
Tax Alert

Newly Released Section 409A Proposed Regulations Governing Deferred Compensation Plans



TAX PRACTICE BOARD

Stephen Brecher

646.225.5921

Stephen.Brecher@WeiserMazars.com

Jeffrey Katz

212.375.6816

Jeffrey.Katz@WeiserMazars.com

Howard Landsberg

212.375.6604

516.282.7209

Howard.Landsberg@WeiserMazars.com

James Toto

732.205.2014

James.Toto@WeiserMazars.com

EDITOR

Richard Bloom

732.475.2146

Richard.Bloom@WeiserMazars.com

On June 21, 2016, the IRS issued highly-anticipated proposed regulations under Sec. 409A governing deferred compensation plans. The newly-released proposed regulations modify and clarify policies that have been in place for over a decade.

The new proposals cap off years of increasing codification of the laws governing deferred compensation, and will be well received by taxpayers and practitioners who administer nonqualified deferred compensation plans. Historically, deferred compensation plans were governed by common law doctrines that the government considered too lax and open to abuse. In a broad effort to address the lack of regulation governing deferred compensation, Section 409A was added to the Internal Revenue Code in 2004. In 2007, the IRS released extensive final regulations under Section 409A, providing definitions and timing and payment requirements under the law. In 2008, additional proposed regulations were issued and tax practitioners awaited these regulations to be issued in final form. The wait appears to be ending as the newly-issued proposed regulations are expected to be finalized after a comment period ending September 20, 2016.

The 2016 proposed regulations do not have an overarching focus, rather they clarify and explain a number of various issues. Failure to comply with Sec. 409A could subject a service provider to immediate income taxation and a 20% excise tax penalty plus interest. Broadly, the proposed regulations focus on the following:



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1. Deferral and Acceleration of Payments:

- The final regulations provided for the addition of a permissible payment event related to a service provider's death, disability, or unforeseen emergency. The proposed regulations extend such flexibility to the death, disability, or unforeseen emergency of a beneficiary as well as the service provider.
- The final regulations provided for acceleration of payments to avoid violation of foreign ethics or conflicts of interest law. This exception initially only allowed accelerated payment of compensation earned within the foreign country that promulgated the law. Under the proposed regulations, this exception has been expanded to permit accelerated payment of deferred compensation without regard to the location of the source, if reasonably necessary to comply with the foreign ethics or conflicts of interest law.
- Proposed regulations also expand ability for plans to accelerate payments to comply with Federal debt collection laws.

2. Exemptions from 409A:

- The final regulations exempted certain stock rights from 409A, as long as any mandatory purchase / repurchase obligation or call right is based upon fair market value. The proposed regulations liberalize this rule by allowing below-fair-market-value measurements in the case of involuntary termination or other employee violations, thereby permitting stock rights to contain claw-back provisions. This has no effect on the requirement that stock rights, such as stock options must still be provided at fair market value at date of grant or the grantee will be subject to 409A.
- The final regulations clarified that otherwise exempt stock rights can benefit from delayed payment schedules upon a change in control, in the same manner as the final regulations treat transaction-based compensation rights subject to 409A.
- The proposed regulations expand the ability of employers to grant stock rights to prospective employees in anticipation of employment if grantee is reasonably expected to commence work within 12 months and already does so, rather than waiting until employment has begun. This may have limited benefit as incentive stock options (ISOs) tax rules require the grantee be employed upon date of grant and securities laws limit a company's ability to provide equity to prospective employees.
- The proposed regulations add a narrow additional exception to the short-term deferral rule, which allows deferral of compensation for 2.5 months without violating Section 409A. The proposed regulations allow payment to be delayed until after the 2.5 month period if the payment would violate federal securities laws or other applicable laws.
- Separation Pay Plans providing payment upon involuntary termination are exempt from 409A under the final regulations if they meet certain requirements. Previous requirements include that total payments must not exceed 200% of the employee's prior year compensation and the payments must be made by the last day of the second calendar year following the employment termination. The proposed regulations clarify that such plans are available to employees whose employment is terminated in the same taxable year they started in. Annualized current pay can be used if terminated employee had no prior year compensation.
- Under the proposed regulations, the exception for annualized recurring part-year compensation for workers, who perform services for part of the year but are paid over 12 months (e.g., teachers), has been liberalized and expanded in scope.
- The proposed regulations expand an exemption allowing for payment of a service provider attorneys' fees to resolve certain types of *bona fide* employment related claims. This exception is being expanded to include any *bona fide* legal claim with respect to the service relationship.

3. Restrictions on Correcting Plans:

- The final regulations contained rules that permit the correction of plan provisions that violate Section 409A while amounts are nonvested. The proposed regulations modify the anti-abuse provisions, restricting the ability of taxpayers to correct plans that violate Section 409A.

4. Technical Corrections and Other Clarifications

- The final regulations permitted acceleration of payments in the context of certain plan terminations and liquidation. The proposed regulations clarify that a service recipient that terminates a plan under this provision must terminate all deferred compensation plans in the same category, not just the plans provided to a specific service provider. Also, in the case of a plan termination, a new plan cannot be adopted for three years following plan termination.
- The proposed regulations clarify that the rules governing a service provider's separation of service in an asset sale applies only to actual asset sales, not to stock sales treated as asset sales pursuant to a Section 338 election.
- The proposed regulations clarify that payment is made when a taxable benefit is actually or constructively received.
- The proposed regulations clarify that the service provider can be an entity as well as an individual.
- The proposed regulations clarify that transfers of certain property such as restricted stock, stock options, and an interest in a Section 402(b) trust (e.g., secular trust) do not qualify as a payment for purposes of Sec. 409A unless structured to be immediately taxable.

The proposed Sec. 409A regulations will become effective after publication of the final regulations in the Federal Register. Taxpayers may rely on the proposed regulations until that time.

Please contact your WeiserMazars tax professional for more information.

Candace L. Quinn, JD, LL.M.s Taxation and Energy
Principal, Global Executive Compensation and Benefits
212.375.6892
Candace.Quinn@WeiserMazars.com

Nathan D. Pliskin, JD, LLM
Senior
212.375.6717
Nathan.Pliskin@WeiserMazars.com

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