Nonqualified Deferred Compensation Plans Must be Amended by December 31, 2020, to Remove Mandatory Payment Delays due to 162(m) Nondeductibility

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The amendments to section 162(m) of the Internal Revenue Code ("Code") under the Tax Cuts and Jobs Act (TCJA) can create a payment trap for nonqualified deferred compensation plans with a mandatory payment delay of amounts that are not deductible under Code section 162(m). The proposed Treasury Regulations under Code section 162(m) permit employers to remove these provisions from a plan by December 31, 2020, and the removal amendment will not be treated as causing an accelerated payment under the Code section 409A regulations.

Permitted Payment Delay

Treasury Regulation § 1.409A-2(b)(7)(i), provides an employer with discretion to delay payment from a nonqualified deferred compensation plan past the designated payment event or date if the employer reasonably anticipates that the scheduled payment would not be deductible. Under Code section 162(m), a payment to a covered employee in excess of $1,000,000 is not deductible. In general, a covered employee is the CEO, CFO and other top three highest paid executives at a publicly traded company. If the nondeductible payment is delayed, it must be paid no later than the first taxable year in which the deduction of such payment will not be barred by the application of Code section 162(m).

Pre-TCJA Treatment

Before the Tax Cuts and Jobs Act, a covered employee in one taxable year was not necessarily a covered employee in a subsequent taxable year and was no longer treated as a covered employee for a taxable year once the employee terminated employment. Therefore, a nondeductible payment delayed under Code section 409A would eventually become deductible, and payable, when either the payment no longer caused the executive to have compensation in excess of $1,000,000 in a single tax year or the executive was no longer a covered employee. Based on those rules, it was certain that at some point in the future the delayed payment would become deductible and payable.

Post-TCJA Potential Payment Trap

The TCJA amendments to Code section 162(m) changed the definition of "covered employee" so that once a person becomes a covered employee, the person remains a covered employee for all subsequent years. After this amendment, there is the potential that a nondeductible payment delayed under a nonqualified deferred compensation plan would never become deductible, or payable, because the employee will always be a covered employee. Consistent with the Code section 409A regulations, most nonqualified deferred compensation plans give the employer discretion to decide whether or not to delay payment of an amount that was not deductible under Code section 162(m). These plans do not need to be amended because the company can simply elect not to delay the payment timing. However, some plans provide for mandatory payment delays if the payment is not deductible under Code section 162(m). These plans should be amended to avoid the potential payment trap described above.

Limited Regulatory Relief

The preamble to the proposed 162(m) regulations states that a nonqualified deferred compensation plan may be amended to remove a mandatory payment delay for payments that are not deductible under Section 162(m). Generally, such an amendment would cause a payment acceleration under Code section 409A. However, the preamble states that the amendment will not be treated as causing an accelerated distribution if the amendment is made on or before December 31, 2020.

Next Steps

Employers should review their nonqualified deferred compensation arrangements to determine if the plan mandates a payment delay for distributions that the employer anticipates will not be deductible under Code section 162(m). If so, the plan must be amended by December 31, 2020, to avoid the potential payment trap for payments that may not become deductible under Code section 162(m).

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