

IRS Issues New Proposed Regulations on Nonqualified Deferred Compensation under Section 409A

On June 21, 2016, the IRS issued new Proposed Regulations under Section 409A of the Internal Revenue Code (the “[Proposed Regulations](#)”), which clarify various issues regarding the treatment of nonqualified deferred compensation under Section 409A. The new rules under the Proposed Regulations generally will not apply unless and until adopted in final regulations issued by the IRS, but companies may rely on the Proposed Regulations in the meantime. A few of the clarifications in the Proposed Regulations are viewed as reaffirming existing guidance and must be followed immediately.

As described in more detail below, the Proposed Regulations:

- expand the scope of certain Section 409A exemptions;
- provide employers greater flexibility regarding payments related to death; and
- clarify the standard for when an employee who becomes an independent contractor has a separation from service.

In addition, the Proposed Regulations include a number of additional changes and clarifications which are generally helpful to employers.

Background

Effective January 1, 2005, Congress adopted a new Section 409A to the Internal Revenue Code, which made sweeping changes to the tax treatment of nonqualified deferred compensation of both private employers and tax-exempt organizations. “Nonqualified deferred compensation” generally is compensation that is earned in one year, but paid in a later year, with the exception of compensation deferred under a Section 401(k) plan or under certain other arrangements. The IRS adopted final regulations under Section 409A in 2007, and subsequently published proposed regulations on income inclusion under Section 409A in 2008.

Under Section 409A, nonqualified deferred compensation became subject to stringent requirements regarding the timing of the deferral and the permissible payment events. Payment is generally allowed only upon a specified date, an employee’s separation from service, disability or death, or upon a change in ownership or control of the employer. Violations of Section 409A result in the deferred compensation being included in income and subject to an additional 20% tax plus interest.

Significant Changes

Expand the Scope of Certain Section 409A Exemptions

- [409A-Exempt Stock Options May Be Granted Prior to Employment](#). Under the existing regulations, the rule that generally exempts stock options from Section 409A only applies if the individual receiving the options provides services to the employer on the date the options are granted. The Proposed Regulations provide additional flexibility by allowing employers to grant exempt options to any person who is reasonably expected to begin, and actually begins, providing services to the employer within 12 months after the options are granted.

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- Separation Pay Plan Exemption Can Be Used for Employees Hired and Terminated in the Same Year. The existing regulations exempt certain severance payments from Section 409A if the amount does not exceed the lesser of two limits, one of which is based on the employee's prior year compensation (which for a newly hired employee would be zero). The Proposed Regulations allow employers to use this exemption for newly hired employees who do not have prior year compensation from the employer, by applying the limit using the employee's annualized current year compensation instead of his or her prior year compensation.
- Payment of Short-Term Deferrals Can Be Delayed to Avoid Violating Applicable Law. Under the existing regulations, compensation is not subject to Section 409A if it must be paid, and is paid, within 2½ months after the year in which it vests. The existing regulations allow such payments to be delayed in certain circumstances, including where payment is administratively impracticable or would jeopardize the employer's ability to continue as a going concern. The Proposed Regulations also allow employers to delay payment where the employer reasonably anticipates that making the payment within the applicable 2½ month period would violate federal securities laws or other applicable laws.

Provide Greater Flexibility for Payments Related to Death

- Payments Can Be Made Upon Death of a Beneficiary. Under the existing regulations, the death of an employee is one of the events that can allow payment of deferred compensation. The Proposed Regulations expand this rule to also allow payment upon the death of a beneficiary who has become entitled to payment of the deferred compensation due to an employee's death.
- Ability to Add Death, Disability, or Unforeseeable Emergency of a Beneficiary as Early Payment Events. The existing regulations allow employers to add an employee's death, disability or unforeseeable emergency as events that would trigger early payment of the employee's deferred compensation. The Proposed Regulations would allow the same treatment for a beneficiary following the employee's death.
- Extended Payment Period Following Death. Under the existing regulations, a payment following death may generally be treated as being timely made if it is made no later than the end of the year in which the death occurred or, if later, by the 15th day of the third calendar month following death. The Proposed Regulations allow employers additional time for making payments following death by providing that payments are timely if they are made by December 31 of the first calendar year following the calendar year in which the death occurs.

Clarify the Standard for When an Employee Who Becomes an Independent Contractor Has a Separation from Service

Under the existing regulations, there was some uncertainty as to whether an employee who moved to independent contractor status could have a separation from service (and thus potentially trigger payment of deferred compensation) prior to also separating from service as an independent contractor. The Proposed Regulations clarify that whether a separation from service occurs at the time an employee changes to independent contractor status is determined under the existing rules applicable to employees (i.e., whether the employee and employer reasonably expect that the level of services will permanently decrease to 20% or less of the preceding 36-month average). If the employee does not have a separation from service at the time of the change, the separation from service rules applicable to independent contractors would apply to determine when the former employee later incurs a separation from service.

Additional Changes

- Clarify that stock options are still exempt from Section 409A even if the amount payable under the

options on an involuntary separation from service for cause, or the occurrence of a condition within the employee's control (*e.g.*, violation of a non-compete obligation), is based on a measure that is less than fair market value.

- Provide that a right to payment or reimbursement of reasonable attorneys' fees and other expenses incurred to pursue a *bona fide* legal claim against the employer with respect to the employment relationship is not deferred compensation.
- Clarify that a stock purchase that is treated as an asset sale for federal income tax purposes is not treated as an asset sale for purposes of determining whether an employee has a separation from service under Section 409A.
- Replace the various standards under the existing regulations for determining what constitutes a "payment" with a generally applicable rule for all purposes under Section 409A. Under the Proposed Regulations, a payment is made when any taxable benefit is actually or constructively received, including a transfer of property that is includible in income and the occurrence of an event that results in the inclusion in income under the economic benefit doctrine.
- Clarify that the special rules for compensation payable on the occurrence of certain types of change in control transactions also apply to stock options that are exempt from Section 409A, so such options can be paid on the same terms applicable to shareholders generally without affecting the exemption from Section 409A.
- Provide that a plan may accelerate the payment of deferred compensation to comply with *bona fide* foreign ethics or conflicts of interest laws, or to comply with federal debt collection laws.
- Clarify that accelerated payment in connection with the termination and liquidation of a plan is permitted only if the employer terminates and liquidates all plans of the same Section 409A type that it sponsors, and not merely all plans of the same Section 409A type in which a particular employee actually participates.
- Modify the existing proposed regulations on how to measure the income included for violations of Section 409A by: (a) clarifying that the time or form of payment of unvested amounts cannot be changed under the income inclusion regulations without complying with the Section 409A subsequent election rules if there is not a Section 409A failure; and (b) providing that if there is an IRS program that provides a correction method(s) for a type of Section 409A failure, that IRS program must be used to correct that type of error with respect to unvested compensation (as opposed to correction under the income inclusion regulations).

Suggested Action

We recommend that employers review their deferred compensation plans, employment agreements, independent contractor arrangements, incentive plans and other arrangements, as well as their compliance policies and administration practices, to identify any opportunities or potential challenges presented by the Proposed Regulations.

For example, employers may wish to:

- consider taking advantage of the additional time allowed for payments following death;

- consider adding the death, disability or unforeseeable emergency of a beneficiary as an early payment event (*e.g.*, if an arrangement provides for installment payments to beneficiaries); and
- verify that they are applying the proper standard for determining whether employees who become independent contractors have a separation from service, especially if such former employees will be providing services at a significantly reduced level.

Additional Information

If you would like more information regarding the Proposed Regulations and how they may apply to your arrangements, please contact a member of Harter Secret & Emery LLP's Employee Benefits and Executive Compensation Group at (585) 232-6500. ■



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