Proposed Modifications/Clarifications to the 409A Regulations

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On June 21st, 2016, the IRS issued proposed regulations that are intended to clarify or modify specific provisions of the 409A regulations, which govern nonqualified deferred compensation plans. The proposed regulations clarify a number of existing provisions of the 409A regulations, which were unclear or may have resulted in multiple interpretations. In addition, there were several modifications enacted to existing provisions that will provide additional flexibility in the design of such plans.

The following describes in some detail the items that would or could significantly affect most plans, followed by a listing of the remaining items. Please note that the terms “service recipient” and “plan sponsor” are used interchangeably, as well as the terms “participant” and “service provider.”

Minor Modification of the Short-Term Deferral Rule

Plans that satisfy the Short-Term Deferral Rule are exempt from 409A. The Short-Term Deferral Rule states there is no deferral of compensation (and therefore not subject to 409A) if two conditions are satisfied:

(i) The participant actually or constructively (i.e., “taxed”) receives the payment no later than the end of the applicable 2½ month period, referred to as the Short-Term Deferral Period. The Short-Term Deferral Period is a 2½ month span following the end of the taxable year in which the participant becomes vested.

(ii) The payment is not a deferred payment.

<u>Current Regulation</u> – Provides exemptions that a payment that otherwise qualifies as a short-term deferral, but is made after the applicable 2½ month period, may continue to qualify as a short-term deferral if the payment is delayed for one of three reasons: (1) the taxpayer establishes that it was administratively impracticable for the service recipient to make the payment by the end of the applicable 2½ month period; (2) making the payment by the end of the applicable 2½ month period would have jeopardized the service recipient’s ability to continue as a going concern; or (3) the service recipient reasonably anticipates that a deduction for the payment would not be permitted under section 162(m).

<u>Proposed Regulation</u> – Adds another exemption - the service recipient reasonably anticipates that making the payment during the applicable 2½ month period will violate Federal securities laws or other applicable law and the payment is made as soon as reasonably practicable following the first date on which the service recipient anticipates or reasonably should anticipate that making the payment would not cause a violation.

Modification to 1.409A-1(b)(4)(ii)

Involuntary Separation Pay Plans

Current Regulation – Involuntary Separation Pay Plans are exempt from 409A if separation pay does not exceed two times the lesser of (1) the service provider's annualized compensation based upon the annual rate of pay for the service provider's taxable year preceding the service provider's taxable year in which the separation from service occurs, or (2) the limit under section 401(a)(17) for the year in which the service provider separates from service. It is also required that the separation pay be paid no later than the end of the 2nd taxable year following the year of separation.

Proposed Regulation – Clarifies that the separation pay plan exception is available for service providers *whose employment begins and ends in the same taxable year*. In that circumstance, these proposed regulations provide that the service provider's annualized compensation for the taxable year in which the service provider separates from service may be used for purposes of this separation pay plan exception *if the service provider had no compensation from the service recipient in the taxable year preceding the year in which the service provider separates from service.*

Example – the Involuntary Separation Pay Plan exemption can apply to a service provider who is hired and terminated in the same year, by utilizing annualized compensation for the year of termination.
Modification to 1.409A-1(b)(9)(iii)

Dual Status as Employee and Independent Contractor and Changes in Status from Employee to Independent Contractor (or Vice Versa)

Current Regulation – A termination of employment generally occurs if the facts and circumstances indicate that the employer and employee reasonably anticipate that no further services would be performed after a certain date or that the level of bona fide services the employee would perform after that date (whether as an employee or as an independent contractor) would permanently decrease to no more than 20 percent of the average level of bona fide services performed (whether as an employee or an independent contractor) over the immediately preceding 36-month period (or if the employee has been providing services to the employer for less than 36 months, the full period of services).

An independent contractor separates from service with a service recipient upon the expiration of the contract (or, if applicable, all contracts) under which services are performed for the service recipient if the expiration is a good-faith and complete termination of the contractual relationship.

If a service provider provides services both as an employee and an independent contractor of a service recipient, the service provider must separate from service both as an employee and as an independent contractor to be treated as having separated from service.

Proposed Regulation – The IRS clarified that when an employee changes to independent contractor status, the 20% employee rule stated above holds. In other words, if an employee changes to an independent contractor "consultant" position, for example, it would not be considered a separation from service unless the 20% rule applied to consulting services. If it did not, there is no 409A separation from service at that time, and the employee could not receive his employee deferred compensation benefit under any employee plan under a separation from service provision. If there is no separation upon the initial change, a subsequent separation will occur going forward when the independent contractor rules, stated above, are satisfied.

1.409A-1(h)(1)(ii), 1.409A-1(h)(2), 1.409A-1(h)(5)

Payment of Death Benefit as a Permissible Payment

Current Regulation – Provides that an amount deferred under a nonqualified deferred compensation plan upon the occurrence of a permissible payment event (including death) may be paid only at a specified time or upon the occurrence of the permissible payment event. The regulation also provides that a payment is treated as made upon a date specified under the plan, including at the time a specified event occurs (i.e., "timely paid"), if the payment is made on that date or on a later date within the same taxable year of the service provider or, if later, by the 15th day of the third calendar month following the date specified under the plan, provided that the service provider is not permitted, directly or indirectly, to designate the taxable year of the payment.

Proposed Regulation –

- Clarifies that the rules applicable to amounts payable upon the death of a service provider also apply to amounts payable upon the death of a beneficiary.
- Provides that an amount payable following the death of a service provider, **or,** following the death of a beneficiary who has become entitled to payment due to the service provider's death, may be paid at any time during the period beginning on the date of death and ending on December 31 of the first calendar year following the calendar year during which the death occurs (the "window"), without violating the "timely paid" rule stated above.
- A plan is not required to specify any particular date within this period as the payment date and may rely on this rule if the plan provides that an amount will be paid at some time during this period. Alternatively, the plan may provide that payment will be made upon death without defining the period at all (no violation as long as payment is actually made during the required period.)
- The beneficiary retains the right to change the date of the payment within this "window" without violating deferral election rules, subsequent deferral rules, or anti- acceleration rules.
- A plan may be amended at any time to conform to this new rule (but not required).

Modification to 1.409A-3(b)
Adds 1.409A-3(d)(2)

Prohibition on Acceleration of Payments to Beneficiaries Upon Death, Disability, or Unforeseeable Emergency

Current Regulation – A prohibited acceleration of a payment does not result from the addition of death, disability, or unforeseeable emergency as a potentially earlier alternative payment event for an amount previously deferred (i.e., it is permissible to add those events even if they were not addressed in the original plan document). This exception applies only with respect to a service provider's death, disability, or unforeseeable emergency.

Proposed Regulation – The ability to add the event extends to a beneficiary who has become entitled to payment due to a service provider's death.

Example: A plan states at the time of the initial deferral, that upon the death of the participant, the beneficiary will be paid 10 annual installments. The plan provisions do not address anything up front relating to the beneficiary's death. The plan may be modified after the participant's death to add a death benefit event for the beneficiary (i.e., commute remaining payments upon the beneficiary's death).
Modification to 1.409A-3(j) (2)

Intervening Event

Current Regulation – An intervening event refers to an event that occurs after payments have already begun. A plan provision may state, or an election may be made, at the time of the initial deferral election, to change the time/form of payment on the occurrence of an intervening event such as death, disability, or a change in control. Such a change will not be considered an acceleration if the new time/form is made earlier than currently being paid.

Example: A plan provides 6 annual installments upon separation from service, but provides that if the participant dies before all 6 installments have been paid, the remaining payments will be paid in a lump sum (death is the intervening event.)

Proposed Regulation – The intervening event rule above applied to participants. The proposal states that the above rule may also apply to beneficiaries who become entitled to payments upon the participant's death.

Example 1: A plan states at the time of the initial deferral, that upon the death of the participant, the beneficiary will be paid 10 annual installments, but upon the death of the beneficiary, all unpaid installments will be paid in a lump sum.

Example 2: A plan provides 10 guaranteed payments upon a separation from service of the participant. Upon his death, remaining payments would continue to the beneficiary. At the time of the initial deferral election, the plan may state that if the beneficiary dies while receiving installments, the remaining installments may be paid in lump sum.
Modification to 1.409A-3(j)(1)

Clarification of the General Termination and Liquidation Rule

Current Regulation – A plan may be terminated and liquidated without being considered an impermissible acceleration under one of three rules. One of them (the general rule) provides that the service recipient must terminate and liquidate all plans sponsored by the service recipient of the same category as classified under the plan aggregation rules under §1.409A-1(c) (e.g., all elective account balance plans, all non-account balance plans) *as if* the same service provider had deferrals of compensation under all such plans. In addition, the plan must satisfy certain pay out rules, and not create another plan of the same type for a period of three years.

Proposed Regulation – Clarifies that the service recipient must terminate and liquidate all plans of the same category that the service recipient sponsors, and not merely all plans of the same category in which a particular service provider actually participates.

Example: Assume that a plan sponsor maintains three elective deferral plans for different categories of executives, and desires to terminate and liquidate one of these plans. In order for the termination of the desired plan not to be considered an impermissible acceleration, the plan sponsor must terminate all three plans under the rules above.
Clarification of 1.409A-3(j)(4)(ix)(C)(2)

Certain Offsets

Current Regulation – Includes a de minimis exception to the anti-acceleration rules by which a plan may permit the acceleration of the time or schedule of a payment, or to make a payment under a plan, in satisfaction of a debt of the service provider if the debt is incurred in the ordinary course of the service relationship, if the entire offset in any taxable year does not exceed $5,000, and the offset is taken at the same time and in the same amount as the debt otherwise would have been due from the service provider.

Proposed Regulation – Expands the current exception to the prohibition on accelerated payments for certain offsets to permit a plan to provide for the acceleration of the time or schedule of a payment, or to make a payment, to the extent reasonably necessary to comply with Federal laws regarding debt collection.
Adds 1.409A-3(j)(4)(xiii)(B)

Description of Other Provisions

- Clarifies that the rules under 409A apply to nonqualified deferred compensation plans separately and are in addition to the rules under section 457A (deferral plans for "nonqualified entities").

- Clarifies 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, or the occurrence of a condition within the service provider's control, is based on a measure that is less than fair market value.

- Modifies the definition of the term "eligible issuer of service recipient stock" to provide that it includes a corporation (or other entity) for which a person is reasonably expected to begin, and actually begins, providing services within 12 months after the grant date of a stock right.

- Provides that a plan under which a service provider has a right to payment or reimbursement of reasonable attorneys' fees and other expenses incurred to pursue a bona fide legal claim against the service recipient with respect to the service relationship does not provide for a deferral of compensation.

- Modifies the rules regarding recurring part-year compensation (i.e., teacher's compensation).

- Clarifies that a stock purchase treated as a deemed asset sale under section 338 is not a sale or other disposition of assets for purposes of determining whether a service provider has a separation from service.

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

- Modifies the conflict of interest exception to the prohibition on the acceleration of payments to permit the payment of all types of deferred compensation (and not only certain types of foreign earned income) to comply with bona fide foreign ethics or conflicts of interest laws.

- Clarifies the provision permitting payments upon the termination and liquidation of a plan in connection with bankruptcy.

- Clarifies and modifies §1.409A-4(a)(1)(ii)(B) of the proposed income inclusion regulations (i.e., penalties for violating 409A) regarding the treatment of deferred amounts subject to a substantial risk of forfeiture for purposes of calculating the amount includible in income under section 409A(a)(1).

- Clarifies various provisions of the final regulations to recognize that a service provider can be an entity as well as an individual.

Effective Date

The proposed regulations will become effective after they are finalized (expected to be finalized in September/October), but may be relied upon immediately.