements are not subject to 409A.

Substitutions

Employers may also be considering substituting or replacing one arrangement with another, for example, substituting or replacing a nonelective account balance arrangement with a bonus life arrangement. The employer may be considering this type of substitution or replacement in order to reduce the amount of cash that may have to be paid or set aside currently. However, employers must be careful when they substitute or replace one arrangement with another because the final regulations include a general prohibition regarding substitutions, which provides, in pertinent part, that:

> "Except as otherwise provided under these regulations, the payment of an amount as a substitute for a payment of deferred compensation will be treated as a payment of the deferred compensation. A forfeiture or voluntary relinquishment of an amount of deferred compensation will not be treated as a payment of the compensation, but there is no forfeiture or voluntary relinquishment for this purpose if an amount is paid, or a legally binding right to a payment is created, that acts as a substitute for the forfeited or voluntarily relinquished amount. Whether a payment or a right to a payment acts as a substitute for a payment of deferred compensation is determined based on all of the facts and circumstances."

The extent, if any, to which this prohibition would apply to the substitution or exchange of one arrangement that is subject to 409A for another so subject is not clear. This is particularly true if both are not currently taxable. For example, if an employer substitutes a bonus life arrangement for a nonelective account balance plan, it is not certain whether the former is treated as a payment of the latter, and if so, whether there would be any immediate tax consequences. In addition, it is not clear how the substituted arrangement should be characterized for purposes of the plan aggregation rules (i.e., as a bonus life arrangement or as a continuation of the nonelective account balance plan). This may become relevant if the bonus life arrangement is subsequently terminated under the third alternative discussed above.

This example also points out that the characterization of certain arrangements under the plan aggregation rules is not necessarily clear. For instance, how should a bonus life arrangement be characterized? Arguments could be made that it could be treated as a nonelective account plan, a nonaccount plan, a split-dollar arrangement or other plan under the plan aggregation rules. A mischaracterization could result in significant adverse tax consequences. If such a plan is either improperly terminated or not terminated in connection with the termination of another plan, all of the arrangements in both categories may be treated as having violated the 409A requirements. In addition, if a plan is characterized in the catch-all category of "other plans," it would not necessarily be self-evident which plans would need to be terminated.

Because there is very little additional guidance in the final regulations about when a new arrangement may constitute a prohibited substitution of another arrangement, employers must proceed cautiously when a new arrangement is established in connection with or proximate to a termination or waiver of an existing arrangement.

Ceasing Elective Deferrals Mid-Year

Another area of concern involves mid-year changes in the amount of elective deferrals. Because of the economic downturn and the desire for additional cash compensation, executives may be asking employers whether they can revoke or change their deferral elections that were previously made and that are now effective. The short answer is that participants generally cannot change their deferral elections once they become effective.

Section 409A imposes requirements, with respect to the timing of a participant's deferral elections, which provide that a participant's election to defer compensation for services performed during a taxable year generally must be made no later than the close of the preceding taxable year. In addition, the deferral election generally must be irrevocable after the start of the taxable year. Thus, if an executive made an election to defer 25% of his or her compensation for 2009 before the beginning of the year, the executive generally cannot revoke or change that election after the beginning of 2009.

Note that an executive may be permitted to revoke or change an election that has not become effective under the final regulations. For example, the final regulations include an exception to the general deferral election timing rules for performance-based compensation. The election to defer performance-based compensation does not have to become irrevocable until six months before the end of the performance period if certain conditions are met (e.g., the performance period is at least 12 months). Thus, if an executive elected to defer 50% of his or her performance bonus for 2009, which is generally payable in March 2010, the executive may be able to revoke or change the election or before June 30, 2009.

However, the terms of the arrangement should be reviewed to determine when the deferral election becomes irrevocable and whether such a change or revocation would be permitted.

Closing

For various reasons, the current economic downturn may be causing both employers and executives to reconsider their existing nonqualified deferred compensation arrangements. To the extent those arrangements are subject to section 409A, employers and executives should proceed cautiously before terminating the arrangements or making any other changes. The section 409A rules allow for a plan to be terminated in only limited circumstances and, even if permitted, a number of conditions must be satisfied, including, in certain cases, that all other plans of the same type must also be terminated and liquidated within a specific time frame. In addition, because of significant uncertainties about whether all of the conditions can actually be satisfied (e.g., whether the termination or liquidation is not proximate to an economic downturn), in many, if not most, cases there may be no viable options for terminating and liquidating a 409A arrangement. Moreover, the final section 409A regulations generally prohibit the substitution of one nonqualified arrangement for another and certain mid-year changes to a participant's deferral elections for a particular year.

In the event that this *Washington Report* is also considered to be a "marketed opinion" within the meaning of the IRS guidance, then, as required by the IRS, please be further advised of the following:

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