Deferred compensation plan distribution events under Section 409A

Internal Revenue Code Section 409A (IRC Section 409A) and final regulations clarify and define the list of permissible distribution events for nonqualified deferred compensation plans.

The law provides for six permissible distribution events, which are:[1]

- Separation from service
- Death
- Disability
- Unforeseeable emergency
- A specified date or according to a fixed schedule (may also be known as "in-service" distributions)
- A change in ownership or effective control of the employer, or a change in ownership of a substantial portion of corporate assets

Separation from service. This generally refers to the occurrence of an event after which an employee is no longer providing service to the employer, typically due to retirement or termination of employment. The regulations provide specific definitions regarding separation from service, including rules relating to independent contractors. See Applied Knowledge Article *Separations from Service*.

Disability. A participant is considered disabled if, as the result of a medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, the participant is: (1) unable to engage in any substantial gainful activity, or (2) receiving income replacement benefits for a period of not less than three months under an accident and health plan covering employees of the participant's employer.[2]

Unforeseeable emergency. Regulations define this as a severe financial hardship resulting from: (1) an illness or accident of the participant, spouse, dependent, or beneficiary; (2) loss of property due to casualty; (3) similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant (e.g. funeral expenses of a spouse or imminent foreclosure or eviction from primary residence). A distribution for an unforeseeable emergency cannot exceed the amount needed to meet the specific hardship, and the taxes reasonably anticipated as a result of the distribution.[3] Due to this restrictive definition and the nature of deferred compensation plans, payments for unforeseeable emergencies should be quite rare. See Applied Knowledge Article *Unforeseeable Emergencies*.

Specified date. Distributions may occur at a specified date or pursuant to a fixed schedule. Generally, this is prior to Separation from Service.[4] Participant elections for such payments must be made at the time of the deferral election.[5]

Change in control. Under IRC Section 409A, distributions can be permitted to plan participants upon a change in control event, either as a participant elected event, a required plan distribution, or as a plan termination event, depending upon plan provisions. Participant elections for distributions upon a change in control event must be made at the time of the deferral election.

There are three possible fact patterns that may be used to trigger change in control distribution provisions:

- **Change in ownership**. Generally, a change in ownership occurs on the date that any one person, or more than one person acting as a group (as defined in the regulations[6]) acquires ownership of stock or voting rights that together with stock already held, constitutes more than 50% of the total value or voting power of the corporation. However, if such a person or group is considered to own more than 50%, or has effective control, the acquisition of more stock or voting rights by that person or group will not be considered a change in ownership.

- **Change in effective control**. Generally, a change of effective control occurs only if (a) any person, or more than one person acting as a group (as defined in the regulations[7]) acquires or has acquired during a 12-month period ownership stock equaling 30% or more of the voting power of the corporation, or (b) a majority of the board of directors is replaced during any 12-month period with directors whose appointment or election is not endorsed by a majority of the board of directors before the date of the appointment or election. However, if such a person or group effectively controls a corporation, the acquisition of more control by the same person or group is not considered a change in effective control.

- **Change in ownership of a substantial portion of the company's assets**. Generally, a change in ownership of a substantial portion of the company's assets occurs if, during a 12-month period, any person or more than one person acting as a group (as defined in regulations[7]) acquires or has acquired assets of the company with a gross fair market value of 40% or more of the total gross assets of the corporation, as valued just prior to the acquisition without taking liabilities into consideration. If the transfer of the assets is to an entity that is controlled by the shareholders of the transferring corporation immediately after the transfer (as defined in regulations), the transfer of assets will not trigger a change of control event.[7]

For all three definitions, the plan document can require a higher percentage than those described above, provided the definition is set forth in the plan no later than the date by which the time and form of payment must be established (as defined in regulations).

The regulations include many exceptions and detailed definitions for these provisions. It is important to work closely with counsel to determine whether a change in control has occurred.

IRC Section 409A permitted accelerations. In addition, distributions are permitted from the plan for certain other events generally out of the participant's control, including:[8]

- Required distributions under a Domestic Relations Order. See Applied Knowledge Article *Transfers of deferred comp account balances in divorce income tax reporting*.
- Distributions under a "certificate of divestiture" required to avoid a conflict of interest.
- Payments of "de minimis" account balances as defined in the plan document.
- Distributions to pay required tax payments as a result of plan participation.

- Payment of plan balances, if they become includible in the participant's income due to violations of IRC Section 409A.
- Plan terminations may result in the distribution of participant balances if IRC Section 409A rules are followed regarding the plan termination. Plan terminations may occur in relation to a Change in Control, at the discretion of the Plan Sponsor, or upon corporate dissolution. See the Applied Knowledge *Plan Terminations under Section 409A*.

Deferred compensation plans are limited to the distribution events and circumstances above. As such, money cannot be distributed for the purposes of a loan to the participant. Further, IRC Section 409A doesn't contemplate rollovers to another nonqualified plan or tax-free to an individual retirement account.

A plan is permitted to specify the controlling distribution event to be the "earlier of" any permitted event above. In addition, it's permissible to have different forms of payment for different distribution events. These forms may either be required by the plan sponsor or made available by election to the plan participant.

It's important to discuss specific facts with your tax and legal advisors because the rules above are complex and often hinge on specific facts.

[1] Internal Revenue Code Section 409A(a)(2).
[2] Treas. Reg. §1.409A-3(i)(4).
[3] Treas. Reg. §1.409A-3(i)(3).
[4] It is important to consult your plan document for specific rules regarding Specified Date payments.
[5] Treas. Reg. §1.409A-3(i)(1).
[6] See Treas. Reg. §1.409A-3(i)(5)(v).
[7] Treas. Reg. §1.409A-3(i)(5)(v).
[8] Treas. Reg. §1.409A-3(j)(4).