

Modifying or Terminating Nonqualified Deferred Compensation Plans

EMPLOYEE BENEFITS & PENSIONS

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EXECUTIVE SUMMARY

- Sec. 409A covers virtually any contractual deferral of compensation other than under a qualified retirement plan or a vacation, sick leave, compensatory time, disability pay, or death benefit plan. Thus, traditional nonqualified deferred compensation plans are subject to Sec. 409A.
- If a plan subject to Sec. 409A fails to meet its requirements (i.e., there is a plan failure), Sec. 409A imposes a 20% penalty, income acceleration of deferred amounts, and interest on the accelerated payments (at 1% above the underpayment rate).
- Plan failures generally include any changes in the form or timing of distributions from the plan.
- Although modifications or terminations of plans may constitute plan failures, certain exceptions to the general Sec. 409A rules allow an employer to modify or terminate a plan without triggering the Sec. 409A sanctions.



Most tax practitioners are aware of the general provisions of Sec. 409A as they are applied to nonqualified deferred compensation arrangements (NQDC plans).¹ With the downturn in the economy and increasing rates of bankruptcy and insolvency, both employers and employees have given second thought to the wisdom and future viability of existing NQDC plans. This article reminds readers of Sec. 409A's general parameters and provides specific guidance on modifying or terminating existing NQDC plans.

Comprehending the effect of Sec. 409A is made difficult by the required multistep, three-pronged analysis. The first step is to determine whether an arrangement to defer compensation is an NQDC plan as defined under Sec. 409A. If so, the second prong of the test determines whether NQDC plan benefits are subject to a substantial risk of forfeiture. When the arrangement is no longer subject to a substantial risk of forfeiture, the third inquiry is whether the NQDC plan inherently suffers from a "plan failure."

If these three events occur, Sec. 409A imposes income acceleration and penalties: Amounts deferred under the NQDC plan for current and preceding tax years are includible in gross income and are subject to an additional 20% penalty. Interest is also added at the underpayment rate plus 1% from the year that such amounts were deferred.²

The rude awakening for tax advisers when Sec. 409A was enacted in 2004 was that virtually any contractual deferral of compensation other than under a qualified retirement plan or a vacation, sick leave, compensatory time, disability pay, or death benefit plan was potentially subject to the new law.³ Thus, not only were traditional nonqualified deferred compensation arrangements subject to Sec. 409A scrutiny, but employment agreements providing for a deferred bonus, severance pay, and/or equity compensation were potentially subject to it as well. The regulations issued under Sec. 409A⁴ specifically noted the potential application of the new law regardless of whether the arrangement constituted a pension plan under the Employee Retirement Income Security Act of 1974 (ERISA) or an individual contract to defer compensation income.⁵

The General Parameters of Sec. 409A

The First Prong

All that is required for a deferral arrangement to constitute an NQDC plan is that the service provider (typically a common-law employee)⁶ has a legally binding right to deferred compensation to be paid in a year after that in which it was earned. If the employer may unilaterally reduce or eliminate that right to compensation, the employee has no legally binding right to it. If an employer would be unlikely to reduce or eliminate the deferred compensation, the employee would be deemed to have a legally binding right to it.⁷

This is the case even if the deferred compensation is subject to a substantial risk of forfeiture. For example, an NQDC plan would exist if a newly hired professional employee and the employer enter into an agreement to pay a deferred compensation benefit 10 years in the future, but only if the employee is still a full-time employee at that time. Even though the right to the deferred payments would be subject to a substantial risk of forfeiture for 10 years, the deferred compensation plan is an NQDC plan from its inception.

Apart from the exempted deferred compensation plans noted in footnote 3, there are a few other deferrals that are exempt from Sec. 409A. Most common is the short-term deferral exception. If deferred compensation is paid out in full within 2½ months after the year of vesting, the arrangement is deemed never to have constituted an NQDC plan.⁸ This exception is frequently used to avoid Sec. 409A NQDC plan status for annual nondiscretionary bonus arrangements based on a productivity factor, as well as long-term deferrals where the payout occurs in a lump sum shortly after the deferred benefit vests. Also excluded from Sec. 409A and NQDC plan characterization are limited categories of separation pay arrangements.⁹ Moreover, if reasonable valuation methodologies are employed, nonqualified stock option and stock appreciation right arrangements will avoid being characterized as NQDC plans.¹⁰

In general, NQDC plans of the same class are aggregated and treated as one plan for testing purposes under Sec. 409A.¹¹ In other words, so-called account balance plans (defined contribution plans) are generally aggregated and treated as one plan. Similarly, all non-account balances (defined benefit plans) are aggregated as well as other possible categories of plans such as nonexempt equity-based arrangements and severance-pay arrangements noted above. A nonexempt separation-pay plan may, therefore, provide a different amount and form of benefit to a given employee from that payable to the same employee from a regular account-balance plan structured for benefit payments on separation from service to the same employer.

The Second Prong

If a deferral arrangement constitutes an NQDC plan, the next inquiry is whether it is contractually subject to a substantial risk of forfeiture, which is similar to the definition in Sec. 83(c)(1) for transfers of property in connection with the performance of services.¹² A substantial risk of forfeiture requires that the deferred compensation be conditional on the future performance of substantial services by the employee.

Moreover, the substantial risk of forfeiture must be bona fide. The regulations presume that if the employee is a direct or indirect owner of the employer there is substantially less likelihood of a realistic substantial risk of forfeiture, and thus there will be a presumption that no substantial risk of forfeiture exists.¹³ In many NQDC plans (particularly elective NQDC plans noted in the text after footnote 19), benefits are never subject to a substantial risk of forfeiture and will be fully vested at all times. In this situation, the tax adviser would skip the second prong analysis and proceed to the third prong.

The Third Prong

If there is an NQDC plan (the first prong) and the NQDC plan has never been or is no longer subject to a substantial risk of forfeiture (the second prong), then if there is a plan failure (the third prong), the acceleration of income and the other Sec. 409A penalties occur in that year.

There are a variety of plan failures under Sec. 409A. The first and most probable would be a prohibited early distribution under the NQDC plan. This would occur if the NQDC plan could pay

any benefits before (1) the employee's separation from service during life,¹⁴ (2) the employee's death, (3) the employee's disability,¹⁵ (4) a time specified in the plan for payout,¹⁶ (5) the time of the change in the employer's ownership or effective control,¹⁷ or (6) the occurrence of an unforeseen emergency.¹⁸

An unforeseen emergency is defined in Sec. 409A(a)(2)(B)(ii) as a severe financial hardship to the participating employee resulting from an illness or accident to the participant, the participant's spouse, or a dependent of the participant. An unforeseen emergency also includes a loss of the participant's property due to casualty or a similar extraordinary and unforeseeable circumstance. Cash flow problems incident to scheduled payments do not constitute an unforeseen emergency.

The unforeseen emergency requirement is met only if the amounts distributed do not exceed the amounts necessary to satisfy the emergency plus amounts necessary to pay taxes reasonably anticipated as a result of the distribution, after taking into account the extent to which such hardship is or may be relieved through reimbursement or compensation by insurance or otherwise or by liquidation of the participant's assets (to the extent the liquidation of such assets would not itself cause severe financial hardship).

A plan failure also includes an ability to again defer payments due to be made under the terms of the NQDC plan. The NQDC plan may permit subsequent elections to delay or change the form of payments if the election cannot take effect until at least 12 months after it is made. However, an election to further defer a distribution due to be made under the most likely scenarios (after the participant's separation from service, upon a predetermined date or schedule, or upon a change in ownership of the employer) must defer the delayed payment for at least an additional five years from when the payment would otherwise be made.¹⁹

Another major category of plan failure relates to the initial deferral election for *elective* NQDC plans (in which the deferral decision is initiated by the employee) as opposed to *nonelective* NQDC plans. There are two broad structural categories of NQDC plans: elective and nonelective. An elective NQDC plan is one under which the employee opts to receive less salary and/or bonus compensation than he or she would otherwise currently receive and to defer receipt of the amount not received currently to a future tax year. The initiative behind the deferral comes from the employee.

Because the employee is initiating the deferral of compensation that he or she would otherwise shortly earn and receive, it would normally be inappropriate to impose a substantial risk of forfeiture on the NQDC plan benefits. Therefore, an elective deferral would typically be fully vested from its inception. Nonelective deferred compensation is different, however. It is not unusual for employers to provide a deferred compensation benefit as a fringe benefit to key employees, and it does not result in their otherwise payable salary and bonus compensation being reduced. Rather, the nonelective deferred compensation arrangement is typically an additional benefit. It is the so-called velvet handcuff mechanism for retaining key employees and usually incorporates a substantial-risk-of-forfeiture requirement that the employee have a number of years of service before the benefits vest and become nonforfeitable.

Elective deferrals must specify the time and form of payment on deferral. An elective deferral is effective only if it is made before the tax year in which the deferred compensation will be earned (e.g., a salary reduction agreement entered into on or before Dec. 31, 2012, to defer 10% of compensation that would otherwise be earned and payable in the 2013 calendar year).²⁰

If the electively deferred compensation is based on performance criteria or services performed over a period of at least 12 months (e.g., bonus compensation based on a fiscal-year net profit increase), the election must be made no later than six months before the end of the measurement period. For a new participant (e.g., a new officer hired midyear), the election must be made within 30 days after the date the new participant becomes eligible to participate in the NQDC plan to initiate deferrals for that year.²¹ A deferral election that remains in place unless the employee changes it (called an evergreen election) is generally permissible.²²

A nonelective NQDC plan does not have to meet the specific timing rules just noted, but the underlying contract must be entered into before the deferred compensation is earned, and the amounts and timing of the deferred compensation payout must be objectively determinable.²³

Terminating, Modifying, or Freezing Existing NQDC Plans

General Impact of Modifying Time or Form of Payments

Sec. 409A puts significant roadblocks in the way of modifying existing NQDC plans. Other than the six allowances for permitted distributions under Sec. 409A noted above, there can generally²⁴ be no variation in either the form or timing of distributions called for under the NQDC plan. With the few exceptions noted below, any variation in the time (either an acceleration or further deferral) or the form (changing a scheduled lump-sum payout to an annuitized stream of payments) constitutes an NQDC plan failure.²⁵ The following are the exceptions.

Termination of NQDC Plan

One of the few exceptions to an acceleration of benefits under an NQDC plan is the full and discretionary termination of that NQDC plan.²⁶ To qualify, the regulations²⁷ require all of the following:

1. Termination and liquidation of the NQDC plan must not occur because of a “downturn” in the employer’s financial health;
2. All related NQDC plans (other similar nonqualified NQDC plans) must also be terminated;
3. No payout under the NQDC plan may occur within 12 months of board action to irrevocably terminate the NQDC plan;
4. All payments must be made within 24 months of the NQDC plan termination by the board; and
5. The employer must not adopt a new similar type of NQDC plan within 36 months from the date the employer first took the board action needed to terminate the NQDC plan irrevocably.

This exception is largely predicated on the first requirement that there not be a downturn in the employer’s financial health. After informal discussion with IRS National Office personnel, the authors verified that the critical element of this financial health requirement involves a meaningful change in the employer’s ability to pay the unsecured deferred compensation benefits.²⁸ That is, was there a negative development that acted as a practical impediment to the employer’s paying the deferred compensation? There are other secondary issues involving the timing of that financial health inquiry. It is clear from the language in the regulations, as well as from the preamble to the regulations,²⁹ that the relevant time for examining the employer’s financial health is not only when the formal action is taken to terminate the NQDC plan but also as benefits are paid out one to two years later.

Another issue involves the second element of this termination exception, the requirement to terminate the relevant NQDC plan and all others of a like class (all account-balance NQDC plans maintained by the employer for all participating employees). The regulations clearly indicate that all such NQDC plans (not just the NQDC plan that is participated in by a particular employee if the termination decision is initiated by one or a few key people) must be terminated and not be reinstated sooner than three years later.

Forfeitures

Can an NQDC plan participant simply forfeit his or her benefits under the NQDC plan? Yes, this is specifically allowed under the regulations³⁰ as long as there is no “substitution” in the mix. For example, if NQDC plan participants forfeited their rights to benefits but received an unusual cash bonus thereafter approximating the discounted value of the NQDC plan benefits they forfeited, there would be an improper substitution. The bonus cash would be deemed benefits paid from the underlying NQDC plan and constitute an improper Sec. 409A acceleration of benefits under that NQDC plan.

What would be the effect of a modification, but not a termination or forfeiture, of an existing NQDC plan and its benefits? For example, if participants agreed to cut the NQDC plan benefits in half by amending the existing NQDC plan, that agreement would be considered a permissible forfeiture as long as the form of payments and the time at which benefits are paid does not change. Again, if the reduction in benefits were compensated for by a formal or informal

payment, there would be an improper substitution of payments and an acceleration of benefits under Sec. 409A.

Deferring Scheduled Payments

Other than in the case of death, disability, or unforeseen emergency, the only way to defer the time of scheduled NQDC plan payments is under the five-year rule in the Code and regulations noted earlier in the text at footnote 19.³¹ That rule applies when the parties consent to re-defer or change the form of scheduled payments. The rule requires that such a change be made at least one year before benefits are otherwise scheduled to be paid and that the new starting time be deferred at least five years from the original date. Here are some illustrations adapted from the regulations:³²

Example 1: Employee *A* participates in an NQDC plan that provides for a lump-sum payment at age 62. *A* wishes to modify the NQDC plan so that the deferred amount will be payable on the later of *A*'s attainment of a specified age or separation from service. Provided that he makes the election on or before his 61st birthday, *A* may modify the NQDC plan so he will receive a lump-sum payment on the later of age 67 or separation from service.

Example 2: Employee *B* participates in an NQDC plan. *B* elects to be paid in a lump sum at age 62. *B* wishes to change the payment form to a life annuity. Provided that *B* makes the election on or before her 61st birthday, she may elect to receive a life annuity beginning at age 67.

Changing Elective Deferrals

Another interesting issue involves deferrals made under an elective NQDC plan (see text at footnote 20), in which the decision to defer is initiated by the employee through a salary reduction agreement. The general rule is that such an elective deferral of compensation must be made before the year in which that deferred compensation is earned. Thereafter the election can be changed each year or retained.

What if an NQDC plan participant electively defers compensation that would otherwise be paid in 2012? Assume a participant made his election timely before Jan. 1, 2012. In May 2012, the participant decides that the election was ill-advised and wants to cancel it. He can for 2013 but not for 2012. A limited exception to this would be with regard to an election to defer performance-based compensation, for instance, a mandatory bonus based on net profits or accounts receivable over a set baseline. The election to defer performance-based compensation does not become irrevocable until six months before the end of the performance period if the performance is measured over at least a 12-month period. So, if the NQDC plan participant was electively deferring this type of compensation, and the bonus would be measured over the Jan. 1 through Dec. 31, 2012, period, a previous election for 2012 could be revoked or changed on or before June 30, 2012.³³

Conclusion

As this article has shown, Sec. 409A generally applies to NQDC plans maintained by closely held employers with the unfortunate consequence of those employers' frequently trying to disengage from the tentacles of Sec. 409A. The abuse that Sec. 409A was intended to blunt occurred with more sophisticated plans maintained by publicly traded employers, where manipulation about the initial deferral decision and the timing of benefit payments was commonplace before 2005.

Although the Small Business Council of America has lobbied vigorously for an exception from Sec. 409A for closely held businesses similar to that found under the Sec. 280G golden parachute rules,³⁴ to date the lobbying has been unsuccessful. Thus, tax advisers to the closely held business community must be aware of when Sec. 409A is applicable generally and how to effectively disengage when compliance with it becomes overwhelming and onerous.

Footnotes

¹ The American Jobs Creation Act of 2004, P.L. 108-357, §885(a), added Sec. 409A, generally effective for deferrals after Dec. 31, 2004.

² Secs. 409A(a)(1)(A) and (B).

³ Excluded from the definition of a deferred compensation plan is (1) a “qualified” retirement plan (i.e., a tax-qualified pension, profit sharing, Sec. 401(k) plan, Sec. 403(b) tax-deferred annuity, or a Sec. 457(b) eligible plan for state, government, or tax-exempt employees); or (2) a “bona fide” vacation, sick leave, disability pay, or death benefit plan (Sec. 409A(d)(1)). Until further guidance is issued, the preamble to the regulations notes that payments to a retiring partner under Sec. 736 are not currently subject to Sec. 409A (T.D. 9321).

⁴ Regs. Secs. 1.409A-1 through 1.409A-6 (T.D. 9321).

⁵ Regs. Sec. 1.409A-1(c)(1).

⁶ According to Regs. Secs. 1.409A-1(f) and (g), the employee or independent contractor providing the services is referred to as the “service provider.” The entity to which the service provider is rendering services is referred to as the “service recipient.” For simplicity’s sake, this article refers to the service provider as the employee and to the service recipient as the employer.

⁷ Regs. Sec. 1.409A-1(b)(1). These concepts, as well as many others found in the regulations, had their genesis in the FICA regulations on deferred compensation at Regs. Sec. 31.3121(v)(2).

⁸ Regs. Sec. 1.409A-1(b)(4). The 2½-month period is measured from the end of the employer’s tax year or the end of the employee’s tax year, whichever is later.

⁹ Regs. Sec. 1.409A-1(b)(9).

¹⁰ Regs. Sec. 1.409A-1(b)(5).

¹¹ Regs. Sec. 1.409A-1(c)(2).

¹² However, Regs. Sec. 1.409A-1(d) notes that certain arrangements that could possibly constitute a substantial risk of forfeiture under Sec. 83 and Regs. Sec. 1.83-3(c), e.g., noncompete agreements, would not constitute a substantial risk of forfeiture for Sec. 409A purposes.

¹³ Regs. Sec. 1.409A-1(d)(3).

¹⁴ Regs. Sec. 1.409A-1(h). Separation from service requires permanent cessation of employment. Significant post-termination consulting would preclude a separation from service, and leaves of absence do not generally constitute separation from service.

¹⁵ Sec. 409A(a)(2)(A)(ii). A disability is defined under Sec. 409A as a mental or physical impairment qualified for Social Security disability payments, or a disability that is expected to result in death or last for more than a year and (1) one that prevents the employee from engaging in substantial gainful activity, or (2) for which the employee is receiving disability income benefits under an employer disability plan for at least three months.

¹⁶ The specified time or fixed schedule of payments needs to be objectively determinable as to the amount and tax year of payment (Regs. Sec. 1.409A-3(b)). For example, a deferred compensation plan that provides that deferred compensation will be made in three annual payments on Dec. 31, following an initial public offering of the employer, would satisfy the requirements that the deferred compensation plan provide for payments at specified times pursuant to a fixed schedule (Regs. Sec. 1.409A-3(i)(1)(i)).

¹⁷ Sec. 409A(a)(2)(A)(v). To the extent that an unamended pre-Sec. 409A deferred compensation plan allows for a payout irrespective of the employee’s separation from service or change in control of the entity, it is likely that the change in control definition will have to be modified by amendment to comply with the rather unique Sec. 409A definition of change in control.

¹⁸ Sec. 409A(a)(2)(A)(vi).

¹⁹ Sec. 409A(a)(4)(C).

²⁰ Sec. 409A(a)(4)(B).

²¹ Regs. Sec. 1.409A-2(a)(7).

²² Regs. Sec. 1.409A-2(a)(1).

²³ Regs. Sec. 1.409A-2(a)(2).

²⁴ The Sec. 409A regulations provide exceptions to the anti-acceleration rule, permitting acceleration in limited circumstances, such as pursuant to a domestic relations order, to comply with ethics or conflicts-of-interest laws, to pay employment taxes, or upon the plan's failure to meet Sec. 409A (Regs. Sec. 1.409A-3(j)(4)).

²⁵ Sec. 409A(a)(3); Regs. Sec. 1.409A-3(j)(1).

²⁶ Other deferred compensation plan terminations are permitted in less common dissolution and change-in-control scenarios (Regs. Secs. 1.409A-3(j)(4)(ix)(A) and (B)).

²⁷ Regs. Sec. 1.409A-3(j)(4)(ix)(C).

²⁸ Author's discussion with an attorney in the IRS Chief Counsel's Office (October 2011).

²⁹ T.D. 9321 (4/17/2007).

³⁰ Regs. Sec. 1.409A-3(f).

³¹ Sec. 409A(a)(4)(B) and Regs. Sec. 1.409A-2(b)(1).

³² Regs. Sec. 1.409A-2(b)(9), Examples (16) and (17).

³³ Sec. 409A(a)(4); Regs. Sec. 1.409A-2(a).

³⁴ See "[SBCA Supports Limiting Code Section 409A to Public Companies.](#)"

EditorNotes

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