Pension Protection Act of 2006 Includes Changes Affecting Nonqualified Deferred Compensation Plans

Two provisions of the Pension Protection Act of 2006 (PPA) directly affect nonqualified deferred compensation plans that are subject to Internal Revenue Code (Code) section 409A. One provision expands participants’ ability to take distributions from these plans. The other provision limits plan sponsors’ ability to make contributions to these plans in certain situations.

Expanded Availability of Hardship and Unforeseeable Emergency Distributions

PPA expands the availability of unforeseeable emergency distributions from accounts attributable to deferrals made to plans subject to section 409A. The new law directs the IRS to issue regulations allowing distributions to be made if a participant’s beneficiary incurs an event that would qualify as an unforeseeable emergency if it occurred with respect to the participant’s spouse or dependent. While this provision is effective August 17, 2006, it will be difficult to put it into practice until the IRS issues guidance. Sponsors of plans that currently permit unforeseeable emergency distributions are not required to adopt this new provision, but may do so if they desire.

Restrictions on Nonqualified Plan Funding during Defined Benefit Plan Restricted Period

Under PPA, if an employer sets aside assets after August 17, 2006, to pay nonqualified deferred compensation to “applicable covered employees” during its defined benefit plan’s “restricted period,” those assets will be immediately taxable to those employees and will be subject to a 20% penalty tax. For each year that the defined benefit plan funding restriction applies and those assets remain set aside, any increase in the value of the assets will also be taxable to the employees and subject to a penalty tax. In addition, if the employer grosses-up an employee’s compensation (directly or indirectly) to pay the penalty taxes, the gross-up amount must be taken into account for purposes of determining the amount taxable to the individual under Code section 409A.

For purposes of these rules, “covered employees” include:

- A corporation’s chief executive officer (CEO), as of the close of the tax year;
- The four highest compensated officers for the tax year, other than the CEO; and
- Individuals subject to section 16(a) of the Securities and Exchange Act of 1934.

A single employer defined benefit plan’s “restricted period” is:

- Any period that the plan sponsor is in bankruptcy;
- The 12-month period beginning six months before the plan’s distress or involuntary termination date; or
- For plan years beginning on or after January 1, 2008, any period in which the plan is in “at risk” status.

These rules do not apply to assets set aside before a restricted period.

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