Proposed Section 409A Regulations Make Several Notable Changes

Employee Benefits Alert
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The Internal Revenue Service (IRS) released proposed regulations on June 21, 2016 under Code § 409A to clarify or modify certain provisions in the final regulations and to modify currently proposed regulations. Specifically, the new proposed rules would amend Treasury Regulations §§ 1.409A-1 through 1.409A-3 that were finalized in 2007 and became fully effective in 2009 when various transition periods ended. The new proposed rules would also modify the “income inclusion” rules originally proposed in 2008, addressing the calculation of amounts includible in income in the event of a violation of Code § 409A. Though the IRS emphasized that the proposed regulations make narrow, discrete clarifications and changes to the final and 2008 proposed regulations, we have identified changes to four areas which, in particular, we think are likely to have a greater impact on the design and operation of deferred compensation plans.

You can still "fix" noncompliant arrangements the year before vesting. The "income inclusion” rules under Treasury Regulations § 1.409A-4, proposed in 2008, provided that a nonqualified deferred compensation arrangement that failed Code § 409A’s requirements could be “corrected” and any income inclusion and additional Code § 409A taxes avoided, if the arrangement was modified prior to the year the amount became vested—that is, while the amount remained subject to a substantial risk of forfeiture. The 2008 proposed regulations included an anti-abuse rule aimed at preventing a pattern or practice of using this rule to avoid the requirements of Code § 409A. In recent months, the IRS had indicated that modifications to the proposed income inclusion rules would address this particular ability to correct an arrangement, and many feared that the IRS intended to eliminate the opportunity altogether. Fortunately, the proposed modifications do not go that far.

The most noteworthy changes to this rule include the new requirement that the correction must be consistent with Code § 409A guidance for that particular error (if a correction method exists). In other words, the IRS wants the correction methods applicable to unvested amounts to be consistent with the correction of vested amounts as set forth in prior IRS Notices 2008-113, 2010-6 and 2010-80, to the extent possible. In addition, the modified income inclusion rules also require that the error be corrected consistently with other similar errors—meaning the IRS wants to prevent employers from structuring special correction methods for each executive. Less notable changes include new rules explicitly prohibiting taxpayers from using the rule permitting modification of noncompliant provisions as a pretext to alter provisions that are otherwise compliant with Code § 409A or manufacturing an error so that the provision can then be corrected.

Changes to stock option/SAR Rules. The proposed regulations clarify several items related to the exemption from the requirements of Code § 409A for stock options and stock appreciation rights (SARs). The final regulations provide that, for purposes of the exemption, if service recipient stock is subject to a mandatory repurchase right, the stock value generally must reflect fair market value. Responding to employer desire for flexibility, the proposed regulations now provide that an option or SAR can remain exempt from Code § 409A even if the stock value under an option or SAR may be reduced in certain particular circumstances if the employee is dismissed for cause or otherwise violates a noncompetition or nondisclosure agreement. The proposed regulations also address employers’ concern with the inability to grant options or SARs to new hires prior to the start of employment under the final regulations by expanding the definition of “eligible issuer of service recipient stock” to include an employer of a future service provider who is “reasonably anticipated” to begin and actually begins providing services for that employer within 12 months.

Employee-Independent Contractor. The proposed regulations also address employees who move from employee to independent contractor or vice versa. A sentence in the final regulations had suggested that an employee who ceases providing
services as an employee and begins providing services as an independent contractor (or vice versa) will not have a separation from service until he or she “has ceased providing services in both capacities.” The proposed regulations eliminate this sentence because it appeared to conflict with a rule providing that an employee who becomes an independent contractor for the same employer and will perform no more than 20% of the services he or she provided in the prior 36 months has experienced a separation from service. Additionally, the IRS has clarified that the rules governing separation from service for an independent contractor apply to determine when an employee who becomes an independent contractor but will continue to perform more than 20% of the prior amount of services finally experiences a separation from service.

**Payment events triggered by beneficiaries.** Many employers have wrestled with administering distributions when both the participant and the participant’s beneficiary have died, yet benefits remain unpaid. The final regulations provide that a participant’s death serves as a distributable event, but employers have been unsure as to whether the same rule applies to a beneficiary’s death. The proposed regulations clarify that the rules applicable to amounts payable upon the death of a participant also apply to amounts payable upon the death of a beneficiary. The proposed regulations also clarify that the rules regarding disability or unforeseeable emergency of a participant apply equally to the beneficiary of a deceased participant. Additionally, the time period by which amounts must be paid out following the death of a participant or beneficiary is extended under the proposed regulations, in light of comments indicating that more time was needed to resolve certain items (e.g., completion of probate). Plans may be amended to provide for this extended time frame without violating Code § 409A’s deferral or payment provisions.

These proposed regulations are effective on the date they are published as final regulations, but taxpayers may rely on the proposed regulations immediately.

**Complete List of Changes.** A more complete list of the clarifications and changes made by the proposed regulations is as follows:

1. Clarify that Code § 409A applies to nonqualified deferred compensation plans separately and in addition to Code §§ 457(f) and 457A.

2. Modify the short-term deferral rule to permit delays in payments for certain enumerated reasons, so that federal securities laws or other applicable laws will not be violated.

3. Clarify that a stock right that does not otherwise provide for a deferral of compensation will not be treated as providing for a deferral of compensation solely because the amount payable under the stock right upon an involuntary separation from service for cause is based on a measure that is less than fair market value.

4. Permit explicitly the issuance of stock rights to individuals who have not begun employment.

5. Clarify that the separation pay plan exception may apply to a service provider who had no compensation from the company during the year preceding the year in which a separation from service occurs.

6. Provide that a service provider’s right to payment or reimbursement of reasonable attorneys’ fees and other expenses incurred to pursue a bona fide legal claim against the company does not provide for a deferral of compensation.

7. Modify the rules regarding recurring part-year compensation for individuals in professions that provide employment for only part of the year (e.g., education).
8. Clarify that a stock purchase treated as a deemed asset sale under Code § 338 is not a sale or other disposition of assets for purposes of determining whether a service provider has a separation from service.

9. Clarify that a service provider who ceases providing services as an employee and begins providing services as an independent contractor is treated as having a separation from service if, at the time of the change, the level of services expected to be provided after the change would constitute a separation from service under the rules applicable to employees.

10. Provide that a “payment” is generally made for purposes of Code § 409A when any taxable benefit is actually or constructively received, and that payment is generally not made if the service provider receives property that is not immediately taxable.

11. Modify the rules applicable to amounts payable following death, including those governing to the permissible time period and payments to beneficiaries.

12. Clarify that the special transaction-based compensation rules apply to stock rights that do not provide for a deferral of compensation and statutory stock options.

13. Provide that death, disability, or unforeseeable emergency of a beneficiary can qualify as a potentially earlier or intervening payment event that does not trigger a prohibited acceleration of payments.

14. Allow the payment of all types of deferred compensation made to comply with foreign ethics or conflicts of interest laws to qualify for the conflict of interest exception to the prohibition on acceleration of payments.

15. Correct a citation error in the provision permitting payments upon the termination and liquidation of a plan in connection with bankruptcy.

16. Clarify certain aspects of rules permitting payments in connection with the termination and liquidation of a plan in situations other than bankruptcy.

17. Provide that a plan may accelerate the time of payment to comply with Federal debt collection laws.

18. Clarify and modify Treasury Regulations § 1.409A-4(a)(1)(ii)(B) of the proposed income inclusion regulations regarding the treatment of deferred amounts subject to a substantial risk of forfeiture for purposes of calculating the amount includible in income under Code § 409A(a)(1).

19. Clarify that a service provider can be an entity as well as an individual.

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