

Plan terminations under IRC Section 409A

Generally, a payment of benefits earlier than specified in a nonqualified deferred comp (NQDC) plan document triggers a violation of Internal Revenue Code (IRC) Section 409A.¹ However, regulations describe three situations where a nonqualified plan may be terminated, and balances distributed to participants. The three scenarios are (1) a change in control of the plan sponsor, (2) at the discretion of the plan sponsor (provided certain requirements are met), or (3) upon corporate dissolution of the plan sponsor.

Terminating a nonqualified plan due to a change in control

Nonqualified deferred compensation plans are ordinarily subject to stringent limitations that preclude most accelerations of promised benefits.² However, upon a “change in control,” a company may terminate and liquidate their plan,³ even though it results in an acceleration of benefits to participants.⁴ Generally, it’s the responsibility of the board or company to amend and/or terminate the plan due to a change in control. The event must meet the IRC Section 409A definition of a change in control. **Plan sponsors should work with their counsel to determine whether a change in control has occurred, as defined in the regulations.** A change in control may include:⁵

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 at Treas. Reg. §1.409A-3(i)(5)(v)(B)) 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:

- any person, or more than one person acting as a group (as defined in the regulations at Treas. Reg. §1.409A-3(i)(5)(v)(B)) acquires or has acquired during a 12-month period ownership of stock equaling 30% or more of the voting power of the corporation, **or**
- 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 any person or more than one person acting as a group (as defined in the regulations at Treas. Reg. §1.409A-3(i)(5)(v)(B)) acquires or has acquired during a 12-month period 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’s 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.

For all three changes in control 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's important to work closely with counsel to determine whether a change in control has occurred. To accelerate benefits following a change in control, stringent rules set forth in regulations must be followed. The following steps describe the requirements under the regulations:⁶

- The Board or company must terminate the plan by taking irrevocable action within 30 days prior to the change in control or during the 12-month period after the change in control;
- All benefits must be distributed within the 12-month period after the company takes all necessary steps to irrevocably terminate the plan;⁷
- Deferrals to the plan must cease;⁸
- The company must terminate and liquidate all plans of the same type, as defined by the plan aggregation rules,⁹ and **Plan aggregation in the context of a Change in Control termination applies only to the participants who undergo a Change in Control and the company responsible for the liability immediately after the Change in Control** Treas. Reg. §1.409A-3(j)(4)(ix)(B). See *Applied Knowledge* [NODC 409A Aggregation Issues](#).

Example. ABC Company experiences a change in control on July 1, 2020. ABC Company can terminate its nonqualified plan anytime during the period from June 1, 2020, to July 1, 2021. On December 1, 2020, ABC company makes an irrevocable election to terminate the plan and cease participant deferrals. ABC company has until December 1, 2021, to distribute balances. If ABC Company has any other nonqualified plans that would be similar and aggregated, those plans must be terminated, as well.

Terminating a nonqualified plan upon the discretion of the plan sponsor

Nonqualified deferred compensation plans are ordinarily subject to stringent limitations that preclude most accelerations of promised benefits. However, if certain requirements are met, a company can terminate and liquidate their plan, even though it results in an acceleration of benefits to participants. To accelerate benefits, these rules need to be followed.¹⁰

- The termination and liquidation of the plan must not be proximate to a downturn in the financial health of the company.
- Plan aggregation rules require that a company terminate and liquidate all plans of the same type, including all plans sponsored by the company (even if the various plans have different participant groups) and all other plans of companies within the controlled group of companies.¹¹
- No payments to participants can be made within the first 12-months after all steps necessary to irrevocably terminate and liquidate the plan, other than payments that would have otherwise been made had the termination and liquidation not occurred.
- All payments must be made within 24-months after all steps necessary to irrevocably terminate and liquidate the plan are completed.
- The company does not adopt a new plan of the same type until at least three years after all steps necessary to irrevocably terminate and liquidate the plan have occurred (plan termination).
- The plan must be amended to cease employee deferral elections (upon plan termination) and once all steps necessary to irrevocably terminate and liquidate the plan have occurred, including providing for payments of benefits under the plan.¹²

Example ABC Company sponsors one deferred comp plan. The plan is no longer meeting their needs and they wish to terminate and liquidate the plan. ABC Company is in strong financial health. On July 1, 2020, ABC's board executes a resolution taking all steps to irrevocably terminate and liquidate the plan. The board resolution provides the balances under the plan will be distributed to participants on August 1, 2021, which is more than 12 months and less than 24 months after the termination. On July 1, 2020, all deferral elections under the plan are suspended. On February 1, 2021, a participant separates from service. The participant will receive a distribution based on the qualifying distribution event per plan terms.

From the date of the termination to the date of the distribution, participants still have market gains or losses on their account based on their investment selections. On August 1, 2021, all participants receive the full value of their account in a lump sum. The company may not sponsor another similar plan, as defined by IRC 409A, until at least July 1, 2023.

If ABC Company is part of a controlled group of companies all plans within the controlled group would need to be terminated. **We recommend plan sponsors review their specific scenario with legal counsel prior to taking any steps to terminate their plan.**

Terminating a nonqualified plan upon corporate dissolution of the plan sponsor

A plan sponsor may terminate a nonqualified plan and distribute participant balances within 12 months of a corporate dissolution under Internal Revenue Section 331 or with approval of bankruptcy court. Taxation to the participant occurs in the year of distribution.

It's important to review your plan document and all relevant facts specific to your company (or companies) prior to termination with your legal and tax advisors, as your plan document may include additional requirements

“Freezing” or “Sunsetting” a plan

In addition to terminating the plan and liquidating balances, a plan may be amended to cease active participation without liquidating balances. However, any active participant deferral elections must run their course for the remainder of the deferral period and participants accounts may continue to reflect investment election and subsequent market fluctuations until the participant has a qualifying distribution event requiring payment. The plan sponsor has the option to allow active participation in the future, subject to IRC Sec. 409A deferral timing rules. See *Applied Knowledge* [Deferral Timing Rules Under Section 409A](#).

¹ See IRC Sec. 409A(a)(3); but see Treas. Reg. §1.409A-3(j)(4)(ix).

² See IRC Sec. 409A(a)(2), (3).

³ Treas. Reg. §1.409A-3(j)(4)(ix).

⁴ IRC Sec. 409A(a)(2)(A)(v).

⁵ Treas. Reg. §1.409A-3(i)(5).

⁶ Treas. Reg. §1.409A-3(j)(4)(ix)(B).

⁷ Most companies document the irrevocable termination in a Board or Corporate Resolution and an amendment to the plan to stop deferrals and accelerate payments.

⁸ Preamble to Section 409A Regulations, VIII (B).

⁹ Treas. Reg. §1.409A-3(j)(4)(ix)(C). If you have multiple nonqualified deferred compensation plans, they should be reviewed to determine if any are deemed to be similar in nature and therefore aggregated.

¹⁰ Treas. Reg. §1.409A-3(j)(4)(ix).

¹¹ Treas. Reg. §1.409A-3(j)(4)(ix)(C) and 1.409A-1(g). If you, or your control group of companies, have multiple nonqualified deferred compensation plans they should be reviewed to determine if any are deemed to be similar in nature and therefore aggregated.

¹² Preamble to Section 409A Regulations, VIII. (B).



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