The Short Term Deferral Rule
Alleviating the Impact of the 409A Regulations

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Introduction

In 2007, the IRS issued the regulations to IRC Section 409A, which govern the treatment for federal income tax purposes of nonqualified deferred compensation (NQDC) plans. The regulations generally provide that, unless certain requirements are met, deferred amounts when vested under an NQDC plan will be currently includible in the plan participant's income and subject to an additional 20% excise tax plus a tax underpayment rate.

Section 409A is a set of complex rules and regulations that define what "is" and what "is not" permitted, as far as provisions in an NQDC plan design. The key requirements that a plan must abide by in order to avoid the above mentioned penalties are: (i) strict timing of when an irrevocable deferral election must be made; [(1)] (ii) benefits may only be paid on the occurrence of a distinct set of permitted distribution events;[(2)] (ii) setting the time and form of the pay out of benefits at the time of the deferral; (iii) prohibitions on (a) accelerating payment of benefits and (b) limitations on delaying the payment of benefits once the time and/or form is elected; and (iv) documentary and definitional requirements.

The Short Term Deferral Rule provides an exemption to required compliance with the 409A rules stated above. In other words, if an NQDC plan satisfies the Short Term Deferral Rule, it will not be required to adhere to the limitations and restrictions listed above in order to avoid penalties. Consequently, the exemption permits the freedom to implement a variety of deferred compensation arrangements that would otherwise be prohibited.

The Short Term Deferral Rule [(3)]

The Short Term Deferral Rule states there is no deferral of compensation (and therefore not subject to 409A) if 2 conditions are satisfied:

(i) The participant ***actually or constructively*** **(i.e., "taxed") receives the payment no later than the end of the applicable two-and-a-half (2 ½) month period, referred to as the Short Term Deferral Period.** The Short Term Deferral Period is a 2 ½ month span following the end of the taxable year in which the participant becomes vested.[(4)]

(ii) **The payment is not a *deferred payment*.**

Consider the first condition - **actually or constructively receives the payment no later than the end of the applicable 2 ½ month period**. This condition will be satisfied if a plan provides that payment will be made by the last day of the Short Term Deferral Period AND is actually paid (or considered paid - "constructively received and taxed") by then.**[5]**

Stated differently, the condition will be satisfied if the payment must be paid in full (or taxed in full) within the 2 ½ month span following the end of the taxable year in which the participant becomes vested.

Example 1: A participant becomes entitled to a vested bonus on December 31st, 2015, and the taxable year of both the employer and the employee is the calendar year. The applicable 2 ½ month period will end on March 15th, 2016. Condition 1 is satisfied if the payment is paid no later than March 15th, 2016.

Example 2: A participant becomes entitled to a vested bonus on the date the employer experiences an IPO (Initial Public Offering). The IPO occurs on June 30th, 2016. Assuming the taxable year of both the employer and the employee is the calendar year, the applicable 2 ½ month period will end on March 15th, 2017. Condition 1 is satisfied if the payment is made no later than March 15th, 2017.

Condition 1 is often referred to as the "Vest and Pay" rule. If the payment condition is "vesting," and the payment is actually made within the applicable 2 ½ month period, Condition 1 is satisfied.

Consider the second condition - "**not a deferred payment.**" A deferred payment is, generally, a payment made **pursuant to a plan** that provides for the payment of an amount to a participant on or after a date or event **that <u>will or may</u> occur** after the end of the applicable 2 ½ month period, such as upon or after a separation from service, death, disability, change in control, or specified time. Consequently, in order to have a valid Short Term Deferral, **the Plan must not permit by its terms a payment to be made outside the 2 ½ month period** (i.e., deferred payment). If there is any such provision in the plan, a payment will not be a Short Term Deferral, even if payment is actually made within the 2 ½ month period.

Here are a few examples that would preclude a payment from being a valid Short Term Deferral:

Reconsider Example 1 above: A participant becomes entitled to a vested bonus on December 31st, 2015, and the taxable year of both the employer and the employee is the calendar year. However, in this case, the plan document states that the amount will be payable on July 1st, 2016. Even if the amount is paid within the applicable 2 ½ month period (i.e., by March 15th, 2016), it would not be a valid Short Term Deferral, since the plan terms permitted payment outside the 2 ½ month period. In fact, in this case, if the participant was actually paid within the 2 ½ month period, the payment would be an impermissible acceleration under 409A and be subject to penalties.

Example 3: A bonus that vests on January 1st, 2016 is to be paid on the later of March 15th, 2017, or upon separation from service. Even if the payment is made within the applicable 2 ½ month period (i.e., by March 15th, 2017 which is 2 ½ months following the close of the vesting year), this is not a Short Term Deferral, since the amount by the plan terms could have been paid outside the 2 ½ month period (i.e., upon separation from service).

Condition 2 may be satisfied even if the plan does state a specific payment date. A plan may be silent on the actual payment date and not be considered a deferred payment, as long as payment is made within the applicable 2 ½ month period and did not have by its terms any provision that implied or stated that it could be made outside the 2 ½ month period.

Example 4: A plan states that a bonus will be credited and vested on December 31st, 2016, but does not state an actual payment date. As long as the payment is made by March 15th, 2017, we have a valid Short-Term Deferral.

Taking Advantage of the Short Term Deferral Exemption

As previously mentioned, designing an NQDC plan that meets the Short Term Deferral exemption will avoid the complexities of complying with the limits and potential penalties associated with 409A. The following are a few of examples of common plan designs that meet the exemption:

- Annual bonus plans (discretionary or performance based) that vest by year end with the payment to be made within the 2 ½ month period.
- Incentive bonus plans where the payment vests upon the achievement of certain performance targets, with the payment to be made within the applicable 2 ½ month period.
- A severance plan where the payment vests upon an involuntary termination without cause and the payment is made within the applicable 2 ½ month period after the separation from service.
- An RSU (Restricted Stock Unit) plan where the shares are distributed within the applicable 2 ½ month period following vesting.
- An Ineligible 457(f) plan with specific vesting dates and no rolling risk of forfeiture provisions.

Conclusion

When designing an NQDC plan, keep the Short Term Deferral Rule in mind. With the Short Term Deferral Rule, the regulations have provided a useful tool for allowing compensation to be deferred in a manner not subject to the 409A rules and potential penalties.

(1) A deferral of compensation must generally occur in the year before the compensation is earned, with a few exceptions.

(2) Separation from Service, Death, Disability, Specified Time or Age, Change in Control, Unforeseen Emergency. All events other than Death and Specified Time or Age are subject to specific definitions.

(3) Reg.1.409A-1(b)(4)

(4) Or if later, a 2 ½ month span following the end of the Plan Sponsor's fiscal year in which the participant becomes vested.

(5) The Regulations provide some exceptions to the basic requirement that payment be made within the 2 ½ month period. Payment may be delayed under certain circumstances (i) if it was administratively impractical to make the payment within the applicable 2 ½ month period, (ii) if the deduction of the employer with respect to the payment would be precluded by Section 162(m) of the Code, or (iii) where the payment would jeopardize the employer's ability to continue as a going concern.