IRS Releases Proposed Section 409A Regulations

The Treasury Department last week issued proposed regulations to supplement the existing guidance on the application of Section 409A of the Internal Revenue Code to nonqualified deferred compensation arrangements.

Section 409A requires that all amounts deferred under a nonqualified deferred compensation arrangement be included currently in gross income (to the extent vested and not previously included) and imposes an additional 20 percent penalty tax on these amounts, unless strict requirements are satisfied regarding (among other things) deferral elections and the time and form of permissible distributions. These proposed regulations, issued June 21, clarify the existing Section 409A regulations and guidance in the following significant ways.

1. **Joint Application of Sections 409A and 457.** The proposed regulations clarify that the Section 409A rules apply separately and in addition to the rules under Sections 457A and 457(f) applicable to nonqualified deferred compensation arrangements sponsored by tax-exempt organizations. The Treasury Department issued long-awaited Section 457 proposed regulations on the same day as these Section 409A proposed regulations (Read our summary of the Section 457 proposed regulations here). The Section 409A proposed regulations clarify that the inclusion of an amount in income under Section 457(f) by reason of vesting will be treated as a payment for all purposes under Section 409A. However, it is still possible for amounts to be considered subject to a “substantial risk of forfeiture” under Section 457(f) and not under Section 409A (e.g., if payment is conditioned on compliance with a noncompetition agreement, which may be recognized as a substantial risk of forfeiture under Section 457(f) but not Section 409A). In these cases, the proposed regulations clarify that the amount payable may not qualify for exemption from Section 409A as a short-term deferral; thus, both Sections 457(f) and 409A apply to the payment.

2. **Clarification of Short-Term Deferral Rules to Allow for Legally Required Delays.** Payments are exempt from Section 409A to the extent that they are made no later than the 15th day of the third month following the end of the calendar year or the service recipient’s taxable year (whichever is later) in which the right to payment is no longer subject to a substantial risk of forfeiture (a “short-term deferral”). The proposed regulations clarify that payments that otherwise qualify as short-term deferrals will continue to qualify even if the service provider is required to delay payment for any reason. This publication may constitute “Attorney Advertising” under the New York Rules of Professional Conduct and under the law of other jurisdictions.
recipient delays making the payment because such “payment would violate federal securities laws or other applicable law.” Delay in payments subject to Section 409A for this same reason is already permitted under the existing regulations.

3. **Definition of Service Recipient Stock Clarified.** The exemption for stock options and stock appreciation rights from Section 409A is limited to “common stock” of the service recipient. Under the current rules, common stock does not include any stock that is subject to a mandatory repurchase obligation or permanent put or call right at less than fair market value. The proposed regulations clarify that a service recipient’s right to repurchase shares upon termination for cause or due to violation of a noncompetition or nondisclosure agreement will not disqualify the shares from being viewed as common stock for purposes of Section 409A. The proposed regulations also clarify that stock options issued to a person within 12 months prior to commencement of service may qualify as service recipient stock as long as vesting is conditioned upon services commencing within that period.

4. **Modification of Rules Following Death.** The proposed regulations expand the category of permissible payment events to include the death, disability or unforeseeable emergency of a beneficiary who becomes entitled to payment due to the service provider’s death, and also allow the acceleration of payments that have already commenced in the event of such an occurrence. The proposed rules provide that an amount payable following the death of a participant or beneficiary may be paid at any time between death and the last day of the calendar year following the calendar year in which the death occurred. They also permit a plan providing for payments during this discretionary payment period following death to be amended to provide for payments during any other period within this discretionary payment period, without complying with the Section 409A change rules. For example, a plan providing for death benefits to be paid within 60 days after death may be amended to provide for payment at any time prior to December 31 of the calendar year following the calendar year in which death occurs, without waiting 12 months for the change to become effective.

5. **Plan Termination Rules Clarified.** Until now, some commentators have interpreted the plan termination rules under Treasury Regulation Section 1.409A-3(j) (4)(ix)(C) to require termination of only those plans in which the applicable service recipient participates. The proposed regulations clarify that the termination and acceleration of benefits pursuant to such regulation is permitted only if the service recipient terminates and liquidates all plans of the same category sponsored by the service recipient, and not merely all plans of the same category in which a particular service provider actually participates. The proposed regulations also require that for a period of three years following this termination and liquidation, the service recipient cannot adopt a new plan in the same category, regardless of which service providers participate in the new plan. In addition, the proposed regulations clarify the rules applicable to termination in connection with bankruptcy.

6. **Corrections Applicable to Unvested Amounts.** Section 409A income inclusion rules effectively permit the correction of plan failures applicable to amounts unvested and unpaid as of the end
of the calendar year in which the correction is made. However, an anti-abuse rule provides that amounts will not be considered unvested to the extent that there is a pattern or practice of accepting impermissible changes in the time and form of payment with respect to unvested deferred amounts. The proposed regulations indicate that while these rules permit the correction of certain plan provisions while amounts are unvested, they were not intended to allow service recipients to avoid compliance with the rules for changing the time or form of payments that otherwise meet the requirements of Section 409A. The proposed rules therefore treat as vested any unvested amounts impacted by a change in a plan provision otherwise not permitted by Section 409A that affects the time or form of payment if no reasonable good faith basis exists for concluding that (1) the original provision failed to meet Section 409A requirements and (2) the change is necessary to bring the plan into compliance. The proposed regulations also give examples of patterns of practice of accepting impermissible changes, and require that if a correction method is prescribed in applicable correction procedures, one of the prescribed correction methods must be used (although applicable penalties or reporting requirements are not required for corrections for unvested amounts).

7. Transaction-Based Compensation Rules Applicable to Exempt Stock Rights. Existing Section 409A regulations permit transaction-based payments upon qualifying change-in-control events to be paid on the same schedule and terms as payments to shareholders generally, if paid within five years after the change-in-control event. However, it was unclear whether the provision for payments under an exempt stock option on the same basis as other shareholders would result in loss of the Section 409A exemption. The proposed regulations clarify that the transaction-based payment rules apply to an exempt stock option or right; thus, payment in a manner consistent with these rules does not result in the stock option or right being treated as having a deferral feature violating Section 409A from the original grant date.

8. Termination of Service Clarified. The proposed regulations clarify that an employee who changes status to an independent contractor is treated as having separated from service if, at the time of the change in status, the level of services reasonably anticipated to be provided after the change would result in a separation from service under the employee rules (i.e., less than 20 to 50 percent of prior level of service).

9. Other Changes. The proposed regulations also include a number of other specific modifications or changes, such as (1) clarification of the rules regarding recurring part-time compensation, (2) the ability to accelerate the time of payment to comply with federal debt collection laws, (3) clarification that a service provider can be an entity, (4) clarification of the “separation pay plan” definition, where a service provider commences and terminates employment in the same year, and (5) providing that a right to reimbursement of reasonable attorneys’ fees in connection with a bona fide legal claim against the employer is not a deferral of compensation.

10. Effective Date. The proposed changes are intended to be applicable on or after the date on which they are finalized. However, taxpayers may rely on the proposed regulations until final regulations are published.