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Impermissibly Linked 409A Plans – The “Gotcha” that Wasn’t Expected

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When Section 409A was added to the Internal Revenue Code by the American Jobs Creation Act of 2004, virtually all observers knew right away that the section would be troublesome and that the taxes imposed would be confiscatory. For companies that sponsor defined benefit SERPs, most thought that those SERPs would be the least of their 409A worries.

If we look at three of the key requirements imposed by 409A, SERP sponsors just didn’t see the same problems that they saw with their other deferred compensation programs.

1. Most SERPs already had formal plan documents.
2. Most participants (at least those who worked until some retirement date) began their benefit upon termination from the company.
3. It wouldn’t be a big deal to require participants to elect their form of distribution from the plan upfront. After all, if the SERP offered a lump sum, almost everyone took it. And if only “actuarial equivalent life annuities” were offered, 409A permits participants greater flexibility to change the form of payment anyway.

But, sponsors, attorneys, and non-attorney practitioners alike did not contemplate the treatment that the regulations and subsequent guidance would give to linked plans. Therein lies the “gotcha.”

Background and history

When Section 409A was added to the Code, it looked like the most troubling aspects for defined benefit SERPs would be that participants would need to make their distribution elections upon participation in the plan and that those elections could not be specified to default to those in the qualified plan. Section 409A(e) begins with “The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section ...” It wasn’t until the IRS and the Department of Treasury began providing guidance that we learned of linked plans.

Oversimplifying a bit, two or more plans are linked if the benefit in one plan is dependent upon the benefit in another plan. A simple example would be a typical excess plan in which the nonqualified plan and the qualified plan have the same formula except that the nonqualified plan ignores the limitations imposed by the pay cap and maximum benefit limitations (Section 415).

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This all seems simple enough, but as the regulatory (and other guidance) process progressed, practitioners experienced an increasing level of confusion, which peaked with the issuance of Notice 2010-6 earlier this year. Until then, we thought that the linked plans rules were pretty clear. Unfortunately, the IRS and Treasury seemed to have a different view of clarity. In fact, during the first week in May, the American Bar Association (ABA) sent a letter to the IRS expressing what it sees as major challenges with the current state of 409A, among them issues with linked plans.

What is the Problem?

In Notice 2010-6, the IRS gave plan sponsors (technically known as service recipients) a means to correct certain documentary failures in plans subject to 409A, often with reduced or completely eliminated tax consequences. In that notice, however, the means by which they addressed linked plans was troublesome. The primary concern is that the examples of failure to comply contained in Notice 2010-6 include some situations that practitioners believed to be compliant under the final regulations.

An example of a typical design that falls into this new gray area - namely, which is controlling the regulations issued first or the notice issued later - is one where the benefit under qualified Plan A offsets the gross benefit under nonqualified Plan B and where the amount of the offset could change depending on the benefit commencement date under Plan A. To flesh out this example:

Plan A general terms

- Benefit = 2% of final average earnings (not in excess of the compensation limit) per year of service payable at normal retirement age (65)
- Early retirement benefit = reduction of 3% per year for each year that the benefit commencement date (not before age 55) precedes age 65

Plan B general terms

- Benefit = 2.5% of final average earnings (W-2) per year of service payable at age 65, less the Plan A benefit payable at Plan A's benefit commencement date
- Early retirement benefit = reduction of 3% per year for each year that the benefit commencement date (not before age 55) precedes age 65
- Initial deferral election = single life annuity at date of termination

The issue that arises under Notice 2010-6 is that the amount of the Plan B benefit can vary based on the participant's behavior with respect to Plan A. For example, if he or she defers

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receipt of Plan A benefit, then his/her Plan A benefit will be larger, making the Plan B benefit smaller. Notice 2010-6 appears to imply that this is an impermissible linkage – despite the fact that the final regulations do not appear to imply any problem with this design.

If the language in Notice 2010-6 is controlling, it looks like the fix is to make the offset equal to the Plan A benefit in some specific form at some specific age (or date of termination, if earlier).

What should plan sponsors do?

As we noted earlier, the ABA has pointed out this and other issues to the IRS. We certainly hope that the ABA is successful.

If not, then we break this issue into two parts. First, we consider two linked nonqualified plans. Notice 2010-6 gives until the end of 2010 for service recipients to fix those documentary problems if they exist. Our advice in the short run is to wait and see.

Perhaps the IRS will fix the problem. Perhaps they will tell us that (virtually all) practitioners have taken the wrong reading of Notice 2010-6 and that these problems do not exist. In the worst case, though, the year has more than seven months remaining and the document fix, if needed, should not take long. If nothing has happened by the middle of the fall to resolve this issue, however, our advice is likely to change at that point to one of action rather than inaction.

The second issue occurs when a nonqualified plan is impermissibly linked with a qualified plan. In this case, Notice 2010-6 gives us no fix. Because of that, there are two potential courses of action: 1) amend the nonqualified plan to fix the potential problem or 2) wait and see.

For most, we would recommend using a wait and see approach for now. However, for those with payment dates coming soon, it is important that any decisions consider the potential effects of the guidance in Notice 2010-6. In either case, your Aon consultant can help.

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