Do You Have Nonqualified Deferred Compensation (NQDC)?

By Bryan K. Bassett and John R. Madsen of Ray Quinney & Nebeker

Many medical practices have nonqualified deferred compensation (NQDC) plans or arrangements as part of the compensation payable to a physician at the time of termination of employment. In many cases, NQDC for a medical practice takes the form of payments after the date of termination of employment based on a physician's collections from the accounts receivable attributable to the physician's personal services. Depending on how such payments are structured, the payments may constitute NQDC that is subject to the complex rules and potential penalties of Internal Revenue Code Section 409A (Section 409A).

Internal Revenue Code Section 409A

Section 409A was added to the Internal Revenue Code effective Jan. 1, 2005, and in general governs and regulates NQDC that is paid by a "service recipient" (i.e. an employer receiving the services) to a "service provider" (which includes employees, and which may include other service providers such as independent contractors, among others). Section 409A was enacted, at least in part, in response to the practice of corporate executives accelerating payments under deferred compensation plans in order to access the funds before their company went bankrupt (for example, as happened with Enron); and also in part as a response by the IRS to reign in a perceived history of tax-timing abuse due to limited enforcement of the so-called constructive receipt tax doctrine. Unfortunately, the scope of Section 409A goes far beyond regulating large public companies and potentially applies to any business of any size with NQDC.

What is Nonqualified Deferred Compensation (NQDC)?

The effects of Section 409A are extensive due to the exceptionally broad definition of deferred compensation. Un-

Under IRS regulations, Section 409A applies whenever there is a “deferral of compensation,” which occurs whenever a service provider has a legally binding right during a taxable year to compensation that is or may be payable in a later taxable year.

der IRS regulations, Section 409A applies whenever there is a “deferral of compensation,” which occurs whenever a service provider has a legally binding right during a taxable year to compensation that is or may be payable in a later taxable year. In turn, unless any deferred compensation falls into a specified set of exceptions (such as, qualified plans like pension and 401(k) plans; certain foreign plans; certain welfare benefits; certain stock option and stock appreciation rights; and certain separation pay plans), the IRS will automatically consider it “nonqualified deferred compensation” covered by Section 409A. Under Section 409A, NQDC must comply with various timing restrictions, unless a regulatory exception applies. In general, there are three main categories of timing restrictions (1) restrictions on the timing of distributions; (2) restrictions against the acceleration of benefits; and (3) restrictions on the timing of deferral elections.

Penalties for Noncompliance

In general, Section 409A assigns compliance failure penalties to the party receiving the NQDC (the individual employee or independent contractor “service provider”), and not to the company paying the deferred compensation “service recipient.” However, employers may separately be subject to penalties and interest for failure to report and withhold income taxes on time with respect to an NQDC that does not comply with Section 409A. For the party receiving the NQDC (service provider), the penalties for non-compliance can be severe, including: (1) being subject to income tax in the year NQDC becomes vested, regardless of when the NQDC is scheduled to be paid; (2) accrued interest on any late payment of the taxable amount; and (3) an additional penalty equal to 20% of the NQDC that was required to be included in gross income.

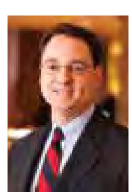
New Electronic Filing Requirement

Although NQDC plans are Employee Retirement Income Security Act of 1974 (ERISA) plans, they are exempt from most ERISA requirements, provided that a written notice is timely filed with the U.S. Department of Labor (DOL). Accordingly, NQDC plans are subject to the so-called “top hat” plan notice requirements, with such notice statement to be made to the Employee Benefits Security Administration (EBSA) of the DOL within 120 days after each NQDC plan is implemented. EBSA issued a final rule effective Aug. 16, 2019, which now requires that the top hat plan notice statement be filed online (electronically). Failure to file the top hat plan notice statement properly and on time could result in NQDC plans being subject to additional ERISA requirements (including but not limited to the requirement to file a Form 5500 annual report) and related penalties.

Takeaways for Utah Providers

Many Utah companies, including private medical practices, may have in place nonqualified deferred compensation (NQDC) arrangements that are subject to Section 409A, without being aware that Section 409A applies, or may not have in place the appropriate plans or documents required for compliance with Section 409A. Further, many employers may not even be aware that certain provisions in employment agreements or other contracts with employees or independent contractors may have created a situation where the NQDC rules and the application of Section 409A are triggered. The regulations under Section 409A are complex and can be difficult to properly navigate. In addition, the penalties for non-compliance are severe. Accordingly, it is critical to consult legal counsel before designing NQDC plans and arrangements to ensure compliance with Section 409A.

Further, if you believe that a Section 409A violation has occurred, then it is important to consult legal counsel for assistance in correcting such violation to help mitigate the impact of Section 409A. If you believe that you may have NQDC as part of any plan or arrangement governing compensation payable by your medical practice to its service providers, then you should have the plan or arrangement reviewed by legal counsel. Companies with NQDC plans should also be aware of the new EBSA final rule effective Aug. 16, 2019, which now requires that the top hat plan notice statement be filed electronically.



Bryan K. Bassett and John R. Madsen are shareholders of the law firm Ray Quinney & Nebeker P.C., and devote a substantial portion of their practice to the representation and business planning of professional entities, as well as healthcare related agreements and transactions.