WRMarketplace
An AALU Washington Report

Thursday, June 11 2015 **WRM# 15-21**

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: Better Consult the Oracle: 8 Key Questions for Code § 409A Compliance – The Gatekeeper to Structuring Effective Deferred Compensation Arrangements.

MARKET TREND: As tax-qualified retirement plans allow income deferral on a fairly limited annual basis, the popularity of nonqualified deferred compensation ("NQDC") arrangements for key employees continues to grow due to the greater income deferral opportunities.

SYNOPSIS: Internal Revenue Code § 409A ("§409A") establishes several critical hurdles to tax-deferrals by imposing 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. Failure to meet these requirements subjects the individual deferring the compensation to substantial additional tax penalties.

TAKE AWAYS: §409A imposes very specific constraints for structuring NQDC arrangements. A general checklist for a §409A-compliant NQDC arrangement (attached) includes: (1) documentation of the arrangement in writing; (2) provision of conforming deferral elections (typically made before the year in which the relevant services are performed); (3) limits on distributions to only those circumstances specifically allowed under §409A; and (4) constraints on the ability to change the timing and form of payment originally selected. Failure to comply with §409A may subject the participant to current income tax on the amount purportedly deferred, plus interest and substantial additional taxes. Accordingly, advisors working in the NQDC arena must have familiarity with these requirements.

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

§409A has revolutionized the world of NQDC arrangements by imposing rigorous standards governing deferral elections under, and distributions from, NQDC arrangements. Failure to satisfy these standards will subject the taxpayer to significant tax penalties.

EIGHT KEY QUESTIONS FOR §409A COMPLIANCE

1. Which compensation arrangements are impacted by §409A?

§409A extends far beyond the typical NQDC plan pursuant to 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 applies to 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. Thus, arrangements such as employment agreements, bonus plans, and long-term incentive plans can trigger §409A.

Further, §409A may impact the funding of a NQDC arrangement. For example, an employer may create a revocable or irrevocable "rabbi trust" to hold assets to be used in connection with a NQDC. §409A, however, can take away some of the employer's flexibility with respect to the revocability of, and timing of deposits into, a rabbi trust. Specifically, §409A prohibits an employer from restricting certain amount to the payment of deferred compensation upon a change in the employer's financial health – i.e., the employer cannot limit the manner in which corporate assets can be used. Thus, if a change in the employer's financial health triggered irrevocability for a revocable rabbi trust or the making of contributions to an irrevocable rabbi trust, the participant would be taxable on the trust amount in the trust and subject to an additional tax penalty (see question 8 below). Thus, it may be advisable to establish a rabbi trust as an irrevocable trust or as one that becomes irrevocable only upon events unrelated to the employer's financial health.

2. ***Are there exceptions to §409A for certain arrangements?***

Yes, there are certain **limited exceptions**. Most notably, 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 are exempt from §409A. The most widespread 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.

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.

A "162 bonus plan," where an employer effectively funds an employee's purchase of life insurance through the payment of bonuses to the employee or possibly through direct payment to the issuing carrier, also may not be required to comply with §409A. This will depend, however, on the structure of the plan and any restrictions the employer may seek to impose. Thus the employer and employee should consult with counsel when designing the bonus plan to determine the potential application of §409A.

3. ***Must the NQDC arrangement be in writing?***

Yes. §409A requires that any NQDC arrangement be in writing and contain substantive provisions designed to ensure compliance with the §409A requirements.

4. ***How does §409A affect the timing of an election to defer compensation?***

§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 all or a portion of his or her salary for 2016, the election to defer must be made, and become irrevocable, no later than December 31, 2015. By comparison, if an individual wishes to defer a bonus payable in 2016 for services performed in 2015, the election to defer the bonus likely must be made, and become irrevocable, by the end of 2014 (*i.e.*, the year before the year in which the relevant services are performed).

In addition to specifying the amount of compensation to be deferred, a deferral election must establish the time and form of payment, in a manner that is consistent with the restrictions of §409A. In a NQDC arrangement other than one in which the taxpayer elects to defer receipt of compensation (*e.g.*, a long-term bonus plan that pays out beyond the short-term deferral period), the time and form of payment must be established when the legally binding right to the deferred compensation is created.

5. ***How does §409A restrict the timing of distributions of deferred compensation?***

§409A narrowly limits to six payment triggers the time or times at which deferred compensation can be paid:

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

Most of these payment triggers are defined in detail in the §409A regulations.

6. ***Can the time originally selected for payment of deferred compensation be changed?***

Generally, the time and form of distribution, once elected, cannot be changed, subject to very few 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 the distribution by at least an additional five years. Likewise, a participant typically cannot elect to accelerate the date set for distribution. Note also that the form of payment originally selected when the deferral election was made or the legally binding right to the deferred compensation was created generally cannot be changed either.

7. ***Does §409A require compliance only at the time a NQDC arrangement is established?***

No. Quite to the contrary, §409A requires compliance in documentation and in plan operation at all times from the time of establishment of the NQDC arrangement until the time the last payment is made.

8. ***What are the penalties imposed for failure to comply with §409A?***

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

- 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

- The amount includible in current taxable income is subject to:
  - **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**
  - 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. As a result, **a failure to comply with the §409A requirements can result in current taxation in excess of 50% of the amount deferred – REGARDLESS of whether the participant has the liquidity available to pay the tax liability.**

TAKE AWAYS:

- §409A imposes very specific constraints for structuring NQDC arrangements. The checklist below includes general requirements for §409A compliance.

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

- 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.

§409A GENERAL COMPLIANCE CHECKLIST

- NQDC arrangement (plan) is:
    - Documented in writing
    - Limits distributions to the following circumstances:
        - Upon the individual's separation from service with the entity maintaining the NQDC plan;
        - Upon the individual's death;
        - Upon the individual's disability;
        - Upon a change in control of the entity liable for the payment of the deferred compensation;
        - Upon the individual's experiencing an unforeseeable financial emergency; or
        - As of a specified date or pursuant to a specified schedule.
    - Prevents the participant from changing the timing and form of payment originally selected (subject to limited exceptions)
- Plan participant has provided conforming deferral elections timely (before the year in which the relevant services will be performed), which:
        - Specify amount of compensation to be deferred
        - Establish the time and form of payment consistent with §409A restrictions

The AALU *WRNewswire* and *WRMarketplace* are published by the Association for Advanced Life Underwriting® as part of the *Essential Wisdom Series*, the trusted source of actionable technical and marketplace knowledge for AALU members—the nation's most advanced life insurance professionals.

WRM #15-21 was written by Greenberg Traurig, LLP
Jonathan M. Forster
Martin Kalb
Richard A. Sirus
Steven B. Lapidus
Rebecca Manicone

Counsel Emeritus
Gerald H. Sherman 1932-2012
Stuart Lewis 1945-2012