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Code Section 409A and You: The IRS Issues New Guidance

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Earlier this summer, the Internal Revenue Service (IRS) issued proposed regulations under Sections 409A and 457 of the Internal Revenue Code (the Proposed Regulations) that modify the final regulations issued on April 17, 2007 (the Final Regulations). The Proposed Regulations include new and clarifying provisions that will affect how employers design and operate their nonqualified deferred compensation plans. Primarily, these changes clarify rules relating to (1) income inclusion, (2) exemptions from Section 409A, and (3) opportunities for acceleration and deferral of payments.

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- Income Inclusion. In 2008, the IRS issued proposed regulations relating to income inclusion, which allowed for the correction of violations of Section 409A without including a deferred amount in income, provided that the correction occurs prior to the calendar year during which the deferred amount would vest. The 2008 regulations state that although an amount may be subject to a substantial risk of forfeiture, the amount may be included in income (and the substantial risk of forfeiture disregarded) if the facts indicate that an employer has a pattern or practice of permitting impermissible changes in the time or form of payment under its nonqualified deferred compensation plans. The Proposed Regulations clarify that an amount will be included in income if the employer either (1) impermissibly changes the time or form of the payment without a reasonable, good faith basis for concluding the original provision failed to meet the requirements of Section 409A or (2) the facts and circumstances indicate the amount would be affected by the employer's pattern or practice of allowing impermissible changes. An employer generally may correct a Section 409A failure only if there is a reasonable, good faith basis for concluding the original provision failed to satisfy Section 409A. The Proposed Regulations are designed to broaden these anti-abuse provisions from the 2008 regulations.
- Payment Being Made. The Final Regulations did not include a generally applicable rule regarding when payments are deemed to have been made under Section 409A. Under the Final Regulations, a payment occurs for short term deferral purposes when an employee actually or constructively receives any taxable benefit, including a transfer of cash, an amount is included in income under the economic benefit doctrine, Section 83, Section 402(b), or Section 457(f), and an amount of deferred compensation is transferred, cancelled, or reduced in exchange for other benefits. The Proposed Regulations expand this rule and treat these events as a payment for all purposes under Section 409A. Practically speaking, this change expands access to the exceptions from Section 409A (e.g., previously, receiving a taxable benefit under Section 457(f) was treated as a payment solely for purposes of the short-term deferral exception, but now may be treated as a payment for purposes of the separation pay plan exception.)
- Separation Pay Plan. The Final Regulations provide that Section 409A does not apply to an amount that an employer pays under a separation pay plan if the amount (1) does not exceed two times the lesser of (a) the employee's total annualized compensation based upon the employee's annual rate of pay in the previous calendar year or (b) $265,000 (for 2016) and (2) is paid before the end of the second full calendar year following the employee's separation from service. The Proposed Regulations clarify that for employees who are hired and discharged in the same calendar year, the employee's annualized compensation for the year of termination may be used.
- Accelerating Payments to Beneficiaries. Under the Final Regulations, payment generally may only be accelerated upon the death, disability, or unforeseeable emergency of the employee. The Proposed Regulations expand these exceptions to the beneficiary who has become entitled to payment because

of the employee's death. This new clarification also applies even if payment has already commenced prior to the employee's or the beneficiary's death, disability, or unforeseeable emergency.

- Payments on Death. The Final Regulations require payments to be made either on a specified date (such as the date of death) or by the 15th day of the third calendar month following the specified date. In the case of death, this rule has created many practical issues, as probate typically cannot be completed within that timeframe. The Proposed Regulations provide that an amount payable upon the death of an employee (or a beneficiary) is timely paid if payment is made at any time between the date of death and December 31 of the first calendar year following the calendar year of death.
- Stock Rights of Prospective Employees. The Final Regulations require an employee to be employed by an employer on the date of the grant of a stock right. The Proposed Regulations allow an employer to issue stock rights to entice a potential employee if the employee is reasonably anticipated to begin work for the employer within the next 12 months and the employee actually does begin work for the employer (or the stock is otherwise forfeited).
- Repurchase of Stock Rights. The Final Regulations provide that certain stock options and stock appreciation rights do not provide for the deferral of compensation (and thus are not subject to Section 409A). However, the Final Regulations exclude from this allowance stock that is subject to a mandatory repurchase obligation or a permanent put or call right if the stock price is based on a measure other than fair market value. The Proposed Regulations clarify that the exclusion set forth above will not apply when the amount payable upon an involuntary termination for "cause" or the violation of a condition by an employee (such as a violation of a covenant not to compete) is based on a measure that is less than fair market value. This technical change allows employers to better deter employees from engaging in detrimental behavior and reduce the amounts paid to employees discharged for cause.

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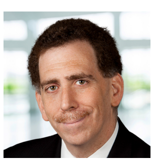

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