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New Proposed Treasury Regulations under Code Section 409A

Article By:

Martin P. Tierney

Kirk A. Pelikan

The Treasury Department recently released proposed changes to the existing regulations under section 409A of the Internal Revenue Code (the Code). The Code section 409A rules apply to a broad spectrum of deferred compensation, severance, retirement and employment arrangements. When the Code section 409A rules apply, failure to meet the stringent Code section 409A requirements can result in an additional twenty percent tax, immediate income taxation upon vesting, and other negative tax consequences. Accordingly, any changes in the Code section 409A regulations can have a wide-ranging impact.

Adjustments to Rule Allowing for Correction of Unvested Deferred Compensation

The most notable aspect of the proposed regulations is the withdrawal and replacement of a prior proposed regulation that provided for important correction opportunities (to avoid the additional Code section 409A tax liability) with respect to unvested deferred compensation. The prior proposed regulation generally allowed for the correction of non-compliant deferred compensation arrangements as long as the arrangement was corrected before the calendar year in which the amounts under the arrangement first became vested. The new proposed regulations maintain this general correction concept; however, its application will be more difficult.

The proposed regulations provide more guidance (and restrictions) on when employer will be deemed to have a “pattern or practice” of permitting impermissible changes in the time and form of payment. If there is such a pattern or practice, the employer may not use the correction rule. In addition, the correction method applied to an unvested arrangement must be consistent with one of the limited correction methods available for vested arrangements (if a correction method exists for the error in question). This greatly increases the complexity of correcting unvested arrangements. Fortunately, in requiring the application of those limited correction methods, the Treasury did not adopt the requirement to report the correction to the IRS that applies to corrections for vested arrangements. Similarly, the additional (but reduced) taxes required when correcting a vested arrangement are not required when correcting an unvested arrangement.

Other Important Changes

The proposed regulations include numerous important clarifications and changes to the application of Code section 409A, including the following:

- **Short-Term Deferrals.** Arrangements that would otherwise meet the exception to Code section 409A for payments that occur within two and one-half months of the end of the year in which vesting occurs, known as the “short-term deferral exception” to Code section 409A, can still qualify for the exception even if they permit a delay in payments to avoid violating Federal securities laws or other applicable law.

- **Stock Rights.** Equity compensation that meets the exception to Code section 409A for certain stock rights that are granted with an exercise price that equals or exceeds fair market value on the grant date (known as the “stock rights exception” to Code section 409A) can still qualify for the exception if the amount payable under the stock right upon an involuntary separation from service for cause, or the occurrence of a condition within the service provider’s control, is based on a measure that is less than fair market value. Similarly, the stock rights exception can now apply for a person who is reasonably expected to begin, and actually begins, providing services to a corporation within 12 months after the grant date of a stock right.

- **Separation Pay Plans.** Code section 409A does not apply to certain separation pay arrangements under which the payout does not exceed the lesser of two times: (a) the Code section 401(a)(17) limit (currently $265,000 for 2016), or (b) the employee’s prior year base salary (known as the “separation pay exception” to Code section 409A). The separation pay exception now clearly extends to employees who were hired and terminated in the same tax year and had no compensation during the year preceding the year in which a separation from service occurs.

- **Expenses for Bona Fide Legal Claims.** The provision of a right to payment or reimbursement of reasonable fees and other expenses incurred to pursue a *bona fide* legal claim against the employer with respect to the employment relationship will no longer be considered a deferral of compensation subject to Code section 409A.

- **Payment Timing and Independent Contractors.** The proposed regulations provide additional guidance on the application of the payment timing restrictions under Code section 409A to situations in which an employee ceased providing services as an employee and begins providing services as an independent contractor (or vice versa).

- **Application to Earn-Outs of Post-Transaction Compensation.** The proposed regulations clarify that certain special rules generally applicable to earn-outs (also known as transaction-based compensation) on equity-based deferred compensation will apply to stock rights and statutory stock options that meet the stock rights exception (i.e., that did not provide for a deferral of compensation) before the transaction.

- **Plan Termination and Liquidation.** The proposed regulations contain important clarifications to the special rules applicable in the event that a deferred compensation arrangement subject to Code section 409A is terminated and liquidated, including details on which plans must be terminated and when a new plan can be adopted.

The proposed regulations contain numerous technical changes not described above, but for the most part the other changes are clarifications that reflect current practice and expectations.

In general, the new proposed regulations may be relied upon by taxpayers until additional guidance is published. Moreover, the former proposed regulation on correcting unvested arrangements has been withdrawn and may not be relied upon.

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