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**TOPIC: Proposed Section 409A Regulations Published**

**CITATION:** Application of Section 409A to Nonqualified Deferred Compensation Plans (REG-123854-12), Proposed Rule, June 22, 2016.

**SUMMARY:** The IRS recently issued proposed regulations supplementing the existing regulations and guidance on the application of Code Section 409A to nonqualified deferred compensation arrangements.

As a whole, the proposed regulations clarify existing rules rather than making substantive changes to Section 409A. The proposed regulations will become effective when they are published as final regulations.

**RELEVANCE:** Section 409A is a tax minefield laid for those employers who sponsor employee benefit plans with deferred compensation elements and for the participants in these plans. If an employer provides benefits to an employee that are subject to Section 409A but under a noncompliant plan, the participating employee will be subject to federal income tax results sooner than expected or desired, and will also be liable for a twenty percent federal penalty tax.

Under its regulations, Section 409A potentially applies to any employment-related benefit payment that may be received in a future year, other than "short-term" deferrals including

- Salary or bonus deferral plans, whether short or long term,
- Nonqualified retirement payments or benefits (including Section 457(f) plans),
- Severance arrangements,
- Employment agreements,
- Incentive compensation or retention arrangements,
- Split dollar plans providing for future roll out of policy equity or forgiveness of indebtedness, and
- Independent contractor agreements providing for deferred compensation.

Life insurance professionals sometimes recommend deferred compensation arrangements, informally financed with life insurance, to business owners looking to provide a valuable benefit to one or more key employees. It is absolutely essential that employers, their counsel and life insurance agents active in the deferred compensation market have an in-depth knowledge of these proposed regulations and an understanding of their scope.

FACTS: The IRS recently issued proposed regulations supplementing the existing regulations and guidance on the application of Code Section 409A to nonqualified deferred compensation arrangements.

The general rule of Code Section 409A essentially requires that all amounts deferred under a nonqualified deferred compensation arrangement be included currently in the covered employee's gross income (to the extent vested and not previously included in gross income). Such amounts will also be subject to an additional 20% penalty tax.

However, these two levels of tax will not be imposed and federal income tax on these amounts will be deferred – IF strict requirements are satisfied regarding (among other things) deferral elections and the time and form of permissible distributions.

The new proposed regulations address certain specific provisions of the existing 409A regulations and are not intended to constitute a general revision or substantial change of existing regulations and guidance. 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.

The proposed regulations clarify existing regulations and guidance in the following significant ways:

1. Joint Application of Sections 409A and 457. The proposed regulations clarify that the 409A rules apply separately and in addition to the rules under 457A and 457(f) applicable to nonqualified deferred compensation arrangements sponsored by tax exempt organizations. Long awaited proposed regulations under Section 457 were issued the same day as the 409A proposed regulations June 21, 2016 (and are discussed separately in an upcoming article). The proposed regulations clarify that the inclusion of an amount in income under 457(f) by reason of vesting will be treated as a payment for all purposes under 409A. However, it is still possible for amounts to be considered subject to a "substantial risk of forfeiture" under 457(f) and not under Section 409A, for example, because payment is conditioned upon compliance with a noncompetition agreement which may be recognized as a substantial risk of forfeiture under 457(f) but not under 409A. Therefore, the proposed regulations clarify that in such cases, the amount payable at the end of the noncompetition agreement may not qualify for exemption from 409A as a short-term deferral, resulting in the application of both sections to the applicable payment.

2. Clarification of Short-Term Deferral Rules to Allow For Legally Required Delays. Payments are exempt from Code Section 409A to the extent that they are made no later than the 15th day of the third month following the later of the end of the calendar year or the service recipient's taxable year 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 for exemption from 409A even if the service recipient (e.g. the employer) delays making the payment because "payment would violate Federal securities laws or other applicable law." Delay in payments subject to 409A is already permitted for this reason but proposed regulations expand existing regulations to include this as a basis for delay of short-term deferral payments without loss of exemption.

3. Definition of Service Recipient Stock Clarified. The exemption for stock options and stock appreciation rights under 409A is limited to "common stock" of the service recipient. Although "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 violation of a noncompetition or nondisclosure agreement will not prevent the shares qualifying as "common stock" for purposes of exemption from 409A. The proposed regulations also clarify that stock options issued to a person in anticipation of providing services to an entity 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 payments due to the service provider's death, and also allow the acceleration of payments which have already commenced in the event of such an occurrence. The proposed rules also 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 death occurs. The proposed regulations further 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 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

31st 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. Some commentators had interpreted the 409A plan termination rules under 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 subsection (C) is permitted only if the service recipient terminates and liquidates all plans of the same category sponsored by the service recipient, not merely all plans of the same category in which a particular service provider actually participates, and that for a period of 3 years following such 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. The proposed regulations also clarify the termination 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 that are not vested or paid 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 permitting 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 without including amounts in income or incurring additional tax, they were not intended to allow service recipients to change the time or form of payments that otherwise meet the requirements of 409A without compliance with applicable change rules. The new rules therefore treat as vested any unvested amounts impacted by a change in a plan provision otherwise not permitted by 409A that affects the time or form of payment - if there is no reasonable good faith basis for concluding (a) that the original provision failed to meet 409A requirements and (b) the change is necessary to bring the plan into compliance. Further, the proposed regulations give specific examples of patterns of practice of permitting impermissible changes and require that, if a correction method is proscribed in applicable correction procedures, one of the proscribed correction methods must be used (although it is not necessary that

applicable penalties or reporting requirements be complied with for corrections with respect to unvested amounts).

7. Transaction Based Compensation Rules Applicable to Exempt Stock Rights. Existing 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, uncertainty has existed with respect to whether the provision for payments under an exempt stock option on the same basis as other shareholders would result in loss of the 409A exemption. Proposed regulations clarify that the special transaction-based payment rules apply to an exempt stock option or right so that payment in a manner consistent with these rules does not result in the stock right being treated as having a deferral feature violating 409A from the original grant date.

8. Termination of Service Clarified. 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 as an independent contractor would result in a separation from service under the employee rules (i.e. less than 20%-50% of prior level of service).

9. Other Changes. Proposed regulations also include a number of other specific modifications or changes such as (i) clarification of the rules regarding recurring part-time compensation (ii) the ability to accelerate the time of payment to comply with Federal debt collection laws (iii) clarification that a service provider can be an entity (iv) clarification of the separation pay plan definition where a service provider commences and terminates employment in the same year, and (v) providing that a right to reimbursement of reasonable attorney's fees in connection with a bona fide legal claim against the employer does not provide for a deferral of compensation judgment.

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