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Proposed Regulations Clarify Penalty Taxes on Income Inclusions

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In 2004, Congress amended the Internal Revenue Code (the "Code") to discourage the deferral of compensation under certain "nonqualified deferred compensation plans." (The term "nonqualified" means generally that a plan is not a "qualified" pension, profit-sharing, or stock bonus plan subject to ERISA and related rules.) Individuals, who typically report their income under the cash receipts and disbursements method of accounting, do not normally report compensation income from employment until it is received by them. Deferred compensation plans thus have the potential to provide a significant tax advantage to individual employees who are compensated under them.

Under a statutory provision added in 2004 ("section 409A"), however, income earned under any "nonqualified deferred compensation plan" must be reported when it is no longer subject to a "substantial risk of forfeiture," even though not yet received, and is subject to a penalty tax and a penalty interest charge, unless the plan: requires that distributions may be made only at a prespecified time or upon the occurrence of certain events, such as separation from service, disability, or a change of control of the employer; precludes the acceleration of payments under most circumstances; and requires that any "deferral election" be made only at prescribed times. If a nonqualified deferred compensation plan violates these rules -- for example, by permitting an acceleration of benefits, or a payment upon an event which is not a permissible payment event -- the punitive provisions of section 409A will apply.[1]

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Basic Rules

If, during any taxable year, a nonqualified deferred plan fails to meet the requirements of section 409A, either by failing to contain the appropriate provisions or by failing to be operated in accordance with the statutory requirements (regardless of what the written plan provisions may provide), any compensation deferred under the plan for that year and all preceding years must be included in income (to the extent not previously included) at the time the employee acquires a legally binding right to payment from the employer or other service recipient, or, if later, when the employee's right ceases to be subject to a "substantial risk of forfeiture."

Section 409A also imposes an additional tax equal to 20% of the compensation required to be included in income. This tax is above and beyond the regular income tax imposed with respect to the deferred compensation, and is payable even if the employee has available losses or other tax attributes to offset the compensation income. Moreover, the employee must also pay interest, determined at the IRS underpayment rate plus 1 percentage point, on any tax underpayment that would have arisen if the deferred compensation amount had been included in the employee's income at the time first deferred or, if later, when the amount ceased to be subject to a substantial risk of forfeiture.

The IRS and Treasury have previously issued guidance that addresses, among other matters, the documentation required for nonqualified deferred compensation plans to avoid punitive treatment under section 409A, safe harbors describing certain short-term deferrals and equity-based compensation arrangements that are not subject to section 409A's requirements, reporting and withholding issues, and transitional relief.[2]

Earlier this month, the IRS issued a notice of proposed rulemaking (REG-148326-05) proposing regulations regarding the calculation of certain amounts includible in income under section 409A with respect to a nonqualified deferred compensation plan that does not meet the documentation and operational requirements of section 409A(a) and regarding the additional tax and interest imposed on participants in such a plan.[3] The regulations are proposed to be effective for taxable years ending on or after the date the regulations are published in final form.

Highlights of Proposed Regulations

Amount includible. The amount includible in an employee's income for a taxable year, due to the failure of a plan to meet the requirements of section 409A(a), is the excess of the total amount deferred under the plan, including amounts deferred in prior years and any additional amounts deferred in the current year, over the portion (if any) of such amounts that are either subject to a substantial risk of forfeiture (for example, by reason of being contingent on the employee's continuing to render substantial services for a specified period) or that have previously been included in income. An amount is treated as having been previously included in income for these purposes if it was properly includible in income in any earlier period *and* the employee in fact included the amount in income, either on an original or amended return or as a result of an IRS examination or court decision.

In general, each year is analyzed independently. Thus, a noncompliant deferral under a plan in a prior year will generally not result in an income inclusion under the plan in a subsequent year in which the plan meets the requirements of section 409A, even if the amount deferred and includible in income in the prior noncompliant year was not in fact included in the employee's income. (However, amounts not reported when required would have to be included in income when ultimately received.)

Manner of computation. The determination of the portion of the total amount deferred that is subject to a substantial risk of forfeiture -- and therefore not currently includible in income even if the plan is not compliant with section 409A -- is made for these purposes as of the last day of the employee's taxable year. Thus, any amount as to which a substantial risk of forfeiture lapses at any time during the taxable year will be includible in income.

In general, the total amount deferred for a taxable year under a plan is defined as including the present value, as of the last day of the taxable year, of the future payments to which the service provider has a legally binding right under the plan. For these purposes, present value is defined as the value as of a specified date of an amount or series of amounts due thereafter, "where each amount is multiplied by the probability that the condition or conditions on which payment of the amount is contingent will be satisfied," as discounted on the basis of an assumed rate of interest to reflect the time value of money.

Certain enumerated factors, such as the risk that payments will not be made by reason of the plan's unfunded status or the risks associated with any deemed or actual investment of amounts deferred under the plan, cannot be taken into account in discounting the present value for these purposes.

With respect to a right to payment of a so-called "formula amount," the determination of the total amount deferred "must reflect reasonable, good faith assumptions with respect to any contingencies as to the amount of the payment, both with respect to each contingency and with respect to all contingencies in the aggregate." A determination at the close of one taxable year may be reasonable even if, in a later year, changes in facts and circumstances indicate that the amount payable is likely to be a greater or lesser amount. In such a case, the increase or decrease due to changes in circumstances is treated as earnings or losses with respect to the deferred amount.

The formula amount rules apply to the extent that the amount payable in the future is dependent on factors that are not determinable at the end of the taxable year for which the total amount deferred is being calculated, such that the amount payable may not readily be determinable as of the end of such year.

To illustrate this point, the proposed regulations describe a situation in which an employee receives on Jan. 1, 2020, a legally binding right to a payment, on the later of Jan. 1, 2024, or the employee's separation from service, of 1% of the employer's net profits for the calendar years 2020, 2021, and 2022. Under the formula amount rules, if the deferred compensation arrangement providing for this right is not documented or operated in accordance with the requirements of section 409A, and if the amounts were not subject to a substantial risk of forfeiture, the computation of the total amount deferred as of Dec. 31, 2020, would apparently be required to take into account reasonable assumptions as to net profits of the employer for subsequent periods.

Except as specifically provided, a risk of forfeiture that would not be considered a substantial risk of forfeiture under the regulations under section 409A, such as a provision that a deferred amount is subject to forfeiture after separation from service under a noncompetition provision, is ignored for purposes of determining the total amount deferred.

If payment of an amount may be made at alternative times or in alternative forms, the total amount deferred is determined, in general, by treating the amount as payable at the time and under the form of payment for which the present value is highest.

Similarly, in general, if the time of payment is dependent on an event that has not yet occurred, the event is treated as occurring on the earliest possible date that the event could occur based on the facts and circumstances. However, a payment trigger event will be disregarded if the nature of the trigger event is such that, if the event were the sole determinative factor as to whether the amount would be payable, the amount would be considered to be subject to a substantial risk of forfeiture.

Thus, for example, if an amount otherwise payable to an employee at a fixed date would be paid earlier upon the involuntary separation from service of the employee, for purposes of determining the total amount deferred, the right to a payment upon involuntary separation from service is disregarded and the amount is treated as payable on the fixed date only. Conversely, if a vested amount would be payable on the earlier of an employee's attainment of age 65 or the date a child of the employee became a full-time student at an accredited college, and the employee had a 10-year old child in the fifth grade

at December 31, 2010, the total amount deferred would be the more valuable of (i) the amount that would be payable on the employee's 65th birthday and (ii) the amount that would be payable on August 1, 2018 (which is indicated to be the earliest time the child could reasonably be expected to enter college).

If a stock right -- for example, the right to a payment determined by reference to the appreciation of shares of stock -- is outstanding on the last day of the taxable year and not compliant with the documentation or operational requirements of section 409A, the amount considered to be deferred under the stock right is the excess of the fair market value of the underlying stock at that time over the sum of the stock right's exercise price and any amount paid for the stock right.

Additional tax amounts. Any amount required to be included in income, by reason of the failure of the plan to meet the requirements of section 409A(a), is subject to an additional income tax equal to 20% of the amount required to be included in income under that subsection.

Interest charge. The proposed regulations discuss in detail the computation of the interest charge on the tax underpayment that would have occurred had the deferred compensation been includible in the employee's income in the year in which the compensation was first deferred or, if later, the year in which such deferred compensation ceased to be subject to a substantial risk of forfeiture.

The examples in the regulations are helpful in illustrating the types of situations in which the interest charge may apply and the computations that may be necessary to determine the amount of the charge.

For example, if an employee elects to defer a portion of the bonus that would otherwise be payable to the employee in each of four consecutive years, not subject to a substantial risk of forfeiture, and the plan meets the requirements of section 409A in each of the first three years but then fails to meet those requirements in the fourth year, the portion of the amount deferred and includible in income as of the end of the fourth year that was deferred and vested in each of the three preceding years must first be determined.

A hypothetical tax underpayment is then calculated for each of the first three years based on the employee's taxable income, credits, filing status, and other tax information for the year. The amount of hypothetical underpayment interest is then determined by applying the appropriate rate of interest to determine the interest that would be due for such underpayment as of the last day of the taxable year for which the amount deferred is includible in income.

If a deferred amount is included in income under section 409A before it is paid, and that amount is permanently forfeited under the terms of the plan, or otherwise permanently lost before it is paid, the service provider is entitled to a deduction in the year in which it is permanently forfeited or otherwise lost. A mere diminution in the deferred amount due to, for example, a loss in value with respect to the property in which the deferred compensation was deemed to have been invested, would not be treated as resulting in a deduction.

The preamble to the proposed regulations observes that, in the case of a service provider who is an employee, the deduction would generally be treated as a miscellaneous itemized deduction, subject to the various limitations applicable to such deductions (such as the 2% floor under Code section 67, and the denial of the deduction for purposes of computation of the additional tax based on alternative minimum taxable income). The preamble indicates that the employee would not be entitled to the further tax benefit that may be accorded with respect to certain deductions attributable to earlier taxable years under Code section 1341 (relating to certain amounts received under claim of right).

The notice of proposed rulemaking also briefly discusses guidance expected to be issued regarding withholding and reporting requirements relating to deferred compensation. In particular, it is stated that the Treasury and the IRS anticipate that the reporting requirements authorized under section 409A to be imposed on employers and other service recipients, to report all amounts deferred under a nonqualified deferred compensation plan on a Form W-2 or Form 1099 regardless of whether such amount is currently includible in income, are expected to be implemented beginning with the first year for which the proposed regulations are issued in final form and become effective. It is expected that those reporting rules will be based on the principles set forth in the proposed regulations as finalized, except that taxpayers will not be required to report deferred amounts that are not "reasonably ascertainable" (as defined) until such amounts become reasonably ascertainable.

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[1] Section 409A may apply to compensation for services provided by independent contractors and others, as well as by employees. For convenience of reference, the term "employee" is used herein to refer to any service provider, and "employer" to refer to the person receiving the services.

[2] See, *inter alia*, Treas. Reg. §§1.409A-1, 1.409A-2, 1.409A-3 and 1.409A-6; IRS Notice 2005-1 (2005-1 C.B. 274); IRS Notice 2007-86 (2007-46 I.R.B. 940); IRS Notice 2008-113 (2008-51 I.R.B. ___); and IRS Notice 2008-115 (2008-52 I.R.B. ___).

[3] Income inclusions by reason of the violation of certain other requirements of IRC §409A, such as the funding-related limitations of §409A(b), are not addressed in the proposed regulations.