# Chapter 7: Small Business Issues


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**Please note.** Corrections for all of the chapters are available at **www.ace.uiuc.edu/taxschool.** For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

## ISSUE 1: IRC §409A — NONQUALIFIED DEFERRED COMPENSATION PLANS

In this discussion of nonqualified deferred compensation plans, the term "employee" includes any nonemployees to the extent they are permitted to participate in these plans. A "nonemployee" for this purpose includes a(n):

- Individual
- Corporation
- S corporation
- Partnership
- Personal service corporation as defined in IRC §269A(b)(1)
- Noncorporate entity that would be a personal service corporation if it were a corporation
- Qualified personal service corporation as found in IRC §448(d)(2)
- Noncorporate entity that would be a qualified personal service corporation if it were a corporation

This generally includes an individual in the capacity of an independent contractor. However this does not apply to an independent contractor if:

1. The individual actively engages in the trade or business of providing services other than as an employee or director of the company to whom the services are being provided,
2. The individual provides significant services to two or more companies to which the individual is not related, and that are not related to one another, and
3. The individual is not related to the company to whom the services are being provided.

### MOST DEFERRED COMPENSATION PLANS

Most tax practitioners are familiar with the deferred compensation plans covered under SIMPLEs, SAR-SEPS, IRC §401(k) plans, and IRC §403(b) plans. When an employee defers part of his compensation into these plans, the amount deferred is still considered wages for purposes of FICA and FUTA.

The employee's Form W-2, *Wage Statement*, indicates the amount deferred in box 12 with the applicable code (D for the §401(k), E for the §403(b), and so on.). This amount is excluded from box 1 wages, but included in boxes 3 and 5, social security and Medicare wages. Since the deferrals are excluded from wages, the employee is paying income taxes on his compensation less the deferrals.




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The amount the employee defers into these plans is normally 100% vested. Therefore the employee is immediately entitled to all the deferred amounts plus (or minus) any earnings on these amounts. The employer's contributions, including any earnings attributed to employer contributions, have different vesting provisions.

When these amounts are withdrawn from deferred accounts, the taxpayer receives Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* showing the amount withdrawn. The amount of the withdrawal is taxable income. If the taxpayer is under age 59½ at the time of the withdrawal, the taxable amount may be subject to an additional early distribution penalty. This penalty is commonly referred to as the "IRC §72(t) penalty." There are various exceptions to this penalty.

## NONQUALIFIED DEFERRED COMPENSATION PLANS

Nonqualified deferred compensation plans operate under different rules. When an employee defers compensation into a **nonqualified plan**, it is similar to the employee telling his company "give me a cut in pay today and pay me the money in the future, if I meet the conditions in our employment contract." Since an employee may never receive the amount deferred, nonqualified deferrals usually are not reported on Form W-2 in the year of deferral.

Assuming the company is still in existence in the future, and the contract conditions have been met, the employee then receives the deferred amounts. At the time the deferred amounts are vested for the employee, or no longer subject to a substantial risk of forfeiture, they are subject to FICA withholding and matching. This is often the same time the employee receives the distribution from the plan, although the vesting could occur earlier than the distribution year.

When deferred amounts from a nonqualified deferred compensation plan are paid to the employee, they are reported on Form W-2, subject to federal income tax withholding. FICA withholding applies if this occurs when the funds are first vested to the employee. The employee reports these amounts as wages. They are earned income for various tax purposes such as allowing the employee to contribute to a traditional or Roth IRA. Regardless of the employee's age, these amounts are not subject to the early distribution penalty since they are not distributions from IRAs or qualified retirement plans.

An employee may pay more social security taxes when participating in a nonqualified deferred compensation plan if his compensation for the deferral year exceeds the maximum compensation subject to FICA.

> **Example 1.** Renaldo earned $150,000 in 2006. He deferred $20,000 into a nonqualified deferred compensation plan. This deferral saves Renaldo income tax and $290 of Medicare tax. It does not save social security taxes since Renaldo is over the maximum social security earnings for 2006.
>
> In 2016 (Year 10), Renaldo becomes vested in the $20,000. His 2016 social security earnings, before the distribution, are only $50,000. Assuming the same FICA rates in 2016, Renaldo's $20,000 of nonqualified deferred compensation is subject to Medicare withholding of $290, plus social security withholding of $1,240. Renaldo paid $1,240 more in social security withholding than if he had not deferred the funds in 2006.

Taxpayers who participate in nonqualified deferred compensation plans are subject to the rules of IRC §409A, created as part of the American Jobs Creation Act of 2004. The IRS released several regulations dealing with these plans. Notice 2005-1 (question and answer format), and Notices 2005-94 and 2006-33 are designed to help clarify questions and cover the details of §409A.

In order to avoid taxation of deferred compensation in the year earned, a nonqualified plan must comply with the following three tests:

1. Distribution test,
2. Acceleration of benefits test, and
3. Election test.



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### Distribution Test

Nonqualified deferrals are not required to be reported in an employee's gross wages, nor are they subject to FICA or FUTA at the time of the deferral, **if the amount deferred is subject to a substantial risk of forfeiture**. "Substantial risk of forfeiture" is defined as existing when the employee's "rights to such compensation are conditioned upon the future performance of substantial services by any individual."[1]

For a deferral to be excluded from income, a plan cannot allow the acceleration of benefits, except as provided by IRS regulations, nor allow distributions any earlier than:[2]

1. When an employee separates from service,
2. When an employee becomes disabled,
3. When an employee dies,
4. At a time specified under the plan,
5. When there is a change in the ownership or effective control of the corporation with the plan (defined as during a 12-month period having either a 35% or larger ownership or a replacement of a majority of the members on the board of directors), or
6. Upon the occurrence of an unforeseeable emergency such as severe financial hardship resulting from an illness or accident of the participant, the participant's spouse or a dependent; a loss of property due to a casualty; or other extraordinary and unforeseeable circumstances beyond the participant's control. In case of hardship, the amount available to be distributed is limited to the costs necessary to deal with the emergency and an amount anticipated to be needed to cover taxes on the distribution.

If a plan fails these tests, the entire amount deferred, that was not previously included in the employee's income, is subject to tax in the year of the failure. This amount is also subject to interest and penalty. The interest is equal to the underpayment rate plus 1% and is applicable for the period starting with the earlier of the year of the deferral or the year the substantial risk of forfeiture no longer exists. The penalty is equal to 20% of the amount required to be included in income.

### Acceleration of Benefits Test

This test is met if a plan does not permit the time or schedule of any payment under the plan to be accelerated, except as provided in the regulations.

### Election Test

To meet the requirements of the election test, a participant must make an election within 30 days after the date he first is eligible to participate in the plan. If the plan is performance-based on services to be performed over a period of at least 12 months, the election must be made no later than six months **before** the end of that period.

If a plan permits, under a subsequent election, a delay in payment or change in the form of payment may not take place until at least 12 months after the date the election was made. Except for payments made because of disability, death, or unforeseen circumstances, payments must be deferred for at least five years from the date the payment would otherwise have been made. In addition, the election to defer may not be made less than 12 months prior to the date of the first scheduled payment.

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1. IRC §409A(d)(4)
2. Treas. Reg. §1.409A-3(g)





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