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Take 409A's Advice … Please: Timing Is Everything for Nonqualified Deferred Compensation Plans

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While most nonqualified deferred compensation plan (NDCP) sponsors will be hard-pressed to find humor in Internal Revenue Code Section 409A compliance, they may be willing to acknowledge that proper administration of payouts from an NDCP shares at least one common attribute with a winning comic performance: for an NDCP to successfully stand up in front of the most demanding critic—the Internal Revenue Service (IRS)—without facing any heckling, the NDCP must practice precision timing with respect to distributions to

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participants. Just as a comedian must work not to deliver a punch line too early or too late, an NDCP needs to avoid improper accelerations or delays of participant payments. A failure to do so can elicit a most unpleasant response in the form of a cacophony of catcalls and boos from participants, or an IRS audit that uncovers Section 409A non-compliance, thereby triggering the resultant cascade of penalties. This column examines some of the toughest timing tests for the satisfactory operation and administration of NDCPs under Section 409A of the tax code.

ACTIVATING THE TRIGGER

Code Section 409A severely restricts employer and/or executive discretion with respect to retaining control over the timing of distributions. It identifies six permissible NDCP distribution triggers, which generally must be established within 30 days of the date the executive first becomes eligible to participate in the plan:

1. A specified payment date (a future distribution date is designated either by the employer and/or executive upon the participant's initial eligibility)[1]

2. Separation from service[2]

3. Disability[3]

4. Death[4]

5. Change in the ownership or effective control of the corporation, or in the ownership of a substantial portion of the assets of the corporation[5]

6. Unforeseeable emergency[6]

Except for death, each trigger has its own special 409A definition, along with complicated rules regarding how it may be applied. There is also a separate rule that permits the attachment of a "window" period to the applicable trigger.[7] Under this rule, the payment can occur up to 30 days prior to the applicable trigger or until the end of the taxable year in which the trigger occurs (or if such taxable year ends less than 2-and-one-half months following the trigger, the fifteenth day of the third month following the trigger). Where the trigger is the occurrence of an event, a plan may also provide for a specified period, which can be a single taxable year or a period not to exceed

90 days.[8] In all cases, the executive must be directly and indirectly prohibited from designating the taxable year of the payment.

Given the demanding standard established by the Code Section 409A rules, delivering compliant NDCP distributions requires mastery of this material and a precise performance by the plan's administrator. Fortunately, as discussed below, the most recent IRS guidance (in the form of proposed regulations issued in 2016) provides some additional guidance on NDCP distributions.

SEPARATION FROM SERVICE

One of the most complex triggers happens to be one of the most commonly used: the "separation from service" distribution trigger. This trigger will not pose problems when the separation is clear cut and final, such as a full retirement, resignation, or termination of employment. Employment separations, however, are often not so simple, such as where an executive's duties are scaled back from his or her previous role (for example, under a "phased retirement" scenario) or where a key employee "retires" but is then retained to consult as an independent contractor. Depending on the extent of the cutback in job responsibilities and the terms of the NDCP, the plan may risk either prematurely commencing payment or impermissibly delaying a distribution that should commence. This may occur if the employer and/or the executive's idea of what constitutes a separation does not align with the guidance under Section 409A. Although this determination is basically a facts-and-circumstances test, Section 409A considers a termination to have occurred if the employer and employee reasonably anticipate that either of these two conditions applies:

1. No future services will be performed after a certain date.

2. The level of bona fide services to be performed after such date (whether as an employee of independent contractor) will permanently not exceed 20 percent of the average rate of services performed over the preceding 36-month period (or the full period, if less than 36 months).

Furthermore, If the new rate of services is over 20 percent but less than 50 percent, such reduction may be treated as a separation from service under Code section 409A, provided special rules are met.[9]

The Section 409A rules also provide that an independent contractor separates from service upon the expiration of a contract under which services are performed if the expiration is a good-faith and complete termination of the contractual relationship.[10]

The Section 409A rules provide that the service period following a Section 409A-permitted separation takes into account work performed both as an employee and independent contractor. Thus, a retiring executive who is re-hired as a consultant will be subject to the above test. Additional relevant factors must also be considered, such as the employer's past practices and reasonable expectations, and its treatment of the executive as an employee for some purposes (such as eligibility for medical benefits).

There had been some confusion over when NDCP sponsors should use the general "separation from service" standard (the 20-percent/36-month rule) applicable to employees, as compared with the specific rule that applies only to independent contractors. Under the 20-percent/36-month rule, a participant who is an employee separates from service if the employer and employee reasonably anticipate that the level of services to be performed after a certain date (as an employee or an independent contractor) would permanently decrease to no more than 20 percent of the average level of services performed (as an employee or an independent contractor) over the immediately preceding 36-month period.

The proposed regulations clarify that when making a determination for a participant who changes employment status from employee to independent contractor or vice versa, sponsors must always first look to the 20-percent/36-month rule. Thus, if this rule is met when the individual changes status, the participant is considered separated from service under the terms of the NCDP. This new guidance also clarifies how to handle situations where applying the 20-percent/36-month rule does not result in a separation from service at the time a participant changes status from an employee to an independent contractor. In such cases, the NDCP sponsor can then instead rely on the independent contractor rule—for example, upon expiration of the contract(s)—to determine the date the participant's future separation of service occurs. Hence, if there is no "separation from service" upon the conversion from employee to independent contractor status, this guidance indicates that there will be no separation from service until the independent contractor status is concluded upon the expiration of the contractual consulting arrangement. This change would appear to indicate that deferred compensation payments can be delayed as long as there is a contractual consulting arrangement, even if services become more limited over time.

DISTRIBUTIONS CUED FROM THE TRIGGER

Once a distribution trigger is activated, the Section 409A compliance clock begins ticking, and NDCP sponsors must deliver their payments

on a timely basis. Although the Section 409A rules acknowledge the administrative impracticality of sponsors being able to deliver the payments on the exact date that the trigger occurs, it also prevents excessive manipulation of the actual payment date. Consequently, payments are Section 409A-compliant only if made within the periods described above.[11]

The proposed regulations clarify that the rules applicable upon the participant's death also apply to amounts payable upon the death of any beneficiary who has become entitled to amounts payable upon the participant's death. For example, while the Section 409A rules already permitted plans to provide that death, disability, or an unforeseen emergency of an NDCP participant can allow early payment of deferred compensation,[12] the proposed regulations extended this same treatment to beneficiaries. Also, recognizing the need for a longer period to resolve certain issues related to the participant's death (for example, confirming the death and completing probate), the proposed regulations also create a separate timing rule for an amount payable following the death of a participant or a participant's beneficiary: the amounts may be paid at any time beginning on the date of death and ending on December 31 of the calendar year following the calendar year of death.

This new guidance provides NDCP sponsors significant flexibility regarding the administrative and/or plan amendment options they can use to incorporate this extended payment deadline. In practice, the Section 409A distribution rules may pose particular problems for NDCP sponsors that maintain non-grandfathered arrangements under which the distribution provisions can no longer be tied to the sponsor's qualified retirement plan. Too many sponsors apply the "wait and see" approach permissible under qualified plans (in other words, no benefit distributions are made until the terminated participants claim the benefit). However, while qualified plan rules permit post-termination benefits to remain unpaid up to April 1 of the year following the year in which the participant attains age 70-and one-half, such open-endedness is not permitted under Section 409A. Therefore, NDCP sponsors must take great care to monitor the occurrence of any of the triggers, possibly outsourcing the administration to a third party with the appropriate resources to coordinate the timely processing of distributions. In addition, because the final processing of distributions may require information such as current address or marital status from NDCP participants, sponsors should educate executives on the necessity of timely commencements of benefits after a trigger occurs. Free from the participant disclosure requirements applicable to qualified plans, NDCP sponsors often take a minimalist approach to participant communication. They, however, should consider the complexity of the Section 409A rules and the

high cost of noncompliance. Providing participants a summary plan description to facilitate their understanding and cooperation could be beneficial for both parties.

MANDATORY VS. PERMISSIBLE DELAYS

The Section 409A rules provide that certain circumstances mandate a delay of distributions while others allow for a permissible delay.

Mandatory Delay

A *mandatory six-month delay* of distributions only applies to the separation from service payment trigger described above and only applies to certain specified employees of companies whose stock is traded on an established securities market or otherwise (including U.S. or foreign exchanges).[13] Specified employees are generally one of the top 50 most highly compensated employees of a publicly traded company; however, the comprehensive rules for determining specified employees are rather complex, and the detailed description of such is beyond the scope of this column. Section 409A does allow NDCP sponsors to elect an alternative method for identifying these employees, provided that such alternative method:

- Is reasonably designed to ensure that all specified employees are identified;

- Is an objectively determinable standard, providing no direct or indirect election to an employee with respect to its application; and

- Results in either all service providers or no more than 200 specified employees being identified as of any date.[14]

Conversely, rather than having to identify these employees and possibly face a Section 409A violation by missing one or more of them, an NDCP sponsor may instead opt to initially design the plan so as to delay payments for all participants for six months after separation from service, regardless of their specified employee status. This option, however, is not practical for existing plans that already limit the six-month delay to only specified employees because it would require an amendment to the plan and such amendment would be considered a re-deferral and thus be subject to the below-described 12-month/five year rule.

Permissible Delay

A *permissible delay* of distributions is allowed under very limited conditions, one at the discretion of either the NDCP participant or sponsor, and the other only at the election of the sponsor.

12-Month/Five-Year Rule

Generally, the participant or the sponsor may delay the payment if: (a) deferral election will not be effective until at least 12 months after it is made; (b) payment is deferred for at least five years from the date it would have been payable absent the election; and (c) election is made at least 12 months before payments were originally scheduled to be made.[15] The applicability of the conditions depends on the specific triggering event or date trigger.

This permissible delay rule is quite limited. The rule, however, offer flexibility in certain situations. The 12-month deferral election condition, for example, may be particularly troublesome when the circumstances—such as a separation from service—dictate that the executives include the NDCP distribution as income in a tax year in which they also earned substantial salaries. To allow for a deferral election in this situation, an NDCP design could use a specified payment date trigger in lieu of a separation from service. For example, assume the plan sets attainment of age 50 as the trigger. As executives approach age 49 (in other words, 12 months before the trigger date), they must decide whether to defer payments to age 55. If they have substantial savings and anticipate their earnings to continue at high levels, chances are they will opt for the deferral. They then will have a similar decision to make as they approach age 54 (in other words, whether to defer to age 60) and, if they elect that deferral, again as they edge toward age 59. If their talents are in high demand and their finances secure, they will most likely remain in the top income tax brackets during these years even if they terminate employment with the NDCP sponsor. Under such circumstances, the desire to defer the income may be sufficient to endure the risks of leaving the benefits in the plan after departure (for example, they will no longer have influence on a company's bottom line and the benefits remain subject to the creditors of the sponsor in the event of its insolvency).

Delay of Payment because of Business Concerns

The NDCP sponsor may permit a delay of payment because of certain business concerns.[16] The Section 409A rules require that the business concern (such as cash-flow issues) and the time for the later

payment are determined by a pre-specified, objective, nondiscretionary formula related to the sponsor's business performance. For example, the formula may call for payments in any given year to be limited to a certain percentage of cash flow. A delay is also permitted if the scheduled payment would jeopardize the ability of the sponsor to continue as a going concern. Under these circumstances, the plan will remain in Section 409A compliance as long as the payment is made in the first year in which the concern is eliminated.[17] In addition, the Section 409A rules also address payment failures that are due to the NDCP sponsor's refusal to pay or its inadvertent delay, requiring, in either case, no collusion between the participant and the sponsor. In these types of situations, the participant must provide timely notice to the sponsor that the benefit is due and unpaid; the Section 409A rules proscribe the details of such notice. The rules provide that a qualified domestic relations order (QDRO) may delay the time of payment.[18]

NOT SO FAST: PROHIBITION OF ACCELERATIONS AND EXCEPTIONS

Although the acceleration of payments is generally prohibited under Section 409A, there are some specific exceptions, which include the following (in addition to death, disability, or unforeseen emergency exceptions discussed above):

1. Compliance with a qualified domestic relations order (QDRO)[19]

2. Compliance with ethic agreements or conflicts of interest laws[20]

3. Payment of state, local, foreign, or employment taxes; taxes arising from a Section 409A violation; or taxes upon vesting in a Section 457(f) plans[21]

4. Limited cash-outs up to a designated dollar amount (Section 409A uses the 401(k) annual deferral dollar limit, which is $19,000 for 2019), provided that if a participant is in two or more NDCPs of the same type (as specified by the Section 409A aggregation rules), the plans must be aggregated to determine if the cash-out may apply[22]

5. Arms-length settlement of bona fide disputes as to a participant's right to a deferred amount[23]

6. Plan termination or liquidation in connection with certain events (for example, designated corporate dissolutions or bankruptcies

and change in control events) or, at the discretion of the sponsor, subject to various restrictions and limitations[24]

The acceleration exceptions described above in (1) and (2) give NDCP sponsors peace of mind because they know they can comply with these requirements without running afoul of Section 409A. The exception in (3) is particularly practical, as it permits the use of plan assets to meet these tax obligations rather than the participant doing so out of pocket. The exceptions in (4) and (5) create opportunities for a quicker disbursement of funds, enabling the sponsor to realize administrative cost savings by virtue of no longer having to maintain the recordkeeping and other costs associated with the applicable benefit. Exception (6) is often very important corporate transactions where executives may not trust purchaser to honor deferred payments. Sponsors, however, should discuss with their advisors the specific rules under Section 409A attached to each of these exceptions prior to utilization.

THE LAST LAUGH

Will the NDCP's final act of distributing benefits bring smiles to the recipients' faces? Not likely if such distributions fail to comply with the Section 409A rules and thereby expose participants to substantial penalties: Section 409A failures require participants to include all previously deferred amounts under the NDCP in gross income and pay on this amount income taxes, employment taxes, and a 20-percent penalty tax, as well as interest and penalties on this amount at the underpayment rate plus one percent and underpayment penalties. Thus, executives should be extremely motivated— on their own or with appropriate prodding by the NDCP sponsor—to cooperate in perfecting the NDCP's timing so as to not bomb in front of that toughest and most crucial crowd—the IRS. Consequently, because the complex setup of the various Section 409A distribution rules leave very little room for operational ad libs, NDCP sponsors must work to tighten up their payment routines in order for the participants to enjoy the full amount of these distributions.

NOTES

1. Treas. Reg. § 1.409A-3(a)(4).
2. Treas. Reg. § 1.409A-3(a)(1).

3. Treas. Reg. § 1.409A-3(a)(2)

4. Treas. Reg. § 1.409A-3(a)(3)

5. Treas. Reg. § 1.409A-3(a)(5)

6. Treas. Reg. § 1.409A-3(a)(6)

7. Treas. Reg. § 1.409A-3(b).

8. *Id*.

9. Treas. Reg. § 1.409A-1(h)(1)(ii).

10. Treas. Reg. § 1.409A-1(h)(2)(i).

11. Treas. Reg. § 1.409A-3(d).

12. Treas. Reg. § 1.409A-3(j).

13. Treas. Reg. § 1.409A-1(i)(1).

14. Treas. Reg. § 1.409A-1(i)(5).

15. Treas. Reg. § 1.409A-2(b)(1).

16. Treas. Reg. § 1.409A-2(b).

17. Treas. Reg. § 1.409A-3(d).

18. Treas. Reg. § 1.409A-2(b)(4).

19. Treas. Reg. § 1.409A-3(j)(4)(ii).

20. Treas. Reg. § 1.409A-3(j)(4)(ii).

21. Treas. Reg. § 1.409A-3(j)(4)(iii)(A).

22. Treas. Reg. § 1.409A-3(j)(4)(v).

23. Treas. Reg. § 1.409A-3(j)(4)(xiv).

24. Treas. Reg. § 1.409A-3(j)(4)(ix).

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