TAX TIP:

NONQUALIFIED DEFERRED COMPENSATION RED FLAGS

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THE INTERNAL REVENUE CODE (THE Code) includes various provisions governing employee benefits and compensation arrangements. One such provision is Code Section 409A, which applies to nonqualified deferred compensation. Nonqualified deferred compensation is defined as "any [arrangement] that provides for the deferral of compensation. . . ."[1] An arrangement provides for the deferral of compensation if a service provider (e.g., an employee) obtains a legally binding right to compensation in one taxable year that is, or may be, payable in a later taxable year.[2] The application of Section 409A is intended to be sweeping in nature and, as a result, it has broad application. The hallmark of Section 409A is the rigidity of the application of its rules and the draconian penalties thereunder. Therefore, practitioners should be aware of the primary rules that come into play when an employer desires to modify compensation or bonus structures that are subject to Section 409A, such as the prohibition on the acceleration of payments, the prohibition on substitutions, and the subsequent deferral rules.

Section 409A generally prohibits the acceleration of any payment that is to be paid pursuant to the terms of a nonqualified deferred compensation plan, whether or not such acceleration is contemplated under the terms of any such plan.[3] In other words, once a plan or arrangement that is subject to Section 409A includes provisions for the timing of payments thereunder, the timing or structure of those payments generally cannot be accelerated. A common issue that arises under the anti-acceleration rules is a drafting error in which the plan or arrangement that is subject to Section 409A specifically includes that the sponsoring company may unilaterally accelerate payments. The inclusion of this provision would constitute a documentation error under Section 409A. If such a provision is acted upon, then it would also be considered an operational failure. Both of which would be subject to potential penalties and would need to be corrected pursuant to the correction procedures under Section 409A. As an example, assume a company sponsors an annual bonus plan for employees. At the conclusion of each calendar year, the bonus an employee may earn will be paid in three annual installments. However, the plan at issue also includes a provision that permits the company, in its discretion, to pay the total annual bonus earned in a lump sum. Such a provision would violate Section 409A. The same concept applies even if the plan or arrangement at issue does not contain acceleration language, but the employer pays out the total annual bonus in a lump sum in its discretion. Section 409A prohibits the acceleration of payments as a general matter.

A related concept to the prohibition on the acceleration of payments is the anti-substitution rule. The anti-substitution rule provides that the payment of an amount as a substitute for the deferred compensation will be treated as a payment of the original deferred compensation.[4] However, the regulations go on to clarify that a forfeiture or voluntary relinquishment of deferred compensation will not be treated as a payment of the original deferred compensation, provided, however, that there is no forfeiture or voluntary relinquishment if an amount is paid, or a legally binding right to a payment is created, that acts as a substitute for the forfeited or voluntarily relinquished amount. A frequent example of this issue arises when an employer and employee have a nonqualified deferred compensation arrangement in place that will pay an employee cash upon a specified date or upon the occurrence of an event (such as retirement, termination of employment, or upon achieving certain performance targets). After the occurrence of such triggering event, the employer wishes to substitute the existing deferred compensation arrangement and any payments thereunder for a different compensation arrangement or a grant of equity in lieu of paying such original deferred compensation. Effectuating such a transaction would violate the substitution rules under Section 409A. As a result, practitioners should be aware of this issue when an employer or an employee wishes to substitute certain compensatory payments that would constitute nonqualified deferred compensation in exchange for a different form of payment (such as equity or another compensatory payment that deviates from the original nonqualified deferred compensation plan).

A final issue that frequently arises under arrangements that are subject to Section 409A is the subsequent deferral of nonqualified deferred compensation. The subsequent deferral rules apply to nonqualified deferred compensation in the event there are subsequent changes to the time and form of a payment of nonqualified deferred compensation. Although a subsequent deferral of nonqualified deferred compensation is not prohibited under Section 409A, the subsequent deferral rules provide that a subsequent change or delay in a payment or a change in the form of a payment is permissible, but only if certain conditions are satisfied.[5] In order for a subsequent deferral of nonqualified deferred compensation to be valid, the following conditions must be satisfied: (i) the subsequent deferral election may not take effect until at least 12 months after the date on which the election is made; (ii) generally, the payment with respect to which such election is made must be deferred for a period of at least five years from the date such payment would otherwise have been paid; and (iii) generally, the subsequent deferral election must be made at least 12 months before the date the payment is scheduled to be paid.[6] For example, assume an employer and an employee have a deferred compensation agreement in place to pay the employee a certain amount of deferred compensation each year over a period of 10 years upon such employee's retirement. The employee's targeted retirement date is Dec. 31, 2024. The annual installment payments will be made on each annual anniversary of the employee's retirement with the first installment scheduled to be paid on Dec. 31, 2025. The employee desires to subsequently defer the payments so they commence at a later date. In order for the employee to validly make a subsequent deferral election, the election must be made on or before Dec. 31, 2024, and the deferred compensation payments cannot commence earlier than Dec. 31, 2030. As a practical matter, it is beneficial to discuss the subsequent deferral rules with clients at the outset of establishing a deferred compensation arrangement because the rigidity of the rules render subsequent deferrals impractical at times. Similar to the prior issues discussed, a violation of the subsequent deferral rules will result in a violation of Section 409A.

In light of the foregoing, it should be noted that the penalties under Section 409A are substantial. To the extent a violation of Section 409A occurs, the amount of deferred compensation that is originally deferred is deemed to be included in the service provider's (e.g., the employee's) gross income. Additionally, such amount included in a service provider's gross income is subject to a 20% excise tax (in addition to a specified interest rate penalty). So, the service provider (or the employee or contractor) is subject to liability in the event of a violation of Section 409A. Finally, additional reporting requirements are imposed in the event of violations. Although penalties are harsh under Section 409A, correction procedures are available under which taxpayers can avail themselves in the event documentation or operational errors do arise under Section 409A.

Deferred compensation can be used as a great tool to attract, retain, and reward employees and contractors. Professional service providers should be aware of the benefits of deferred compensation as well as the red flags to appropriately advise clients. The rules and regulations contained within Section 409A that govern nonqualified deferred compensation are complex, but non-qualified deferred compensation is becoming an increasingly popular benefit to provide to a company's workforce. ◀

The professionals at Koley Jessen are equipped to advise on the structure, implementation, and operation of deferred compensation arrangements to achieve the client's goals. Peter Langdon is an attorney in Koley Jessen's Employment and Benefits Department. With extensive experience advising clients on employee benefits, executive compensation, nonqualified deferred compensation, and general employment law matters, he is well equipped to navigate the complex landscape of employee benefits. For further inquiries, contact Langdon at peter.langdon@koleyjessen.com.

ENDNOTES

1 *I.R.C. § 409A(d)(1).*
2 *Treas. Reg. § 1.409A-1(b)(1).*
3 *Treas. Reg. § 1.409A-3(j)(1).*
4 *Treas. Reg. § 1.409A-3(f).*
5 *Treas. Reg. § 1.409A-2(b)(1).*
6 *Treas. Reg. § 1.409A-2(b)(1)(i)-(iii).*

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