

# Deferred comp deferral and distribution elections

Participants in nonqualified deferred compensation plans have many issues to consider when completing compensation deferral and distribution elections. Internal Revenue Code Section 409A (IRC Section 409A) and the final regulations make it clear that these elections must be completed in a timely fashion for the deferral of compensation to be effective.

## General rules of deferral elections

IRC Section 409A generally requires that participant deferral elections must be in place prior to the start of the calendar year in which the compensation to be deferred is earned.<sup>1</sup> The election is generally irrevocable and may not be changed or terminated; however, it's permissible to modify an existing deferral election, as long as the modification occurs before the last permissible date to have the election in place.<sup>2</sup> Upon the occurrence of a disability<sup>3</sup> or unforeseeable emergency<sup>4</sup> as defined by IRC Section 409A, or a hardship distribution from a 401(k) plan,<sup>5</sup> a deferral election may be cancelled.

An exception to the calendar-year deferral election rule is provided for performance-based compensation. The definition of performance-based compensation is subject to detailed regulations under IRC Section 409A, but it generally involves compensation earned over at least 12 months, and which is "contingent on the satisfaction of pre-established organizational or individual performance criteria". For compensation meeting this definition, IRC Section 409A allows participants to complete a deferral election up to six months before the end of the service period to which the performance-based compensation applies.<sup>6</sup> For a more detailed discussion on issues impacting performance-based compensation, see the Applied Knowledge article titled *Performance-based compensation deferrals*.

In addition, deferral elections for bonus compensation that isn't performance-based earned over a fiscal-year period must be completed before the start of the fiscal-year earning period.<sup>7</sup> For example, if an employer pays a bonus (not performance-based) earned over the year ending September 30, the election to defer that compensation must have been made before October 1 of the prior year. If the bonus was performance-based, the employee would have until March 31 of the current year to make the election.

## Elections upon becoming newly eligible

Another exception to the general rule exists for initial deferral elections for participants in new plans, or for participants who become newly eligible in an existing plan. Such an election must be made within 30 days of the participant's eligibility to participate in the plan.<sup>8</sup> This election applies only to compensation earned subsequent to the date the deferral election becomes irrevocable. If the newly eligible participant misses the 30-day window, they must wait until the beginning of the next calendar year for the deferral election to take effect.

Under IRC Section 409A, newly eligible participants who wish to defer compensation earned "based upon a specified performance period (for example, an annual bonus)," whether the compensation is performance-based or not, must also make deferral elections within 30 days after becoming eligible.

This election then applies to a ratable portion of compensation earned based on the number of days of service provided after the deferral election becomes irrevocable, divided by the total days of service during the performance period. For an example to calculate the deferral of newly eligible earnings, see the Applied Knowledge article titled *Performance-based compensation deferrals*.

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## Fiscal-year bonus

Another exception to the general rule exists for compensation, which is earned based on the fiscal year of the company. Such election must be made prior to the beginning of the fiscal year<sup>7</sup> prior to which it is earned.

## Performance-based compensation

In addition to the above, performance-based compensation is another exception to the general timing rule. Performance-based compensation is compensation where the amount of, or entitlement to, the compensation is contingent on the satisfaction of pre-established organizational or individual performance criteria. For a detailed analysis, see the Applied Knowledge article titled *Performance-based compensation deferrals*.

## Impact on missing deferral timing rules

IRC Section 409A deferral timing rules noted above are very stringent. If a participant misses the deadline, the deferral may not be made, as there is not any administrative relief or exceptions to the deferral timing rules.

## Distribution elections as to the time and form of payment

When a compensation deferral election is made, the participant must also make a distribution election as to the time and form of payment of their deferred compensation account.<sup>9</sup>

As permitted by the employer's plan design, the participant may elect different distribution options for events permitted by IRC Section 409A, including separation from service, death, disability, or upon a change in control. In addition, the participant may elect a distribution to be made at a specific date while the participant is still in-service. Also, as permitted by plan design, most common payments may be in the form of a lump-sum or installment payments.

IRC Section 409A also addresses multiple payment events. A plan may provide that a participant is entitled to receive a distribution upon the earlier of different payment events. For example, a participant may have elected an in-service distribution occurring 10 years from the date of election. If the participant separates from service before the in-service distribution is scheduled to start, the participant's election regarding distribution at separation from service would become effective instead, and the in-service distribution would not occur.

A payment upon an intervening event (assuming it's a permissible payment event under IRC Section 409A) may override an existing payment schedule already in payment status. For example, a plan could provide that a participant would receive six installment payments commencing at separation from service, but also provide that if the participant died after payments commenced, all remaining benefits would be paid in a lump sum.

**It's very important to review your plan document to determine if multiple payments or intervening events are part of your plan design.**

## Elections to change the time and form of payment

It's possible to change the time and form of payment after the initial election has been filed, but IRC Section 409A places restrictions on when and how these changes take effect.<sup>10</sup>

Generally, a change in the time or form of payment is allowed if:

- The change takes effect at least 12 months or later from the date the new election is made;
- The change is communicated at least 12 months before the date the participant is scheduled to receive the first payment; and
- The date of the first payment is deferred at least five years.

Please see the Applied Knowledge Article titled *Subsequent deferral elections under IRC Section 409A* for a more detailed discussion.

## Planning considerations

Although Section 409A gives participants flexibility in deferring compensation and electing payment events and forms of payment in deferred compensation plans, the rules require the participant to plan carefully before making those elections. Deferral elections are generally irrevocable once made, and any changes to the time and form of payment will require at least a five-year delay in the first payment. There are many options in plan design available to plan sponsors, so plan participants should carefully consider each election option, and be aware of how and when changes may be made.

<sup>1</sup>Treas. Reg. §1.409A-2(a)(3)

<sup>2</sup> For example, a participant may make a deferral election for their performance-based compensation along with their calendar year election before the year starts, and they may then modify the election for performance-based compensation up to six months before the end of the service period of the performance-based compensation.

<sup>3</sup> Treas. Reg. §1.409A-3(j)(4)(xi)

<sup>4</sup> Treas. Reg. §1.409A-3(j)(4)(viii)

<sup>5</sup> Treas. Reg. §1.409A-3(j)(4)(viii)

<sup>6</sup> Treas. Reg. §1.409A-2(a)(8)

<sup>7</sup> Treas. Reg. §1.409A-2(a)(6)

<sup>8</sup> Treas. Reg. §1.409A-2(a)(7)

<sup>9</sup> Treas. Reg. §1.409A-2(a)(1)

<sup>10</sup> Treas. Regs. Section 1.409A-2(b)



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