

insights

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Section 409A: Top 10 rules for compliant non-qualified deferred compensation

Internal Revenue Code Section 409A regulates nonqualified deferred compensation (NQDC) plans and arrangements, which are commonly used to provide supplemental compensation to key executives. Complying with Section 409A is critically important because noncompliance will result in an executive being subject to income tax in the year NQDC becomes vested, regardless of when the NQDC is scheduled to be paid. In addition, an executive must pay a 20% excise tax on noncompliant NQDC, as well as interest on any late payment of income taxes. Employers may be subject to penalties and interest for failure to timely report and withhold income taxes with respect to NQDC that does not comply with Section 409A.



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Given the draconian consequences of violating Section 409A, it is critical that HR professionals, as well as executives, understand basic elements of Section 409A and the impact Section 409A has on the design of NQDC plans and arrangements.

Over four hundred pages of regulations have been issued under Section 409A. The following is a summary of ten principles that are central to understanding the scope and impact of Section 409A.

1. **Broad impact on executive compensation arrangements.** Section 409A defines NQDC as a legally binding right to compensation that is payable (and taxable) in a later tax year. Thus, Section 409A can impact not only traditional NQDC plans, such as salary deferral plans and supplemental executive retirement plans (SERPs), but also arrangements such as executive employment agreements, severance agreements and unwritten bonus programs. These rules apply not only to executives but all employees, as well as independent contractors.

2. **Elections of time and form of payment.** Generally, initial elections to defer the payment of compensation must be irrevocable before the beginning of the year in which the compensation is earned. Initial deferral elections to defer payment of performance-based deferred compensation can be made six months before the end of the performance period in which the compensation is earned, but only if the performance period is at least 12 months long, the executive continuously works throughout the performance period, and the performance-based compensation is not readily ascertainable at the time the deferral election is made. Any subsequent changes to elections of time and form of payment of NQDC must be made at least 12 months prior to the scheduled payment date and must defer payment for at least five years. The subsequent election is not effective for 12 months.
3. **Limited distribution events.** Distribution of NQDC may only be made upon (i) death, (ii) disability, (iii) separation from service, (iv) a fixed date specified at the time of deferral, (v) a change of control, or (vi) hardship. As noted below, most of these terms are specially defined under Section 409A.
4. **Acceleration of NQDC is generally prohibited.** Under Section 409A, the accelerated payment of NQDC is generally prohibited. This is true whether acceleration occurs at the discretion of the executive or the employer. There are a few exceptions to this rule. However, even accelerated payment of NQDC upon plan termination is strictly limited.
5. **Section 409A has unique definitions for common terms.** Application of Section 409A is particularly difficult because commonly defined terms have a much different definition under Section 409A. For example, the term "plan" is defined to include all plans of the same type that cover a single individual. A "separation from service" occurs only if the executive no longer works for any member of the employer's controlled group. If the executive continues consulting at a level that is at least 50% of the level of his or her prior service (as measured over the preceding 36 months), there is a presumption that no separation from service has occurred. If the executive works at a level that is less than 20% percent of his or her prior service, there is a presumption that a separation from service has occurred. Any Section 409A analysis must take into account these special definitions.
6. **Plans of the same type are treated as a single plan.** Plans of the same type are treated as a single plan for purposes of determining compliance with Section 409A. There are nine types of plans. Thus, for example, a Section 409A violation with respect to a participant's salary deferral plan will also constitute a violation with respect to the participant's bonus deferral plan and any Section 409A penalties will be calculated based on the total NQDC provided under both plans.
7. **Short-term deferrals.** Short-term deferrals are not treated as NQDC that is subject to Section 409A. Compensation that is paid not later than 2½ months after the close of the plan year in which such compensation vests, is not considered NQDC. If the plan permits the possibility of payment after the 2½-month limitation, it will not qualify as a short term deferral even if the compensation is actually paid within the 2½ month period. Also, vesting is uniquely defined under Section 409A. For example, non-compete provisions do not delay vesting and, generally, elective deferrals, such as salary deferrals, are never considered unvested.
8. **Separation pay.** Generally, severance pay may be NQDC that is subject to Section 409A unless it satisfies one of several exceptions set forth in the regulations. For example, severance pay due to involuntary separation that (i) does not exceed the lesser of (A) Two times the executive's annual compensation for the preceding year, or (B) Two times the compensation limit applied to qualified retirement plans (i.e., \$530,000 for 2016) and (ii) is paid no later than end of second year after the year of the separation is exempt from Section 409A. Special rules apply in determining whether separation for "good reason" is considered involuntary separation.
9. **Six-month delay for publicly traded companies.** Payments of NQDC to key employees of public companies may not commence for at least six months following separation from service.
10. **Substitutions will be scrutinized.** Under the Section 409A regulations, payment of current compensation in exchange for NQDC to be paid in the future may be treated as an impermissible acceleration of the NQDC in violation of Section 409A. For example, it is critical to examine the impact of a restated employment agreement on existing NQDC to determine whether an impermissible substitution has occurred.

As indicated above, Section 409A imposes many complex rules on NQDC. Fortunately, the IRS has developed a program to correct Section 409A violations that are quickly discovered and properly corrected. It is critical to consult legal counsel before designing NQDC plans and arrangements to ensure compliance with Section 409A. Should a Section 409A violation occur, e.g., a failure to timely pay NQDC, it is important to consult legal counsel for assistance in correcting such violation to minimize the impact of Section 409A.

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