Non-qualified deferred compensation: Know it when you see it

MICHAEL RILEY | TAX AND BENEFITS CHALLENGES | JAN 16, 2017

WHAT IS NON-QUALIFIED DEFERRED COMPENSATION?

This is a surprisingly tricky question. When people talk about deferred compensation, that's usually short-hand for "non-qualified" deferred compensation. Generally, this is compensation that is paid in a year after the year it is earned. In the vast majority of cases, the goal is to defer both the compensation and the tax on that compensation. But achieving that goal takes planning because there will be no tax deferral, and a penalty tax will apply, if the agreement, plan, or arrangement does not comply with written and operational requirements of the tax code, specifically Section 409A.

Deferred compensation has long been, and continues to be, a staple in the executive compensation portfolio for large and small, public and private companies. It can provide a very attractive benefit for executives and is often combined by companies with other arrangements to create meaningful retention incentives.

Basically, if a right to compensation is acquired in one year, and the compensation will be paid in a subsequent year, that might be a non-qualified deferred compensation agreement or plan that requires special handling. It is very important to determine at the outset of that agreement, plan, or arrangement whether it constitutes non-qualified deferred compensation, so it can be designed and operated in accordance with Section 409A in order to avoid immediate taxation and penalties on executives.

WHAT ARE SOME EXAMPLES OF NON-QUALIFIED DEFERRED COMPENSATION ARRANGEMENTS?

Broadly speaking, the term "non-qualified" deferred compensation is used to identify compensation plans or arrangements that are not "qualified" retirement plans, but are designed to defer the payment and taxation of earned compensation into a future year.

That leaves a lot of common forms of compensation potentially subject to the rules that apply to non-qualified deferred compensation – i.e. Section 409A. For example, supplemental executive retirement plans (SERPs), elective deferral arrangements that allow executives to defer bonuses to later years, and excess benefit plans that make up for the contribution limitations under qualified retirement plans are all common forms of non-qualified deferred compensation.

WHAT OTHER TYPES OF EXECUTIVE COMPENSATION PROGRAMS MIGHT YOU BE SURPRISED TO FIND OUT ARE NON- QUALIFIED DEFERRED COMPENSATION PLANS?

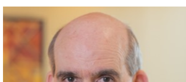
Non-qualified deferred compensation can go by many names, so don't go by the name. We have already mentioned SERPs. Phantom stock is often non-qualified deferred compensation subject to Section 409A. Stock options are generally exempt from being treated as non-qualified deferred compensation, but in some cases they will be subject to Section 409A – e.g., if the options are granted with the strike price below the fair market value of the stock on the date of the grant. Even some expense reimbursement arrangements can be deemed to be non-qualified deferred compensation that need to comply in writing and in operation with Section 409A. For these reasons, companies generally subject all of their compensation arrangements to a Section 409A analysis to be sure that they have not inadvertently created a non-qualified deferred compensation plan that violates Section 409A and exposes executives to a penalty tax.

WHAT IS NOT NON-QUALIFIED DEFERRED COMPENSATION?

There are a number of types of plans and arrangements that defer compensation that are not "non-qualified" deferred compensation. Most notably, qualified retirement plans involve a tax deferral, but are "qualified" plans, meaning that they meet extensive and rigorous company-wide requirements that allow them to pay benefits on a tax-deferred basis.

As was already mentioned, most forms of equity compensation plans are not non-qualified deferred compensation and, therefore, are not subject to Section 409A. There are other significant exceptions. For example, separation pay that is paid within two years of involuntary termination can be exempt (up to a statutory limit) from the rules that apply to non-qualified deferred compensation. Also, bonuses and other types of incentive compensation that are paid soon after (generally, by March 15 of the following year) being earned (generally, when no longer subject to forfeiture) are exempt from Section 409A.

Although, annual bonuses and grants of options or other forms of equity awards will generally not be non-qualified deferred compensation subject to these rules, but this depends on whether the applicable agreements or plans meet very specific exceptions under Section 409A. **This is a point worth emphasizing: many arrangements that do not appear to be non-qualified deferred compensation are, in fact, non-qualified deferred compensation arrangements that require compliance with Section 409A**. Panter, "Beware of the Phantom…Equity." You do not want to be surprised a year or two into a compensation agreement or plan to discover that it is non-qualified deferred compensation that does not comply with Section 409A. That's why you want to know it when you see it.



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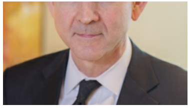
I have extensive experience helping business owners and executives negotiate compensation and ownership agreements and



develop retirement and estate plans. I understand that they do not want problems; they want it done.

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