



A TRAP FOR THE UNWARY—A WHOLE

Non qualified deferred compensation plans offer flexibility and tax savings for employer and employee—but they also pose the possibility of income acceleration and stiff penalties and interest.

NEW MEANING: THE PERILS OF SECTION 409A

JONATHAN CHAPMAN, CPA

Non qualified deferred compensation (“NQDC”) plans are fairly common. Typically, the employer and employee enter into an agreement where the payment of compensation for services to be performed will be deferred to some point in the future. There is considerable flexibility with NQDC plans (tailoring the plan to specific employees, amounts funded, vesting, etc.) as compared with their qualified plan cousins such as pension and profit sharing plans, 401K plans and various equity-based plans including ESOPs, stock bonus and incentive stock option plans that must comply with certain statutory and regulatory restrictions.

Unlike qualified plans, the employer’s deduction in the case of a NQDC plan is timed to coincide with the employee’s inclusion in taxable income. So, for example, an employee with deferred compensation of \$100,000 would incur, in a properly structured NQDC plan, federal income tax of \$30,000 upon distribution, assuming a 30%

federal tax rate, and the employer would deduct \$100,000. But wait, as they say in the commercials, “there’s more!!” In addition to the \$30,000 federal income tax, the employee could be faced with a \$20,000 penalty. But wait . . . we’re not finished. The employee could also be faced with an interest charge on tax deficiency (at rates that I defy anyone to achieve on his own).

Welcome to the new world of Internal Revenue Code Section 409A, a creature of the American Jobs Creation Act of 2004. This article will discuss 409A’s requirements and its rather harsh economic penalties for failing to comply with them. In addition, we will explore the broad scope of 409A and how it may apply to situations that would normally not be considered deferred compensation. Finally, we will look at some of the exceptions to 409A and some very important transition rules concerning grandfathered deferred compensation.

Of some urgency, certain actions must take place in 2005 in order to avoid these

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penalties, including a review of every possible arrangement, written or otherwise, that could even remotely be viewed as a deferred compensation plan.

Definition and exclusions

Section 409A broadly defines a NQDC plan as any plan that provides for the deferral of compensation, excluding qualified employer plans such as qualified pension, profit sharing and stock bonus plans, and certain vacation leave, sick leave, compensatory time, disability pay or death benefit plans.¹ Compensation is deferred under the plan if the service provider (i.e., an employee or independent contractor) has a legally binding right to compensation that has not been actually or constructively received during the year and the payment of such compensation is deferred to a later year.²

The scope of this definition is considerably broad and would encompass verbal as well as written agreements. What would normally not be considered deferred compensation may well be caught up in these rules. Consider, for example, a fairly common executive perk, a personal financial planning allowance, where an unused portion may be carried over to a subsequent year. The carryover element would, on a literal basis, constitute compensation (i.e., the personal financial allowance) that is deferred (the carryover of the unused amount), assuming that the executive is vested at the end of the year. Think of the surprise on the executive's face when he finds that he is subject to a 20% penalty on the unused portion. This would not make for a pleasant conversation between the executive and his employer's H.R. department.

Failure to Comply with 409A requirements

As pointed out in the above example, 409A imposes a significant penalty and interest as well as acceleration of tax for failing to comply with all of its requirements. There are specific consequences for failure to comply with the 409A requirements.

Income Acceleration. All compensation deferred under the plan for the

taxable year and all preceding taxable years is included in gross income to the extent not subject to a substantial risk of forfeiture³ and not previously included in gross income.⁴ For example, assume that Mary, an XYZ employee, elects in 2004 to defer \$50,000 compensation earned in 2005 until her son begins college. Further assume that Mary has earned such compensation and it is not otherwise subject to a substantial risk of forfeiture as of the end of 2005. Finally, assume that her son begins college in 2009 and, in accordance with the plan, the deferred compensation is distributed to her in 2009. As will be discussed shortly, the agreed upon timing of the distribution fails one of the requirements of 409A. Therefore, Mary was required to include the \$50,000 in her 2005 tax return, not in 2009 when she receives the compensation.

Interest. Interest is charged at the underpayment rate plus 1% on the underpayment of tax that would have occurred had the deferred compensation been includible in gross income for the taxable year in which first deferred or, if later, the first taxable year in which such deferred compensation is not subject to substantial risk of forfeiture.⁵ In Mary's case, both the deferral and vesting (i.e., no substantial risk of forfeiture) occur at the end of 2005, as mentioned above. Therefore, because the plan failed to satisfy all of the requirements of 409A, Mary should have included \$50,000 in her 2005 tax return. Assuming a 35% tax bracket, Mary has an underpayment of tax totaling \$17,500 as of April 15, 2006. She will incur interest from April 15, 2006 to the date such tax is ultimately paid.

Penalties. A 20% penalty is charged on the compensation required to be included in taxable income.⁶ In Mary's case, she would be subject to a \$10,000 penalty for 2009. Not a great day for Mary. However, all of this unpleasantness could have been avoided if, instead of the distribution's being tied to her son's beginning college, the distribution were tied to a specific date (say, September 1, 2009). This, I believe, is a clear illustration of the trap for the unwary. A simple change to the

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ADDITIONAL PROPOSED IRS AND TREASURY REGULATIONS: ADDENDUM-OCTOBER 5, 2005

Subsequent to the writing of this article, the IRS and Treasury issued proposed regulations providing further guidance on the application of 409A to nonqualified deferred compensation plans. This addendum modifies this article to take into account certain provisions under these regulations.

Corrective action relief; deadline extended

Relief is provided as to the date by which corrective actions must be taken to bring a plan into compliance with 409A. Notice 2005-1 imposed a December 31, 2005, deadline to amend a plan to bring it into compliance. The proposed regulation extends this deadline to December 31, 2006. The regulations also extend to December 31, 2006 the date through which the plan must be operated in good faith compliance with 409A and Notice 2005-1.

Short-term exclusion rules

There was some question as to whether a written plan was required in order to exclude benefits paid within 2¹/₂ months after the end of the year of service. The government dropped the written plan requirement for short-term deferrals. However, it is strongly recommended that taxpayers adopt a written plan in case such short-term deferrals are not paid within the 2¹/₂ months after earned but are paid within the same calendar year. A payment made within the same calendar year as the designated date is treated as paid on the designated date. The written plan would allow for the position that a date has been designated.

Stock appreciation rights

Notice 2005-1 imposed considerable complexity in the case of stock appreciation rights, creating different rules for public and private companies. The regulations simplified these rules, treating stock appreciation rights similar to stock options, regardless of whether the stock appreciation right is settled in cash and regardless of whether the stock appreciation right is based on service recipient stock that is not readily tradable on an established securities market.

Severance

Severance, referred to as "Separation Pay Arrangements" in the regulations, is excluded from the 409A rules in the case where separation pay is paid under an arrangement that is a collectively bargained separation pay arrangement that provides for separation pay upon an actual involuntary separation from service. In addition, the regulations exclude separation pay due to involuntary separation that is not paid under a collectively bargained arrangement where the separation pay does not exceed, in general, two times the lesser of the service provider's annual compensation for the year prior to the year of involuntary separation or the maximum amount of compensation that may be taken into account for certain retirement plan contribution limitations, currently \$210,000.

In addition to involuntary separation arrangements, the regulations also exclude separation pay that is paid under what is referred to as "Window Programs." The term "Window Program" refers to a program established by the service recipient to provide for separation pay in connection with a separation from service, for a limited period of time, no greater than one year, to service providers who separate from service during that period.

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Section 409A requirements

As illustrated, the consequences for failing to satisfy the 409A requirements are severe. Needless to say, it is critical that both the employer and employee understand these requirements and ensure that their NQDC plan is in compliance.

Under Section 409A, NQDC plans are subject to certain restrictions concerning the timing of distributions from the plan and the timing of elections to defer compensation, and are prohibited from any acceleration of distributions. These requirements must be both part of the plan and adhered to operationally. In other words, it is not sufficient for the plan to provide for the particular requirement; the plan must also be operated in accordance with the requirement.⁷

A failure to satisfy any of these requirements, either contractually or operationally, will trigger the above penalties, interest and income acceleration. These sanctions are applied on an employee-by-employee basis.⁸ To make matters worse, these consequences are imposed at the employee⁹ level even if the violation is caused by the employer. For this reason, the employee should be especially diligent in providing that the plan be reviewed by a competent professional and insuring that it is in compliance with 409A or amended, as appropriate. In fact, it has been suggested that the more diligent employee may well insist that the plan provide that the employer reimburse the employee for any penalties resulting from a violation of 409A.

There are certain grandfathering provisions such that amounts deferred and vested¹⁰ before 2005 and related earnings are not subject to these rules. As a cautionary note, if the NQDC plan that includes compensation that has been grandfathered is “materially modified” after October 3, 2004, grandfathering will be lost. In other words, a modification to the plan can expose substantial amounts of deferred compensation accumulated as of December 31, 2004, to 409A and related penalties and interest. And, to make matters worse, the employee may not even know about it until he is audited by the IRS and by then it will

be too late. This will likely create a very expensive time bomb for some unsuspecting retired employees. (We will review guidance provided by the IRS as to what constitutes a material modification.)

Specific 409A requirements

With all of this discussion as a backdrop, let’s take a look at some of the specifics of 409A.

Requirement Number 1—Distributions. Under Section 409A, distributions of previously deferred compensation from NQDC plans may not be made any earlier than (1) the employee’s separation from service, (2) disability, (3) death, (4) a specified time or pursuant to a fixed schedule, (5) a change in the ownership or effective control of the corporation or in the ownership of a substantial portion of the corporation’s assets, or (6) the occurrence of an unforeseeable emergency.¹¹ It should be noted that a “specified time” does not include a specified “event” such as an employee’s child beginning college, while it does include, for example, a distribution upon the employee’s attaining age 65.¹² (Recall that this was the problem with Mary’s plan.)

Disability is defined, in general, as the inability to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of at least 12 months.¹³

In the case of an unforeseen emergency attributable to an accident or illness of the employee, the employee’s spouse or the employee’s dependent, a distribution may be made for the financial consequences incurred by the employee. Financial hardship is determined by taking into account reimbursements, compensation by insurance or by a limited liquidation of the employee’s assets.¹⁴ In addition, distributions to pay taxes reasonably anticipated as a result of the distribution are permitted.

A common provision in many NQDC plans is an acceleration clause. An acceleration clause allows the employee to accelerate a distribution from the plan subject to a monetary penalty imposed on the employee. Under the doctrine of constructive receipt, the employee is subject to tax on

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deferred compensation if such compensation is available to the employee at any time.¹⁵ Although the acceleration clause, by itself, would render the compensation available and, therefore, immediately taxable to the employee, the monetary penalty (sometimes referred to as a “haircut”) provision is generally relied upon as a substantial limitation or restriction such that the compensation is not available to the employee and, therefore, the employee is not in constructive receipt.¹⁶ The acceleration clause brings us to the second requirement.

Requirement Number 2—Acceleration of Benefits. As a general rule, a NQDC plan may not permit acceleration of the time or schedule of any payment under the plan, except as provided by regulations issued by the Secretary. As of the date of this writing, no regulations have been issued. However, IRS Notice 2005-1 does allow for an accelerated distribution of deferred compensation under certain circumstances. Specifically, a distribution may be accelerated if such distribution is:

1. to someone other than the plan participant under a domestic relations order (kind of a good news/bad news situation);
2. in the case of a conflict of interest, compliance with a certificate of divestiture;
3. in the case of a section 457(f) plan (i.e., a certain NQDC plan provided by governmental and tax exempt organizations), an amount sufficient to pay income taxes upon the employee’s vesting;
4. in an amount not greater than \$10,000 where the payment accompanies the termination of the entirety of the employee’s interest in the plan, the payment is made on or before the later of (a) December 31 of the calendar year in which occurs the employee’s separation from service or (b) the date 2 1/2 months after the participant’s separation from service, and
5. in an amount necessary to pay the FICA tax on compensation deferred and related income tax on the distribution to pay the FICA tax.¹⁷

Requirement Number 3—Deferral Elections. In general, an election to defer compensation (including bonuses) for ser-

vices rendered must be made by the close of the taxable year prior to the year in which the related services are rendered.¹⁸ For example, a deferral election for compensation earned in 2006 must be made by December 31, 2005. An exception is provided in the case of an employee’s first year of eligibility to participate in the plan, such that the employee may make an election to defer compensation for services to be performed subsequent to the election within 30 days after the employee becomes eligible to participate.¹⁹ In the above example, an employee who first becomes eligible to participate in the plan on July 1, 2006, has until July 31, 2006, to make the election to defer compensation for services to be performed subsequent to the election.

In the case of “performance-based” compensation where compensation is based on services performed over a period of at least 12 months, the election may be made no later than 6 months before the end of the period.²⁰ Again, in the above example, if 2006 compensation is based on the employee’s performance, such as achieving certain production goals, the employee has until June 30, 2006, to make the election.

Performance-based compensation is with reference to satisfaction of organization or individual performance criteria and the performance criteria are not substantially certain to be met at the time a deferral election is permitted. Performance criteria must relate to the performance of the participant service provider, a group of service providers that includes the participant service provider, or a business unit (this may include the entire organization) for which the participant service provider provides services.²¹

Instead of accelerating distributions, an employee may, for a variety of reasons, wish to defer an upcoming distribution from a NQDC plan. Section 409A allows for this, subject to certain limitations. Specifically, an election is permitted to delay a payment under a NQDC plan if the election is made at least 12 months before the scheduled payment and, except in the case of payments for death, disability and unforeseen emergencies, such payment is deferred for at least 5 years after the scheduled payment date.²² For example, if the scheduled payment is January 1, 2007, an election to defer the payment must be made by Decem-

ber 31, 2005, and the deferred payment cannot be made any earlier than January 1, 2012.

So, once it is determined that an arrangement constitutes a NQDC plan, the above rules come into play. But, it must first be determined whether a specific arrangement constitutes a NQDC plan to begin with. If it doesn't, section 409A doesn't apply. The following are examples of certain arrangements that do not constitute NQDC.

Short-term deferrals

NQDC does not include compensation that is paid or constructively received by the employee by the later of the date that is 2 1/2 months after the end of the employee's first tax year or the employer's first tax year in which the amount is no longer subject to a substantial risk of forfeiture.²³ For example, in the case of a calendar year employer, compensation deferred and vested (i.e., not subject to a substantial risk of forfeiture) as of December 31, 2005, and paid to the employee by March 15, 2006, does not constitute NQDC. In the case of an employer with a fiscal year ending June 30, 2006, compensation deferred and vested as of December 31, 2005, and paid to the employee by September 15, 2006, does not constitute NQDC. Note that with a fiscal year employer, the 2 1/2 month rule allows for a further tax deferral to the employee without the plan becoming subject to 409A.

Nonqualified stock option plans

A discounted nonqualified stock option plan where the exercise price is less than the underlying stock's fair market value at the date the stock option is granted is subject to section 409A.²⁴ Given that, in most nonqualified stock option plans, the employee is given discretion as to when to exercise the option, such plans will not satisfy the distribution timing requirements and will be in violation of 409A. However, an "at-the-money" stock option where the exercise price may never be less than the stock's fair market value at the grant date is generally not treated

as NQDC and, therefore, not subject to 409A.²⁵

Stock appreciation rights

Things become a bit more complicated in the case of stock appreciation rights or "SARS." The rules are different for public and private companies in determining whether the SAR is subject to 409A.

In the case of a publicly traded company, SARs do not constitute NQDC and, therefore, are not subject to 409A if the following requirements are met:

1. the SAR's exercise price may never be less than the underlying stock's fair market value on the grant date;
2. the employer's stock that is subject to the SAR is traded on an established securities market;
3. upon exercise, the SAR must be settled by delivery of this traded stock;
4. the SAR does not include any deferral feature, other than the deferral of income recognition until the exercise of the right.

In the case of a non-publicly traded company, the SAR must have been granted on or before October 3, 2004 and, as above:

- the SAR's exercise price may never be less than the underlying stock's fair market value on the grant date;
- the SAR does not include any deferral feature, other than the deferral of income recognition until the exercise of the right.

Stated another way, non-publicly traded company SARs granted after October 3, 2004, are automatically subject to 409A.²⁶

Severance

Care must be taken in reviewing the specific terms of any severance agreement. The typical severance agreement where the severance is triggered upon an employee's involuntary termination and is paid in a lump sum or within the 2 1/2 month period discussed earlier should not be subject to 409A. However, the severance agreement should provide for a definite payment date or schedule in cases where severance for involuntary termination is not paid in a lump

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sum or within the 2 1/2 month period. Otherwise, the unsuspecting terminated employee could have another shock by way of interest and the 20% penalty upon examination.

Care must be especially taken in the case of a severance agreement that provides severance to an employee who voluntarily leaves. Such a plan may create a legally binding and vested right to the employee and, with no specific payment date, could expose the employee to the 409A penalty and interest.

Effective dates

Section 409A is effective for compensation deferred after 2004.²⁷ Amounts deferred as of December 31, 2004, and earnings related to such amounts, where the employee has a legally binding right to such compensation and is vested (i.e., the amount deferred is not subject to a substantial risk of forfeiture) are not subject to 409A.²⁸ As discussed earlier, care must be taken in modifying plans that include such grandfathered deferred compensation. A “material modification” of a plan after October 3, 2004, will result in amounts otherwise grandfathered as of December 31, 2004, to become subject to 409A.²⁹ This could be catastrophic for affected employees.

For example, assume that an employee who has accrued and vested deferred compensation of \$200,000 as of December 31, 2004, under a plan that permits accelerated distributions, receives his deferred compensation in 2006. Because of grandfathering, he is not subject to the 20% penalty and interest upon receipt, even though the plan itself is not in compliance with 409A because of the acceleration clause. Now assume that, unbeknownst to the employee, the employer amends the plan in such a way that a material modification has occurred. Now the employee is subject to a \$40,000 penalty plus interest, causing a rather unpleasant conversation between the employer and employee.

Material modification

Needless to say, understanding what constitutes a “material modification” is extremely important. Although the IRS has

provided guidance in this area, the rules are tricky and can easily trip up a taxpayer who, in good faith (by the way, there is no relief for acting in good faith), attempts to amend the plan.

In general, IRS Notice 2005-1 provides that a material modification occurs where a benefit or right existing as of October 3, 2004, is enhanced or a new benefit or right is added. This is the case even where the employer exercises discretion under the terms of the plan. However, a material modification does not include an employer’s exercise of discretion over the time and manner of payment of a benefit to the extent that such discretion is provided under the terms of the plan as of October 3, 2004. In addition, an amendment to the plan to bring it into compliance with the provisions of 409A will not be treated as a material modification unless the amendment enhances an existing benefit or right or adds a new benefit or right, in which case, a material modification will have occurred. This is so even where the benefit or right is permitted under 409A. For example, adding a distribution event for disability, permitted under 409A, would constitute a material modification.³⁰

Confused yet? Given the material downside in making a mistake here, it has been suggested that it may be a good idea to avoid amending plans with grandfathered deferred compensation and, instead, adopting a new plan and freezing the existing one.

Corrective actions

A corrective period is allowed to bring a plan into compliance with 409A in the case of a plan adopted before December 31, 2005. This relief is provided where the plan is operated in good faith compliance with 409A and IRS Notice 2005-1 during 2005 and is amended on or before December 31, 2005, to conform to the provisions of 409A. In addition, the plan may be amended to provide for new payment elections with respect to amounts deferred prior to the election provided that the plan is so amended and the employee makes the election on or before December 31, 2005.³¹

A plan adopted before December 31, 2005, may be amended to allow a partici-

pant to terminate participation in the plan or cancel a deferral election provided that the amendment is made on or before December 31, 2005, and the amounts subject to termination or cancellation are includible in income of the employee in the calendar year 2005 or, if later, in the taxable year such amounts are earned and vested.³²

Conclusion

As I mentioned at the outset, the severity of the penalties for violating 409A are such that it is imperative that all plans that even remotely may be viewed as NQDC plans should be reviewed. In many cases, existing plans are not in compliance with these rules and the unexpected trap for the unwary waits to be sprung. ■

NOTES

¹ IRC Section 409A(d)(1).

² IRS Notice 2005-1, Q&A 4.

³ A substantial risk of forfeiture exists where the person's rights to the deferred compensation are conditioned upon future performance of substantial services by any person or the occurrence of a condition related to a purpose of the compensation. IRS Notice 2005-1, Q&A 10.

⁴ IRC Section 409A(a)(1)(A).

⁵ IRC Section 409A(a)(1)(B).

⁶ Id.

⁷ IRC Section 409A(a)(1)(A).

⁸ The punitive consequences are applied to the particular employee whose compensation has been deferred rather than all employees under the plan. IRC Section 409A(a)(1)(A)(iii).

⁹ IRC Section 409A more accurately refers to "participants" rather than "employees" in that these rules apply to non employees such as independent contractors as well as employees. For ease of discussion, I have chosen the term "employee" but it should be noted that the term is meant to include all participants in the plan.

¹⁰ Vesting occurs when the deferred compensation is no longer subject to a substantial risk of forfeiture.

¹¹ IRC Section 409A(a)(2).

¹² See H.R. Conf. Rep. No. 108-755.

¹³ IRC Section 409A(a)(2)(C).

¹⁴ IRC Section 409A(2)(B)(ii). The liquidation of an employee's assets is limited to the extent the liquidation itself would not cause a severe financial hardship.

¹⁵ Treas. Reg. Sec. 1.451-2(a) provides, in part, that income not actually in the taxpayer's possession is constructively received by the taxpayer in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time or he could have drawn upon it during the taxable year if notice of intention to withdraw had been given.

¹⁶ Id. The regulation provides an exception to constructive receipt where a taxpayer's control of its receipt is subject to substantial limitations or restrictions. An example in the regulations illustrating this exception to constructive receipt is where a depositor must forfeit 3 months of interest upon withdrawal or redemption before maturity of certain one year or less certificates of deposits and similar deposits. This provision has been relied upon in viewing the haircut for accelerated distributions as providing an exception to constructive receipt.

¹⁷ IRS Notice 2005-1, Q&A 15.

¹⁸ IRC Section 409A(a)(4)(B)(i).

¹⁹ IRC Section 409A(a)(4)(B)(iii).

²⁰ IRC Section 409A(a)(4)(B)(iii).

²¹ IRS Notice 2005-1, Q&A 22.

²² IRC Section 409A(a)(4)(C).

²³ IRS Notice 2005-1, Q&A 4(c). A substantial risk of forfeiture exists where entitlement to the amount is conditioned on the performance of substantial services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial.

²⁴ Although discounted stock options are not explicitly treated as NQDC plans under the statute, the Conference Report as well as Notice 2005-1, Q&A 4(d)(ii) strongly imply that they are.

²⁵ Id.

²⁶ IRS Notice 2005-1, Q&A 4.

²⁷ P.L. 108-357, Section 855(a).

²⁸ IRS Notice 2005-1, Q&A 16(b).

²⁹ IRS Notice 2005-1, Q&A 16(a) and P.L. 108-357, Section 855(d)(2)(B).

³⁰ IRS Notice 2005-1, Q&A 18.

³¹ IRS Notice 2005-1, Q&A 19.

³² IRS Notice 2005-1, Q&A 20.