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

November 2020

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

Under IRS rules, Section 409A failures can be inadvertent, resulting from paying "early" or "late." They can arise from payroll errors, missteps by 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; 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.

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

- Payments due in 2020 but paid "late" often are not 409A failures at all. Other same year issues can be corrected with minimal consequence.
- 2019 failures to defer or timely pay can be corrected with minimal consequence in 2020 as long as the participants were not insiders.
- 2018 failures to defer or timely pay (or 2019 failures involving insiders) can be corrected with reduced consequences in 2020 (20% tax usually limited to the amount of the mistake).

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

Takeaway: *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, 2020 is the deadline to correct various Section 409A failures that occurred in 2018 or 2019.*
- *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).*

PUBLICLY TRADED COMPANIES: SPECIAL 162(M) DEADLINE FOR PLANS THAT REQUIRED DELAY

The 2017 tax reform law generally restricted the ability of publicly traded companies (newly including those with publicly traded debt) to deduct pay to top executive officers. In particular, the Treasury and IRS interpret the changes so that Section 162(m)'s $1 million deduction limit continues to apply even to payments made after an executive's termination of employment. This means that the deduction limit cannot be avoided simply by delaying payment of amounts that become due to an executive.

Some employers previously managed Section 162(m) limits by delaying payments until they become deductible. In some cases, plans include language giving employers discretion to delay payment. In other cases, plans include language requiring delayed payment. Complicating matters in either case, Section 409A has very specific limits on the ability to delay payment to comply with Section 162(m). Under Section 409A, a change to these provisions could be an impermissible deferral or acceleration that results in a Section 409A failure.

In light of the changes and stringent limits under Section 409A, Treasury and IRS determined that relief should be available to allow delays of payment to be removed. In particular, the Treasury and IRS said that employers can amend their plans no later than December 31, 2020 to remove a required delay and that such amendment-

- will not result in an impermissible acceleration of payment under Section 409A regulations; and
- will not be considered a material modification for purposes of losing 162(m) grandfathered status.

Employers should review their non-qualified plans and equity plans to determine whether they provide for a discretionary or required delay. If so, amendments should be seriously considered.

FICA TAX PRE-PAY OPPORTUNITY IN 2020 OR 2021?

It is not yet known whether the Presidential transition and potential for changes in the balance of legislative power could result in significant new tax legislation in 2021 or 2022. Some taxpayers have been bracing for the possibility of increased employment taxes.

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.

SECTION 409B INCOME TAXATION UPON VESTING?

Recent legislative proposals from both Republicans and Democrats, supported by recent academic commentary, make it a virtual certainty that proposals will again surface to accelerate the taxation of nonqualified deferred compensation so that they are taxed when they vest even before they paid. Taxation upon vesting already is the rule for FICA purposes (Section 3121(v)) and for non-grandfathered plans of non-profit entities (Section 457(f)). Indeed, Hill staffers have recently indicated to us that such a change is at the top of the list of revenue raisers because of perceived bipartisan support. Members believe this idea is politically palatable and would garner widespread popular support because nonqualified deferred compensation plans are limited to higher paid executives.

If such a proposal is passed, key questions are whether-

- Exceptions might apply for plans providing retirement income (for example, similar to the exception under 4 USC § 114 that prevents states from taxing non-residents on retirement income);
- Amounts are grandfathered so that existing deferrals can avoid taxation until they are paid; or
- Taxation is phased in over a transition period.

At this point, it may be difficult for employers to take specific action to prepare for these potential changes. At a minimum, employers should be sure to include disclosures in their deferred compensation plan summaries explaining to participants that U.S. tax laws may change.