

[**New IRS Regulations to Impact Non-Qualified Plans**

Bud Schiff, CEO of NYLEX Benefits and Mark Niziak, managing director of ERISA Services at New York Life Retirement Plan Services, recently hosted a series of webinars discussing ways to measure the success of non-qualified plans for those companies who sponsor them and the impact on sponsors of new IRC Section 409A regulations that will be enacted by December 31, 2007.

At the same time, a new NYLEX Benefits article focuses on executive benefits and deferred compensation changes resulting from these IRS rules and highlights the top 20 actions plan sponsors should consider taking to address them effectively. We encourage you to read the [full article \(see below\)](#) that is also slated to appear in the October issue of National Underwriter magazine. If you have specific questions about how the new IRS 409A regulations could impact you or your participants, please contact your Relationship Manager.

NYLEXBenefits

Executive Benefits – Deferred Compensation

Considerations and Opportunities Generated By IRC §409A

INTRODUCTION

Internal Revenue Code (IRC) Section 409A provides rules for the income tax treatment of amounts deferred under defined contribution nonqualified deferred compensation (NQDC) plans, including defined benefit supplemental executive retirement plans (SERPs) as well as other deferral arrangements. On April 10, 2007, Treasury and the Internal Revenue Service issued 400 pages of final regulations under IRC §409A. These final regulations require that all plans must operate in accordance with these rules by December 31, 2007 and further require that plan documents be amended by that date.

This article is intended to provide a brief overview of these rules and to identify and summarize some of the new opportunities. The article should not be considered as a comprehensive analysis of the final regulations.

Issuance of the final Section 409A regulations signals the end of the transition period that has been in effect since October 2004.

Employers have until the end of 2007 to amend their covered plans to conform to the new requirements.

Many uncertainties about deferred compensation arrangements have been resolved.

STATUTORY OVERVIEW

Inclusions:

The deferred compensation rules under §409A generally apply to any arrangement that provides for deferral of compensation (including those covering only one individual). Included in the definition are defined contribution and defined benefit SERPs and certain stock option, stock appreciation rights and severance plans.

Exclusions:

Certain tax favored retirement plans, such as qualified retirement plans and 403(b) plans, and bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plans are statutorily exempt from the new rules. Other exceptions include: short term deferrals; stock options; stock Appreciation Rights (SARs); and separation pay arrangements.

Plans Must Be In Writing:

All plans must be in writing. The documentation requirements must be met by December 31, 2007, although plan sponsors must be able to show that plans have been operated in accordance with §409A before that date. The regulations require that a "savings clause," that is a statement that plan provisions not in conformance with §409A will be disregarded, and will have no effect.

Three New Key Requirements:

New requirements must be satisfied both in the form and operation of covered plans, and are in addition to the existing statutory and judicially imposed rules. They include –

1. Distributions;
2. Acceleration provisions; and
3. Elections.

Distribution Restrictions:

Deferred compensation cannot be distributed any earlier than the occurrence of one of six specified events –

1. Separation from service;
2. Disability;
3. Death;
4. A specified time;
5. Change in ownership or control;
6. The occurrence of an unforeseeable emergency (as defined in §409A).

Election Restrictions:

Generally, deferral elections must be made prior to the year in which the relevant compensation is earned. Exceptions are made in the case of a newly established plan or where a participant is newly eligible to participate. Elections to defer "performance based compensation" may be made no later than six months before the end of the performance measurement period, as long as such period is at least 12 months. Elections as to the time and form of distribution must be made when the deferral elections are made. Changes in distribution elections are permitted, as long as certain specified requirements are met.

Consequences of Noncompliance:

If a plan is determined not to comply with §409A, either because the plan itself is deficient or it has not operated in accordance with the rules, the tax consequences can be severe. An affected participant may be taxed immediately on all amounts deferred under the plan, plus an interest charge dating back to the year the compensation was deferred or became vested. In addition, a 20% penalty tax will be imposed on the deferred amounts.

Acceleration Restrictions:

Except as expressly permitted, a plan may not allow any acceleration of the time or schedule of a payment.

Effective Dates:

All plans subject to the new rules must comply with the final regulations by the end of 2007. Section 409A applies only to amounts deferred in taxable years beginning after December 31, 2004. However, where a plan combines pre- and post-December 31, 2004 deferrals, the entire

plan will have to meet the §409A requirements. Therefore, where a pre-§409A plan exists that includes significant provisions that no longer may be permitted under §409A, it may make sense to “freeze” that plan and establish a new plan for post-§409A contributions.

Transition Rules:

Importantly, the transition rules give participants the opportunity to make changes with respect to both the time and form of payment for elections previously made.

Issues Not Addressed in the Regulations:

The final regulations do not address the calculation and timing of amounts that must be included in taxable income under §409A. Nor do the regulations provide further guidance as to the reporting and withholding requirements imposed by that section. Further guidance has been promised with regard to these matters.

Matters for Immediate Consideration:

Plan sponsors and their advisors should conduct a review of all deferred compensation plans and arrangements to ascertain what provisions must be changed to conform to §409A and the final regulations. Virtually all plans will have to be amended. The transition provisions also may permit changes to plans provisions, or changes to elections made previously by plan participants.

SUMMARY - “TOP 20” THINGS TO KNOW AND CONSIDER REGARDING IRC §409A

1. Don't assume you are in compliance even if you put your plan in place after 2004
2. Use the 2007 transition year to change previous elections or correct mistakes
3. Pre-§409A advantageous plan provisions may be saved by freezing your old plan and adopting a new §409A compliant version
4. Section 409A aggregation rules require that similar plans of an employer be operated consistently
5. Watch out for “one-off” executive benefit arrangements (special perks) that may be characterized as §409A deferred compensation plans
6. Nonqualified plans linked to 401(k) plans must be reviewed to make sure elections will meet §409A requirements
7. For flexibility, consider electing a series of annual installments rather than a lump-sum distribution
8. Consider “laddering” in-service distributions to achieve flexibility
9. Defined benefit SERP participants can choose between actuarial equivalent life annuities without having to meet the §409A five year additional deferral requirement
10. Use available safe harbors to determine who is a “specified employee” for §409A purposes
11. Plans can require mandatory distributions of de minimus balances so plan sponsors can avoid carrying these accounts
12. Change in Control Provision – don't automatically choose an immediate distribution
13. Watch out for events that will trigger automatic funding of a Rabbi Trust. This could result in immediate participant taxation
14. In an asset sale transaction, the buyer and seller can agree on whether there has been a separation from service which would trigger a distribution
15. Avoid §409A compliance issues by properly structuring your stock compensation arrangements – use fair market valuations and avoid deferral features
16. Involuntary separation pay up to two times current salary can (with limits) avoid §409A characterization. “Good reason” separations may qualify as involuntary
17. Using stock unit or phantom plans may be better than granting stock options
18. Short term nonqualified incentive plans can be an effective retention tool
19. After-tax plans (similar

to “Roth IRAs”) are an alternative to having to deal with §409A 20. Evaluate the impact of all §409A revisions with regard to the following plan issues –

- Legal requirements
- Accounting implications
- Tax implications
- Actuarial or other funding implications
- Plan administration requirements

CONCLUSION

The final §409A regulations include many provisions more liberal than were contained in the proposed regulations previously issued. Nevertheless, the regulations as finally adopted include rules that must be followed if a deferred compensation plan is to meet the requirements of §409A. If the IRS determines that a plan has not complied with these rules, the consequences can be harsh and expensive. Therefore, a review of existing plans is imperative for all concerned.

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