

February 2009

TAX BULLETIN

SHORT-TERM DEFERRALS OF COMPENSATION: DELAYED PAYMENTS

Internal Revenue Code Section 409A regulates the tax treatment of “nonqualified deferred compensation plans.” With limited exceptions, this term is defined to include any agreement where compensation is earned in one tax year and received in a future year. Amounts deferred under such plans generally will be included in the employee's gross income in the year payment is received if certain requirements and restrictions are satisfied. The failure to comply with these requirements results in harsh consequences for the employee or other service provider: the inclusion of deferrals in current income, a 20% penalty and interest.

The primary focus of these rules is formal deferred compensation arrangements that were potentially abusive. However, the law was written to cover a much broader array of plans or arrangements. Because of economic pressures facing businesses today, certain short-term compensation deferral arrangements normally exempt from Section 409A may need to be extended, resulting in application of Section 409A.

Compensation paid within 2-1/2 months after the end of the tax year is not considered deferred compensation. As such, the requirements of Section 409A do not apply. In a cash-tight economy, the ability to comply with the 2-1/2 month rule may be difficult for many businesses. Deferral of payment beyond the 2-1/2 month period will invoke the provisions of Section 409A unless certain exceptions apply.

The regulations provide for the following two narrow situations where a payment of a short-term deferral can be delayed without triggering the harsh consequences of §409A:

1. It is administratively impracticable to make the payment by the end of the 2-1/2 month period and the impracticability was unforeseeable; or
2. The payment would jeopardize the ability of the service recipient to continue as a going concern.

If either of these conditions exists, payment must be made as soon as practicable or when it will no longer create a going concern issue in order for the protection offered by this exception to apply.

The term “administratively impracticable” is not defined in the Regulations. It likely includes situations such as computer/software failure, fire, or other unexpected emergencies which result in a short delay in payment. It is less likely the term would include financial difficulties, however unforeseeable, that do not rise to the level of the going concern issue specifically addressed in the Regulations.

Arguably, drafters of the current provisions did not envision the unexpected issues raised by the present economic downturn. At this time, however, every effort should be made to comply with the 2-1/2 month time limit and documentation of the reasons for any delay of payment should be retained.

We will keep you apprised of any developments in this area. In the interim, if you have questions or if we can assist you in addressing particular deferred compensation issues, please contact your Wolf Financial Group representative.