IslerDare PC

EMPLOYEE BENEFITS UPDATE

July 26, 2016

New Section 409A Rules Impact Nonqualified Deferred Compensation Plans

Executive Summary

- On June 21, 2016, the Treasury Department and IRS proposed clarifying changes to final and proposed regulations under Section 409A of the Internal Revenue Code ("Section 409A"), which impact a wide range of nonqualified deferred compensation arrangements. Taxpayers may rely on the proposed rules immediately, as the final regulations are not expected to significantly differ from the proposed regulations.

What You Should Do

- Review your existing nonqualified deferred compensation arrangements to determine whether any changes are needed in light of the new guidance. Work with your consultants and outside legal counsel to determine how the guidance may impact proposed compensation arrangements that are being considered for your organization.
- Remember that rules under Section 409A are independent of those under Section 457 of the Internal Revenue Code ("Section 457"), which apply to tax-exempt and governmental employers. The IRS recently published proposed regulations under Section 457 that seek to harmonize aspects of Section 457 with Section 409A. However, some important differences do persist, so that tax-exempt organizations need to take great care to comply with both the 409A and 457 regulatory regimes.

Background

Section 409A applies to nonqualified deferred compensation ("NQDC") arrangements (*i.e.*, where a participant has a legally binding right during a taxable year to compensation that is or may be payable in a later tax year), and provides strict requirements to those arrangements, including those relating to the timing of elections and distributions. Failing to comply with the complex rules under Section 409A results in the immediate inclusion of deferred amounts in gross income, to the extent the amount is not subject to a "substantial risk of forfeiture", and an additional excise tax of 20 percent and other potential penalties on the participant. Final regulations were previously issued in 2007, and proposed regulations regarding income inclusion were issued in 2008. The new proposed regulations issued last month do not change the fundamental Section 409A regime, but provide some additional clarifying guidance. Some of the more notable features of the guidance are summarized below.

Limits on the Ability to Change the Terms of a NQDC Arrangement

One of the most significant changes to the 2008 proposed income inclusion rules limits the ability to make changes to an unvested benefit prior to the year of vesting without incurring a penalty. The new proposed regulations clarify that in order to correct a possible Section 409A violation by changing the time and form of payment of an amount that is unvested as of the applicable year-end:

1) There must be a reasonable, good faith basis to conclude that an actual Section 409A violation was present (*i.e.*, the proposed income inclusion rules can no longer form the basis for any time or form of payment changes to a compliant deferred compensation arrangement);
2) The correction to change the payment or form of timing is necessary for the arrangement to comply with Section 409A;
3) Consideration should be given to whether, and how, similar Section 409A failures were dealt with in the past, and how similar failures will be avoided in the future; and
4) Procedures under any existing current IRS correction programs (*e.g.*, those set forth in IRS Notice 2010-6) must be followed, if applicable.

Separation from Service from Employee to Independent Contractor
Under the 2007 final regulations, an employee generally has a "separation from service" for Section 409A purposes when the employee and employer reasonably expect that the employee's service will permanently decrease to 20% or less than the average level of services provided before the change in employment. For independent contractors, a separation from service occurs when the contractual relationship has completely terminated.

The new proposed regulations clarify that when an employee transitions to an independent contractor status, the 20% threshold applies to determine whether a separation from service has occurred for Section 409A purposes. If the 20% threshold was not met upon the initial change to independent contractor status, a subsequent separation from service only occurs when the contractual relationship has completely terminated.

Short-term Deferrals
Under Section 409A, payments made within 2½ months following the year in which an arrangement is no longer subject to a substantial risk of forfeiture is exempt from Section 409A as a "short-term deferral." The new proposed rules provide that a payment can still qualify as a short-term deferral even if made after the applicable 2½ month period, as long as the employer reasonably anticipated that making the payment on its original schedule would have violated federal securities law or other applicable law.

Separation Pay Plan Limits
The 2007 final regulations provide an exemption from the Section 409A rules for severance payments that do not exceed the lesser of two times (1) the annual compensation includible under Section 401(a)(17) of the Internal Revenue Code (*i.e.*, $265,000 for 2016), or (2) the individual's prior-year pay; provided that other certain requirements are met. The proposed rules clarify that for purposes of determining the applicable severance amount limit, annualized current-year pay can be used if an individual has been hired and terminated in the same year.

Transaction-based Compensation
The 2007 final regulations provide that the payment terms of stock-based deferred compensation in a corporate or similar transaction may be revised to the extent that the payments are not delayed more than 5 years beyond the corporate transaction, and the terms mirror the payout terms applicable to the company's shareholders. The proposed regulations make it clear that statutory stock options and otherwise exempt stock rights also qualify for relief under this transaction-based compensation rule.

Other Notable Clarifications:

- If an employer terminates a nonqualified deferred compensation arrangement in connection with a corporate transaction, an employer must terminate and liquidate all plans of the same 409A category that the employer sponsors, not only those in which an affected service provider actually participates.
- A for-cause termination or a breach of certain restrictive covenants can provide a basis for a forfeiture or claw-back where less than fair market value is paid for stock options or stock appreciation rights.
- Exempt stock rights may be made to prospective employees if the grantee is reasonably expected to start work within 12 months and actually does so.
- A payment will be considered to have been made for Section 409A purposes at the time that it results in taxable income to the employee for the then-current taxable year (*e.g.*, a transfer of restricted stock is not considered a "payment" unless the employee makes a so-called "83(b) election" to include the value in current income).
- Payments upon death may be paid at any time designated by the employer or payee up to and including December 31 of the calendar year following the calendar year in which death occurs. Employers may provide for this flexibility without having to comply with the rules under Section 409A that generally apply to changes to the timing of payments, and do not have to amend the nonqualified deferred compensation arrangement to do so.
- An arrangement subject to Code Section 409A may be amended to add a beneficiary's death, disability or unforeseeable emergency as a potential earlier alternative payment event for beneficiaries who have become entitled to payment by virtue of an employee's death. Similarly, a schedule of payments to an employee or a beneficiary that has already commenced may be accelerated upon the employee's or beneficiary's subsequent death, disability or unforeseeable emergency.

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If you would like to discuss how the new proposed 409A rules (and Section 457 rules, if you are a tax-exempt entity) may impact your organization's nonqualified deferred compensation arrangements, please contact us.

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