Corporate Tax - USA

Recent IRS activity focuses on non-qualified deferred compensation plans

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Recent Internal Revenue Service (IRS) efforts have provoked renewed discussion of the legal regimes governing non-qualified deferred compensation plans. First, the IRS announced a small-scope audit project addressing Internal Revenue Code Section 409A. Second, it released Revenue Ruling 2014-18 addressing Internal Revenue Code Section 457A. In view of these efforts, employers that provide non-qualified deferred compensation plans to their executives should understand both the guidance to date concerning Sections 409A and 457A and areas for possible further development.

Section 409A

Regulations
Final regulations under Section 409A were issued in 2007 and became generally effective for the tax years beginning on or after January 1 2009.

The final regulations outline the legal regime under Section 409A, which imposes strict rules on the form and operation of non-qualified deferred compensation plans for US taxpayers, along with immediate income inclusion and significant tax penalties for participants in non-compliant plans. This regime includes definitions of key concepts such as:

- non-qualified deferred compensation plan;
- deferral of compensation;
- substantial risk of forfeiture;
- service provider;
- service recipient; and
- separation from service.

It also includes requirements for initial and subsequent deferral elections and their interaction with elections under other employer plans and other legal obligations such as domestic relations orders. Finally, it includes permissible payment events such as separation from service, unforeseeable emergency and disability, and exceptions to the general prohibition under Section 409A on the acceleration of payments.

The final regulations reserve two major areas for future guidance – the calculation of income inclusion under Section 409A and the funding of non-qualified deferred compensation plans. In 2008 the IRS issued proposed regulations which provide detailed rules for determining the amount includable in income due to the failure to meet the requirements of Section 409A and the calculation of any additional taxes due with respect to that failure. Taxpayers may rely on these proposed regulations only to the extent provided in IRS Notices 2008-115 and 2010-6.

Guidance regarding funding remains forthcoming. Until such guidance is available, pursuant to IRS Notice 2006-33 taxpayers may rely on a reasonable, good-faith interpretation of the applicable provisions of Section 409A. While non-qualified deferred compensation plans for purposes of Section 409A will generally also constitute 'top hat' plans which must be unfunded in order to comply with the Employee Retirement Income Security Act, Section 409A includes its own funding rules which affect the use of rabbi trusts that could otherwise satisfy the act.

Other IRS guidance
Subsequent to the final regulations, the IRS issued notices addressing three major non-compliance issues under Section 409A – operational failures, documentary failures and wage withholding and reporting. Further, some guidance issued before the final regulations remain in effect with respect to specific issues.

The tax consequences of operational and/or documentary non-compliance with Section 409A can be severe for affected participants in non-qualified deferred compensation plans. In order to mitigate those consequences in certain situations, the IRS issued Notice 2008-113 with respect to operational failures and Notice 2010-6 with respect to documentary failures (both notices were later modified by Notice 2010-80). Notice 2008-113 provides correction mechanisms for operational failures such as failing to defer compensation or deferring compensation in excess of the agreed amount. Notice 2010-6 provides correction mechanisms for documentary failures, such as impermissible payment events and impermissible definitions of otherwise permissible payment events. Taxpayers who follow the prescribed correction mechanism in a timely manner may obtain relief from the full application of the income inclusion and the additional taxes under Section 409A.

While the tax burdens of Section 409A fall primarily on the affected participants in non-qualified deferred compensation plans, determining the amounts to include in income and the proper withholding and reporting with respect to such amounts is the responsibility of the entity paying the compensation. IRS Notice 2008-115 provides interim guidance on these obligations. It also permits taxpayers to rely on the proposed income inclusion regulations when determining amounts includible in gross income and the taxes payable with respect thereto, provided that the taxpayer complies with all the provisions of the proposed regulations.

Additional information and reporting guidance is available in IRS Notice 2005-1, which remains in effect with respect to specific issues not superseded by the final regulations. These issues include the application of Section 409A to arrangements of certain tax-exempt organisations and to arrangements between a partnership and a partner of the partnership.

Case law

To date, two court rulings have addressed Section 409A. Because of the dates of the applicable facts, both rulings are based on IRS Notice 2005-1, relevant portions of which have been superseded by the final regulations. Therefore, the extent to which these rulings will be cited as authority in future decisions based on the final regulations remains to be seen. They address areas which are likely to recur in litigation:

- income inclusion under Section 409A;
- the question of what constitutes a substantial risk of forfeiture; and
- what happens if any exceptions to Section 409A apply to a given set of facts.

In *Slater v Commissioner* the Tax Court found that an independent contractor's commissions were not subject to a substantial risk of forfeiture and thus had to be included in income under Section 409A. In *Sutardja v United States* the Court of Federal Claims found that discounted stock options constituted deferred compensation to which the plaintiff had a legally binding right for purposes of Section 409A. Further, the option term of up to 10 years precluded the application of the short-term deferral exception to Section 409A even when the plaintiff exercised the option within the two-and-a-half month period for short-term deferrals.

Section 457A

No final or proposed regulations exist under Section 457A, which applies to the non-qualified deferred compensation plans of non-qualified entities (eg, employers in certain offshore jurisdictions). The IRS has indicated informally that proposed regulations are unlikely to be issued in the near future. Pending further guidance which the IRS has stated will be prospective only, taxpayers may rely on IRS Notice 2009-8 which consists of a series of questions and answers addressing topics including:

- the effective date of Section 457A;
- when compensation is includible in income;
- what constitutes a substantial risk of forfeiture;
- what constitutes a short-term deferral;
- which entities are subject to Section 457A; and
- the interaction of Sections 457A and 409A.

Taxpayers may also rely on Revenue Ruling 2014-18 which amplifies portions of IRS Notice 2009-8 with regard to non-statutory stock options and stock appreciation rights. Specifically, Revenue Ruling 2014-18 provides that:

- a non-statutory stock option exempt from Section 409A is exempt from Section 457A;
- a stock appreciation right exempt from Section 409A that at all times by its terms must be settled, and is settled, in service recipient stock is exempt from Section 457A; and
- a stock appreciation right that may be or is settled other than in service recipient stock is not exempt from Section 457A, regardless of whether the stock appreciation right is a non-qualified deferred compensation plan for the purposes of Section 409A.

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