IRS Clarifies Aspects of 409A Regulations

By Scott E. Galbreath

Almost a decade after issuing final regulations under Code Section 409A, the IRS has issued proposed regulations to clarify them.

Introduction

Internal Revenue Code Section 409A (Code Section 409A) governs deferred compensation arrangements and imposes requirements regarding when compensation can be deferred, when it can be distributed, and how it can be held. Code Section 409A was enacted in 2004 to be effective for tax years beginning after that date. Generally, if a deferred compensation arrangement subject to Code Section 409A fails to meet the rules of Code Section 409A, the compensation will be taxable when the employee's right to the compensation is no longer subject to a substantial risk of forfeiture regardless of whether received. In addition to being taxable, the amounts deferred are subject to a 20 percent federal penalty tax, plus accrual of interest on tax owed from the date deferred at a bonus rate of one percent higher than the rate for other tax liabilities.

Under Code Section 409A, a deferred compensation plan is any plan or arrangement, other than a qualified plan, that provides for a deferral of compensation. A plan provides for the deferral of compensation if, under the terms of the plan and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that is, or may be, payable to (or on behalf of) the service provider in a later taxable year. Service providers can be employees or independent contractors. Among other things, Code Section 409A provides that distributions can only be made upon a separation from service, disability, death, a change in control of the employer, a specified time, or an unforeseeable emergency. Additionally, Code Section 409A generally prohibits the acceleration of payment of deferred compensation with certain exceptions. This provision was a reaction to the situation at Enron whereby executives participated in nonqualified deferred compensation plans that permitted them to accelerate the payment of such deferred compensation by forfeiting a small percentage of the overall benefit as a penalty for early access. This was known as a "haircut." The executives accelerated their distributions and paid the "haircut" penalty while the company was experiencing financial hardship. This practice is prohibited under Code Section 409A.

On June 22, 2016, the Internal Revenue Service (IRS) issued new proposed regulations (proposed regulations) under Code Section 409A meant to clarify aspects of the final regulations under that section issued in 2007 (final regulations) as well as proposed regulations dealing with income inclusion issued in 2008. The IRS stated the proposed regulations, "address certain specific provisions of the final regulations and the proposed income inclusion regulations and are not intended to propose a general revision of, or broad changes to, the final regulations or the proposed income inclusion regulations." [81 Fed. Reg. 40568]

These clarifications mean that employers that have deferred compensation plans subject to Code Section 409A should review them against the new guidance to determine whether their plans should be revised to take advantage of new opportunities or to ensure the plans remain in compliance. The proposed regulations will become effective 90 days after they are finalized, but taxpayers may rely on them now.

This article summarizes the major issues in the proposed regulations. The proposed regulations provide

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clarification on Section 457 plans, death payments, acceleration of payments, separation from service, and stock options and stock appreciation rights.

457 Guidance

The proposed regulations reiterate the position of the final regulations that a plan subject to Code Section 457(f) may be subject to Code Section 409A. Code Section 457 governs deferred compensation plans of tax-exempt organizations or state and local governments and sets forth specific requirements for these plans to be "eligible" plans. If the plan meets the requirements to be an eligible plan, participants will not be subject to tax on the deferred compensation until payment is actually received. If such a plan fails to meet the requirements, it is considered an "ineligible" plan governed by Code Section 457(f). Under that section, participants under an ineligible plan must include the deferred compensation in gross income in the year in which the participant's right to the compensation is no longer subject to a substantial risk of forfeiture. The proposed regulations provide that the Code Section 409A rules apply to deferred compensation plans separately and in addition to any requirements under Code Section 457(f). [81 Fed. Reg. 40578] Separately, the IRS issued proposed regulations under Code Section 457(f) meant to coordinate the definition of substantial risk of forfeiture under Code Sections 409A and 457(f). (See Tax-Exempt Entities column in this issue.)

The proposed regulations also provide similar guidance with respect to deferred compensation plans of nonqualified entities under Code Section 457A. That Code Section governs nonqualified deferred compensation plans by certain foreign corporations or partnerships whose income is substantially allocated to foreign persons or organizations. If the foreign entity is not qualified under Code Section 457A, the deferred compensation is included in the gross income of the participant when no longer subject to a substantial risk of forfeiture. The proposed regulations clarify that these plans may also be separately subject to Code Section 409A even though Code Section 457A was enacted after the final regulations under Code Section 409A. [81 Fed. Reg. 40578]

Death Payment Flexibility

The proposed regulations address a number of issues regarding death benefits. First, they clarify that the death of a beneficiary can itself be a qualified distribution on account of death. [81 Fed. Reg. 40581]

Death Payment Period Extended

The proposed regulations also extend the time period for payment on account of death through the end of the first year following the year of death (Death Payment Period). [81 Fed. Reg. 40581-2] Payments will be considered timely if made at any time during this period. The plan need not specify a payment date but may provide generally that it will be made during the period. Further, the plan can provide that the beneficiary may have discretion to choose the payment date during the period. This is quite unexpected as one of the principal prohibitions under the Code Section 409A regime is to avoid discretion as to the time of payment.

Plans that provide for payment at a particular time during the Death Payment Period such as "within 60 days after death" may make such payment at any time during the Death Payment Period without amending the plan and such payment will not be a Section 409A violation.

Acceleration of Payments

Plan Termination and Liquidation

The proposed regulations clarify certain provisions regarding the permitted acceleration of payments under a deferred compensation plan subject to Code Section 409A upon the voluntary termination and liquidation of the plan. Payments may be accelerated provided the employer terminates the plan and all other plans of the same category that are considered to be a single plan under the regulations. [Treas. Reg. § 1.409A-3(j)(4)(ix)(C)(2)] Thus, all elective deferral plans must be aggregated with each other. Likewise, all nonelecive plans are treated as one, as are all stock rights plans, and so on.

However, the final regulations used the unfortunate phrasing, "if the same service provider had deferrals of compensation under all . . . such plans." [Treas. Reg. § 1.409A-3(j)(4)(ix)(C)(2)] Some commenters wondered whether that meant that only those plans of the category being aggregated that had common participants needed to be terminated. The proposed regulations clarify that the employer sponsor must terminate all plans in the category required to be aggregated for the exception from the prohibition against acceleration to apply. [81 Fed. Reg. 40583]

Likewise, the final regulations provided that the employer sponsor could not adopt a deferred compensation plan of the same category within three years of liquidating the plan that used the same "under all such" language. [Treas. Reg. § 1.409A-3(j)(4)(ix)(C)(5)] The proposed regulations clarify that this means no plan of the same category can be adopted within the three-year period regardless of who participates. [81 Fed. Reg. 40583]

Foreign Ethics and Conflicts of Interest Laws

The final regulations provided an exception to the prohibition on acceleration of payments when the acceleration is necessary to comply with the bona fide ethics or conflict of interest laws of a foreign country. Under the final regulations, the exception only applied to foreign earned income from the country whose law was being complied with. [Treas. Reg. § 1.409A-3(j)(4)(iii)(B)] The proposed regulations recognize that payments of US earned income may be accelerated if necessary to comply with such foreign laws. [81 Fed. Reg. 40583]

Clarifications Regarding Separation from Service

The proposed regulations clarify a couple of issues regarding the term "Separation from Service," a qualifying distribution event under Code Section 409A.

Change in Status

The proposed regulations clarify that when an employee changes his or her status to that of an independent contractor such change in status can qualify as a Separation from Service event, triggering a distribution. The change of status can qualify as a Separation from Service provided that the level of bona fide services of the independent contractor is reduced sufficiently under the terms of the plan. Generally, this means the former employee could provide no more than 20 percent of the average level of services provided to the employer over the prior three-year period. [81 Fed. Reg. 40580]

Separation Pay Exception Available for Short-Term Employees

Severance pay is generally deferred compensation under Code Section 409A. However, there is an exception for separation pay that does not exceed a threshold dollar amount and is paid within two years from the date of separation from service. To be excepted from Code Section 409A, the pay must be due to an involuntary separation or voluntary resignation for good reason as defined in the regulations. The separation pay cannot exceed two times the lesser of: (1) the employee's prior annual compensation; or (2) the limit on compensation that can be considered under a qualified plan under Code Section 401(a)(17), which is $265,000 for 2016. [Treas. Reg. § 1.409A-1(b)(9)(iii)(B)] This is often called the "Two Times" exception.

The proposed regulations clarify that if an employee is terminated in the same year that he or she was hired, the separation pay exception is still available. [81 Fed. Reg. 40580] Prior to the proposed regulations, it was unclear whether the exception was available because an employee separating in the year of hire would have no prior year compensation. This would make the amount of separation pay eligible under the Two Times formula, zero. The proposed regulations clarify that in the case of a same-year termination, in applying the Two Times exception, the annualized compensation during the year of separation would be used.

Section 338 Election Does Not Cause Separation from Service

Under Code Section 409A, when a company is sold in a stock deal, employees are not treated as incurring a Separation from Service just because there is a new owner of the company stock. On the other hand, if the assets of a company are sold, the buyer and seller can agree whether the sale constitutes a termination of employment under the "same desk rule." Additionally, under Code Section 338, the parties can elect to treat a stock sale as an asset sale for income tax purposes. The proposed regulations clarify that the Section 338 election will not cause employees to experience a Separation from Service for Code Section 409A purposes. [81 Fed. Reg. 40580]

Reimbursement of Attorney's Fees

The proposed regulations also clarify that a provision for the reimbursement of attorney's fees in an employment contract for a successful claim brought against the employer following termination is not deferred compensation under Code Section 409A. [81 Fed. Reg. 40580]

Stock Options and Stock Appreciation Rights Clarification

The proposed regulations clarify certain aspects regarding compensatory nonstatutory stock options (stock options) and stock appreciation rights (SARs), which are both called "stock rights" under Code Section 409A. Statutory stock options, also known as incentive stock options, are generally exempt from Code Section 409A, provided the exercise price can never be lower than the fair market value of the underlying stock on the date of grant, and it contains no other feature of deferral. SARs are exempt from Code Section 409A if the value used as the initial value of the stock from which the appreciation is measured is not lower than the fair market value of the stock on the grant date and there is no additional feature of deferral.

Clawbacks at Less than Fair Market Value

The proposed regulations clarify that options and SARs can provide for mandatory buy backs at less than fair market value when the recipient is terminated for cause or upon the occurrence of a condition within the grantee's control, such as the violation of a noncompete agreement. Such a provision will not cause the stock right to be subject to Code Section 409A. [81 Fed. Reg. 40579]

Grants Before Employment Permitted

The proposed regulations also clarify that an employer can grant a stock option or SAR to an individual before they are actually hired by the employer. Under the final regulations, the options or SARs had to be for the stock of the employer for which the grantee was already working (or members of the same controlled group) in order to be exempt from Code Section 409A. Therefore, an otherwise exempt option or SAR issued pre-employment would be subject to Code Section 409A. The proposed regulations provide that an option or SAR may be issued pre-employment and still qualify as exempt from Code Section 409A provided the new hire is expected to start working for the employer within 12 months of the grant date and actually begins working within that period. [81 Fed. Reg. 40579]

Transaction-Based Rules Apply to Stock Rights

The final regulations provide that transaction-based compensation will comply with Code Section 409A provided the payments are made on the same schedule and under the same terms as applied to the employer's shareholders generally under the change in control transaction and the payments are made within five years of the change in control. [Treas. Reg. § 1.409A-3(i)(5)(iv)] Transaction-based compensation payments are payments whereby, due to a change in control, the employer purchases stock or stock rights held by the service provider or payments are made that are calculated with reference to the employer's stock. The proposed regulations clarify that these rules apply to statutory and nonstatutory stock options as well as SARs that are not otherwise subject to Code Section 409A. That is, the purchase of such options or rights under the transaction-based compensation rules will not cause the stock rights to be subject to or violate Code Section 409A. [81 Fed. Reg. 40582]

Other Clarifications

The proposed regulations also provide some clarification to recognize that a service provider may be an entity and not only an individual; extend the exceptions to the short-term deferral rule to include a delay in payment to avoid violating federal securities laws; provide that a payment to comply with federal debt collection laws will not violate the prohibition on acceleration; and increase the amount of recurring part-year compensation a worker can earn and qualify for the exception from Code Section 409A to the Code Section 401(a)(17) limit.

Conclusion

While none of the clarifications under the proposed regulations are earth shattering, they are significant enough to warrant a review of the design and provision of employers' deferred compensation arrangements. The review should consider whether changes need to be made to remain compliant as well as whether there are now opportunities to add flexibility and ease of administration. In particular, equity compensation plans such as stock options and SARs should be analyzed to see if they should be amended to permit grants before hire, clawbacks at less than fair market value, or transaction-based compensation concepts. In addition, if a plan has been interpreted in a manner that does not comply with the proposed regulations, the employer should consider correcting the plan under the IRS correction programs or comment on the proposed regulations in an attempt to persuade the IRS to change its interpretation when finalizing the proposed regulations.

The IRS began a compliance initiative project in 2014 that includes deferred compensation issues under Code Section 409A. This provides more incentive for employers to review their deferred compensation plans now. Of course, such review should be conducted by a professional who has expertise in deferred compensation plans and Code Section 409A. ■