WRMarketplace
An AALU Washington Report

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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: IRC §409A – Essential for Effectively Deferring Compensation.

MARKET TREND: The recent rise in income tax rates has generated a resurgence of interest in tax-deferral planning, including nonqualified deferred compensation arrangements ("NQDCs"). To provide effective guidance in response to the increasing requests for advice on NQDCs, however, advisors must understand how enactment of IRC §409A directly impacts these plans and appreciate the substantial tax penalties for non-compliance.

SYNOPSIS: While NQDCs can help highly compensated employees and executives defer income tax liability on their compensation, the 2004 enactment of IRC §409A ("§409A") implemented several hurdles to achieving the desired tax-deferral benefits. §409A imposes a complex series of requirements governing plan documentation, the timing and content of elections to defer compensation, and the form and timing of the actual payment of deferred compensation.

TAKE AWAY:

- §409A imposes very technical constraints on the manner in which a NQDC can be structured. In broad strokes, a §409A-compliant deferral arrangement must:
    - Be in writing;
    - Provide conforming deferral elections (typically made before the year in which the relevant services are performed); and
    - Limit distributions to only those circumstances specifically allowed under §409A.

- Failure to comply with §409A may subject the participant to current income tax on the amount purportedly deferred, plus interest and penalties.

- Given this complexity and the severity of penalties for failure to comply, advisors working in the NQDC arena must have familiarity with §409A and should consult with experienced legal counsel or accountants when assisting with the implementation of an arrangement.

- Despite these fairly rigid requirements, the benefits of NQDC planning in this high income tax environment may be well worth the cost and effort of §409A compliance.

PRIOR REPORTS: 12-46; 10-124; 08-80; 07-44; 07-20; 07-16; 06-33; 04-133; 04-135.

MAJOR REFERENCES: ***IRC §409A; Treas. Reg. §§1.409A-1, 1.409A-2, 1.409A-3.***

As noted in previous *Washington* Reports, income tax planning, particularly related to the deferral of compensation, has become a predominant objective of corporations attempting to attract and retain executives, as well as for individuals seeking financial planning assistance, particularly into their retirement. Previous *Washington* Reports have addressed key principles and techniques relevant to the effective deferral of compensation, such as constructive receipt and economic benefit, and the use of rabbi trusts, including the investment of the assets of those trusts in life insurance. While those concepts remain important, the enactment of §409A was a game-changer in the deferred compensation arena, making knowledge of its requirements absolutely essential to advisors who offer guidance on NQDCs. This *Washington Report* provides an overview of §409A and a description of its core requirements.

WHY IS §409A SO IMPORTANT?

The importance of §409A lies in the substantial ramifications that result from a failure to comply with its requirements. ***§409A imposes significant penalties on the employee (or other service provider) if a NQDC does not comply with restrictions on deferral elections and the timing of distributions of deferred compensation.***

PENALTIES FOR NON-COMPLIANCE

Individuals participating in NQDCs that fail to comply with §409A – either in form or in operation – are subject to significant adverse federal tax consequences. Specifically:

1. The individual is subject to ***current income taxation on the amount deferred, even if the individual cannot actually or constructively receive the deferred amounts presently***; and
2. The amount includible in current taxable income is subject to:
   a. ***An additional tax equal to the interest that would have been imposed on that taxable amount*** if it had been taxable at the time of the original deferral; ***plus***
   b. An additional tax at the rate of ***20%***.

Also, some states – most notably, California – have their own versions of §409A that also impose state taxes for §409A violations.

Accordingly, ***a failure to comply with the §409A requirements can result in current taxation in excess of 50% of the amount deferred.***

APPLICATION BEYOND TYPICAL NQDCs

§409A applies to arrangements far beyond the typical NQDC under which an individual elects to forego current compensation in exchange for a promise to receive that compensation (with earnings) at a future date.

As a general rule, §409A subjects virtually any arrangement in which an individual is to receive compensation in a year after the year in which the individual acquires a legally binding right to receive that compensation to its requirements. Thus, arrangements such as employment agreements, bonus plans and long-term incentive plans can give rise to deferred compensation subject to §409A.

There are certain limited exceptions to this general rule. Tax-qualified retirement plans are not subject to §409A. Also exempt from this section are payments classified as "short-term deferrals" under the applicable Treasury regulations, which are defined as payments made no later than 2-1/2 months after the end of the taxable year in which the individual's rights to the payment cease to be subject to a substantial risk of forfeiture. The classic example of a short-term deferral is the annual performance bonus that is paid early in the year following the year in which it is earned. This exemption is probably not particularly useful in the context of long-term tax-planning, because it requires individuals to subject the amounts they defer to a significant risk of loss (*e.g.*, forfeiture if the participant ceases working for the employer before a specified time), a condition most individuals will find undesirable.

Another common exemption applies to stock options and stock appreciation rights ("**SARs**") that are granted with an exercise price that cannot be less than the fair market value of the related stock on the date of the grant of the option or SAR and that do not provide for a deferral of payment of the compensation (*i.e.*, the delivery of the stock or the cash payment under the SAR) beyond the date of exercise. While this exception is popular in compensation planning in larger companies – particularly publicly traded ones – it is probably of limited utility in the income tax planning context for business owners, as the grant of options or SARs to these individuals frequently does not create value for those individuals because they already own most if not all the value of the company.

COMPLIANCE CONSIDERATIONS

<u>Written Documentation of Arrangement</u>

Parties considering a NQDC must appreciate the need for proper documentation of the arrangement. Deferred compensation arrangements subject to §409A ***must be set forth in a written document that contains substantive provisions that are consistent and designed to ensure compliance with the requirements of §409A.*** Failure to document an arrangement properly will expose the participant to the applicable penalties to the same extent as would a failure to operate the arrangement in compliance with the substantive requirements.

<u>Deferral Elections</u>

§409A generally requires that an individual make the election to defer compensation before the beginning of the taxable year in which the services giving rise to the compensation to be deferred are performed. Thus, if an individual wishes to defer his or her 2015 salary, the election to defer must be made, and become irrevocable, no later than December 31, 2014. In comparison, if an individual wishes to defer a bonus payable in 2015 for services performed in 2014, the election to defer the bonus likely must be made, and become irrevocable, by the end of 2013 (*i.e.*, the year before the year in which the relevant services are performed).

There is an exception to this general rule for bonuses that qualify as "performance-based compensation," which would allow the deferral election to be made no later than six months before the end of the performance period for which the bonus is paid. Care must be taken, however, in using this exception, because the types of bonuses that meet the "performance-based compensation" requirements are fairly restrictive.

Two other related exceptions also may assist with deferred compensation planning. They apply to newly established plans and to newly eligible participants in existing plans. In each case, the affected individual can make a deferral election within the first 30 days of becoming eligible to participate in the plan. The election can only apply, however, to compensation earned after the date of the election. The application of this exception is relatively straightforward in the context of an election to defer salary, but an election to defer a bonus that is payable in part for services performed after the date of the election is subject to some complicated proration requirements that may increase the chances of noncompliance with §409A. In these cases, the employer and participating employee may want to consider whether the desired planning result can be achieved by waiting to defer the bonus earned for the first full year of plan participation.

In addition to specifying the amount of compensation to be deferred, a deferral election must establish the time and form of payment of the deferred compensation, as discussed below.

Timing and Form of Distributions

Timing. §409A narrowly limits the time or times at which deferred compensation can be paid. Specifically, deferred compensation can ***only*** be paid as of one of six payment triggers:

1. The individual's separation from service with the entity maintaining the deferred compensation plan;
2. The individual's death;
3. The individual's disability;
4. A change in control of the entity liable for the payment of the deferred compensation;
5. The individual's experiencing an unforeseeable financial emergency; or
6. As of a specified date or pursuant to a specified schedule.

Separation from Service. An individual generally experiences a separation from service with the entity maintaining the plan when the parties reasonably expect that the level of services the individual will perform for the entity will permanently decrease to no more than 20% of the average level of services the individual had been performing for the entity over the immediately preceding 36-month period. The individual and the entity can agree, however, at the time the deferred compensation plan is established, to consider a diminution in services performed to a pre-established level between 20% and 50% of the level performed during the preceding 36-month period. This issue is particularly important when developing a deferred compensation plan for a significant owner of the company; care should be taken to ensure that, if distribution is intended to be made upon the individual's separation from service, the individual's plans for transitioning the business are taken into account.

Change in Control. When establishing an exit strategy using a payment from a deferred compensation arrangement, planning will likely need to take into account when a change in control of the company is considered to occur for purposes of §409A. Under the applicable

Treasury regulations, a change in control, a change in effective control, and a change in ownership of a substantial portion of a corporation's assets can trigger payment of deferred compensation. For these purposes,

- A "change in control" is generally defined as the acquisition by a person or by more than one person acting as a group of stock possessing more than 50% of the total fair market value or total voting power of the stock of the corporation.

- A "change in the effective control of a corporation" occurs when a person or more than one person acting as a group acquires, over a 12-month period, stock possessing more than 30% of the total fair market value or the total voting power of the company. It may also occur if there is the replacement of a majority of the members of the corporation's board of directors over a 12-month period, and the appointment or election of the new directors is not endorsed by the majority of the members of the corporation's board of directors before the date of appointment or election.

- A "change in ownership of a substantial portion of a corporation's assets" occurs when a person or more than one person acting as a group acquires, during a 12-month period, assets from the corporation that have a total gross fair market value of 40% or more of the total fair market value of the corporation's assets immediately before the acquisition.

Unforeseeable Financial Emergency. The definition of an "unforeseeable financial emergency" that would allow a distribution from a deferred compensation plan is highly restrictive – much more so than the definition applicable to a "hardship" distribution under a qualified 401(k) plan – and very difficult to satisfy. Accordingly, participants should not anticipate that funds deferred under NQDCs will be available in the event of financial difficulties.

Specified Date or Specified Schedule. For the purpose of making payment upon a specified date or pursuant to a specified schedule, the date or schedule must be objectively determinable at the time the deferral is made. For example, one can specify that distribution will be made in the year 2020, upon the tenth anniversary of deferral, or upon the attainment of age 62. On the other hand, one cannot specify distribution, for example, when a child goes to college or gets married. It is possible, however, to provide for distribution to be made upon "the earlier to occur of" one or more otherwise permissible events. For example, a participant can specify that distribution will be made upon the earlier to occur of separation from service or attainment of a specified age.

Form. In addition to specifying the date of payment of deferred compensation, the participant must specify the form of distribution. For example, the participant can elect distribution in a lump sum, in installments, or in the form of an annuity.

Limited Ability to Change. Generally, the time and form of distribution, once elected, cannot be changed, subject to very limited exceptions. For example, a participant can defer further the date scheduled for distribution, provided that the further deferral election is made at least 12 months in advance of the date distribution was scheduled to be made and defers distribution by at least an additional five years. Likewise, a participant typically cannot elect to accelerate the date set for distribution. Again, there are some extremely limited exceptions to these rules, a detailed review of which is beyond the scope of this *Washington Report*.

TAKE-AWAYS

- §409A imposes very technical constraints on the manner in which a NQDC can be structured, a full discussion of which is beyond the scope of this *Washington Report*. In broad strokes, however, a §409A-compliant deferral arrangement must:
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