

IRS Overreaches in Applying Section 409A to Independent Contractors

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A general legal advice memorandum (GLAM) published by the IRS in December 2022, AM 2022-007, threatens to expand application of section 409A to deferred compensation payments for businesses engaged in commerce that provides services to a wide array of unrelated clients or customers. Before the GLAM, those businesses were believed to be exempt from section 409A.

From its inception in 2005, section 409A's regulation of nonqualified deferred compensation (NQDC) plans focused on arrangements benefiting dedicated service providers in largely exclusive service relationships, especially employees and non-employee directors. Section 409A was never intended to apply to commercial arrangements for businesses that serve multiple clients (like law firms, accounting firms, consulting firms, and medical practices). The section 409A regulations implemented the concept in a detailed rule called the "independent contractor exception," which expressly exempts from section 409A commercial arrangements for compensation established by businesses that are not in a largely exclusive service relationship with primarily one client.

The GLAM departs from the long-accepted understanding of the scope of the independent contractor exception. The GLAM appears to require any payment of deferred compensation to a professional business arising from its services to be made only by the direct service recipient or client and only if it has with that client a "plan" that sufficiently describes the deferred payment arrangement. That position would significantly limit the independent contractor exception, thereby broadening the potential applicability of section 409A to businesses engaged in commerce serving multiple clients or customers.

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