# Proposed 409A Regulations: Designing Permissible Distributions

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At the heart of the Section 409A proposed regulations are restrictions on how elections to defer must be made and when benefits may be distributed. The failure to comply with these rules will result in highly unfavorable tax consequences. This Alert, the third of four to be issued, focuses on how participants may receive distributions under a 409A arrangement to preserve the maximum tax deferral.

This series of Alerts assumes a general familiarity with Code Section 409A, so if you would like to refresh your knowledge in this area, please review our previous Benefits Alerts for background information on this topic.

**Initial Election of Time and Form of Payment**

The general rule is that an election establishing the initial deferral election must be made prior to the year in which the compensation is earned. A plan, by its nonelective terms or required participant election at that time, must provide for payment at a specified time or by a schedule that is objectively determinable (disregarding acceleration except for death or disability).

An exception to the election-timing rule permits an election within 30 days after a participant is first eligible for a category of deferred compensation arrangements, if the election is limited to compensation earned after the election.

Elections for performance-based compensation permit some design opportunities: elections must be made at least 6 months before the end of the performance period of at least 12 months, so long as achieving the defined goal is substantially uncertain or the amount is unascertainable.

If the arrangement is nonelective, specifying the time and form of payment, the initial determination of time and form of payment will be considered an initial deferral election, which must be made prior to a participant obtaining a legally binding right to the deferred compensation.

**Distributions**

***General Rule***. No payment of deferred compensation will be permitted earlier than certain permissible events, including—

- separation from service,
- date of disability,
- death,
- change of control,
- unforeseeable emergency, or
- a specified time.

In certain circumstances, an arrangement may provide that distribution is made as of the earlier of, or later of, specified permissible events or a specified time.

"***Separation from service***" is termination of employment, including death or retirement. Employment is deemed to continue during a leave of up to 6 months, and longer if the leave is protected by contract or statute. If a "separated" participant continues to work at pay of at least 20% of average of the last 3 years, or is consulting for at least 50% of the average of the last 3 years pay, no termination will have occurred.

Certain key employees of publicly-traded companies will be required to wait an additional 6 months following separation from service if the separation triggers distribution. Affected key employees will be determined on a 12-month basis designated by employer, and the delay will apply for the 12 month period that begins on the 1st day of the 4th month following the end of the identification period.

"***Disability***" applies using one of three permitted definitions of disabled, the selection of which will be consequential in terms of plan operation and information to be provided to participants regarding claims.

A "***change of control***" results from—

- *Ownership change*: Acquisition by a person or group of 50% or more of the fair market value or voting power of stock.

- *Effective control change*: Acquisition by a person or group of 35% or more of the fair market value or voting power of stock.

- *Board change*: Majority of board members in 12 months is not approved by 50% of board.

- *Change in ownership of substantial portion of assets*: Acquisition by person or group of 40% or more of gross fair market value of assets in 12 months.

Certain events qualify as "***unforeseeable emergencies***" and some do not:

- Qualifying costs include expenses incurred for medical, casualty, funeral and related taxes.

- Non-qualifying costs include college tuition, home purchase, and expenses that can be satisfied from other sources.

***Delayed Distribution***. A distribution may be delayed without resulting in a violation of 409A if the date of distribution is an objectively determinable date or year following a distribution event. Then payment can be made—

- by end of the calendar year within which the date falls, or
- if later, by the 15th day of the 3rd calendar month following the date, similar to the short-term deferral rule.

**Acceleration of Distributions**

***Prohibition***. Generally, acceleration of payment will violate 409A. This means that the once-common practice of "haircuts" are prohibited. However, acceleration is permitted for certain needs or events, such as—

- allowing for payment of taxes,
- if the plan is not 409A compliant,
- payment according to domestic relations orders, and
- de minimis payments up to $10,000.

***Plan Termination***. Payment may be made following the termination of plan if the termination complies with certain requirements—

- the termination is pursuant to the plan's terms,
- the termination applies to a specific category of deferred compensation and all similar arrangements are terminated as to all participants,
- only otherwise allowable payments are made within 12 months of termination,
- all payments are made within 24 months, and
- a similar plan is not adopted for at least 5 years.

***Subsequent Deferral Elections***. Subsequent deferral elections or changes in the form of payment ("re-deferrals") may be permitted. However, they may not take effect for 12 months and must defer the first payment for at least 5 years from when it would have been made. This "delay" rule is not applicable to distributions on death, disability, or unforeseeable emergency. Depending on the plan's design, a re-deferral may have the effect of accelerating the rate of payment to a participant.

If you have any questions about how these rules may affect your plan's design or operation, contact any of the attorneys in Holland & Hart's Benefits Law Group.

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*might affect the analysis or commentary. Similarly, the analysis may differ depending on the jurisdiction or circumstances. If you have specific questions as to the application of the law to your activities, you should seek the advice of your legal counsel.*