H. Compensation

1. Nonqualified deferred compensation

Present Law

In general

Compensation may be received currently or may be deferred to a later time. The tax treatment of deferred compensation depends on whether it is qualified (that is, eligible for tax-favored treatment)\(^{410}\) or nonqualified and, if nonqualified, whether it is funded or unfunded. In the case of a funded nonqualified deferred compensation arrangement, funded amounts are included in income when the right to the compensation vests, that is, when it is no longer subject to a substantial risk of forfeiture.\(^{411}\) Earnings after vesting may be taxed annually or when paid.

Under general tax principles, unfunded nonqualified deferred compensation generally is not included in income until actually or constructively received.\(^{412}\) However, under statutory rules generally applicable to nonqualified deferred compensation arrangements, income inclusion is delayed until receipt only if specific requirements are met. Otherwise, deferred amounts are included in income at vesting, with certain additional income taxes. In addition, in the case of certain arrangements, statutory rules require nonqualified deferred compensation to be included in income at vesting, and depending on the arrangement, earnings after vesting may be taxed annually or when paid.

General rules for nonqualified deferred compensation

In general

Various requirements apply to a nonqualified deferred compensation plan in order to avoid income inclusion at vesting.\(^{413}\) Absent a specific exception, these requirements apply in addition to any special rules for particular types of nonqualified deferred compensation plans.

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\(^{410}\) For a discussion of present law relating to tax-favored retirement plans, see Joint Committee on Taxation, *Report to the House Committee on Ways and Means on Present Law and Suggestions for Reform Submitted to the Tax Reform Working Groups* (JCS-3-13), May 6, 2013, Part II.I.

\(^{411}\) Depending on the funding vehicle, the tax treatment of funded nonqualified deferred compensation may be governed by section 83, 402(b), or 403(c). Similar treatment applies under a common law doctrine of economic benefit, as applied, for example, in *Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff’d per curiam*, 194 F.2d 541 (6th Cir. 1952), and Rev. Rul. 60-31, Situation 4, 1960-1 C.B. 174. Under section 404(a)(5), (b), and (d), nonqualified deferred compensation is generally deductible by the service recipient for the taxable year in which the amount is includible in the service provider’s income, subject to any applicable limits on deductibility.

\(^{412}\) Treas. Reg. secs. 1.451-1(a) and 1.451-2; Rev. Rul. 60-31, 1960-1 C.B. 174.

\(^{413}\) Section 409A, generally effective for amounts deferred in taxable years beginning after December 31, 2004. For further discussion of the tax treatment of nonqualified deferred compensation before 2005 and concerns
A nonqualified deferred compensation plan must provide that compensation for services performed during a taxable year generally may be deferred at the service provider’s election only if the election to defer is made no later than the close of the preceding taxable year (or at such other time as provided in Treasury regulations). In the case of any performance-based compensation for services performed over a period of at least 12 months, the election may be made no later than six months before the end of the service period. The time and form of distributions from the plan must be specified at the time of initial deferral. However, subject to certain requirements, a plan may allow later changes in the time and form of distributions.

Distributions from a nonqualified deferred compensation plan may be allowed only upon separation from service (as determined by the Secretary of the Treasury), death, a specified time (or pursuant to a fixed schedule), change in control of a corporation (to the extent provided by the Secretary of the Treasury), occurrence of an unforeseeable emergency, or if the service provider becomes disabled. A nonqualified deferred compensation plan may not allow distributions other than upon the permissible distribution events and, except as provided in regulations by the Secretary of the Treasury, may not permit acceleration of a distribution.

If these requirements are not met, all amounts deferred by a service provider under the plan are currently includible in income to the extent such amounts are not subject to a substantial risk of forfeiture and not previously included in gross income. For this purpose, a person’s rights to compensation are subject to a substantial risk of forfeiture if the rights are conditioned on the future performance of substantial services by any person or the occurrence of a condition related to a purpose of the compensation, provided that the possibility of forfeiture is substantial. A condition imposed on the right to compensation may constitute a substantial risk of forfeiture

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414 Under a special rule, when a “specified employee” separates from service, distributions may not be made earlier than six months after the date of the separation from service or, if earlier, the date of the employee’s death. Specified employees are key employees (as defined in section 416(i)) of publicly-traded corporations and generally include officers (limited to 50 employees) having annual compensation greater than $175,000 (for 2017), five-percent owners, and one-percent owners having annual compensation from the employer greater than $150,000.

415 In the case of an employee, under section 3401(a), the amount included in income constitutes wages subject to income tax withholding. In addition to current income inclusion, an interest factor tax at the rate applicable to underpayments of tax plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or, if later, when not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to a 20-percent additional tax. Under section 409A(b), current income inclusion, interest, and a 20-percent additional tax may also result from certain arrangements involving offshore assets set aside to fund nonqualified deferred compensation (regardless of whether the assets are available to satisfy claims of the general creditors of the service recipient), the restriction of assets to provide nonqualified deferred compensation in connection with a change in the employer’s financial health, or assets set aside to provide nonqualified deferred compensation during a period when the employer (or controlled group member) maintains an underfunded defined benefit plan.
even if the imposition of the condition was intended in whole or in part to defer taxation of the compensation to the service provider.416

Definition of nonqualified deferred compensation plan

A nonqualified deferred compensation plan subject to these rules generally includes any plan, agreement or arrangement (including an agreement or arrangement that includes one person) that provides for the deferral of compensation (including actual or notional income on deferred compensation), other than a qualified employer plan, or any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan.417 A qualified employer plan for this purpose means a qualified retirement plan, a tax-deferred annuity plan, a simplified employee pension plan, a simple retirement account plan, an eligible deferred compensation plan of a tax-exempt or State or local government employer, a plan established before June 25, 1959, and funded only by employee contributions, or a qualified governmental excess benefit arrangement.418

Under Treasury regulations, certain other types of arrangements are not considered a deferral of compensation and thus are not subject to these rules.419 For example, an exception applies to amounts that are not deferred beyond a short period of time after the amount is no longer subject to a substantial risk of forfeiture (referred to as a “short-term deferral”).420 Under this exception, a deferral of compensation generally does not occur if the service provider actually or constructively receives the amount on or before the last day of the applicable two and one-half month period. The applicable two and one-half month period is the period ending on the later of the 15th day of the third month following the end of: (1) the service provider’s first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture; or (2) the service recipient’s first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture.

In addition, Treasury regulations provide an exception for certain separation pay (severance) arrangements. This exception applies to separation pay pursuant to a window program, or separation pay provided upon an involuntary separation from service (as defined) that meets certain requirements as to amount and timing of payment. The amount cannot exceed twice the service provider’s annualized compensation in the preceding taxable year (or if less, twice the section 401(a)(17) limit in effect for the year in which the separation from service occurs); and the plan must require this amount to be paid no later than the end of the second

416 Sec. 409A(d)(4) and Treas. Reg. sec. 1.409A-1(d). The Secretary of the Treasury is authorized to prescribe such regulations as may be necessary or appropriate to carry out the purposes of section 409A.

417 Sec. 409A(d)(1).

418 Secs. 401(a), 403(a) and (b), 408(k) and (p), 457(b), 501(c)(18), and 415(m).


taxable year following the end of the service provider’s taxable year in which the separation from service occurred.\textsuperscript{421}

Treasury regulations also provide exceptions for certain stock options and stock appreciation rights ("SARs") with respect to service recipient stock, referred to collectively as "stock rights."\textsuperscript{422} In general, under the regulations, a stock option or SAR does not provide for the deferral of compensation if the exercise price of the stock option or SAR cannot be less than the fair market value, on the date the option or SAR is granted, of the stock subject to the option or SAR and the stock right does not otherwise include a deferral feature. Similar exceptions apply to arrangements involving mutual company units and partnership interests. Exceptions apply also for incentive stock options and options under an employee stock purchase plan ("statutory options").\textsuperscript{423}

Additional rules

Under Treasury regulations, the term "service provider" includes an individual or any of specified entities for any taxable year for which the individual or entity accounts for income from the performance of services under the cash receipts and disbursements method of accounting.\textsuperscript{424} The relevant entities are a corporation, an S corporation, a partnership, a personal service corporation, a noncorporate entity that would be a personal service corporation if it were a corporation, a qualified personal service corporation, and a noncorporate entity that would be a qualified personal service corporation if it were a corporation. However, an exception applies for a service provider engaged in the trade or business of providing services (other than as an employee or director of a corporation or in a similar position in the case of an entity that is not a corporation) if the service provider provides significant services to at least two service recipients that are not related to each other or the service provider. This exception does not apply to the extent the service provider provides management services, that is, services involving the actual or de facto direction or control of the financial or operational aspects of a trade or business of the service recipient, or investment management or advisory services provided to a service recipient whose primary trade or business includes the investment of financial assets (including real estate investments), such as a hedge fund or real estate investment trust.

\textsuperscript{421} Treas. Reg. sec. 1.409A-1(b)(9)(iii).

\textsuperscript{422} Treas. Reg. sec. 1.409A-1(b)(5). A SAR is a right to compensation based on the appreciation in value of a specified number of shares of stock occurring between the date of grant and the date of exercise of the right. In the case of a SAR, the exercise price is the amount subtracted from the fair market value of the stock on the date the SAR is exercised to determine the appreciation in value since the date of grant.

\textsuperscript{423} Secs. 421-424.

\textsuperscript{424} Treas. Reg. sec. 1.409A-1(f).
Nonqualified deferred compensation of State or local government or tax-exempt employers

Special rules apply to “eligible\(^{425}\)” and “ineligible” deferred compensation plans of State and local government and tax-exempt employers.\(^{426}\)

Amounts deferred under an eligible deferred compensation plan generally are not included in income until received. In order for a plan to be an eligible plan, the plan must limit deferrals to a dollar amount ($18,000 for 2017, plus an additional “catch-up” amount for older participants) or, if less, the participant’s includible compensation. The plan must also meet various other requirements.

In the case of an ineligible deferred compensation plan (that is, a plan that does not meet the requirements to be an eligible plan), deferred amounts are treated as nonqualified deferred compensation and includible in income for the first taxable year in which there is no substantial risk of forfeiture of the rights to such compensation, even though the plan is unfunded. For this purpose, a person’s rights to compensation are subject to a substantial risk of forfeiture if the rights are conditioned on the future performance of substantial services by any individual.\(^{427}\)

Earnings post vesting are generally taxed when paid.

Certain plans are excluded from being treated as deferred compensation, including bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, and death benefits.\(^{428}\)

Nonqualified deferred compensation from certain tax indifferent parties

In general

Under special rules, any compensation deferred under a nonqualified deferred compensation plan of a nonqualified entity is generally includible in income by the service provider when there is no substantial risk of forfeiture of the service provider’s rights to such compensation, regardless of the method of accounting used by the service provider.\(^{429}\)

Some aspects of the rules for eligible deferred compensation plans are quite different for plans of State or local government employers and plans of tax-exempt employers. In particular, an eligible deferred compensation plan of a State or local government is a tax-favored, funded arrangement, similar to a qualified defined contribution plan, whereas an eligible deferred compensation plan of a tax-exempt employer must be unfunded. These rules in effect limit the amount of unfunded nonqualified deferred compensation that can be provided on a tax-deferred basis by a tax-exempt employer.

\(^{425}\) Sec. 457, which also contains exceptions for various arrangements.

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\(^{427}\) Sec. 457(f)(3)(B).

\(^{428}\) Sec. 457(e)(11)(A).

\(^{429}\) Section 457A, generally effective for deferred amounts attributable to services performed after December 31, 2008.
only if the rights are conditioned on the future performance of substantial services by any individual.\footnote{Under section 457A(d)(1)(B), to the extent provided in regulations, if compensation is determined solely by reference to the amount of gain recognized on the disposition of an investment asset, the compensation is treated as subject to a substantial risk of forfeiture until the date of such disposition. No regulations or other guidance applying this rule has been issued.} A condition related to a purpose of the compensation (other than future performance of substantial services) does not result in a substantial risk of forfeiture.

If the amount of any deferred compensation is not determinable at the time the compensation is otherwise includible in income, the compensation is includible when the amount becomes determinable. In that case, the income tax attributable to the compensation includible in income is increased by the sum of (1) an interest charge, and (2) an amount equal to 20 percent of the includible compensation. The interest charge is equal to the interest at the rate applicable to underpayments of tax plus one percentage point imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture.

\textbf{Nonqualified entity}

The term “nonqualified entity” includes certain foreign corporations and certain partnerships (either domestic or foreign). A foreign corporation is a nonqualified entity unless substantially all of its income is effectively connected with the conduct of a U.S. trade or business or is subject to a comprehensive foreign income tax. A partnership is a nonqualified entity unless substantially all of its income is allocated to persons other than foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax and organizations exempt from U.S. income tax.

The term comprehensive foreign income tax means with respect to a foreign person, the income tax of a foreign country if (1) the person is eligible for the benefits of a comprehensive income tax treaty between the foreign country and the United States, or (2) the person demonstrates to the satisfaction of the Secretary of the Treasury that the foreign country has a comprehensive income tax.

\textbf{Nonqualified deferred compensation}

For purposes of these special rules, the term “nonqualified deferred compensation plan” is generally defined in the same manner as under the general rules for nonqualified deferred compensation (and includes any agreement or arrangement, as well as actual or notional income on deferred compensation) with certain modifications.

Nonqualified deferred compensation includes any plan that provides a right to compensation based on the appreciation in value of a specified number of equity units of the
service recipient. However, IRS guidance provides some exceptions. In general, under the guidance, a stock option is not treated as nonqualified deferred compensation for this purpose if the exercise price of the stock option cannot be less than the fair market value, on the date the option is granted, of the stock subject to the option and the option does not otherwise include a deferral feature. A similar exception applies to arrangements involving the right to purchase an equity interest in a noncorporate entity. Exceptions apply also for statutory options. Finally, an exception applies for a SAR if the exercise price of the SAR cannot be less than the fair market value, on the date the SAR is granted, of the stock subject to the SAR and the SAR does not otherwise include a deferral feature, but only if the SAR by its terms at all times must be settled in service recipient stock and is settled in service recipient stock.

A special “short-term deferral” exception applies, under which compensation is not treated as deferred if the service provider receives payment of the compensation not 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 (within the meaning of the special rules).

**Description of Proposal**

**In general**

Under the proposal, any compensation deferred under a nonqualified deferred compensation plan is includible in the gross income of the service provider when there is no substantial risk of forfeiture of the service provider’s rights to such compensation. For this purpose, the rights of a service provider to compensation are treated as subject to a substantial risk of forfeiture only if the rights are conditioned on the future performance of substantial services by any individual. Under the proposal, a condition related to a purpose of the compensation other than the future performance of substantial services (such as a condition based on achieving a specified performance goal or a condition intended in whole or in part to defer taxation) does not create a substantial risk of forfeiture, regardless of whether the possibility of forfeiture is substantial. In addition, a covenant not to compete does not create a substantial risk of forfeiture.

The proposal applies without regard to the method of accounting of the service provider. Because of the definition of substantial risk of forfeiture under the proposal, a taxpayer using either the cash method of accounting or the accrual method of accounting may be required to include deferred compensation in income earlier than the method of accounting would otherwise require.

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431 Sec. 457A(d)(3)(A). The Secretary of the Treasury is authorized to prescribe such regulations as may be necessary or appropriate to carry out the purposes of section 457A.

Nothing under the proposal is to be construed to prevent the inclusion of amounts in income under any other income tax provision or any other rule of law earlier than the time provided in the proposal. Any amount included in income under the proposal is not required to be included in income under any other income tax provision or any other rule of law later than the time provided under the proposal.

**Nonqualified deferred compensation**

For purposes of the proposal, the term “nonqualified deferred compensation plan” means any plan that provides for the deferral of compensation, other than a qualified employer plan, a bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plan, and any other plan or arrangement designated by the Secretary of the Treasury consistent with the purposes of the proposal. The Secretary shall not provide an exception for severance plans, bona fide or otherwise, in regulations or other guidance. A qualified employer plan for this purpose means a qualified retirement plan, a tax-deferred annuity plan, a simplified employee pension plan, a simple retirement account plan, an eligible deferred compensation plan of a State or local government employer, or a plan established before June 25, 1959, and funded only by employee contributions.

In addition, a nonqualified deferred compensation plan for purposes of the proposal specifically includes any plan that provides a right to compensation based on the value of, or the appreciation in value of, a specified number of equity units of the service recipient. Such a compensation right does not fail to provide for the deferral of compensation merely because the compensation is to be paid in cash or by the transfer of equity. The proposal applies to all stock options and SARs (and similar arrangements involving noncorporate entities), regardless of how the exercise price compares to the value of the related stock on the date the option or SAR is granted. It is intended that no exceptions are to be provided in regulations or other administrative guidance. However, it is intended that statutory options are not considered nonqualified deferred compensation for purposes of the proposal. An exception is provided for that portion of a plan consisting of a transfer of property described in section 83 (other than nonstatutory stock options), or a trust to which section 402(b) applies, or relating to statutory options under section 422 or 423 for which there is no disqualifying disposition.

For purposes of the proposal, a plan includes any agreement or arrangement, including an agreement or arrangement that includes one person. In addition, references to deferred compensation are treated as including references to income (whether actual or notional) attributable to deferred compensation or income. However, compensation is not treated as deferred for purposes of the proposal if the service provider receives payment of the compensation not later than two and one-half months after the end of the service recipient’s or service provider’s taxable year, whichever is later, during which the right to the payment of such compensation is no longer subject to a substantial risk of forfeiture (within the meaning of the proposal).

**Additional rules**

The Secretary of Treasury is directed to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the proposal, including regulations disregarding a
substantial risk of forfeiture in cases where necessary to carry out the purposes of the proposal. Except as provided by the Secretary of the Treasury, for purposes of the proposal, rules similar to the controlled group rules for qualified retirement plans apply.\footnote{Sec. 414(b) and (c).}

Under the proposal, the present-law general rules for nonqualified deferred compensation and the present-law rules for nonqualified deferred compensation from certain tax indifferent parties are repealed. In addition, the present-law rules for eligible and ineligible deferred compensation plans of tax-exempt employers and for ineligible deferred compensation plans of State and local governments do not apply with respect to deferred amounts attributable to services performed after December 31, 2017.

In addition, the proposal applies income tax reporting and withholding, as applicable, to amounts required to be included in gross income of employees and other service providers, including nonresident aliens subject to U.S. taxation.

**Effective Date**

The proposal generally applies to amounts attributable to services performed after December 31, 2017. In the case of any deferred compensation amount to which the proposal does not otherwise apply solely by reason of the fact that the amount is attributable to services performed before January 1, 2018, to the extent such amount is not includible in gross income in a taxable year beginning before 2027, such amount is includible in income in the later of (1) the last taxable year before 2027, or (2) the taxable year in which there is no substantial risk of forfeiture of the rights to such compensation (determined in the same manner as determined under the proposal). Earnings on deferred amounts attributable to services performed before January 1, 2018, are subject to the proposal only to the extent that the amounts to which the earnings are attributable are subject to the proposal.

The Secretary of the Treasury is directed to issue guidance, no later than 120 days after enactment of the proposal, providing a limited period of time during which a nonqualified deferred compensation arrangement attributable to services performed on or before December 31, 2017, may, without violating the general rules for nonqualified deferred compensation, be amended to conform the date of distribution to the service provider to the date amounts are required to be included in income under the proposal. If the service provider-taxpayer is also a service recipient and maintains one or more nonqualified deferred compensation arrangements for its service providers under which any amount is attributable to services performed on or before December 31, 2017, the guidance is to permit any such arrangement to be amended to conform the dates of distribution under that arrangement to the date amounts are required to be included in the income of the taxpayer. An amendment to a nonqualified deferred compensation arrangement made pursuant to the guidance is not to be treated as a material modification of the arrangement for purposes of the general rules for nonqualified deferred compensation.