Taxation of Deferred Compensation under IRC Section 409A

The Basics

What is the rule?

Section 409A of the Internal Revenue Code establishes a complex regime for taxation and regulation of nonqualified deferred compensation.

Who does it apply to?

The reach of Section 409A is extensive, as it applies to employees, directors and third-party service providers of private and public companies, as well as certain tax-exempt entities. The reach of Section 409A is further extended through its broad definition of “nonqualified deferred compensation.” Under this definition, many garden variety compensation arrangements have the potential to give rise to nonqualified deferred compensation, including:

- 401(k) restoration plans;
- Change-in-control severance arrangements;
- Excess pension plans;
- Executive expense reimbursement programs (when reimbursement is taxable);
- Executive employment contracts;
- General severance arrangements;
- Short-term and long-term incentive plans;
- Supplemental executive retirement plans;
- Time-vested restricted stock unit plans; and
- Voluntary deferral plans.

What is the impact of noncompliance with Section 409A?

The penalties for noncompliance with 409A are severe. Upon vesting, compensation deferred under a noncompliant plan or arrangement will become subject to regular federal income tax, a 20% excise tax and penalty interest accruing from the date of vesting. All these taxes and interest are payable by the recipient of the deferred compensation, not the employer.

What are the basic rules of Section 409A?

Generally, Section 409A requires nonqualified deferred compensation arrangements to satisfy the following rules:

- **Timing of distributions under a nonqualified deferred compensation arrangement**. Benefits under a nonqualified deferred compensation plan must be paid at a specified time or under a fixed schedule established before or at the time the compensation was deferred, or upon the occurrence of one or more of the following five permissible payment events:

  — Death;
  — Disability;
  — Separation from service;

— The occurrence of an unforeseeable emergency; or
— A change in the ownership or effective control of the company, or the ownership of a substantial portion of the company's assets.

A plan may be structured to permit the payment of deferred compensation to occur upon the earlier of two or more of the following events.

- **Delayed distributions for "specified employees" due to termination of employment**. If benefits are payable upon an employee's termination of employment and the employee is a "key employee," then commencement of benefit payments must be delayed for six months following the employee's termination. Key employees are certain highly paid officers and employees who are 5% owners or 1% owners with annual compensation in excess of $170,000.

- **Initial election regarding deferral of compensation and form of payment**. If a plan permits an employee to elect to defer compensation, choose the form (e.g., lump sum, installments) in which deferred compensation will be paid or both, then generally the election must be made in the year preceding the year in which the compensation would otherwise be earned. The election must be irrevocable once the year begins. A number of exceptions are allowed regarding the timing of deferral elections. For example, (i) in an employee's first year of eligibility to defer compensation, the employee can elect to defer compensation within 30 days of becoming eligible and (ii) with respect to performance-based compensation relating to at least a 12-month performance period, an employee may elect to defer the performance-based compensation at any time before the date that is 6 months before the end of the performance period, provided that the amount of compensation that will be earned is not ascertainable on the date the election is made.

- **Subsequent election regarding deferral of compensation and form of payment**. If a plan permits an employee to change his initial election to defer compensation, the form or timing or both, then the plan must meet the following requirements:

  — The subsequent election to defer must be made at least 12 months before the date of the first scheduled payment.

  — The subsequent election to defer cannot take effect for 12 months.

  — The payment must be deferred for at least 5 years from the date such payment would otherwise have been made.

- **Prohibition on acceleration of payments**. Generally, neither an employee nor employer may cause nonqualified deferred compensation to be paid or distributed prior to the scheduled payment date, subject to a number of limited exceptions. These exceptions include accelerating payment due to a domestic relations order, the payment of employment tax, the payment of state, local and foreign withholding tax, the cash out of an employee's entire interest, provided that it does not exceed the limits under Section 402(b) (for 2016, the limit is $18,000 indexed for inflation) and payment upon termination or liquidation of a nonqualified deferred compensation arrangement.

What arrangements are exempt from 409A?

Certain compensation arrangements or vehicles are exempt from the requirements under Section 409A, including:

- Restricted stock.
- Stock options/stock appreciation rights granted at-the-money.
- Compensation payment that satisfies the "short-term deferral" rule (generally, a payment meets the short-term deferral rule if it is made within 2½ months after the end of the tax year in which the compensation was earned).
- Separation payments that are made as a result of an involuntary termination or participation in a window program, that do not exceed two times the lesser of (i) the employee's annual rate of pay in the year prior to separation or (ii) the compensation limit under section 401(a)(17) (for 2016, the limit is $265,000, indexed for inflation).