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PENSION ANALYST

Important information — Plan administration and operation

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IRS proposes clarifying regulations for nonqualified deferred compensation plans

Who's affected

These proposed rules are applicable to plan sponsors of and participants in nonqualified deferred compensation plans and other arrangements subject to Internal Revenue Code section 409A.

Background and summary

On June 22, 2016, the IRS published proposed regulations intended to clarify and modify existing IRS guidance regarding the application of Internal Revenue Code section 409A ("section 409A") regarding nonqualified deferred compensation arrangements. On the same day, the IRS also issued proposed regulations under Internal Revenue Code section 457. A separate Pension Analyst publication will address those 457 proposed regulations.

Some provisions of the proposed section 409A rules are helpful to plan sponsors, as they provide increased flexibility in certain limited situations. Other proposed rules would be considered more in the nature of technical amendments that will have limited impact on the day-to-day operation and administration of traditional nonqualified deferred compensation plans (e.g., voluntary deferral plans). The proposed rules also include a change to a portion of the proposed income inclusion rules from 2008 regarding 409A violations that addresses when amounts subject to a substantial risk of forfeiture will have that risk of forfeiture disregarded to prevent abuse.

While these rules are not effective until they become finalized, taxpayers may rely on them immediately. Comments are being accepted on the proposals until September 20, 2016.

Action and next steps

These rules do not require nonqualified deferred compensation plan sponsors to take any specific action. However, plan sponsors and their counsel should review the information in this publication to understand how it may apply to their plans and participants.

In this issue

Overview

Under section 409A, nonqualified deferred compensation arrangements that do not satisfy certain rules may subject affected participants to immediate income inclusion of all deferred amounts under the plan (and any other "plan" of the same category under the section 409A plan aggregation rules). Failures to comply with the requirements of section 409A may also result in the application of an additional federal income tax of 20% above the taxpayer's applicable tax bracket and imposition of interest at the underpayment rate plus 1%. Final regulations were issued in 2007, and operational and documentary corrections programs to address certain violations of section 409A were established in 2008.

Since final section 409A rules were issued in 2007, a number of questions have arisen regarding the interpretation of the rules. The recent proposal modifies the rules to provide more clarity on certain of these issues.

Deferral of Compensation

Short-term deferral rule

The 2007 final rules provided a "short-term deferral rule" as an exemption to section 409A, under which an amount is not considered a "deferral of compensation" subject to section 409A if it is required to be paid and is actually or constructively paid on or before the later of:

- The 15th day of the third month following the end of the service provider's tax year in which the service provider's right to the payment is no longer subject to a substantial risk of forfeiture; or
- The 15th day of the third month following the end of the service recipient's tax year in which the service recipient's right to the payment is no longer subject to a substantial risk of forfeiture.

The proposed rules modify the "short-term deferral rule" to permit a delay in payments to avoid violating Federal securities laws or other applicable law.

Separation pay plans

Under the final rules from 2007, separation pay plans that provide for payment only upon an involuntary separation from service or pursuant to a window program do not provide for a "deferral of compensation" (and therefore are not subject to section 409A) provided they meet certain requirements. One of these requirements is that the separation pay generally not exceed two times the lesser of:

- The service provider's annual compensation based upon the annual rate of pay for the service provider's tax year preceding the tax year in which the separation from service occurs; or
- The compensation limit under section 401(a)(17) for the year in which the service provider separates from service.

The proposed rules clarify that the separation pay plan exemption is available for service providers whose employment begins and ends in the same tax year. In this circumstance, the service provider's annual compensation for the tax year in which the separation from service occurred may be used for purposes of the separation pay plan exception if the service provider had no compensation from the service recipient in the tax year preceding the year of the separation from service.

Separation from service

Under the section 409A final rules from 2007, if an individual was performing services as an employee and then ceased to perform those services, but began to provide services as an independent contractor, the individual must have a "separation from service" both as an employee and as an independent contractor to be treated as having separated from service under section 409A. Under the proposed rules, an individual who terminates employment and begins providing services as an independent contractor is treated as having a separation from service for section 409A purposes 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.

For example, if an individual were providing services as an employee and then ceased providing such services, but commenced providing services as an independent contractor at a level that was less than 20% of the average level of services performed over the preceding three years as an employee, there would be a separation from service for section 409A purposes. In contrast, if an individual were providing services as an employee and then ceased providing such services but commenced providing services as an independent contractor at a level that was more than 20% of the average level of services performed over the preceding three years as an employee, there would *not* be a separation from service for section 409A purposes until a separation as an independent contractor occurs, as the employee standard would not have been met at the time of change in status.

References to a payment being made

The proposed regulations provide a general rule to determine when a payment is considered to have been made for all provisions of the section 409A rules. A payment is made, or the payment of an amount occurs, when any taxable benefit is actually or constructively received. However, payment does *not* occur upon:

- The grant of an option that does not have a readily ascertainable fair market value;
- A transfer of property that is nonvested for which the service provider did not make a valid election under section 83(b); or
- A contribution to a trust described in section 402(b) or a transfer or creation of a beneficial interest in such a trust, unless and until the amount is includible in income under section 402(b).

While the 2007 final rules treated amounts included in income under section 457(f) as a payment for the section 409A “short-term deferral” rule, such amount was not treated as a payment for other purposes under section 409A. The proposed rules clarify that the inclusion of an amount in income under section 457(f) is generally treated as a payment for all purposes under section 409A.

Payments on account of death

The final rules provide that an amount deferred under a nonqualified deferred compensation plan may be paid only at a specified time or upon an event described in the rules. Payments upon the death of a service provider were subject to the same timing rules as other distribution events. Therefore, under the terms of the applicable plan and the 409A final rules, payments often had to be made by the end of the calendar year in which the death occurred. This could be problematic in the event, for example, of a delay in notification to the plan sponsor of the occurrence of a death that would trigger distribution.

The proposed rules provide additional flexibility in that an amount payable following the death of a service provider, or following the death of a beneficiary, will be treated as timely paid for 409A purposes if it is 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. A plan is not required to specify any particular date within that period as the payment date and may rely on this rule if the plan provides that an amount will be paid at some point within the period. Further, the proposed rules also provide that a plan currently providing for payment within this period following death may be amended to provide for payment of the amount (or payment may be made without amending the plan) at any other time during the applicable period following the death without violating section 409A.

Prohibition on acceleration of payments

The 2007 final rules contain an exception to the prohibition on acceleration of payments for the addition of death, disability, or unforeseeable emergency as to the service provider as a potentially earlier alternative payment event for an amount previously deferred. The proposed rules extend this exception to include additions of death, disability, or unforeseeable emergency of a beneficiary who becomes entitled to payment due to the service provider’s death. The proposed rules also clarify that a schedule of payments that has already commenced prior to a service provider’s or beneficiary’s death, disability or unforeseeable emergency may be accelerated upon the death, disability, or unforeseeable emergency.

Amount includible in income

Proposed income inclusion rules issued by the IRS in 2008 provide that, in the event of a failure to comply with section 409A, nonvested amounts can be excluded from the calculation of the amount includible in income as a result of the failure and therefore could be corrected without impact. Those rules contain an anti-abuse provision under which an amount will be treated as vested (and therefore subject to income inclusion and related 409A consequences) under certain conditions. However, due to concerns that section 409A failures as to nonvested amounts were being made as a pretext to establish or change the time or form of payment in a manner that fails to comply with section 409A, the proposed rules modify the anti-abuse rule in the 2008 proposed income inclusion regulations by:

- Clarifying that a nonvested deferred amount will be treated as vested for a taxable year during which there is a change in a plan provision that is not otherwise permitted under section 409A and that affects the time or form of payment of the amount if there is no reasonable, good faith basis for concluding that the original provision failed to meet the rules of section 409A and that the change is necessary to bring the plan into compliance;
- Providing examples of the types of facts and circumstances that indicate whether a service recipient has a pattern or practice of permitting impermissible changes in the time or form of payment with respect to nonvested deferred amounts under one or more plans;
- Providing that to the extent applicable guidance regarding the correction of section 409A failures prescribes a particular correction method for a type of plan failure, that correction method must be used if a service recipient chooses to correct that type of failure with respect to nonvested deferred amounts; and
- Providing that substantially similar failures affecting nonvested deferred amounts under other plans sponsored by the employer are to be made in a consistent manner.

Other clarifications

The proposed rules also contain the following other clarifications and technical amendments:

- **Section 457(f) and Section 457A** - The 2007 final rules provided that nonqualified deferred compensation plans under sections 457(f) and 457A may also be nonqualified deferred compensation plans under section 409A. The proposed rules clarify that the rules under section 409A apply to such a plan separately and in addition to any requirements applicable to the plan under section 457A or 457(f), as the case may be.

- **Stock rights** - The 2007 final rules provide that nonstatutory stock options and stock appreciation rights do not provide for the deferral of compensation under section 409A if certain rules are met. The proposed rules clarify that a stock right that does not otherwise provide for a deferral of compensation will not be treated as providing for a deferral of compensation solely because the amount payable under the stock right upon an involuntary termination for cause or the occurrence of a condition within the employee's control (such as the violation of a covenant not to compete) is based on a measure that is less than fair market value.

  The proposed rules also 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.

- **Employment-related legal fees and expenses** - Under the final rules, an arrangement does not provide for a deferral of compensation to the extent that it provides for amounts to be paid as settlements or awards resolving certain legal claims, such as wrongful termination, employment discrimination, etc. The proposed rules provide that an arrangement to pay or reimburse reasonable legal fees incurred to enforce a claim with respect to the service/employment relationship generally does not provide for a deferral of compensation.

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- **Recurring part-year compensation** - To better address employees in the field of education, the proposed rules further expand the flexibility previously provided in Notice 2008-62 and provide that arrangements involving recurring part-year compensation do not provide for a deferral of compensation if:
  - The payment of the recurring part-year compensation is not deferred beyond the last day of the 13th month following the first day of the service period for which the recurring part-year compensation is paid, and
  - The amount of the employee's recurring part-year compensation does not exceed the annual compensation limit under section 401(a)(17) for the calendar year in which the service period commences.

- **Asset purchase transactions** - The 2007 final rules permit a seller and buyer in an asset purchase sale to specify whether a service provider of the seller prior to the transaction is treated as separating from service if the service provider provides services to the buyer after and as a result of the sale. The proposed rules clarify and confirm that this rule does *not* apply to stock sales which are treated as deemed asset sales under IRC section 338.

- **Transaction-based compensation** - The final rules contain special rules for timing of payment of certain transaction-based compensation in connection with certain types of changes in control. The proposed rules clarify that the special rules for transaction-based compensation also apply to statutory stock options and stock rights that did not otherwise provide for deferred compensation before the transaction-related purchase or agreement to purchase the stock right.

- **Compliance with foreign ethics or conflicts of interest laws -** The final rules provide that a plan may accelerate the time or schedule of a payment, or a payment may be made under a plan, to the extent reasonably necessary to avoid the violation of a Federal, state, local, or foreign ethics or conflicts of interest law. The proposed rules expand this provision to permit the acceleration of any nonqualified deferred compensation if the acceleration is reasonably necessary to comply with a *bona fide* foreign ethics or conflicts of interest law.

- **Plan terminations and liquidations** - Under the 2007 final rules, one of the exceptions to the general anti-acceleration rule permits the termination and accelerated liquidation of all plans of the same category, subject to certain requirements. The proposed rules confirm that the acceleration of a payment due to a plan termination that occurs pursuant to this rule is permitted only if the service recipient terminates and liquidates all the plans of the same category that it sponsors (not just all plans in the category in which a particular service provider actually participates). The proposed regulations also clarify that when a termination and liquidation under this rule occurs, the service recipient cannot adopt a new plan of the same category as the terminated and liquidated plan(s), regardless of which service providers participate in the plan.

Next steps

Plan sponsors should review this publication to ensure plans are designed and operated in accordance with the rules under section 409A.

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