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IRS Provides New 409A Guidance: New Proposed Regulations Provide Additional Clarity, Warn of Abusive Practices and Present Planning Opportunities

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On June 21, 2016 the IRS issued proposed regulations to modify and clarify existing regulations under Section 409A of the Internal Revenue Code. Many of these changes resulted from practitioner comments and the IRS' experience with Section 409A after issuing the final regulations. Overall, most of the proposed changes are favorable, albeit modest, and provide some planning opportunities. Plan sponsors will have more flexibility to use exemptions from Section 409A and vary payment schedules under special circumstances. Other changes were more in the nature of technical corrections, and are unlikely to affect current plan administrative practice. The IRS also used the proposed regulations to warn taxpayers about certain practices that it currently considers to violate the Section 409A final regulations. Set forth below is a brief summary of these changes.

Additional flexibility to use Section 409A exemptions

- ***Expanded availability of the rules for transaction-based compensation for stock rights and incentive stock options.*** The final regulations allow employers to delay the payment of deferred compensation that is subject to Section 409A and tied to the employer's stock value in connection with a change in control. Specifically, these payments can generally be made on the same schedule, terms and conditions as the stockholders as part of the change in control (not to exceed five years). The proposed regulations allow for this same type of delayed payment schedule to be used with respect to a cash out of stock rights and incentive stock options in connection with a sale of a company without violating Section 409A. Unfortunately, the proposed regulations do not address the practice of converting stock rights, based on the option spread at the time of a change in control, into another form of compensation, such as a right to receive cash or unvested restricted stock or stock units that would be paid or vest according to the original vesting schedule for the stock rights.

- ***Ability to grant 409A exempt stock rights prior to an individual's commencing employment.*** The exemption for stock rights (i.e., stock options and SARs) under Section 409A is not available under the final regulations unless the grantee "provides direct services" on the grant date. As a result, it appeared that a prospective employer could not grant stock rights until the grantee first began services for the new employer, which could create challenges in negotiating employment terms. In response to this problem, the proposed regulations provide that the stock rights exemption is available when stock rights are granted to a prospective employee when it is “reasonably anticipated” that services will begin within 12 months after the grant date and the grantee actually begins providing services within that period. If services do not begin within that period, the stock right must be forfeited. Note the proposed regulations do not extend this relief with respect to stock rights that might be granted shortly after terminating employment as part of a settlement agreement.

- ***New ability to reduce payments under stock rights due to bad behavior.***The stock rights exemption does not include stock that is subject to a mandatory repurchase obligation (other than a right of first refusal) or a permanent call right if the repurchase price is based on a measure other than the fair market value. Employers often provide for stock to be repurchased at the lesser of fair market value or cost in restricted stock agreements in order to prevent bad behavior by employees, and many have questioned why this type of provision should not be allowed as part of a stock right. The proposed regulations provide that the stock rights exemption is available when using a measure other than fair market value when repurchasing stock in connection with a for cause termination or a breach of a noncompete or non-solicitation covenant.

- ***Availability of severance pay safe harbor for newly hired employees.*** The final regulations provide that certain types of severance plans are exempt from Section 409A. The existing involuntary severance pay safe harbor and window program exemptions only apply to the extent that the employee has annualized compensation for the immediately preceding year, thereby suggesting that these exemptions would not apply to situations when an employee begins and ends employment in the same taxable year. The proposed regulations provide that these exemptions are available to these employees, and that they are to be applied based on employee’s annualized compensation for the taxable year of employment termination.

- ***Expanded exemption for reimbursements to enforce a plan or agreement.*** Employment agreements often provide for reimbursement of attorneys’ fees and expenses in connection with an employment disputes. The final regulations only provide an exemption from Section 409A for attorneys’ fees and expenses in connection with settlement of certain bona fide claims (e.g., wrongful termination, employment discrimination, the Fair Labor Standards Act, workers’ compensation statutes). The proposed regulations expand the exemption under the final regulations to include reimbursement of attorneys’ fees and expenses for any bona fide legal claim against an employer with respect to employment (so that required contractual payments need not meet the general rule for timing of reimbursements under the final regulations)

- ***Minor expansion of the short-term deferral rule.*** Section 409A exempts amounts that are paid shortly after vesting?defined as paid within two and one-half months after the end of the later of the employer or the employee’s taxable year in which amounts vest (e.g., March 15 of Year 2 when amounts vest in Year 1 and both the employee and employer are calendar year taxpayers). Payments that are delayed until after that date are subject to Section 409A under the final regulations unless payment is administratively impractical, payment would jeopardize the employer's ability to continue as a going concern or the payment would not be deductible under Section 162(m)). The proposed regulations expand this exemption to include delayed payments solely as necessary to avoid violating federal securities laws or other applicable laws.

- ***Expanded availability of exception for recurring part-year compensation.*** In limited employment situations, compensation for services provided during a period of less than 12 months is paid over 12 months and is paid over more than one taxable year, for example, teachers and professors working at educational organizations. IRS Notice 2008-62 (2008-29 IRB 130) provided an exception for this type of pay arrangement defined as "recurring part-year compensation". The proposed regulations provide that a plan or arrangement under which a service provider receives recurring part-year compensation does not provide for the deferral of compensation if the plan does not defer payment of any of the recurring part-year compensation to a date beyond the last day of the 13th month following the first day of the service period for which the recurring part-year compensation is paid, and the amount of the service provider's recurring part-year compensation (not merely the amount deferred) does not exceed the annual compensation limit under section 401(a)(17) ($265,000 for 2016) for the calendar year in which the service period commences.

Additional flexibility to accelerate or defer payments of deferred compensation

- ***Payments on account of death.*** A common problem is the timely payment of deferred compensation to a beneficiary or estate following a participant's death, and particularly if it occurs late in the calendar year. The proposed regulations provide more time to make these payments without violating Section 409A. Specifically, payment may be made until December 31 of the first year following the year of the employee's death, and the recipient may have the right to designate the taxable year of payment without violating Section 409A.

- ***Greater flexibility to accelerate payments to beneficiaries.*** The final regulations did not allow beneficiaries due amounts under a nonqualified deferred compensation plan to accelerate the payment of their benefits. A beneficiary's inability to access deferred amounts scheduled to be paid over several years has often been a source of frustration. The proposed regulations now provide employers the flexibility to make accelerated payments of a participant's account balance remaining after death to a beneficiary on account of the beneficiary's death, disability or unforeseeable emergency, whether or not the deferred amounts are in pay status.

- ***Ability to accelerate payments to comply with bona fide foreign ethics laws or conflicts of interest laws.*** The final regulations allow employers to accelerate the payment of deferred compensation to comply with a foreign ethics or conflicts of interest law, but only with respect to foreign earned income from sources within the foreign country that passed the law. The proposed regulations eliminate the restriction on the types of compensation that qualify under this provision. Any type of deferred compensation may be accelerated "as reasonably necessary" to comply with a bona fide foreign ethics or conflicts of interest law.

- ***Ability to accelerate payments to comply with federal debt collection laws.*** The final regulations provide a limited ability to accelerate payment in order to pay a participant's debt (generally limited to $5,000 for certain types of debt). IRS and Treasury have determined that limited offset right under the final regulations is in conflict with certain laws regarding debt collection by the federal government, and the proposed regulations allow for accelerated payment to the extent "reasonably necessary" to comply with federal laws regarding debt collection.

Technical corrections and clarifications

The proposed regulations make the following technical corrections and clarifications:

- Section 409A applies to nonqualified deferred compensation plans separately and in addition to the rules under Section 457(f) (with respect to deferred compensation plans of tax exempt organizations) and Section 457A (with respect to certain offshore deferred compensation plans).

- A person who terminates employment and begins providing services as an independent contractor is treated as having a separation from service for purposes of Section 409A if, at the time of the change, the level of services reasonably anticipated to be provided after the change would result in a separation from service under the rules applicable to employees.

- The proposed regulations correct references to the Bankruptcy Code within the final regulations that permit payment upon the termination and liquidation of a plan in connection with bankruptcy.

- Under the final regulations, the term "service provider" is defined to include an individual, corporation, subchapter S corporation, partnership, personal service corporation or non-corporate entity that would be a personal service corporation if it were a corporation, qualified personal service corporation and non-corporate entity that would be a qualified personal service corporation if it were a corporation. The proposed regulations clarify the final regulations to reflect that a service provider can be an entity as well as an individual. The proposed regulations also clarify the final regulations to correct an erroneous reference to "service provider" that should be "service recipient."

Existing practices that violate Section 409A

Plans that must be terminated under plan termination rule in connection with a change in control. The final regulations allow an employer to accelerate payment of deferred compensation on plan termination in connection with a change in control under certain circumstances. A question that was raised under this plan termination rule is whether all plans of the same type that are sponsored by the employer must be terminated, or only plans of the same type . . . .in which the employee was actually a participant. The final regulations require that:

> "the service recipient [employer] terminates and liquidates all agreements, methods, programs, and other arrangements sponsored by the service recipient that would be aggregated with any terminated and liquidated agreements, methods, programs, and other

arrangements under §1.409A-1(c) if the same service provider had deferrals of compensation under all of the agreements, methods, programs." (Emphasis added.)

Some taxpayers had asserted that if the intention was to cover all similar plans whether or not the employee was a participant in them, the quoted language would have said "as if" the same service provider had deferrals of compensation under all of the agreements. The proposed regulations state that the plan termination provision noted above is not ambiguous, and that the Section 409A final regulations currently require that all similar deferred compensation plans within the controlled group be terminated, regardless of who is a participant in those plans.

What qualifies as a "separation from service" in certain M&A transactions.The final regulations provide a special rule for determining when there is a separation from service under Section 409A in an asset sale. Provided that certain conditions are met, the parties to an asset sale can generally designate whether the seller's employee who continues to provide services to the buyer immediately after a sale has a separation from service for purposes of Section 409A. The proposed regulations clarify that this provision is limited to actual asset sales, and not stock transactions that are treated as an asset sale under a Section 338 election for corporate income tax purposes, "as employees do not experience a termination of employment, formal or otherwise" in a stock sale.

Transfers of property interests that do not qualify as payment for purposes of Section 409A. Some taxpayers have apparently taken the position that transfers of certain property interests qualify as "payment" for purposes of Section 409A. Examples include restricted stock, stock options and transfer of an interest in a Section 402(b) trust (e.g., a secular trust). The proposed regulations clarify that these types of property transfers do not qualify as "payment" for purposes of Section 409A unless they are structured in a manner so that there is immediate income tax.

Correcting 409A violations under proposed income inclusion rules

Proposed income inclusion regulations issued by the IRS in 2008 allow corrections of certain Section 409A violations while deferred compensation is unvested during a taxable year. Specifically, changes can be made to the time or form of payment under a plan or agreement in order to comply with Section 409A. The correction rules include an anti-abuse provision under which deferred compensation will be generally treated as vested, and therefore subject to tax under Section 409A despite being unvested, if there "a pattern or practice" of making corrections under the facts and circumstances. The proposed regulations further restrict the ability to use these correction rules as follows:

- Changes cannot be made to the time or form of payment using the proposed income inclusion regulations when the existing provisions meet Section 409A requirement. In other words, there must be a "reasonable, good faith basis" for concluding that the original payment provision failed to meet Section 409A requirements of section 409A(a) and that change is "necessary" to bring the plan into compliance.

- Non-compliant payment provisions cannot be corrected under the proposed income inclusion regulations when they are added "as a pretext" for later making changes to payment terms that would otherwise not be permitted under Section 409A.

- The proposed regulations list various facts and circumstances to be considered under the anti-abuse rule, including whether the employer has taken "commercially reasonable measures" to identify and correct substantially similar failures "promptly upon discovery," whether substantially similar failures have occurred with respect to unvested deferred amounts to a greater extent than with respect to vested deferred amounts, whether substantially similar failures occur more frequently with respect to newly adopted plans and whether substantially similar failures appear intentional, are numerous, or repeat common past failures that have since been corrected.

- Correction of payment provisions are generally to be made in a manner that's consistent with generally applicable guidance regarding the correction of section 409A failures (such as under Notice 2010-6), and that substantially similar errors much be corrected in a similar manner under this guidance.

Effective Date

The proposed regulations are scheduled to effective after being finalized. The existing rules apply before then but, in the interim, taxpayers may rely on the proposed regulations. However, as noted above, the portions of the proposed regulations under the heading "Existing Practices that Violate Section 409A" are viewed by Treasury and IRS to be currently in force under the existing regulations. Similarly, taxpayers may continue to rely on the proposed income inclusion regulations, as modified by the new proposed regulations as noted above.

Click here to view the Section 409A proposed regulations.

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