A TRAP FOR THE UNWARY

PUNITIVE PENALTIES UNDER IRC SECTION 409A

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A critical component to every business is its people. Employees invariably look to employers to provide employee benefits, such as health insurance. An often-overlooked employee benefit that can help both large and small businesses attract, retain, and reward employees is non-qualified deferred compensation. Professional advisors should be familiar with non-qualified deferred compensation to provide optimal professional services in raising this potential benefit and to identify potential issues regarding the maintenance and operation of non-qualified deferred compensation so that punitive penalties may be avoided.

Non-qualified deferred compensation is essentially compensation earned in one taxable year and paid in a subsequent taxable year.[1] The primary scenario in which non-qualified deferred compensation arrangements arise is the retention of service providers, particularly high-level, or high-performing, team members. A similar situation in which these arrangements arise is when an organization is targeting a particular individual to join its team. Non-qualified deferred compensation arrangements are typically found in employee incentive plans, employment agreements, separation agreements, and individual non-qualified deferred compensation agreements. Non-qualified deferred compensation is typically structured in the form of a plan in which multiple participants participate, as opposed to individual agreements. However, individual agreements providing for non-qualified deferred compensation are not uncommon.

As an example, suppose High Tech Inc. wants to retain its chief financial officer (CFO) for a period of time in the future. As a result, High Tech Inc. and its CFO enter into an agreement on Sept. 1, 2022, whereby High Tech Inc. will credit $10,000 to a hypothetical account for the CFO on Jan. 1 of each year for five years beginning in 2023. The CFO will also contribute a specified portion of the CFO's annual bonus to the account each year. The CFO's deferred compensation and the employer's contributions will then be paid out upon the CFO's retirement in equal annual installments over a period of 10 years. This arrangement would be subject to Internal Revenue Code (IRC) Section 409A as non-qualified deferred compensation.

As an additional example, assume High Tech Inc. wishes to implement a long-term retention tool for a business development executive that provides a benefit of having an interest in the underlying value of High Tech Inc.'s stock so that such individual has "buy in" to grow the company. However, High Tech Inc. does not want to give up any actual equity. High Tech Inc. would be well-suited to offer this employee shares of phantom stock that track the underlying value of the stock of High Tech Inc. without giving up any actual equity. Alternatively, High Tech Inc. could also consider

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a stock appreciation rights arrangement. The underlying value of the phantom stock or stock appreciation would then be paid to the business development representative at a certain time in the future. The phantom stock benefit is considered non-qualified deferred compensation, while the stock appreciation arrangement could be considered non-qualified deferred compensation depending on how it is structured.

Non-qualified deferred compensation is governed by IRC Section 409A. IRC Section 409A defines non-qualified deferred compensation as "any plan that provides for the deferral of compensation. . . ."[2] 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.[3] The primary concern under IRC Section 409A are the punitive penalties for non-compliance. In the event of a violation of IRC Section 409A, all compensation deferred for the tax year and all preceding tax years is includible in the applicable service provider's gross income.[4] Additionally, when income is included in a service provider's gross income as a result of a violation, a 20% penalty excise tax is imposed on the amount included in the gross income of the service provider as well as an interest rate penalty based on the underpayment rate plus 1%.[5] The total excise tax is imposed on the service provider. Based on the harsh penalties contained in IRC Section 409A, care must be taken in adopting, maintaining, and operating non-qualified deferred compensation arrangements.

Although not exhaustive, some of the more prominent rules that must be dealt with in implementing, maintaining, and operating non-qualified deferred compensation arrangements relate to providing for permissible payment events and the anti-acceleration of payments. Non-qualified deferred compensation can only be paid upon certain permissible payment events, which include: (i) death, (ii) disability, (iii) a change of control, (iv) a specified time, (v) separation from service, and (vi) an unforeseeable emergency.[6] If non-qualified deferred compensation provides for, or is paid for, any reason other than those listed, the arrangement will be in violation of IRC Section 409A as either a documentation error or operational failure, as applicable. In the event a non-qualified deferred compensation arrangement includes an impermissible payment event for unvested non-qualified deferred compensation and payments have not yet been made, the plan documentation error may be corrected by amending the plan document, pursuant to Internal Revenue Service (IRS) corrections procedures.[7]

Similarly, issues arise when non-qualified deferred compensation payments may be accelerated, or paid prior to the time provided for in the governing document. For example, if a plan provides for three annual installment payments upon a separation from service, but also provides that the employer has the discretion to pay the full amount sooner than such three-year period, then IRC Section 409A would be violated based on an impermissible acceleration of payment.[8] Corrections for this type of drafting error are available under the IRS correction procedures by amendment, prior to the payment of any accelerated amounts.[9] However, if an employer has discretion to accelerate payments and an accelerated payment is actually made under the arrangement, such accelerated payment may be corrected pursuant to IRS correction procedures, but the associated penalties will depend upon when the correction is made.[10]

Non-qualified deferred compensation allows employers to provide unique benefits with respect to attracting, retaining, and rewarding talent. Professional service providers should be aware of the benefits of non-qualified deferred compensation for their clients. Such knowledge allows professional service providers to offer unique and beneficial advice. Although the rules and regulations contained within IRC Section 409A are complex, in the battle for talent, the benefits significantly outweigh the costs associated with the creation of and compliance with non-qualified deferred compensation.

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[1]However, non-qualified deferred compensation arrangements can be structured with significantly more complexity, such as deferral features accompanying stock options and stock appreciation rights plans as well as phantom stock arrangements, but such discussion is beyond the scope of this article.
[2]IRC § 409A(d)(1). The term "plan" as used in IRC Section 409A generally refers to any plan, agreement, or arrangement that provides for the deferral of compensation.
[3]Treas. Reg. § 1.409A-1(b)(1).
[4]IRC § 409A(a)(1)(A).
[5]IRC § 409A(a)(1)(A).
[6]Treas. Reg. § 1.409A-3(a)(1)-(6). Each of the permissible payment events is specifically defined in the regulations, except for death. As a result, careful drafting must be applied to ensure the permissible payment events are properly structured within the nonqualified deferred compensation arrangement.
[7]IRS Notice 2010-6(VII)(A)(2).
[8]Treas. Reg. § 1.409A-3(j)(1).
[9]IRS Notice 2010-6(VII)(E).
[10]IRS Notice 2008-113.