The IRC §409A Minefield

by James F. McDonough, Jr. on September 11, 2013

Tax professionals frequently encounter non-qualified deferred compensation plans (“NQDCA”) in the context of an estate or business. NQDCA’s include any arrangement where an employee or a service provider (independent contractor) receives a legally binding right to receive compensation in one year but it is not actually received until a later year. A legally binding right includes those situations where the service provider has the right to receive income if conditions are met. The inherent problem is that many plans in place have not been reviewed for compliance and have not been modified to satisfy these rules. The consequences of an IRC §409A violation are severe and include a back income tax, interest from the original date of deferral, and a penalty equal to 20% of the deferred compensation.

§409A was enacted in 2004 and regulations, consisting of nearly 400 pages, were issued in 2007. §409A also applies to a NQDCA between a partnership and its employees. Partnership equity awards are covered by a separate set of rules, at least for now.

§409A does not trigger recognition of income if the NQDCA satisfies certain requirements. First, deferrals in advance of having the right to the income must be made by the service provider (employee, independent contractor). Second, there must be a definite payment schedule which may include payments to be made after death or upon disability of the service provider, on a change of control or unforeseen emergency. Third, employees of publically traded employers must wait six months before receiving payment. Fourth, a service provider may alter a payment schedule by accelerating or deferring payments for Qualified Domestic Relations Order, but not beyond five (5) years.

An individual relying on NQDCA payments for retirement income would do well to ensure compliance. An individual owning an interest in a business would be well advised to become compliant to protect the value of the enterprise. Finally, clients who contemplate selling their businesses would do well to address the issue before due diligence begins and the sales price of the business is diminished by the potential liability.