If you read one thing...

- The Internal Revenue Service (IRS) has issued proposed regulations on the application of Code Section 409A to nonqualified deferred compensation plans that clarify and modify previous guidance on Section 409A which taxpayers may rely on until final regulations are issued.

- Among other things, the proposed regulations stipulate when a payment is deemed made for Section 409A purposes and provide that a payment does not include a transfer of substantially non-vested property for which no Section 83(b) election has been made.

- The proposed regulations also establish an anti-abuse rule for making changes to deferred compensation amounts that are subject to a substantial risk of forfeiture.

IRS publishes new proposed regulations on Section 409A

On June 21, 2016, the Department of the Treasury published proposed regulations on the application of Section 409A of the Internal Revenue Code of 1986, as amended (the “Code”) to nonqualified deferred compensation (“NQDC”) plans. The proposed regulations clarify or modify certain provisions in previously published final regulations on Section 409A (the "Final Regulations").

Background

Section 409A sets parameters on when service providers, including employees and independent contractors, may be paid NQDC, which is generally compensation earned in one year and paid in a subsequent year and not paid pursuant to a tax-qualified plan. Subject to certain exceptions, payment of NQDC must occur only in connection with the service provider’s separation from service, death, disability, experience of an unforeseeable emergency, a change in control (generally with respect to the service recipient) or on a fixed payment date or schedule. In addition and also subject to exceptions, Section 409A prevents the acceleration or subsequent delay of NQDC payments. Violation of Section 409A could result in a heavy tax burden for the service provider. Amounts deferred under an NQDC plan that is in violation of Section 409A are generally includible in the service provider’s income and subject to a 20% additional tax plus interest.
When a payment is deemed made

A deferral of compensation does not occur for purposes of Section 409A if the service provider actually or constructively receives a payment that is not a “deferred payment” on or before the fifteenth day of the third month following the end of the service provider’s or the service recipient’s first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture (the “Short-Term Deferral Period”). A “deferred payment” is a payment that is or may be made outside the Short-Term Deferral Period. A payment is treated as actually or constructively received if the payment is includible in income.

The proposed regulations establish a general rule for when a payment is deemed to be made, specifically that a payment is made when any taxable benefit is actually or constructively received or upon the transfer, cancellation or reduction of an amount of deferred compensation in exchange for benefits under a welfare plan, a non-taxable fringe benefit or any other nontaxable benefit. However, the occurrence of any of the following is not considered a payment: (i) a grant of an option that does not have a readily ascertainable fair market value; (ii) a transfer of property that is substantially non-vested with respect to which the service provider does not make a valid Section 83(b) election; or (iii) a contribution to a trust under Section 402(b) or a transfer or creation of a beneficial interest in such trust unless and until such amount is includible in income under Section 402(b). Interestingly, a payment in the form of a “profits interest” in a partnership in which the service provider makes a valid Section 83(b) election should constitute a payment for purposes of these rules even though a properly structured profits interest should not result in any taxable income upon making the election.

Calculation of amount includible in income

The amount includible in income if an NQDC plan fails to meet the requirements of Section 409A at any time during the taxable year does not include amounts subject to a substantial risk of forfeiture. This has been interpreted to permit otherwise impermissible changes to amounts subject to a substantial risk of forfeiture. The proposed regulations apply an anti-abuse provision to this rule. Certain amounts will not be considered subject to a substantial risk of forfeiture for the taxable year (even though otherwise subject to a substantial risk of forfeiture) if (i) an impermissible change is made to a plan provision providing for the time or form of payment of the deferred amount if the service recipient has not made a reasonable, good faith determination that, absent the change, the provision fails to comply with Section 409A; (ii) the service recipient has engaged in a pattern or practice of permitting substantially similar failures to comply with Section 409A under one or more NQDC plans while amounts deferred under the plans are non-vested and the facts and circumstances indicate that the deferred amount would be affected by the pattern or practice; or (iii) the correction of the 409A failure affecting the deferred amount is not consistent with the applicable correction method, if applicable, or the failure is not corrected in substantially the same manner as a substantially similar failure affecting a non-vested deferred amount under another plan sponsored by the service recipient. Solely with respect to the deferred amount, the requirements under applicable correction guidance with respect to eligibility, income inclusion, additional taxes, premium interest, and information reporting by the service recipient or service provider do not apply.
Reduction in stock right payments due to bad behavior
Certain stock rights (i.e., stock options and stock appreciation rights) granted with respect to “service recipient stock” do not provide for deferral of compensation under Section 409A. Service recipient stock is generally common stock under Section 305 of a corporation that is an eligible issuer and is not subject to a mandatory repurchase obligation or a permanent put or call right if the stock price under such right or obligation is based on a measure other than fair market value. The proposed regulations clarify that a stock price will not be treated as based on a measure other than fair market value if the amount payable on a service provider’s involuntary separation from service for cause or violation of a condition within the service provider’s control (whether or not the condition is specified at the time the stock right is granted) is based on a measure that is less than fair market value. Practically, this permits employers to reduce the amount an employee will receive under a stock right if the employee gets fired for cause or breaches a restrictive covenant obligation.

Modification to short-term deferral exception
A payment that would otherwise be made within the Short-Term Deferral Period described above, but is delayed, may still not be subject to Section 409A if it is established that it was administratively impracticable for the service recipient to make the payment by the end of the Short-Term Deferral Period; making a payment within that period would jeopardize the service recipient’s ability to continue as a going concern; or the service recipient reasonably anticipates that a deduction for the payment would not be permitted under Section 162(m). The proposed regulations supplement these exceptions to include payments that otherwise qualify as short-term deferrals, but are made outside the Short-Term Deferral Period if the service recipient reasonably anticipates that making the payment during that period would violate federal securities law or other applicable law and the payment is made as soon as reasonably practicable following the date the payment would not cause a violation.

Miscellaneous
In addition to the above, the new proposed regulations do the following:

- Clarify that the rules under Section 409A to apply to NQDC plans separately and in addition to the rules under Section 457A.
- Modify 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.
- Clarify that certain separation pay plans that do not provide for deferral of compensation may apply to a service provider who had no compensation from the service recipient during the year preceding the year in which a separation from service occurs.
- Provide that a plan under which a service provider has a right of 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.
• Modify the rules regarding recurring part-year compensation, which are typically relevant for teachers.

• Clarify 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.

• Clarify that a service provider who ceases providing serves as an employee and begins providing services as an independent contractor is treated as having a separation from service, if, at the time of the change in employment status, the level of services reasonably anticipated to be provided after the change would result in a separation from service under the rules applicable to employees.

• Modify the rules applicable to amounts payable following death, including providing that (i) the rules applicable under the Final Regulations to amounts payable upon the death of a service provider also apply in the case of the death of a beneficiary who has become entitled to the payment of an amount due to the service provider’s death and (ii) an amount payable following the death of a service provider or such beneficiary that is to 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 in which the death occurs is treated as timely made if it is paid during that period.

• Clarify that the rules for transaction-based compensation apply to stock rights that do not provide for a deferral of compensation and statutory stock options. Under the Final Regulations, transaction-based compensation may be treated as paid at a designed date or pursuant to a payment schedule that complies with Section 409A if it is paid on the same schedule and under the same terms and conditions as apply to payments to shareholders generally with respect to stock of a service recipient pursuant to a change in control. Likewise, transaction-based compensation will not fail to meet the requirements of initial or subsequent deferral election rules under Section 409A if the compensation is paid no later than five years after the change in control event. The proposed regulations clarify that these special payment rules apply to a statutory stock option or a stock right that did not otherwise provide for a deferral of compensation before the purchase or agreement to purchase the stock right. Therefore, the purchase or agreement to purchase a statutory stock option or stock right in a manner consistent with these rules does not result in a statutory stock option or stock right being treated as having provided for the deferral of compensation from the original grant date.

• Provide that the addition of the death, disability or unforeseeable emergency of a beneficiary who has become entitled to a payment due to a service provider’s death as a potentially earlier or intervening payment event will not violate the prohibition on the acceleration of payments.

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

• Clarify other rules permitting payment in connection with the termination and liquidation of a plan. To terminate a plan under Section 409A and accelerate payment thereunder, the service recipient must terminate and liquidate all plans that it sponsors, which would be aggregated with the terminated plan, if the same service provider had deferrals of compensation under all such plans. The proposed regulations clarify that the acceleration of payment pursuant to this rule is permitted only if the service provider meets all of the conditions set forth.
recipient terminates and liquidates 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. In addition, for a period of three years following the termination and liquidation of a plan, the service recipient cannot adopt a new plan of the same category as the terminated and liquidated plan, regardless of which service providers participate in the plan.

- Provide that a plan may accelerate the time of payment to comply with federal debt collection laws.
- Clarify various provisions of the Final Regulations to recognize that a service provider can be an entity as well as an individual.

**Effective Date**

The provisions of the proposed regulations are proposed to be applicable on or after the date on which they are published as final regulations. Taxpayers may, however, rely on these proposed regulations before they are published as final regulations. Certain provisions of the proposed regulations are not intended as substantive changes to the current requirements under Section 409A and are considered effective immediately, including certain of those relating to when a payment is deemed made.
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