Subsequent deferral elections under IRS Section 409A

Nonqualified deferred compensation plans are subject to strict standards under Internal Revenue Code Section 409A (IRC Section 409A), including six permissible distribution events and a general prohibition against acceleration of distributions.[1] The Code provides some limited flexibility when a participant wishes to delay a distribution or change the form of the payment (sometimes referred to as "subsequent deferral election" or "redeferral").[2] Code requires that:

- The election to change or delay a payment takes effect only 12 months after date the election is made.[3]
- The payment must be delayed for at least five years from the date it would have been paid[4] (it must be "pushed out" at least five years). Payments due to death, disability, or an unforeseeable emergency are not subject to this requirement.
- The election to change or delay a payment must be made at least 12 months prior to the first scheduled payment.[5]

Considerations

- A subsequent deferral election cannot be revoked once properly executed by the participant and accepted by the employer.
- The Code does not restrict the number of times a participant may push out an account, subject to the plan sponsor's limits.

The Treasury Regulations provide plan sponsors the ability to make distributions either in a lump sum or in installments payments. Installments may be treated in one of two ways:[6]

- **As a single payment spread out over time –** This method takes into consideration only the first payment of the installment. As such, the irrevocable election to delay or change the form of payment must be made at least 12 months before the original payment date of this first installment, and it must be delayed for a minimum of five years. Consequently, each subsequent installment is also delayed or changed. This method is the default under the regulations.
- **As a series of individual payments –** This method treats each payment of the installment stream independently. As such, the irrevocable election to delay or change the form of payment must be made 12 months in advance of the *each* installment and delay *each* installment for a minimum of five years. The plan document must state that installments are being treated as "a series of individual payments."

It's important to know which method a plan is using, as it can impact how, or even if, a subsequent deferral is permitted.[7]

Examples

Let's look at a few examples if a participant wishes to delay or change an initial deferral election.[8]

Example 1: A participant has one account to be distributed in a lump sum upon separation from service. The participant has not separated from service or had another permissible distribution event. The participant wants to withdraw a portion of their account balance. This is not permitted due to the general prohibition against benefit accelerations under IRC Section 409A.[9]

Example 2: A participant has one account to be distributed upon separation from service in a single lump sum. The participant is planning to separate from service on July 1, 2023. On May 15, 2023, the participant wishes to change the payment to five annual installments. This is not permitted because the election was not made more than 12 months prior to the distribution event.

Example 3: A participant has an in-service account to be distributed on January 1, 2023, in a lump sum. On July 1, 2021, the participant makes an election to delay the payment until January 1, 2028. The re-deferral is permissible because the election was made 12 months prior to the distribution date and the payment was delayed five years.

Example 4: **A participant has an in-service account which is to be distributed in five annual installments beginning on January 1, 2023.** The participant wishes to change the form of the payment to a lump sum to be distributed on January 1, 2028. The participant makes an irrevocable election to make this change July 1, 2021. The plan treats installment payments as a single payment. The participant will be allowed to make this election because it was made more than 12 months prior to the distribution event and the first payment was delayed five years.

If the plan treated installments as a series of individual payments, the change to a lump sum would not be permitted. The installment payment due on January 1, 2024, would need to be pushed out to at least 2029, the second installment to 2030, and so on. However, the participant could make an election to delay all payments for five years.

Example 5: A participant has an account which is to be distributed in a lump sum upon separation from service. On January 1, 2023, the participant makes an election to change the form of payment to five annual installments. This election becomes effective in 12 months. On August 1, 2023, the participant separates from service. The participant's account will be distributed in a lump sum because the election was not made more than 12 months prior to the payment date.

It is common for participants to make changes to in-service accounts, which have an ascertainable payment date, to delay income. On the other hand, for separation from service accounts, which have an unknown payment date, the delay of payment is less appealing because participant will be no longer employed with the employer, yet the account continues to be subject to the risk of forfeiture in event of the employer's bankruptcy.

It's important for participants to consult their tax or legal advisors as to the ramifications of making a change or delay of payments.

[1] IRC Sections 409A(a)(2)(A) and 409A(a)(3).
[2] IRC Section 409A(a)(4)(C).
[3] IRC Section 409A(a)(4)(C)(i).
[4] IRC Section 409A(a)(4)(C)(ii).
[5] IRC Section 409A(a)(4)(C)(iii).
[6] Treas. Regs. Section 1.409A-2(b)(2)(iii).
[7] The Principal Financial Group model document treats installments as a single payment.
[8] Dates used in the examples are for illustrative purposes only and do not refer to a specific moment in time.
[9] See IRC Section 409A(a)(2)(A).

Principal®

principal.com

Insurance products issued by Principal National Life Insurance Company (except in NY) and Principal Life Insurance Company®. Plan administrative services offered by Principal Life. Principal Funds, Inc. is distributed by Principal Funds Distributor, Inc. Securities offered through Principal Securities, Inc., Member SIPC and/or independent broker/dealers. Referenced companies are members of the Principal Financial Group®, Des Moines, IA 50392.

The subject matter in this communication is educational only and provided with the understanding that Principal® is not rendering legal, accounting, investment, or tax advice. You should consult with appropriate counsel, financial professionals, and other advisors on all matters pertaining to legal, tax, investment, or accounting obligations and requirements.