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This alert is the last of four to be issued describing the new Internal Revenue Code Section 409A proposed regulations issued on October 4, 2005. This segment primarily focuses on the application of Code Section 409A to Section 457(f) plans, but also addresses separation pay and split-dollar life insurance.

Impact of Section 409A on Section 457(f) Plans

While Code Section 409A specifically does not apply to Code Section 457(b) plans, it does apply to Code Section 457(f) plans. Under these plans of tax-exempt and governmental employers, benefits are taxable to participants immediately on an unsecured promise to pay benefits at a future time, unless that benefit is subject to a substantial risk of forfeiture.

Pre-409A, participants in 457(f) plans could avoid current taxation by maintaining a substantial risk of forfeiture (within the meaning of Section 457(f)) beyond the date their benefits vested. This was often accomplished with a rolling risk of forfeiture—a common practice used to defer vesting until termination of employment, or a non-compete clause—commonly used to defer recognition of income following termination of employment. Neither of these techniques, however, constitutes a "substantial risk of forfeiture" under Section 409A (which may cast a shadow of doubt over the permissibility of these techniques for 457(f) purposes). Nor do these techniques comply with the time and form of distribution and anti-acceleration provisions of Section 409A. Accordingly, if a Section 457(f) plan sponsor would like to allow participants the ability to defer payment beyond the time benefits vest, for 409A purposes, it must permit participants the ability to make an election as to when the benefits will be distributed from the plan prior to the time a deferral is made and in accordance with the election and distribution rules of 409A.

The ability to make a subsequent election under the 409A regulations may spare rolling vesting from obsolescence. The proposed regulations provide that participants may change distribution elections to further delay a payment or change the form of a payment, so long as (1) the election is made at least 12 months before the time payment would be made, and (2) the original distribution date is deferred for at least 5 years from the date the payment would have been made. A 457(f) plan sponsor can apply this "12/5" rule to give 457(f) plan participants some flexibility to defer payment beyond the date of vesting by amending its plan to allow for a 5-year rolling vesting period which would require a participant's election to extend the distribution date. Practically speaking, however, 457(f) plan participants may not wish to risk a forfeiture for an additional 5-year period, and instead, elect to take their benefit into current income on their original vesting date.

Plans that allow its participants to roll or delay vesting under any circumstances should be carefully reviewed and amended to comply with the proposed regulations' much more expansive definition of substantial risk of forfeiture. Similarly, 457(f) plans that permit a non-compete should also be amended, as under 409A, a non-compete requirement will not be treated as a substantial risk of forfeiture.

Separation Pay Plans

Severance plans (referred to in the new regulations as "separation pay arrangements") are generally subject to 409A, which was one of the big surprises for practitioners, since Notice 2005-1 left many unanswered questions on this topic. A "separation pay arrangement" is any arrangement that provides for compensation where one of the conditions to receiving payment is a separation from service, whether the separation is on account of voluntary or involuntary reasons. Generally speaking, the right to separation pay is deferred compensation, although the proposed regulations provide limited exclusions from Section 409A for the following forms of payment:

• *Short-term deferrals*: generally a payment received no more than two and one-half months from the end of the year.

• *Payments on account of certain involuntary terminations or window programs*: programs offered for a limited time period to employees who terminate employment during a set period, including involuntary separation pay arrangements or window programs, under which (1) the aggregate payments do not exceed two times the annual compensation limit under Code Section 401(a)(17) ($220,000 for 2006) (or, if less, two times the employee's annual compensation for the preceding calendar year), and (2) all payments are made by no later than December 31 of the second calendar year following the year of separation.

• *Reimbursement pay*: certain reasonable reimbursements (if otherwise excludable from gross income and deductible by the company) that incurred and reimbursed before December 31 of the second calendar year following the year of termination.

• *De minimis payments*: payments, including benefits, upon termination of employment not exceeding $5,000.

• *Collectively bargained programs*: payments upon an actual involuntary separation if contained within a collective bargaining agreement and subject to an arms-length negotiation between employee representative and an employer or employers.

Split Dollar Life Insurance

The Treasury and the IRS have left open the possibility that certain types of split dollar life insurance arrangements may be subject to 409A, such as certain types of "endorsement" plans that transfer interests in the life insurance to the service provider's beneficiary or beneficiaries. While the new regulations do not expressly address the application to split-dollar life insurance, further guidance is expected. The Treasury and the IRS have requested comments for arrangements grandfathered under the split dollar regulations.

If you have any questions about how these rules may affect your plan's design or operation, contact any of the attorneys in Holland & Hart's Benefits Law Group.
