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Section 409A: Fifteen Years Later

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by Robert Delgado, Erinn Madden, and Carly Rhodes, Washington National Tax[*]

Fifteen years ago, a comprehensive set of rules and definitions restricting employers and employees in the design and modification of deferred compensation arrangements—section 409A—was enacted. First in a series, this article provides high level background and generally describes the overall framework of those rules, which serve as the foundation for future articles addressing a variety of related topics: deferred compensations in the merger and acquisition context, equity compensation, plan and document corrections, deferred compensation in the private equity and hedge fund space, cross-border considerations, and foreign plans.

When section 409A[1] was first enacted in October 2004, it transformed the tax landscape of—and conversations around—nonqualified deferred compensation ("NQDC").[2] Employers were faced with a barrage of new, complex rules in what previously operated under a patchwork of guiding principles in an inconsistently policed space. The new statutory provisions codified a comprehensive set of rules and definitions specifically restricting employers and employees in the design and modification of deferred compensation arrangements. Notably, these provisions restrict their ability to maintain discretion over the timing of receipt of income.

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[*] *Robert Delgado is the principal-in-charge of the Compensation and Benefits group of Washington National Tax ("WNT"). Erinn Madden is a managing director and Carly Rhodes is a senior manager with the WNT Compensation and Benefits group.*

[1] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

[2] American Jobs Creation Act of 2004, Pub. L. No. 108–357 (Oct. 22, 2004).

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In the time since these rules took effect, additional guidance—largely in the form of regulations, notices, and revenue procedures—continues to shed more light on these provisions. Available guidance has helped practitioners develop a clearer picture of how to navigate within this more rigid framework. Fifteen years later, careful attention and analysis are still required to structure, maintain, and operate NQDC plans in a manner compliant with the section 409A requirements.

This article provides a high level background and generally describes the overall framework of the section 409A rules. It serves as the foundation for a series of articles addressing a variety of issues under section 409A. Future articles will address specific topics such as issues associated with NQDC in the merger and acquisition context, equity compensation, plan and document corrections, NQDC in the private equity and hedge fund space, cross-border considerations, and foreign plans.

The History

Prior to enactment of section 409A, the taxation of NQDC was governed by various Code sections, as well as the principles of constructive receipt and economic benefit.[3] The timing of income inclusion was dependent on the facts and circumstances, including whether the arrangement was considered funded or unfunded. Compensation paid out under an unfunded arrangement was generally includible in income when actually or constructively received; amounts deferred under a funded arrangement were generally includible in income for the year in which the individual's rights to the amount were transferable or not subject to a substantial risk of forfeiture ("SROF"). [4]

Although the governing tax principles were well established, there was limited guidance addressing the application of those rules to the specific facts and circumstances of various deferred compensation arrangements. Moreover, with no reporting regime in place, it was difficult and inefficient to audit and enforce the timely taxation of NQDC and to identify perceived abuses.[5]

The actions of certain Enron Corporation executives in the weeks leading up to its 2001 bankruptcy helped to focus public attention on these issues and demonstrate the potentially abusive effect of certain plan provisions and practices. Prior to its bankruptcy filing, Enron permitted certain highly compensated employees to receive early distributions of NQDC subject only to a 10 percent haircut. Following Enron's bankruptcy filing, the remaining NQDC funds were frozen and the remaining participants who were not entitled to accelerated distributions became unsecured creditors of the company. Following the news of perceived abuses by Enron executives, proposals for new legislation regulating NQDC abounded. Many of these proposals laid the groundwork for the provisions that eventually became section 409A.

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3 *See* H.R. Conf. Rep. No. 108-755 (Oct. 7, 2004), *available at* 2004 WL 2335174.

4 Staff of the Joint Comm. on Tax'n, 108th Cong., Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations (Comm. Prt. 2003). *See also* sections 61, 83, 402(b), and 451.

5 Regina Olshan & Erica F. Schohn, Section 409A Handbook 2 (1st ed. 2010).

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The report issued by the House Ways and Means Committee in connection with the enactment of section 409A highlights some of the concerns that section 409A was intended to address. Specifically, the report identified perceived abuses of the deferral of taxation, including arrangements "that allow participants to receive distributions upon request, subject to forfeiture of a minimal amount (i.e., a 'haircut' provision)", as well as offshore rabbi trusts that effectively shielded assets from creditors of the employer yet were treated as unfunded and thus permitted deferral of income.[6]

Section 409A was enacted as part of the Jobs Creation Act of 2004. As enacted, section 409A went into effect as of January 1, 2005, and is applicable to NQDC earned and vested after that date, as well as certain pre-2005 NQDC arrangements that are materially modified after October 3, 2004.

Taxation under Section 409A and the Consequences of Noncompliance

Amounts paid under an exempt plan or a compliant NQDC plan, defined and discussed in more detail below, are generally not includible in the gross income of the recipient until distribution. In other words, NQDC is generally not taxable until it is actually or constructively received.[7]

Deviating from this general rule, noncompliant section 409A amounts are subject to current income inclusion when the amounts are no longer subject to an SROF (often commonly referred to as vesting). A U.S. taxpayer who receives noncompliant NQDC is also subject to a 20 percent additional federal income tax, as well as potential penalties and interest at the underpayment rate plus one percent. To the extent the noncompliance continues in subsequent tax years, additional taxation under section 409A is applicable.

Compensation is subject to a **substantial risk of forfeiture** for section 409A purposes if entitlement is conditioned on (1) the performance of substantial future services or (2) the occurrence of a condition related to a purpose of the compensation (e.g., a performance metric), and the possibility of forfeiture is substantial.

Forfeiture upon violation of a non-compete restriction generally does not constitute an SROF.

This term has nuances that separate it from the term as used in sections 83 and 457A.

From a state law perspective, California also imposes its own penalty for failure to comply with section 409A. Notably, California imposes a five percent additional tax on section 409A failures in the year of income inclusion (reduced from 20 percent for tax years beginning prior to 2013).

Service recipients (generally, employers) are required to report the income related to a section 409A failure in Box 1 on a Form W-2 or Box 7 on a Form 1099, as applicable, and must also report the amount subject to income inclusion as a result of the section 409A failure in Box 12 using code Z or in

[6] *See* H.R. Rep. No. 108-548 (June 16, 2004), available at 2004 WL 1380512.

[7] Note that nonqualified deferred compensation paid by a "qualified entity" within the meaning of section 457A may be subject to different rules and timing for income inclusion. In addition, NQDC may be subject to Social Security and Medicare taxes and related withholding in the year of vesting under the special timing rule. Section 3121(v)(2).

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Box 15b, respectively.[8] The amounts includible in income are subject to withholding even if no payment is actually made until a future year. Potential penalties may apply for failure to properly and timely report or to withhold and deposit related taxes. Employers are not required to withhold the additional 20 percent income tax or the premium interest tax.

When an employer provides NQDC under a plan that fails to comply with section 409A, the resulting tax burden can be substantial and largely falls on the individual participant. Potential section 409A exposure from an employer perspective has typically been viewed in the limited context of compensation withholding and reporting errors, usually caught on internal audit or in connection with a corporate transaction such as merger, unless the employer had a contractual obligation to do more. However, recent litigation has raised the question as to whether an employer can be held liable to the employee for additional taxes, interest, and penalties resulting from a section 409A failure of the employer's plan.[9]

Nonqualified Deferred Compensation—What's Covered and What's Not

Section 409A generally governs unfunded NQDC. However, its reach is much broader, and more nuanced, than it may appear from this term. Generally, NQDC exists when a service provider has a legally binding right during one tax year to compensation that is or may be payable in a later tax year.[10] This includes situations in which an employee or contractor elects to defer compensation such as salary or bonus, as well as compensation that is structured to pay out upon a specified future event or time. It can also include equity and equity-based compensation, such as restricted stock units ("RSUs") and certain stock options or stock appreciation rights ("SARs").

> To be compliant with section 409A, the material terms of the plan must be set forth in writing. Compensation deferred under a program that does not satisfy the written plan requirement may nevertheless be subject to section 409A and in immediate violation of its rules.

Exclusions from the Reach of Section 409A

What is *not* covered by section 409A is often a more pressing and challenging question than what is. There are a number of categories of compensation that are not considered to fall within the meaning of "nonqualified deferred compensation" for this purpose, and are therefore excluded from the requirements and consequences of section 409A.

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[8] For ease of reference, "service recipient" and "service provider" will be used interchangeably with "employer" and "employee," respectively.

[9] *See* Wilson v. Safelite Group, Inc., 930 F.3d 429 (6th Cir. 2019).

[10] Section 1.409A-1(b)(1).

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For example, traditional *qualified* retirement plans, such as 401(k)s and defined benefit pensions, are not within its purview. Other exclusions include certain foreign plans and many welfare benefit plans.

Common exceptions to NQDC governed by section 409A include:

- Qualified employer plans
- Certain foreign plans
- Certain welfare benefits
- Short-term deferrals
- Restricted stock
- Stock options and stock appreciation rights meeting certain specified requirements
- Separation pay plans meeting specified requirements

Short-term deferral. A frequently used exception to the definition of deferred compensation is for amounts that qualify as a "short-term deferral." Payments may generally qualify as a short-term deferral—and thus not be considered a deferral of compensation subject to section 409A—if actually or constructively received within 2½ months following the end of the tax year in which the SROF lapses and there is no plan provision allowing payment at a later date. The applicable tax year is the service recipient's or service provider's—whichever would create a longer short-term deferral period. If the payment was never subject to an SROF, then the question of whether the compensation is a short-term deferral is keyed off the date the recipient first has a legally binding right to the payment and when the payment will (or may) be made.

Some common examples of a short-term deferral include an annual bonus that is paid shortly following year-end, RSUs settled shortly after vesting, and lump-sum severance payments made shortly after a separation from service.

Even if the payments are not made within the 2½-month timeframe, there are certain limited situations in which the short-term deferral exception may still apply. Notable situations include payments that are administratively impracticable, payments that jeopardize the employer's ability to continue as a going concern, payments that would give rise to a deduction limitation by reason of section 162(m), or for certain transaction-based compensation.

Property Transfers. In addition, section 409A generally does not reach the transfer of property within the meaning of section 83 even if that property is not vested at transfer (such as restricted stock). This exception also covers other funded plans pursuant to which plan assets are set aside beyond the reach of the employer's creditors (such as an employee benefit trust taxable under section 402(b)).

Stock Options and SARs. Stock options and SARs are often considered exempt from section 409A, but exemption is not a guarantee. To achieve an exempt status, the stock options or SARs must meet a list of requirements including that the underlying stock is service recipient stock, the exercise price may never be less than the fair market value on the date of grant, and the award does not include any additional deferral feature.[11] Unsurprisingly, each of these conditions has specific definitions (and important limitations) described in the section 409A regulations.[12] Statutory stock options, including

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[11] Section 1.409A-1(b)(5).

[12] Special rules apply in the event of a modification of an option or a corporate transaction.

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incentive stock options and employee stock purchase plans, are also exempt from section 409A regardless of whether they meet the above-described requirements.

Separation Pay. There is also an exception from the section 409A requirements for certain separation pay arrangements in which payment is made solely in the event of an involuntary termination or pursuant to a window program. An involuntary termination under section 409A generally includes a voluntary termination for good reason. Under the safe harbor in the regulations, a good reason termination may be considered involuntary if certain conditions occur, including a material diminution in the service provider's base compensation or a material change in the geographic location at which the service provider must perform services, as well as satisfaction of timing and notice provisions related to the occurrence of the condition and the eventual separation.

Deferred compensation that may be excluded from section 409A as separation pay is also subject to limitations in both the aggregate amount and the payment timing. Generally, a plan that provides for payment of deferred compensation may be excluded as separation pay only if it does not exceed two times the lesser of (1) the sum of the service provider's annualized compensation for the prior tax year, or (2) the maximum amount that may be taken into account as compensation for qualified plan purposes for the year of separation (for 2019, $280,000). In addition, the plan must require the separation pay to be paid out by the end of the service provider's second tax year following the year of separation (by December 31, 2021, for a 2019 separation).

Grandfathered Arrangements. Additionally, amounts deferred before January 1, 2005, under a plan that has not been materially modified since October 3, 2004, may be considered "grandfathered" and therefore exempt from the specific rules of section 409A. Amounts are only considered "deferred" for this purpose if the amount was earned and vested (i.e., no longer subject to an SROF); amounts becoming earned and vested on or after January 1, 2005, may still be subject to the section 409A restrictions.

A **service provider** for section 409A purposes includes an individual, corporation, S corporation, partnership, qualified or other personal service corporation (including a noncorporate entity that would be classified as such if it were a corporation) for any tax year in which the individual or entity accounts for gross income from the performance of services under the cash method of accounting. Certain unrelated independent contractors are exempt from this definition. This term generally includes a former service provider.

Independent contractors such as directors and individuals providing management services are generally considered a service provider for section 409A purposes.

A **service recipient** means the person for whom the services are performed and with respect to whom the legally binding right to compensation arises. This term also generally encompasses all persons that would be considered a single employer under the sections 414(b) and (c) aggregation rules.

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Restrictions on the Deferral of Compensation

Initial Deferrals

One of the first steps in complying with section 409A is the initial deferral of compensation. If the NQDC plan permits the service provider to make an election as to the time of payment, the form of payment (e.g., lump sum or installments[13]), or both the time and form of payment, the plan and the election must satisfy certain requirements. To maintain the deferral of taxation and comply with applicable rules, an election must generally be made and become irrevocable before the start of the year in which the services are performed to earn the compensation.

A deferral election will not be considered irrevocable with respect to certain compensation unless or until the service provider may no longer change or revoke that election. For example, if a service provider can make an election to defer the bonus earned over the following calendar year at any time beginning on November 1 and may change or revoke that election up until December 31, the election is not deemed to have been made until December 31. Restrictions regarding election timing can still be satisfied by plans that include an evergreen election (an election that remains effective year over year until changed) provided the election becomes irrevocable with respect to specified future compensation on the same timeline described above.

When the plan does not permit a service provider to make an election regarding deferred amounts, the service recipient must elect or the plan must otherwise designate the deferral details, adhering to a similar timeline.

There are limited exceptions to this general initial deferral election timing. For example, when a service provider first becomes eligible to participate in a plan, the initial deferral election may generally be within 30 days after first becoming eligible.[14] Even under these circumstances, the election may only be made with respect to compensation relating to services performed after the election is made. An extension of time for making an initial deferral election is also permitted with respect to performance-based compensation.[15] The election may typically take place up until six months before the end of the performance period provided the performance period is at least 12 months and the service provider performs services continuously from the date the performance criteria is established through the election date and the compensation has not yet become readily ascertainable.

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[13] The entitlement to a series of installment payments is generally treated as entitlement to a single payment under section 409A. However, a plan may specifically provide that at all times with respect to the amount deferred, the right to a series of installments is to be treated as the right to a series of separate payments. Also, a change in the period over which installment payments are made, or a change in the commencement date, is generally considered a change in the time or form of payment. Section 1.409A-2(b)(iii).

[14] Section 1.409A-2(a)(7).

[15] Section 1.409A-2(a)(8).

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Subsequent Deferrals

After an irrevocable initial deferral election is made, the time and form of payment generally cannot be modified unless the changes adhere to the rules for subsequent deferral elections. The opportunity to further delay a payment and/or change the form of the payment must be provided in the plan document and the provisions must typically require that:

- The subsequent election must not take effect until at least 12 months after the election is made;
- The new payment date must be postponed for at least five years from the date the original payment would otherwise have been made or begun to be made; and
- Any election related to a payment to be made at a specified time or fixed schedule be made at least 12 months before the date the payment is otherwise scheduled to be paid or begun to be paid.

These rules also apply to the addition or elimination of a payment-triggering event, such as a change in control of the company. In addition, subsequent deferral elections may generally only further delay the receipt of payment, not permit acceleration.

Restrictions on the Distribution of Compensation

In addition to regulating the time and manner of deferring compensation, section 409A places strict limitations on the time and form of payments of NQDC. As discussed above, the time and form of payment must generally be specified in advance. With respect to timing, there are six permissible payment events for section 409A deferrals:

- Separation from service
- Change in control
- Fixed payment date (including specified calendar year) or pursuant to a fixed schedule
- Disability
- Death
- Unforeseeable emergency

Defining the Terms

Each of the permissible payment events (other than death) has a specific definition for section 409A purposes. Although the prescribed definitions are often in line with the commonly understood meaning of the terms, there are nuances that may become critical when applying these terms to certain factual scenarios.

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An employee experiences a **separation from service** under section 409A upon death, retirement, or a termination of employment.

Whether a termination of employment has occurred is based on the facts and circumstances. To determine whether a separation has occurred, the regulations include presumptions based on a specified percentage of prior services and provides the opportunity to set a different presumptive threshold.

A bona fide leave of absence (including military and sick leave) that does not exceed six months is generally not considered a separation from service.

For example, a service provider is not considered to have separated from service if there is not a separation from all applicable (generally, related) service recipients. Additionally, no separation is deemed to occur when the service provider continues to provide a significant level of services, for example as an independent contractor, following termination of the employment relationship.

A key payment event for many deferred compensation plans is a change in control. Employers often want to ensure liquidity for participants in the event of merger or sale of the company, and it may be valuable to designate a different form of payment in such event. Depending on the structure and complexity of the transaction, it is not always immediately clear whether the event constitutes a change in control within the meaning of section 409A.

A **change in control** event for section 409A purposes includes a change in the ownership or effective control of the corporation or a change in the ownership of a substantial portion of the corporation's assets. The default definition included in the regulations can be tailored in the plan document to provide a narrower meaning.

An initial public offering, or IPO, does not constitute a change in control—and therefore does not constitute a permissible payment event—under section 409A.

Although each of these specified payment events must generally adhere to a specific definitional framework described in the section 409A regulations, they are not bound to the same limitations when used solely as a vesting event. Further, acceleration of vesting does not typically create a section 409A violation if the payment terms are compliant and remain the same regardless of the acceleration. For example, NQDC may become vested in the event of a service provider's disability under a noncompliant section 409A definition without creating a section 409A failure if the NQDC remains subject to a compliant distribution event. Similarly, although an IPO is not a permissible payment event, compensation deferred under a section 409A compliant plan may become vested in the event of an IPO. Moreover, NQDC payable on an IPO may be structured as an arrangement that is exempt from section 409A if the deferred compensation becomes vested and pays out on an IPO within the short-term deferral period.

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Permissible Variations on Payment Timing and Amount

NQDC subject to section 409A must be paid only upon one or more of these specified events. However, there is some flexibility in these rules that allows for practical operation of the plan. Distributions do not have to be made precisely on the date of the distribution event. Generally, a payment is treated as timely if it is made after the distribution event, but within the same calendar year (or if later, by 2½ months following the distribution event). Plans may generally provide for payment within a limited period following a permissible event, provided the recipient does not have discretion to select the year of taxation. In some instances, payment of the deferred compensation is conditioned on the service provider taking a particular action. For example, it is common for companies to require an employee to execute and return a release of claims prior to issuing payment of severance. The IRS has addressed these situations specifically and set forth alternative methods for compliance to ensure that that the service provider does not retain discretion to influence the year of taxation.[16]

In addition, a plan may generally only designate a single time and form of payment for each deferred compensation amount payable upon a specified permissible payment event. In other words, other events or conditions generally cannot be used as a toggle to change the time and form of payment elected, except in limited circumstances. For example, if a plan provides for payment of a deferred amount upon a separation from service, it may not provide for one form of payment (e.g., annual installments) on a voluntary termination and another form (e.g., lump sum) on an involuntary termination.

There are specific exceptions to this anti-toggling rule. In the event of a separation from service, a plan may designate a different time and form of payment with respect to:

- A separation during a period not to exceed two years immediately following a section 409A change in control;
- A separation before or after a specified date or combination of specified date and specified period of service; or
- A separation from service that does not fall into either of the two categories above.

For example, the plan may provide for a lump sum payment upon a separation from service prior to the service provider attaining age 65 and payment in 10 annual installments upon a separation from service after age 65. In addition, a plan may designate an alternative time and form of payment for deferred compensation payable upon disability, death, change in control, or an unforeseeable emergency dependent on whether the permissible event occurs on or before a single specified date.

A plan may nevertheless provide for a single time and form of payment only upon a specific subset of a permissible payment event (e.g., an involuntary separation from service) when the alternative subsets result in forfeiture.

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[16] *See* Notice 2010-6, 2010-3 I.R.B. 275; Notice 2010-80, 2010-51 I.R.B. 853.

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A plan may also provide for an objective formula to determine the amount of deferred compensation payable on a given date. In keeping with the purpose and objectives of section 409A, the formula must generally be objective, established within the framework for making a deferral election, and the service provider must have no discretion or control over the determination.

Six-Month Delay for Separation Payments Made to Specified Employees

Additional restrictions on distribution timing apply to highly compensated executives of a public company who receive payment in connection with their separation from service. Payments of section 409A deferred compensation to an individual who is considered a "specified employee" at the time of separation may not be made until at least six months following the date of separation. If a specified employee dies during the six-month period, the plan may allow for immediate payment.

The six-month delay must be included in the written plan terms and serves as an additional protection against executive abuse in that the amounts payable to the executive on separation continue to remain subject to the company's creditors for an additional six months.

A **specified employee** for section 409A purposes means a service provider who is a key employee of a service recipient with publicly traded stock.

A key employee generally includes up to 50 of the top highly compensated officers, five percent owners, and highly compensated one percent owners based on the applicable key employee identification date.

Plans typically comply with this requirement by taking one of two approaches: (1) making a catch-up payment equal to the amount that would otherwise be made during the six-month period at the beginning of the seventh month then following the regular schedule for the remaining payments; or (2) delaying the commencement of the normal payment schedule in its entirety for six months. For example, assume Executive A is entitled to severance on termination payable in 24 monthly installments. The plan might provide that either the first six monthly installments will pay out in the seventh month or might provide that the 24 months begins with the seventh month following termination.

Acceleration of Payments Prohibited

A core requirement to enforce the section 409A anti-abuse objective is that payments may not be accelerated (i.e., paid out earlier than the timing initially elected). Prior to enactment of section 409A, as demonstrated through the actions of Enron executives, NQDC arrangements often permitted early payment at the service recipient's discretion or at the service provider's request if subjected to a "haircut" provision. Both of these provisions would now create a section 409A violation. Once the deadline for making an initial deferral election has passed, neither the service provider nor the service recipient can exercise discretion to permit early payment. A plan provision that permits this type of discretion also violates section 409A. This prohibition applies with respect to vested NQDC and amounts that remain subject to an SROF.

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All actions taken with respect to NQDC that is subject to section 409A should be considered in light of the prohibition on acceleration. Whether a particular action amounts to an impermissible acceleration is dependent on all facts and circumstances.

Addition or deletion of a permissible payment event that could result in an earlier payment is typically viewed as an impermissible acceleration under section 409A. However, as with most section 409A rules, there are specific and limited exceptions. Although the later addition of death, disability, or unforeseeable emergency as a payment trigger may have the effect of accelerating the time of payment if those events occur and trigger payment, the addition of these payment triggers will generally not violate the anti-acceleration rules. Failing to include these as payment events up front is generally considered to be an oversight rather than a strategy for tax abuse.

There are various other exceptions to the prohibition on accelerated payments of NQDC subject to section 409A, such as:

- cash-out of de minimis distributions
- distributions required under a qualified domestic relations order
- distributions to satisfy certain tax obligations
- distributions to coordinate with section 457A income inclusion rules
- distributions in connection with a plan termination

> A **plan termination and liquidation** may provide for accelerated distributions and is generally permitted under section 409A in three circumstances:
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> – In connection with the service recipient's insolvency;
> – In connection with a change in control;
> – When all aggregated arrangements of the service provider are terminated, not proximate to a downturn in financial health, and
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>   - No payments pursuant to termination are made within 12 months,
>   - All payments are made within 24 months, and
>   - The service recipient may not establish any new arrangements of the same type for any service provider within three years following the date of termination.

The available exceptions provide some needed flexibility for service recipients and service providers to respond to practical concerns but are generally narrowly tailored to achieve this flexibility without creating loopholes to bypass the section 409A protections.

Substitutions

When deferred compensation subject to section 409A is cancelled or forfeited and a new right to deferred compensation is granted, there may be a substitution for section 409A purposes. The payment of an amount as a substitute for a payment of NQDC is treated as a payment of that NQDC. Stated another way, when the facts and circumstances indicate that entitlement to NQDC was made in substitution, the substituted amount is generally treated as a continuation of that preexisting right to

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section 409A deferred compensation. As such, the section 409A restrictions typically cannot be circumvented by simply canceling an existing NQDC obligation and making a new grant with the desired change in terms.

Whether a payment or right to a payment is a substitute under section 409A is determined based on all facts and circumstances. In some instances, when the new payment or right explicitly results in the reduction or offset of the existing right, the new amount is clearly a substitute. In other situations, whether a new payment or right to payment constitutes a substitute is less clear. When the new payment or right to payment is proximate to forfeiture or relinquishment of the existing right, there is a presumption that the new amount constitutes a substitute for section 409A purposes. This presumption can be rebutted by demonstrating that the new amount would have been received regardless of the forfeiture or voluntary relinquishment.

As an example of these substitution rules, assume the service recipient and service provider would like to provide for early payment of a current deferred compensation amount subject to section 409A but current payment would cause an impermissible acceleration. If the parties agree to cancel all or a portion of the existing right and replace it with compensation payable on an earlier schedule, it may be viewed as a substitution and earlier payment would continue to create impermissible acceleration concerns for section 409A purposes.

When Section 409A Should Be Considered and Other Concerns

Before a plan or arrangement is put in place, it is important to consider the rules and potential implication of section 409A to ensure the structure and all supporting documentation is in compliance with, or satisfies all requirements for exemption under, section 409A. At both the planning stage and during implementation, it is critical that all stakeholders have a clear understanding of the terms and definitions, the intended operation, and the importance of operating the plan in accordance with its provisions and section 409A rules.

Even if a plan or payment arrangement is structured to satisfy or be exempt from the requirements of section 409A, deviating—even slightly—from the plan terms can run afoul of these rules and invalidate the exemption. As discussed, the result for the service provider can be particularly punitive.

Failing to comply with section 409A, either in form or operation, can easily go undetected for years and give rise to potentially significant historical exposure, including obligations for the company and harsh tax consequences for valued employees and contractors. As such, reviewing for section 409A compliance is a critical component of a healthy benefits program and an important consideration for impending transactions, whether rooted in the tax planning and strategy or due diligence processes. When a documentary or operational failure is identified in a NQDC arrangement, there are certain correction opportunities that may be available to mitigate exposure and curtail future failures.

There are many nuances and exceptions to the rules described above that should be considered and that are not addressed in this article. Further, there are detailed and complex technical rules around

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various types of equity awards, foreign plans and cross-border service providers, corporate transactions and restructuring, as well as detailed correction procedures with specific steps and consequences. Many of these topics will be discussed in more detail in subsequent articles.

Coming Up…

Equity and equity-based awards are a key component of many compensation packages. The type of award or awards offered is often tailored to the employer's business as well as the objectives of the compensation. Inherently tied to company performance, equity-based compensation can serve to incentivize service providers to maximize company value. Equity-based awards may take many forms and vary widely in terms and conditions. Whether awards are intended to comply with section 409A or satisfy requirements of an exemption, these considerations should play an important role in the design and operation of the award program. Even when properly structured, later action can invalidate an exemption or create a section 409A violation. Failing to adhere to the specifications of section 409A can result in additional taxes and penalties over the life of the award. For more details on common missteps, applicable rules, and planning considerations in the equity and equity-based award context, stay tuned for the next installment in our *Section 409A: Fifteen Years Later* series.

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