Nonqualified Deferred Compensation Rules for Tax-Indifferent Entities (Section 457A)

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This practice note explains the application of Internal Revenue Code Section 457A, which restricts the ability of certain tax-indifferent entities (so-called nonqualified entities) to defer compensation for services provided by their service providers. It provides guidance on practical steps for attorneys advising such entities on nonqualified deferred compensation plans.

This practice note is divided into the following topics:

- Purpose of Section 457A
- Application of Section 457A
- Substantial Risk of Forfeiture
- Nonqualified Entities
- Service Providers
- Nonqualified Deferred Compensation Plans
- Tax Effect of Section 457A
- Relationship between Section 457A and FICA Taxes
- Relationship between Sections 457A and 409A
- Effective Date and Transitional Rule

Purpose of Section 457A

Section 457A of the Internal Revenue Code (the IRC) was enacted shortly after Section 409A, which both govern nonqualified deferred compensation. However, where Section 409A regulates the timing of the payment of nonqualified deferred compensation, Section 457A effectively eliminates the payment of nonqualified deferred compensation by so-called nonqualified entities. This is because Section 457A requires that the nonqualified deferred compensation be included in the employee's (or other service provider's) income either (1) as soon as it is no longer subject to a substantial risk of forfeiture (using the limited definition under Section 457A) if the amount is determinable at that time or (2) as soon as the amount becomes determinable after ceasing to be subject to a substantial risk of forfeiture, in which case, the service provider is subject to an additional 20% tax on the deferred amount plus an interest penalty. Section 457A, therefore, causes the service provider to pay tax on determinable amounts of nonqualified deferred compensation once the amount is nonforfeitable, so there is no advantage to defer payment. Moreover, the 20% tax and interest penalty provisions for arrangements where the amount is indeterminate at the time it becomes nonforfeitable are essentially strictly punitive.

The policy behind Section 457A is to limit the payment of nonqualified deferred compensation by entities that are indifferent to when they receive a deduction for the compensation expense (i.e., the so-called nonqualified entities). In a taxable entity, any benefit a service provider obtains by deferring compensation is mitigated by the fact that the deferral delays the entity's tax deduction until the time of payment. Thus, deferral will be respected for income tax (although potentially not for FICA tax) purposes, provided that it complies with certain rules set forth in Section 409A of the IRC. However, in the case of an entity not subject to tax, this mitigation does not occur, and therefore the entity has no incentive to limit the payment of nonqualified deferred compensation. Section 457A is in many ways the analog of Section 457(f), which imposes similar (but not identical) rules on nonprofit and governmental entities.

A nonqualified entity, therefore, does not have as much freedom as most other entities to defer taxation through nonqualified deferred compensation arrangements. Ideally, nonqualified entities should structure their compensation arrangements so as to avoid Section 457A. To the extent a compensation arrangement is subject to Section 457A (a Section 457A arrangement), consideration must be given to the tax consequences to the service providers. Moreover, Section 457A arrangements must be carefully drafted to take into account not only Section 457A, but the nonqualified deferred compensation rules of Section 409A, the FICA tax rules of Section § 3121(v), and (in the case of a domestic partnership or other entity over which the U.S. has jurisdiction) the Employee Retirement Income Security Act (ERISA). Each of these concerns are addressed in this practice note.

Application of Section 457A

Section 457A applies to amounts paid:

- By a nonqualified entity
- To a service provider
- Under a nonqualified deferred compensation plan

Such an amount becomes includible in income for tax purposes:

- When it ceases to be subject to a substantial risk of forfeiture (i.e., when vested, as determined for Section 457A) –or–
- If an amount is not determinable when vested, when it becomes determinable

In addition, if the amount of nonqualified deferred compensation is not determinable when vested, the service provider will be subject to (1) an additional 20% tax on the amount and (2) an interest penalty, determined at the underpayment rate plus 1% as if the amount had been included in income when vested. I.R.C. § 457A(a), (c). See Tax Effect of Section 457A for more details.

Substantial Risk of Forfeiture

Compensation subject to Section 457A is taken into account for income tax purposes when it ceases to be subject to a substantial risk of forfeiture, assuming the amount is determinable at that time. In general, the rights of a service provider to compensation are treated as subject to a substantial risk of forfeiture only if the person's rights to compensation are conditioned upon the future performance of substantial services by any individual.

Section 457A provides that, to the extent provided in future regulations, if compensation is determined solely by reference to the amount of gain recognized on the disposition of an investment asset, such compensation is to be treated as subject to a substantial risk of forfeiture until the date of such disposition. I.R.C. § 457A(d)(1)(b)(i). For this purpose, an investment asset means any single asset (other than an investment fund or similar entity):

- Acquired directly by an investment fund or similar entity
- With respect to which such entity does not (nor does any person related to such entity) participate in the active management of such asset (or if such asset is an interest in an entity, in the active management of the activities of such entity) –and–
- Substantially all of any gain on the disposition of which (other than such deferred compensation) is allocated to investors in such entity

I.R.C. § 457A(d)(1)(b)(ii).

No such regulations have been promulgated to implement the above provision. However, the intent may have been to deal with "side pocket" and other identified investments. In a side pocket investment, a hedge fund will identify a specific illiquid asset, and will allocate it entirely to present participants in the hedge fund. Future investors do not receive any portion of the side pocket. And present investors do not receive any of its value when they cash out of the hedge fund, but only when the side pocket investment is liquidated. If the anticipated holding period of the side pocket investment is significantly longer than the vesting period, this could cause issues under Section 457A without further relief. In theory, this rule offers the opportunity for some relief for these kinds of arrangements if the IRS wants to give it. However, the absence of regulations to date means that such arrangements would be hazardous for the recipient.

Section 457A has a more restrictive definition of substantial risk of forfeiture than is provided in several other IRC sections that use the same term. For example, a substantial risk of forfeiture for purposes of Section 457A cannot be created by, for example, a provision that the payment will be made only if certain earnings goals are met, even though a substantial risk of forfeiture for purposes of Section 409A can in some instances be created by such an agreement. See Substantial Risk of Forfeiture under the IRC and Substantial Risk of Forfeiture Definition Comparison Chart for detailed comparisons of the definitions under the various IRC provisions.

Nonqualified Entities

Any entity that is determined to be a nonqualified entity is subject to Section 457A. The entity subject to the determination (and potential nonqualified entity status) is the entity that would be entitled to a compensation deduction under U.S. federal income tax principles if the entity paid the deferred amounts to the service provider in cash in the relevant taxable year. I.R.S. Notice 2009-8, 2009-1 C.B. 347, Q&A 14. The plan sponsor is typically, but not always, the employer of the service provider.

The rules governing nonqualified entities depend on whether the entity is a corporation or a partnership. Specifically, the tests turn on whether "substantially all" of an entity's income is derived from certain sources (in the case of a corporation) or is allocated to (in the case of a partnership) specific kinds of parties. The rules are described in the sections that follow.

Corporations

Only foreign corporations (as defined in I.R.C. § 7701(a)(3)), (e.g., corporations, associations, joint-stock companies, and insurance companies that are not domestic (as defined in I.R.C. § 7701(a)(4))) may be nonqualified entities. I.R.S. Notice 2009-8, Q&A 7. A foreign corporation is a nonqualified entity unless substantially all of its income:

- Is subject to U.S. tax due to being effectively connected with the conduct of a trade or business in the United States (see "Effectively Connected Income Test" below)
- Is subject to a comprehensive foreign income tax (see "Comprehensive Foreign Income Tax Test" below) –or–
- Is eligible for the benefits of a comprehensive income tax treaty between the applicable foreign country and the United States

I.R.C. §§ 457A(b)(1)(A), (B); 457(d)(2)(A).

Effectively Connective Income Test

Substantially all of the income of a foreign corporation is treated as effectively connected with the conduct of a trade or business in the United States only if, for the taxable year of the foreign corporation ending with or within the service provider's relevant taxable year, at least 80% of the gross income of the foreign corporation is effectively connected with the conduct of a trade or business in the United States under I.R.C. § 882 that is not exempt from U.S. federal income tax pursuant to a treaty obligation of the United States (e.g., because the income is not attributable to a permanent establishment). I.R.S. Notice 2009-8, Q&A 9.

Comprehensive Foreign Income Tax Text

Substantially all of the income of a foreign corporation is subject to a comprehensive foreign income tax if, for the taxable year of the foreign corporation ending with or within the service provider's relevant taxable year (as described under "When to Determine Nonqualified Entity Status" below), such foreign corporation:

- Is not taxed by the foreign corporation's country of residence under any regime or arrangement that is materially more favorable than the corporate income tax otherwise generally imposed by such country –and–
- Either:
  - Is eligible for the benefits of a comprehensive income tax treaty between its country of residence and the United States –or–
  - Demonstrates that it is resident for tax purposes in a foreign country that has a comprehensive income tax

I.R.S. Notice 2009-8, Q&A 8(a).

Notwithstanding the above test, substantially all of the income of a foreign corporation will not be treated as subject to a comprehensive foreign income tax if the foreign corporation's:

- Taxable income (determined under the laws of its country of residence) excludes, in whole or in part, nonresidence source income realized by the foreign corporation –and–
- Aggregate amount of nonresidence source income that is excluded for the relevant taxable year exceeds 20% of the gross income of the foreign corporation

I.R.S. Notice 2009-8, Q&A 8(b).

Partnerships

A partnership (as defined in I.R.C. § 7701(a)(2)) is a nonqualified entity unless substantially all of its income is allocated to persons other than:

- Tax-exempt organizations –or–
- Foreign persons with respect to whom such income is not either
  - Subject to a comprehensive foreign income tax –or–
  - Eligible for the benefits of a comprehensive income tax treaty between the applicable foreign country and the United States

I.R.C. § 457A(b)(2).

Substantially all of a partnership's income is treated as allocated to eligible persons with respect to a taxable year only if at least 80% of the gross income of the partnership for such taxable year is allocated to eligible persons. I.R.S. Notice 2009-8, Q&A 11(a).

Note that while a corporation can be subject to Section 457A only if it is a foreign corporation, a partnership need not be a foreign partnership in order to be subject to that section. A domestic partnership can be subject to Section 457A based on having either tax haven or tax-exempt partners.

S Corporations

It would appear that an S corporation would be treated as a partnership rather than a corporation due to I.R.C. § 1372. While the language is not entirely clear (Section 1372 refers to "fringe benefits," and it is unclear whether deferred compensation should be treated as a fringe benefit or cash), treatment of an S corporation as a partnership would appear to be appropriate, given an S corporation's pass-through status.

When to Determine Nonqualified Entity Status

The determination of whether a plan sponsor is a nonqualified entity is made as of the last day of each of the service provider's taxable years in which the nonqualified deferred compensation is no longer subject to a substantial risk of forfeiture and remains deferred. Whether a partnership is a nonqualified entity as of the last day of the service provider's taxable year is determined based on the allocations (or deemed allocations) of gross income by the partnership for the partnership's taxable year ending with or within the service provider's taxable year. If a partnership does not yet have a taxable year that has ended or ends on the last day of the service provider's taxable year, a reasonable, good faith estimate of such allocation (or deemed allocation) of the partnership for its current taxable year must be used to determine whether it is a nonqualified entity. I.R.S. Notice 2009-8, Q&A-13.

Service Providers

The term service provider includes nonemployee service providers as well as employees. A service provider subject to Section 457A may be:

- An individual
- A corporation
- A subchapter S corporation
- A partnership
- A personal service corporation
- A noncorporate entity that would be a personal service corporation if it were a corporation

I.R.S. Notice 2009-8, Q&A-5.

However, an independent contractor is not a service provider subject to Section 457A if an arrangement with respect to the independent contractor would be excluded from coverage under 26 C.F.R. § 1.409A-1(f)(2) (generally excluding arrangements with independent contractors having multiple unrelated clients, but not excluding arrangements with such independent contractors that provide management services). Id.

Note that to the extent a Section 457A arrangement covers service providers of an entity subject to U.S. law (typically, a domestic partnership), it will typically have to be structured as a plan for a select group of management and highly compensated employees (i.e., a top hat plan), to avoid various requirements under ERISA. For more information, see Top Hat Plan Statement Filing Rules and Procedures.

Nonqualified Deferred Compensation Plans

The definition of nonqualified deferred compensation plan under Section 457A and the exceptions from such definition are very similar to those under Section 409A, with certain important differences. In many places terms defined under Section 409A are incorporated by reference.

General Rule

With certain exceptions, an arrangement is a nonqualified deferred compensation plan for purposes of Section 457A if the arrangement:

- Is described in I.R.C. § 409A(d) (generally, an arrangement where the service provider has a legally binding right to compensation that is or may be payable in a future tax year) –or–
- Provides a right to compensation based on the appreciation in value of a specified number of equity units of the service recipient

I.R.C. § 457A(d)(3). This is true regardless of whether the arrangement is a formal plan, or a less formal arrangement (e.g., part of an employment contract with a single individual).

With regard to equity arrangements, Section 457A does not apply to restricted stock includable in income under I.R.C. § 83. However, stock appreciation rights (other than those discussed in "Exempt Equity Arrangements," below (and presumably, comparable rights in a noncorporate entity) would be subject to Section 457A unless they qualified for the short-term deferral exemption, even though they would not be subject to Section 409A. See I.R.S. Notice 2009-8, Q&A 2. See "Exempt Equity Arrangements," below, for a more complete listing of the types of equity arrangements covered.

Short-Term Deferral Exceptions

Section 457A provides for two so-called short-term deferral exceptions from the general rule, as follows:

1. The service provider actually receives payment within 12 months after the end of the taxable year of the service recipient (for this purpose, the entity for which the service provider is directly providing services) during which the right to the payment of such compensation is no longer subject to a substantial risk of forfeiture.
2. The arrangement qualifies as a short-term deferral under 26 C.F.R. § 1.409A-1(b)(4) applied using the definition of substantial risk of forfeiture under Section 457A.

I.R.C. § 257A(d)(3)(B); I.R.S. Notice 2009-8, Q&A 4.

As earlier noted in the section entitled Substantial Risk of Forfeiture, the IRS is authorized to implement special rules for compensation based on the appreciation of a specified investment asset, extending the period in which such amounts are subject to a substantial risk of forfeiture until the disposition of the asset. If those rules are put in place, the 12-month short-term deferral rule under (1) above will not be available for those arrangements (although they may still be exempt from Section 457A if the Section 409A short-term deferral rule requirements as described in (2) are satisfied). I.R.C. § 457(d)(1)(B)).

Example (short-term deferral (1)). Suppose that Bob, a calendar year taxpayer, is an employee of X Corporation, which has a taxable year ending June 30. Under an agreement with X Corporation, Bob has a legally binding right to receive a bonus payment on June 30, 2022 based on his performance in the year ending June 30, 2019, provided that his employment continues until at least July 1, 2020. If payment is timely made, the arrangement will not be subject to Section 457A because the payment became nonforfeitable July 1, 2020, which was in X Corporation's taxable year ending June 30, 2021, and was made within 12 months after the end of that taxable year.

Under the short-term deferral rule described in (2) above, an amount is not subject to the rules of Section 409A (and therefore is not subject to the rules of Section 457A) if the amount is required by the arrangement to be, and is actually (or constructively) received, by the later of the date that is:

- 2½ months after the end of the service provider's first taxable year in which the compensation is no longer subject to a substantial risk of forfeiture –or–
- 2½ months after the end of the first taxable year of the service recipient in which the compensation is no longer subject to a substantial risk of forfeiture

26 C.F.R. § 1.409A-1(b)(4)(i)(A).

Obviously, this short-term deferral rule will in most cases be superfluous because the applicable 2½ month period will end before 12 months after the end of the taxable year of the service recipient in which the substantial risk of forfeiture lapsed. However, there are at least two circumstances where the Section 409A short-term deferral rule could play a role.

First, if the IRS implements the special substantial risk of forfeiture rules for compensation based on appreciation of a specified investment asset, the Section 409A short-term deferral rule will be the only short-term deferral rule available for those arrangements.

The second situation involves extensions of the Section 409A short-term deferral rule's applicable period. The applicable 2½ month period can be extended for any of the following reasons:

- It was administratively impracticable for the service recipient to make the payment by the end of the applicable 2½ month period for a reason that was not foreseeable when the arrangement was entered into.
- Making the payment by the end of the applicable 2½ month period would have jeopardized the service recipient's ability to continue as a going concern, provided further that the payment is made as soon as administratively practicable or as soon as the payment would no longer have such effect.
- The service recipient reasonably anticipates that a deduction for the payment would not be permitted under I.R.C. § 162(m) for a reason that was not foreseeable when the arrangement was entered into.
- The payment would violate Federal securities laws or other applicable law.

26 C.F.R. § 1.409A-1(b)(4)(ii); Prop. Treas. Reg. § 1.409A-1(b)(4)(ii)) (81 Fed. Reg. 40,569, 40,578–79 (June 22, 2016)).

Thus, in the rare instances where one of these exceptions are triggered, an arrangement may be exempted from Section 457A by reason of the short-term deferral rule of Section 409A.

Example (short-term deferral (2)). Suppose that Susan is supposed to receive a bonus from Corporation Y before March 15, 2020, based on work performed in 2019. The bonus is nonforfeitable as of December 31, 2019. Both Susan and Corporation Y are on a calendar year. However, due to reasons unforeseeable at the time the arrangement was entered into, payment of the amount before March 15, 2020 would jeopardize Corporation Y's ability to continue as a going concern. The first time the payment can be made without having that effect is July 1, 2021. That is more than 12 months after the end of Corporation Y's taxable year in which the payment became nonforfeitable. However, because the arrangement is excluded from coverage under Section 409A due to its extended short-term deferral rules, it will not be treated as covered by Section 457A.

Exempt Plans

Section 457A does not apply to certain arrangements which receive special tax benefits, including the following:

- A qualified plan described in I.R.C. § 401(a)
- A qualified annuity (as described in I.R.C. § 403(a))
- Any tax-sheltered annuity or account (as described in I.R.C. § 403(b))
- Any simplified employee pension (within the meaning of I.R.C. § 408(k))

- Any simple retirement account (within the meaning of I.R.C. § 408(p))
- Certain grandfathered pension plans to which only employees make contributions (as described in I.R.C. § 501(c)(18))
- Any eligible deferred compensation plan of a government or tax-exempt employer (within the meaning of I.R.C. § 457(b))
- An excess benefit plan (as described in I.R.C. § 415(m))
- Certain pension, etc., plans created or organized in Puerto Rico (as described in ERISA § 1022(i)(2))
- Any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan

See I.R.C. § 409A(d) (incorporated by reference in I.R.C. § 457A(d)(3)(A)).

Exempt Equity Arrangements

Certain equity arrangements are exempt from Section 457A, as follows:

- Restricted stock or other restricted property taxable under I.R.C. § 83
- A stock appreciation right which by its terms at all times must be settled in service recipient stock, and is settled in service recipient stock (and otherwise meets the requirements of 26 C.F.R. § 1.409A-1(b)(5)(i)(B))
- Nonstatutory stock options on service recipient stock issued with an exercise price not less than fair market value at the date of grant and with no other deferral feature
- Incentive stock options

By contrast, the following equity arrangements are subject to Section 457A, unless an exception (such as a short-term deferral exception (discussed above under "Short-Term Deferral Exceptions")) applies:

- Nonstatutory stock options that do not have a readily ascertainable fair market value
- Nonstatutory stock options issued with an exercise price less than fair market value at the date of grant
- Stock appreciation rights not described in the list of exempt arrangements, above
- Restricted stock units

See I.R.S. Notice 2009-8, Q&A 2.

Tax Effect of Section 457A

The timing of income inclusion for nonqualified deferred compensation under Section 457A depends on whether the amount of such compensation is determinable at the time when it is no longer subject to a substantial risk of forfeiture.

Income Inclusion for Determinable Amounts

The calculation of the amount to be included in income is consistent with the rules under Section 409A, which are currently in the form of a notice and proposed regulations. See Notice 2008-115, 2008-2 C.B. 1367; Prop. Treas. Reg. 1.409A-4 (73 Fed. Reg. 74,380). The IRS has stated that taxpayers may rely on this guidance until further guidance is issued. I.R.S. Notice 2009-8, Q&A 16.

For determinable amounts, the amount deferred is subject to tax under Section 457A when it is no longer subject to a substantial risk of forfeiture. I.R.C. § 457A(a). The earnings on that amount are subject to tax on an annual basis, to the extent they are nonforfeitable. However, the service provider is entitled to a loss deduction if the right to the nonqualified deferred compensation is later forfeited. I.R.S. Notice 2009-8, Q&A 15, 16, 18.

Example. Wanda is promised an amount equal to $10,000, plus compounded interest at a rate of 4%, on attainment of age 65. The amount is nonforfeitable. Assuming that 4% is a reasonable rate of interest, she will immediately be taxed on $10,000 because there is no substantial risk of forfeiture. In year 2, she will be taxed on the interest accrued for that period, 4% of $10,000, or $400. In year 3, she will be taxed on 4% of the total accrued principal ($10,000 + $400), or $416. This will continue through the final year of interest accrual.

If no interest is credited, or the rate of interest is not reasonable, the initial amount will be adjusted to reflect the present value of the future deferred compensation, and then imputed interest based on a reasonable rate will be credited each year. I.R.S. Notice 2009-8, Q&A 15.

Example (no interest credited). George is promised a flat amount of $100,000 in 10 years. The amount is nonforfeitable. Again, assume that 4% is a reasonable rate of interest throughout the entire period. He will be taxed on the present value of $100,000 (which would be $67,556.42) this year. In each subsequent year, he will be taxed on the interest on $67,556.42, at a 4% rate of interest.

Example (excessive interest credited). Meredith is promised $20,000, plus interest at a rate of 25% a year, after 10 years. Thus, the total amount that will be paid is $186,264.51. The amount is nonforfeitable. Assume that 4% is a reasonable rate of interest. Instead of being taxed this year on $20,000, Meredith will be taxed this year on the present value of $186,264.51, or $125,833.63. She will then be taxed on each subsequent year on the earnings on $125,833.63 at a 4% rate of interest.

Income Inclusion and Interest and Penalty Taxes for Indeterminable Amounts

If the amount deferred under Section 457A is not determinable at the time the substantial risk of forfeiture lapses, it will be included in income as soon as it becomes determinable. In addition, the service provider is subject to:

- An additional 20% income tax –and–
- Interest at the underpayment rate (as determined under I.R.C. § 6621) plus 1% on the underpayment of federal taxes that would have occurred if the amount had been included in income when no longer subject to a substantial risk of forfeiture

I.R.C. § 457A(c).

An amount is determinable if it is paid under an account balance plan (i.e., a plan under which a specific amount is deferred, and credited with earnings thereafter). If not, it will be considered not to be determinable if it is a formula amount unknown at the end of the taxable year because it is based upon factors that remain variable as of the end of such year. For example, an amount based on future profits of the service recipient would not be determinable.

I.R.S. Notice 2009-8, Q&A 19; Prop. Treas. Reg. § 1.409A-4(b)(2)(iv) (73 Fed. Reg. 74,380, 74,396 (Dec. 8, 2008)).

Relationship between Section 457A and FICA Taxes

In theory, a determinable amount subject to Section 457A is subject to income taxes when it ceases to be subject to a substantial risk of forfeiture, and also to FICA taxes when it ceases to be subject to a substantial risk of forfeiture under I.R.C. § 3121(v). Nevertheless, the amount subject to tax may be different for income and FICA tax purposes. For purposes of income taxes, the amount deferred is taxed when the substantial risk of forfeiture lapses. If the amount is not paid immediately, future earnings on the deferred amount are subject to income tax on an annual basis. By contrast, FICA taxation applies only to the initial deferral, not to earnings thereon.

Moreover, an amount may be subject to income tax in one year, and FICA tax in another, due to differences in how the term substantial risk of forfeiture is defined for purposes of Sections 457A and 3121(v). For example, suppose that an amount is subject to forfeiture if a former employee does not comply with the terms of a noncompetition agreement. FICA taxation may be delayed until the noncompetition agreement ends, while income taxation may apply immediately. For further details, see Substantial Risk of Forfeiture under the IRC.

Relationship between Sections 457A and 409A

When drafting an arrangement subject to Section 457A, it is also important to consider the impact of Section 409A. While the details of Section 409A are beyond the scope of this practice note, that section imposes a 20% penalty on any nonqualified deferred compensation arrangement that does not meet its rules (plus an interest penalty, where applicable). Regulations clarify that Section 409A applies to nonqualified deferred compensation plans (as defined therein) separately and in addition to the rules under Section 457A. 26 C.F.R. § 1.409A-1(a)(4). Thus, it is critical that a Section 457A arrangement be drafted so as either to avoid coverage by, or meet the terms of, Section 409A. For further details on Section 409A, see Section 409A Fundamentals.

Being subject to Section 457A will not in itself make a deferred compensation arrangement exempt from Section 409A. However, most arrangements subject to Section 457A provide that compensation will be paid as soon as it ceases to be subject to a substantial risk of forfeiture, because there is no tax advantage in deferring it beyond that point. Such arrangements will typically not be subject to Section 409A due to the short-term deferral rule described above.

Moreover, an arrangement that provides a right to compensation based on the appreciation in value of a specified number of equity units of the service recipient (e.g., a stock appreciation right that does not meet the exemption discussed on "Exempt Equity Arrangements," above) may be subject to Section 457A, but not to Section 409A.

However, to the extent that an arrangement is structured to avoid Section 457A by paying the deferred compensation no later than 12 months after the end of the taxable year of the service recipient during which the right to the payment of such compensation is no longer subject to a substantial risk of forfeiture, the arrangement will still be subject to Section 409A if amounts are payable beyond the applicable 2½ month short-term deferral period under Section 409A.

Conversely, if payment of deferred compensation is dependent on the service recipient's meeting certain earnings goals, the compensation will be considered subject to a substantial risk of forfeiture under Section 409A, but not under Section 457A (due to the difference in how each section defines the term). As a result, the amount deferred would be immediately taxable under Section 457A if the amount were not paid by the end of the service recipient's taxable year following the taxable year in which the amount was deferred (i.e., when the right to the compensation became legally binding since the amount was never subject to a substantial risk of forfeiture for purposes of Section 457A).

Nevertheless, the arrangement may be subject to Section 409A rules that will prevent the amount from being paid at the time it is subject to tax under Section 457A without triggering the Section 409A interest and penalty taxes. These rules can create hardships if an agreement is not properly structured.

Example. Suppose that Adrian is to receive deferred compensation after 10 years, assuming that certain earnings goals are met for the first five years. He will be taxed on the amount deferred immediately under Section 457A, because the amount is considered nonforfeitable. However, he may not have the money to pay that tax immediately. And the arrangement cannot be modified to permit him to be paid immediately (either the whole amount, or even an amount necessary to pay the tax) without triggering the 20% tax and interest penalty under Section 409A, except as permitted under certain transitional relief described in the next section.

In addition, as described in the next section, Section 409A may be a concern with respect to arrangements adopted before the effective date of Section 457A.

Effective Date and Transitional Rule

Section 457A was added by Section 801(a) of the Tax Extenders and Alternative Minimum Tax Relief Act of 2008, Div. C of Pub. L. No. 110-343 (TEAMTRA). It generally applies to amounts deferred that are attributable to services performed after December 31, 2008.

Under a transitional rule, deferred amounts attributable to services performed before January 1, 2009 are includible in gross income in the later of:

- The last taxable year beginning before 2018 –or–
- The first taxable year in which there is no substantial risk of forfeiture of the rights to such compensation

TEAMTRA § 801(d).

Obviously, arrangements adopted before TEAMTRA were not structured with Section 457A in mind. This has created issues, as described below, for coordinating Section 457A and Section 409A.

Deferrals Made and Vested before 2005

Section 409A does not apply with respect to amounts deferred and vested in taxable years beginning before January 1, 2005, if the arrangement under which the deferral is made is not materially modified after October 3, 2004. 26 C.F.R. § 1.409A-6. However, Section 457A applies to such pre-2005 deferrals, subject to the transitional rule above.

In many instances, the sponsor of an arrangement subject to Section 457A, but grandfathered under Section 409A, wanted to modify the arrangement to provide that amounts will be paid out at the time such amounts are subject to tax. Under the transitional rule of Section 457A, the amounts (being already vested) would be taxable in the last taxable year beginning before 2018. I.R.S. Notice 2017-75, 2017-52 I.R.B. 602, provided that modifying the plan to pay the amounts out when they became taxable would not be treated as a material modification for purposes of 26 C.F.R. § 1.409A-6.

Example. Susan deferred amounts in 2003, and those amounts were immediately vested. Those amounts were originally supposed to be paid when she attained age 65, which will not be until 2023. However, under the transitional rule to Section 457A, she was taxable on those amounts in 2017. Her employer was permitted to modify the arrangement to pay those amounts in 2017, without that modification being considered a material modification that would subject the plan to Section 409A and thus trigger the 20% penalty and interest that would apply to accelerations of benefits.

2005 through 2008 Deferrals and Pre-2005 Deferrals That Vested in 2005 or Later

Plans set up between 2005 and 2008 were generally set up to comply with Section 409A. However, under the transitional rule to Section 457A, benefits from those years will be includible in gross income in the later of:

- The last taxable year beginning before 2018 –or–
- The first taxable year in which there is no substantial risk of forfeiture of the rights to such compensation

In general, Section 409A does not permit the acceleration of benefits. However, I.R.S. Notice 2017-75 permits acceleration of benefits in order to pay the tax due under Section 457A.

Note that the rules for pre-2005 deferrals are different from the rules for 2005 through 2008 deferrals. For the former, the entire amount can be paid at the time taxes are imposed. For the latter, only an amount necessary to pay the taxes can be paid at that time.

Example. Jordan was covered by an arrangement in 2005 under which, if he remained in employment until 2020, he would receive payment beginning at age 65 (which would occur in 2030). Under the transitional rule to Section 457A, he is taxable on those amounts in 2020. If his employer were to accelerate the entire amount of deferred compensation, he would be subject to the 20% penalty plus the interest penalty under Section 409A. However, I.R.S. Notice 2017-75 permits the employer to accelerate just that portion of the payment necessary to pay the tax due in 2020.

Related Content

Practice Notes

- Section 409A Fundamentals
- Substantial Risk of Forfeiture under the IRC

Checklist

- Substantial Risk of Forfeiture Definition Comparison Chart

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Carol Calhoun has significant experience with employee benefits matters, including qualified retirement plans, health and welfare arrangements, executive compensation, and insurance and annuity products. Carol has significant experience with standard pension plans – both defined benefit and defined contribution; 401(k); the full array of government and nonprofit plans, including 403(b) and 457; excess benefit plans; cafeteria/flexible spending; and a wide variety of welfare plans (e.g., health, life, and disability).

Carol assists employers of all kinds with their benefit plans. She also represents boards of trustees of multiemployer and governmental plans, and agencies charged with administering employee benefit plans.