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IRC § 409A

I. Background

- A. Before the enactment of IRC § 409A, no single provision of the Code¹ directly and comprehensively addressed the tax consequences of nonqualified deferred compensation; rather, a grab bag of Code provisions, IRS rulings, and court cases established those consequences.
1. Constructive receipt. IRC § 451.
 2. Economic Benefit. Sproull v. Commissioner, 16 T.C. 224 (1951), aff'd per curiam, 194 F.2d 541 (6th Cir. 1952); IRC § 83.
 3. Matching of payer's tax deduction with payee's income realization. IRC § 404(a)(5).
 4. Tax consequences of nonqualified funded trust for deferred compensation. IRC § 402(b).
 5. Imposition of FICA tax when services performed or at vesting. IRC § 3121(v).
 6. Rabbi trusts. Rev. Proc. 92-64, 1992-2 C.B. 422 and various private letter rulings.
- B. The basic economic trade-off of nonqualified deferred compensation is that the payer does not get a deduction for a nonqualified deferred compensation amount until the payee is required to recognize the amount as income. IRC § 404(a)(5)
1. 1980's Albertson case established that IRC § 404(a)(5) deferral of deduction includes a deferral for the deduction of notional earnings on deferred amounts.

¹ References herein to the "Code" are, of course, to the Internal Revenue Code of 1986, as amended.

2. IRC § 404(a)(5)'s delay of the payer's deduction until the payee's recognition of income would appear to protect the fisc from the economic impact of the use of nonqualified deferred compensation.
 - (a) However, rise of corporate tax shelters in 1990's undermined the protection of IRC § 404(a)(5).
 - (b) Also, perceived abuse of nonqualified deferred compensation by Enron and other companies led to pressure for reform.
- C. While the basic tax principles and Code sections that governed nonqualified deferred compensation were well-settled, there were longstanding areas of disagreement between Treasury and IRS, on the one hand, and the private bar, on the other, over how some of those tax principles applied.
 - (a) Constructive receipt: When did you need to make an election to defer an amount? Treasury and IRS said in the taxable year before the taxable year in which services performed. Private bar, based on Oates and Veit cases, said any time before the amount was legally "due and payable." What about redeferrals? Financial penalties? Ability to request distributions for hardship?
 - (b) Economic benefit: Did a rabbi trust with a financial health trigger not result in a taxable economic benefit until the financial health trigger conditions occurred? Could you have an offshore rabbi trust? What about individual direction of notional investments?
 - (c) What constitutes nonqualified deferred compensation: Are discounted stock options nonqualified deferred compensation? What about SAR's?
- D. Treasury and IRS were hampered in their ability to address tax uncertainties by Revenue Act of 1978 provision that prohibited Treasury or the IRS from deviating from prior law with respect to the taxation of deferred compensation programs of private employers.
- E. Nonqualified deferred compensation has been largely invisible to IRS auditors.
 1. Individual returns to not disclose amounts until they are included in income.
 2. Corporate auditors don't see nonqualified deferred compensation until it is paid and deducted.

- F. Treasury and IRS had been rumored for years to be preparing guidance that would have moved away from prior, unrealistic positions on some issues, such as timing of the deferral election, but that would also have attempted to rein in some practices. At the same time, Treasury had been lobbying Congress to repeal the Revenue Act of 1978 freeze on new regulations or rulings.
- G. The fact that, in an audit that successfully challenged the deferral of an item, all that was at stake was inclusion of the item in income (i.e., the service provider was basically no worse off than if he or she had not attempted to defer the item in the first place) was a disincentive to IRS to attempt to vigorously enforce its views regarding nonqualified deferred compensation tax rules.
- H. Legislative response to the collapse of Enron and other corporate scandals, which featured many nonqualified deferred compensation abuses (use of corporate tax shelters to offset lack of deductions; use of financial health triggers or discretionary early distributions to place money off-limits to creditors) gave Treasury and the IRS an opening to push their legislative agenda regarding nonqualified deferred compensation.
- I. House Ways and Means Committee Chairman Bill Thomas's (R-CA), who has a reputation as a tax policy purist, drafted a provision that eventually became Section 885 of the American Jobs Creation Act of 2004 (AJCA 2004). It was included in part because it was scored as a revenue raiser. AJCA of 2004 Section 885 enacted IRC § 409A.

II. Overview of IRC § 409A

- A. IRC § 409A does not repeal any previously existing Code provision involved in nonqualified deferred compensation, but rather is a new superstructure built on top of existing law.
- B. IRC § 409A takes a sweeping view of what constitutes “nonqualified deferred compensation.”
- C. IRC § 409A creates clear, narrow rules for nonqualified deferred compensation in the areas of the timing of deferral elections and distributions; it also prohibits the use of financial health triggers and offshore rabbi trusts.
- D. IRC § 409A creates a harsh tax penalty regime for nonqualified deferred compensation that does not satisfy all of the new deferral election timing, distribution, and funding rules.
 - 1. No one will want to have non-compliant nonqualified deferred compensation.

- E. By defining nonqualified deferred compensation very broadly, but then specifying a fairly narrow set of rules for nonqualified deferred compensation that really is completely suitable only for a relatively simple type of nonqualified deferred compensation program, i.e., elective account-based plans, IRC § 409A has created an enormous canvas that Treasury will need to fill in with a myriad of special rules and compromises.
 - 1. Taxation of SAR's is one example.
 - F. IRC § 409A is effective for amounts deferred after December 31, 2004.
 - 1. The inapplicability of IRC § 409A to amounts deferred before January 1, 2005 is lost if the plan under which the amount was deferred is "materially modified" after October 3, 2004.
 - G. IRC § 409A does not say anything about notional investment of account balances; the argument that close individual control over notional investments might cause taxation under a "dominion and control" theory seems to have been pushed to the side for now.
- III. Definition of "nonqualified deferred compensation" to which IRC § 409A applies
- A. IRC § 409A(d)(1) provides that a nonqualified deferred compensation plan is "any plan that provides for the deferral of compensation other than . . . a qualified employer plan [under IRC § 401(a), 457(b), or similar provision], and . . . any bonafide vacation, leave, sick leave, compensatory time, disability pay, or death benefit plan."
 - B. The foregoing definition seems to sweep very broadly (e.g., stock options, restricted stock, phantom stock, severance pay), and in IRS Notice 2005-1 Treasury and IRS have indicated that they intend to push IRC § 409A into virtually every crevice of executive compensation, while making targeted policy-based exceptions for certain arrangements not typically viewed as being nonqualified deferred compensation.
- IV. How IRC § 409A's tax penalty regime works
- A. If at any time a plan of nonqualified deferred compensation does not satisfy, in both form and operation, the deferral election timing, distribution, and funding rules of IRC § 409A, then all compensation deferred under the plan is includible in income in the year of the failure, an additional 20% tax is assessed, and to the extent portions of the total included amount are attributable to amounts deferred in earlier years, an interest charge is assessed. IRC § 409A(a)(1).
 - B. Note that the inclusion in income would trigger deductibility to the obligor under IRC § 404(a)(5) and that there are no tax penalties on the obligor.

1. Sets up interesting situation because while penalties would be all on obligee, IRC § 409A compliance failure would in virtually all factual contexts have been caused by employer.
 2. Note that just because an amount has been included in the participant's income because of an IRC § 409A compliance failure, this would not automatically mean the amount could be distributed under the terms of the plan.
 - (a) In fact, an IRC § 409A compliance failure is not one of the permitted distribution events under IRC § 409A, and presumably inclusion of such a provision in a plan would itself be an IRC § 409A compliance failure triggering inclusion in income.
 - (i) However, it may be possible to add non-IRC § 409A-compliant distribution provisions immediately after an IRC § 409A failure causing inclusion in income - - the addition itself would be another IRC § 409A failure, but since all amounts would already have been taxed under the plan and the tax penalties would have applied, it might not make any difference.
- C. Note that Notice 2005-1 indicates some backing away from the notion, as stated in the statute, that an IRC § 409A compliance failure causes all amounts under the plan to be included in participants' taxable income and subject to penalties; at least for the 2005 transition period, it introduces the notion that some failures may affect only an individual or group of individuals. See IRS Notice 2005-1, Q&A-19(b).
1. E.g., a plan has an IRC § 409A-compliant provision for distributions in the event of unforeseeable emergencies, but one participant inadvertently receives an amount based on a claimed unforeseeable emergency that does not comply with IRC § 409A - - only that participant would apparently be affected.
 2. Or an impermissible plan provision is added for a group of participants, but does not affect other participants - - only the group to whom the amendment applies would be affected. Statement of Treasury Department representative made during January 6, 2005 ABA Teleconference.
 3. Additionally, Q&A-9 of Notice 2005-1 says, "Unless otherwise specified in this notice, the requirements of § 409A are applied as if . . . a separate plan or plans is maintained for each service provider. . . ."

- V. When deferral elections must be made under IRC § 409A
 - A. The general rule is that the election to defer must be made no later than the last day of the taxable year preceding the taxable year in which the services are performed for which the compensation would be payment. IRC § 409A(a)(4)(i).
 - B. There are only two exceptions to the general rule.
 - 1. In a participant's first year of participation, an election to defer compensation earned during the year, but after the date of the election, may be made as late as 30 days after the participant becomes eligible. IRC § 409A(a)(4)(ii).
 - 2. In the case of "performance-based compensation based on services performed over a period of at least 12 months," the election must be made not later than six months before the end of the performance period. IRC § 409A(a)(4)(iii).
 - (a) Per legislative history, "performance-based" is to be defined similarly to the way it is defined for purposes of IRC § 162(m).
 - (b) The performance-based exception doesn't provide much practical help for most discretionary bonus programs, because uncertainties as to the payment and amount of the bonus may make it impractical to make an election six months out.
- VI. IRC § 409A's distribution rules provide that distribution of nonqualified deferred compensation can be made only in the case of six events. IRC § 409A(a)(2).
 - A. Separation from service. IRC s 409A(a)(2)(A)(i).
 - 1. In the case of "key employees," as defined in IRC § 416(i) distribution on separation from service must be delayed until six months after separation from service. IRC § 409A(a)(2)(B)(i)
 - 2. "Separation from service" is to be defined in regulations, and the qualified plan controlled group rules apply to prevent transfers between affiliates from being treated as separations from employment. IRC § 409A(a)(2)(A)(i) and IRC § 409A(d)(6).
 - B. Disability as defined in the statute. IRC § 409A(a)(2)(A)(ii) and IRC § 409A(a)(2)(C).
 - C. Death. IRC § 409A(a)(2)(A)(iii).

- D. At a time, or pursuant to a schedule specified as of the date of deferral. IRC § 409A(a)(2)(A)(iv).
 - E. A change in control. IRC § 409A(a)(2)(A)(v).
 - 1. As written, appears to apply to corporations only.
 - 2. Change in control is to be defined in a way similar to the definition under IRC § 280G. Conference Report.
 - F. An unforeseeable emergency of the participant. IRC § 409A(a)(2)(A)(vi).
 - 1. IRC § 409A includes a definition of unforeseeable emergency that restricts it to illness, accident, or property casualty of the participant, spouse, or dependent, or to “other similar extraordinary and unforeseeable circumstances . . . beyond the control of the participant.” IRC § 409A(a)(2)(B)(ii)(I).
 - 2. Amount distributed based on unforeseeable emergency must be limited to amounts necessary to respond to emergency, plus tax on amount distributed. IRC § 409A(a)(2)(B)(ii)(II).
 - G. Notice what are not permitted distribution events under IRC § 409A.
 - 1. A specified event with no definite time, e.g., birth of first child.
 - 2. Plan termination (other than following change in control of corporation).
 - 3. Distribution on request if willing to take “haircut.”
 - 4. An IRC § 409A failure that causes the amount to be taxed.
 - 5. Distribution based on financial trigger, e.g., deteriorating balance sheet.
 - 6. Exercise of discretion by employer.
 - 7. Distribution because a corresponding amount under a qualified plan is being distributed.
- VII. IRC § 409A’s rules for making changes to deferral elections
- A. Can never elect to accelerate a distribution before its previously scheduled time. IRC § 409A(a)(3).
 - B. Can make a change to delay a payment or to change the form of payment if election meets certain requirements.

1. Election to change must be made at least 12 months before the date on which it takes effect. IRC § 409A(a)(4)(C)(i).
2. The change must defer the first payment subject to the election by at least five years from the date it would otherwise have been made. IRC § 409A(a)(4)(C)(ii).
3. Rules will be worked out regarding changes involving installments, which could otherwise result in prohibited acceleration.

VIII. IRC § 409A's rules prohibiting certain informal funding devices

- A. An offshore rabbi trust or similar security device will cause immediate IRC § 409A failure and consequent income tax inclusion and penalties. IRC § 409A(b)(1).
 1. Exception for foreign rabbi trusts and similar security devices where substantially all services giving rise to deferred amounts were performed in the jurisdiction in which the rabbi trust or similar security device is located. IRC § 409A(b)(1) (flush language).
- B. A "financial health" trigger in a rabbi trust (so-called "rabbicular trust") will also cause immediate IRC § 409A inclusion, even if conditions that would pull trigger have not yet occurred. IRC § 409A(b)(2).

IX. New nonqualified deferred compensation reporting rules

- A. The total amount of an employee's deferrals of compensation for the year under a nonqualified deferred compensation plan will now be required to be reported in an informational box on the employee's IRS Form W-2. IRC § 6051(a)(B).
- B. An inclusion of an amount in an employee's income on account of an IRC § 409A failure is subject to withholding, whether or not the amount is actually paid to the employee. IRC § 3401(a) (sentence added at end).

X. IRC § 409A's effective date

- A. Applies generally to amounts deferred after December 31, 2004. AJCA 2004 § 885(d)(1).
 1. Excludes earnings on pre-2005 deferrals. AJCA 2004 § 885(d)(2)(A).
 2. Treasury and IRS take position that exemption for pre-2005 deferrals and earnings on deferrals does not apply to rules prohibiting offshore informal funding and financial health triggers.

- B. Grandfather for pre-2005 amounts does not apply if plan is “materially modified” after October 3, 2004. AJCA 2004 § 885(d)(2)(B).
- C. PGA lobbied for and received special permanent exemption from IRC § 409A. AJCA 2004 § 885(d)(3).
- D. Congress required Treasury to issue transitional guidance within 60 days of date of enactment providing a limited period during which pre-2005 plans could be amended to permit participants to rescind elections to defer post-2004 amounts and also could be amended retroactively to bring them into compliance with IRC § 409A for post-2004 deferrals. AJCA 2004 § 885(f).
 - 1. This is the statutory basis for Notice 2005-1’s transition relief.
 - 2. Congress also required Congress to provide guidance within 90 days of enactment defining “change in ownership or effective control” of a corporation. AJCA 2004 § 885(e). This guidance was included in Notice 2005-1.