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2021 Year-End Tax Issues for Non-Qualified Plans

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DECEMBER 31 DEADLINE FOR CORRECTING SECTION 409A FAILURES

Amid the year-end crush, one area worth the focus of tax and HR departments is the potential for Section 409A failures. There is a window to avoid – or at least identify and correct – such errors by year-end. Failures commonly arise in connection with-

- Deferred compensation plans
- Excess 401(k) and Pension plans
- SERPs
- Equity compensation plans
- Voluntary retirement programs

Under IRS rules, Section 409A failures can be inadvertent and victim to a Goldilocks conundrum – paying either too "early" or too "late" is a problem. Failures can arise from payroll errors, missteps by, or imperfect communication with, third-party vendors, or HRIS software not fully matching changes in status or transfers of employment to plan benefits.

Common failures include:

- Mistakenly not deferring pay in accordance with a participant's election, such as not applying an election to a bonus payment;
- Paying out plan benefits even though the participant did not separate from service – for example, because the participant moved to an affiliated employer or partially-owned joint venture; and
- Not paying out plan benefits even though a participant separated from employment and is owed benefits – for example, delaying payment while an employee is on payroll but no longer providing material services because of a reduction in status or a leave of absence.

Employers can correct many of these failures under IRS corrections guidance:

- Payments due in 2021 and paid "late" but prior to 2022 often are not 409A failures at all. Other same year issues can be corrected with minimal consequence.
- 2020 failures to defer or timely pay can be corrected with minimal consequence in 2021

Takeaway: *An ounce of* Section *409A prevention is worth a pound of cure-*

- *Uncorrected Section 409A failures can result in significant consequences. In addition to a 20% additional tax on the participant's entire benefit, it is not uncommon for premium interest and other penalties to be just as costly or even more than the 20% additional tax.*
- *IRS corrections guidance can provide relief to all or a portion of potential penalties.*
- *December 31, 2021 is the deadline to correct various Section 409A failures that occurred in 2019 or 2020.*
- *Employers and their recordkeepers should review plan operations to identify common failures. It is often useful to focus on participants who entered pay status or had a change in employment (separation, transfer, transition to consulting).*

as long as the participants were not "insiders," as defined in Notice 2008-113.

- 2019 failures to defer or timely pay (or 2020 failures involving insiders) can be corrected with reduced consequences in 2021 (20% tax usually is limited to the amount of the mistake, rather than applying to all aggregated plan benefits).

Corrections made in accordance with IRS guidance can provide important protections to both employees and employers. Although the Section 409A 20% additional tax generally falls on employees, employees may seek or expect reimbursement for this additional tax cost. In addition, employers can face reporting and withholding penalties in connection with Section 409A failures.

STATE TAXATION OF NON-QUALIFIED DEFERRED COMPENSATION

Increasing remote work has expanded state income tax compliance challenges for employers. COVID-19 also has increased retirement rates. At the same time, a number of states are increasing income tax rates on the highest earners. As a result, state taxation of non-qualified deferred compensation payouts is receiving greater attention from plan participants, tax departments, and state taxing authorities alike. Numerous states – notably California, New York, and Massachusetts – are particularly aggressive in seeking to tax former residents on amounts that they receive in connection with services performed while they were resident in the state.

The Pension Source Act (4 U.S.C. §114) provides protection from these aggressive states, but only if the plan is carefully designed to meet the Pension Source Act requirements.

One shield under the Pension Source Act is for plans where payment is made in equivalent installments over at least 10 years. Many plans offer such an election; however, it may not take effect if the employee does not reach a particular retirement age. To achieve more participant-friendly results, employers should consider whether they should allow participants to modify their plan deferral elections – but must do so only in a manner that complies with Code Section 409A.

Another shield under the Pension Source Act is for excess or mirror plans that supplement the benefits provided under a qualified retirement plan, even if payments are made in lump sums. Recent New York advisory opinions suggest that the relief may not be limited to amounts that are calculated squarely based on the terms of the 401(k) plan – one opinion indicated that the exception covered a plan with a non-elective, company-provided credit that did not directly connect to the formula under the 401(k) plan. The New York opinion's implication is that the Pension Source Act could extend to amounts that cannot be provided under a qualified plan because of the qualified plan nondiscrimination requirements or the Code's explicit dollar limits. If this is correct, it should not matter if the non-qualified plan deferrals are based on the participant's elective deferrals or non-elective company credits.

Takeaway: *When we review employer practices regarding non-qualified plan state income taxation, we find that it is an area where compliance risks and planning opportunities may have been overlooked. Tax departments should understand how their payroll departments administer non-qualified plan (and equity) payouts for state income tax purposes, work to ensure that plan and payroll vendors can provide necessary reporting support, and evaluate whether plan design changes are desirable.*

EXPANDED SECTION 162(M) DISALLOWANCE STILL SET FOR 2026

Congress considered including in the infrastructure legislation and Build Back Better (BBB) Act various expansions to the Section 162(m) disallowance that applies to publicly traded companies. Ultimately, the only provisions that remain in the BBB Act that passed the House are a few technical "clarifications."

These changes would ensure that pay after termination of employment is covered by Section 162(m) and limit other strategies practitioners may have hoped to use to avoid the application of Section 162(m).

Notably, even if it passes the Senate, the BBB Act would *not* accelerate to 2022 the expansion to the definition of "covered employees" that currently is set to take effect in 2026 under the American Rescue Plan Act (ARPA) of 2021 (P.L. 117-2, passed in April 2021). The ARPA's expansion provides that, after the CEO, CFO, and next top-3 highest paid officers are identified, the next five highest paid employees (whether officers or not) also will be considered covered employees.

Acceleration of this change would have been particularly problematic because there are a number of questions about its application that remain unanswered. For example:

- Can a former employee count toward one of the next five highest paid employees (for example, as a result of a large deferred compensation payout)?
- How is pay calculated for the next five highest paid (for example, is it SEC-based pay, which takes amounts into account when earned, or W-2 pay, which takes non-qualified benefits into account only as they are paid)?
- Can an employee count toward the next five highest paid employees if the employee already would be counted as a result of the "once-a-covered-officer, always-a-covered-officer" rule?

The Treasury Department has not issued any guidance to date. Interested taxpayers may consider whether to submit comments to the Treasury on these or other issues. We regularly assist clients with the preparation of IRS and Treasury comment letters and have submitted numerous comments specifically on Section 162(m).

See more on IPB's 162(m) Resources page.

Prepare for Potential Loss of Deferred Income Taxation?

In recent years, legislation introduced by both sides of the aisle has included a new Code Section 409B, which would accelerate the federal income taxation of non-qualified deferred compensation. Instead of being taxed when amounts are paid to them, employees instead would be taxed on non-qualified plan benefits when amounts are credited for them or accrued (or vested, if later). (FICA taxation already uses a rule like this.)

If these proposals gain traction, there are still significant questions:

- To what extent will existing deferrals be grandfathered?
- If there is not grandfathering, will there be a time horizon over which existing deferrals must be taxed?
- What action can employers take (e.g., accelerating payments, albeit at significant cash flow cost) if existing deferrals become taxable?
- What exceptions might apply including, for example, for equity pay?

At this point, the proposal has reappeared multiple times. It is perceived to be a revenue raiser with bipartisan support, so it easily could be slipped into future legislation. Companies with material deferred compensation liabilities should stay tuned and consider the cash flow hit that may be involved if the legislation is adopted. We also recommend that employers' non-qualified plan communications put participants on clear notice that the tax consequences of plan participation are not guaranteed and can very well change.

Contact us. If you have questions, please contact Spencer Walters, Kevin O'Brien, or any other member of our Benefits & Compensation practice.