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409A PLANS

Deferred compensation plans under 409A are nonqualified plans sponsored by for-profit entities and are typically established to supplement the retirement income of Highly Compensated Employees (HCE) and/or top management employees. These plans are contractual, unsecured promises between the employer and the employee to pay retirement benefits.

Since there are no limits on the compensation that can be considered or contributions, there are many different types of deferred compensation plan designs. There is also no annual nondiscrimination compliance testing that applies to 409A plans.

For which corporate structures do 409A plans work best?

The tax structure of the plan sponsor is key to whether establishment of a deferred compensation plan would be beneficial to an employer. These plans function best when they are set up to benefit non-owner executives.

Due to the "unfunded" requirement, if the employer sets aside and invests assets for the future funding of the plan, the assets are still owned by the sponsoring entity and are subject to tax at the employer level. If the sponsoring employer is a flow-through entity such as a sole proprietor, partnership, or an S-Corp, the asset income flows through to the owner who then pays the tax on the nonqualified assets. Conversely, when a corporation sponsors a deferred compensation plan in the same scenario, the corporation pays income tax on the assets at a corporate level instead at an individual owner level. This scenario also illustrates how employee deferrals in a nonqualified plan of a flow-through entity are not beneficial.

When the owner of a flow-through entity defers into a nonqualified plan, he pays tax on his deferrals without being in receipt of the funds, whereas an owner in a C-Corp may have more of an advantage to defer their own compensation into the nonqualified plan if their tax rate is higher than the corporate tax rate.

What is a substantial risk of forfeiture (SRF)?

For all the flexibility the employer receives in plan design for 409A nonqualified plans, there are limitations. The employer contributions in a 409A plan must be subject to a substantial risk of forfeiture (employee deferrals into a 409A are never subject to an SRF).

According to IRC §409A: "*Compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and then possibility of forfeiture is substantial.*"

Essentially, there can be a clause in the plan that requires the participant to meet certain goals and/or perform future service before the funds can be theirs. An example of an SRF is continued employment until age 60. These clauses should be drafted by the employer with their legal counsel to fit their specific business needs.

The SRF clause functions to delay taxation and constructive receipt of the funds. 409A has a two-step taxation structure where the funds become subject to FICA and Medicare when the funds are no longer subject to SRF, and then they are subject to income tax when distributed or when the participant has constructive receipt of the funds. Constructive receipt for this purpose is basically when the participant can take a distribution. It is important that the SRF be drafted so that taxation and constructive receipt occur at the same time, in order to avoid compliance issues.

How are the contributions taxed?

For 409A purposes, taxation occurs when there is no longer an SRF and the employee needs to include the balance in their taxable income. If the SRF does not link taxation and distribution, it is possible for the participant to be taxed on funds that they do not yet have access to. For employee deferrals, the participant is taxed on the deferrals when they take a distribution on those funds but the deferrals are included in income for FICA and FUTA at the point they are deferred. The employer receives the tax deduction when the participant takes constructive receipt of the assets.
To avoid taxation, these arrangements need to be unfunded. Employers can choose to set aside and invest funds in accounts owned by the company and the company would be responsible for the tax on the earnings. Employees are not always comfortable with the idea that their potential retirement income does not exist somewhere.

The employer could establish a rabbi trust to give the employee some security. A rabbi trust is an agreement between the employer and the trustee that still subjects the assets to the employer's creditors, keeping the arrangement unfunded. However, the funds in the rabbi trust may only be used to pay the benefits of the plan or the employer's creditors. The assets set aside in the rabbi trust cannot revert to the company, even in a hostile takeover.

How are employee deferrals exempt from federal income tax?

As with other retirement plans, 409A deferred compensation plans can allow for employee and employer contributions. If a 409A plan allows its participants to defer their own funds, a specific process needs to be followed. First, the participant must make an election to defer by the end of the year before the year of deferral. In the first year of participation, this election can be made within 30 days after the first day of participation. The deferral election, once made, must be irrevocable. The participant must also choose the future time and form of payment for those funds. This process is essential to follow for the deferrals to be tax deferred and to avoid penalties for the participant.

Final considerations

If you are interested in establishing a 409A plan, you should discuss the arrangement with your tax advisor and legal counsel to ensure the tax rules will support the type of deferral you have in mind, and that the plan will be able to meet your objectives. This publication is provided for educational and informational purposes only and does not contain legal or tax advice. Accordingly, you should not take action on this information without first consulting your legal and tax counsel.