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Benefits & Compensation
2021 Year-End Preparation for Non-Qualified Plans

DECEMBER 31 DEADLINE FOR CORRECTING 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 the Goldilocks conundrum – resulting from paying either too "early" or too "late." Failures can arise from payroll errors, missteps by or imperfect communication with third-party administrators, 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 trailing 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 that is either wholly owned or even just a 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 retained on payroll but no longer providing substantial services because of a reduction in status or a leave of absence.

Takeaways: *An ounce of year-end 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.*
- *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 should review their plans – or have their recordkeepers review plan operations – to identify common failures. It is often useful to focus on participants who entered pay status or who recently had a change in employment (separation, transfer, transition to consulting).*

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 as long as the participants were not “insiders,” as defined in Notice 2008-113.
- 2019 failures to defer or timely pay (or 2019 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.

FICA Tax Pre-Pay Opportunity?

Flexibility under FICA tax regulations offers opportunities if employment tax rates increase in future years. In particular, deferred compensation plan benefits generally are subject to FICA tax when the services giving right to the pay are performed or the amounts become vested, whichever is later. However, employers can, and often do, delay FICA taxation of benefits under non-account balance plans until the amounts are "reasonably ascertainable."

If FICA taxes will increase, it might be advantageous *not* to delay FICA taxation of non-account balance plan (SERP and excess DB plan) benefits until the amounts are "reasonably ascertainable." Taking these amounts into account earlier when rates are lower could shield them from additional tax later at higher rates. (This result has been true in the past but may not necessarily apply in future legislation.)

Employers with executives accruing non-account benefits should continue to monitor legislative developments and consider whether it may be advantageous to offer a pre-payment of FICA tax to recipients of non-account balance non-qualified plan benefits.

Prepare for Potential Loss of Deferred Income Taxation?

Legislation proposed by Republicans and Democrats alike would impose federal income tax on non-qualified deferred compensation plan amounts as they are credited or accrued, or when they are vested if later. If this passes, individuals would not be able to defer income taxation until amounts are paid to them by their employer. The approach for federal income taxation would therefore match the approach for FICA taxation.

There are still significant questions to be worked out:

- 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., accelerate payments) if existing deferrals become taxable?
- What exceptions might apply including, for example, for equity pay?

At this point, we are cautiously hopeful that this proposal will not be passed. However, it is a revenue raiser with bipartisan support, so it could be included in future legislation. We recommend that clients’ communications addressing the tax consequences of participating in non-qualified deferred compensation plans at least caution that these tax consequences could change.