The 409A Proposed Regulations: Clarifying Guidance for Employers

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Last month, the Internal Revenue Service (IRS) issued proposed regulations under Internal Revenue Code (Code) Section 409A (Section 409A) in conjunction with its issuance of long-awaited proposed regulations under Code Section 457(f) (Section 457(f)). For copies of our Client Alerts discussing the Section 457 proposed regulations, click on our "publications" tab here.

The Section 409A proposed regulations clarify or modify the final regulations issued under Section 409A in April 2007 (2007 Regulations) and the Section 409A income inclusion proposed regulations issued in December 2008. They also provide guidance on certain issues that were not addressed in the 2007 Regulations. This Client Alert summarizes certain key points from the proposed regulations and what employers should know going forward. While Section 409A applies to employees and other service providers such as independent contractors, for simplicity this Alert refers primarily to “employees.”

Deferral of Compensation – Exemptions and Clarifications

For purposes of Section 409A, a nonqualified deferred compensation plan means any plan or arrangement that provides for the deferral of compensation. Section 409A and the 2007 Regulations describe various types of plans, programs and practices that are exempt from Section 409A (such as 401(k) plans and 403(b) plans) or that do not provide for the deferral of compensation within the meaning of Section 409A (and therefore are not subject to Section 409A). The proposed regulations modify and clarify certain aspects of these exemptions as follows.

**Section 457(f) and Section 457A**

The 2007 Regulations provide that nonqualified deferred compensation plans under Section 457(f) (which applies to nonqualified plans of tax-exempt and state and local governmental employers) and under Section 457A (which applies to nonqualified plans of certain foreign corporations and certain domestic or foreign partnerships) may also be nonqualified deferred compensation plans within the meaning of Section 409A. When this is the case, the rules of Section 409A apply to such plans separately and in addition to the requirements of Section 457(f) and Section 457A.

**Short-Term Deferral Rule Expanded – Avoidance of Federal Securities Laws Violations**

The short-term deferral rule is perhaps the most well-known exemption to Section 409A. Under this rule, an amount is not considered deferred compensation (and therefore it is not subject to Section 409A) if it is required to be paid and is actually or constructively paid on or before the 15th day of the third month following the end of the employee’s or the employer’s tax year (whichever is later) in which the employee’s right to the payment is no longer subject to a substantial risk of forfeiture. This is often referred to as the “2½-month period.”

The 2007 Regulations extend the short-term deferral exemption to certain payments paid after the end of the applicable 2½-month period due to administrative impracticability if making the payment would jeopardize the employer’s ability to continue as a going concern or the employer reasonably anticipates that a deduction for the payment would not be permitted under Code Section 162(m). The proposed regulations further extend the short-term deferral exemption to permit a delay in payment if the employer reasonably anticipates that making the payment during the 2½-month period will violate federal securities laws or other applicable law. However, payment must be made as soon as reasonably practicable following the date the employer anticipates or reasonably should anticipate that making the payment would not cause such violation.

**Stock Rights**

The 2007 Regulations provide that nonstatutory stock options and stock appreciation rights (collectively, stock rights) do not provide for the deferral of compensation under Section 409A if certain requirements are met. In recognition that employers may wish to reduce the amount payable under a stock right if the employee engages in behavior harmful to the employer, the proposed regulations clarify that a stock right will not be treated as providing for the 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 or a nondisclosure agreement) is based on a measure that is less than fair market value.
The proposed regulations also modify the term “eligible issuer of service recipient stock,” which may assist with the grant of stock rights prior to the commencement of employment. Under the 2007 Regulations, an “eligible issuer” means the employer for whom an employee provides services on the grant date of the stock right. Because this could restrict employers from granting stock rights during employment negotiations (i.e., prior to the commencement of employment), the proposed regulations provide that an employer will be considered an eligible issuer of service recipient stock if (i) it is reasonably anticipated that an individual will begin providing services to the employer within 12 months after the grant of a stock right, and (ii) the person actually begins providing services within such period, or the stock right is forfeited if services do not so begin.

Compensation Under the Separation Pay Plan Exemption

Separation pay plans (as defined in the 2007 Regulations) do not provide for the deferral of compensation to the extent certain requirements are met. Of these requirements is that the separation pay generally not exceed two times the lesser of (i) the employee’s annualized compensation based upon the employee’s annual rate of pay for the calendar year preceding the calendar year in which separation from service occurs, or (ii) the compensation limit under Section 401 (a)(17) of the Code for the year in which separation from service occurs.

The proposed regulations clarify that the separation pay plan exception is available for an employee whose employment begins and ends in the same tax year (for example, because the individual was not employed by the employer during the preceding year). In this situation, the employee’s annualized compensation for the tax year in which separation from service occurs may be used for purposes of the separation pay plan exemption.

Reimbursement of Employment-Related Legal Fees and Expenses

The 2007 Regulations provide that an arrangement does not provide for the deferral of compensation to the extent it provides for amounts to be paid as settlements or awards resolving bona fide employment-based legal claims, such as claims for wrongful termination, or for the reimbursement or payment of reasonable attorneys’ fees or other reasonable expenses incurred by an employee related to such bona fide legal claims.

In recognition that employment agreements may provide for the reimbursement of attorneys’ fees in connection with employment-related disputes, the proposed regulations provide that an arrangement does not provide for the deferral of compensation under Section 409A to the extent it provides for the payment or reimbursement of an employee’s reasonable attorneys’ fees and other expenses incurred by an employee to enforce a claim against the employer with respect to the relationship.

Recurring Part-Year Compensation

The proposed regulations simplify current IRS guidance regarding recurring part-year compensation (as defined in the 2007 Regulations) in recognition that educational employers often structure their pay plans to provide even cash flow for employees who do not work a portion of the year. For example, a teacher providing services during a 10-consecutive-month school year may receive recurring part-year compensation.

Under the proposed regulations, recurring part-year compensation that is earned over a period of service does not provide for the deferral of compensation (and therefore is not subject to Section 409A) if (i) 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, and (ii) the recurring part-year compensation does not exceed the annual compensation limit applicable to qualified plans for the calendar year in which the service period begins (this limit is $265,000 for 2016).

Certain Separations from Service

No Separation from Service in Section 338 Deemed Asset Sales

The 2007 Regulations allow a buyer and a seller in an asset sale to specify whether an employee of the seller is treated as separating from service with the seller where the employee is hired by the buyer after and as a result of the sale. The proposed regulations clarify that this rule does not apply to stock sales which are treated as deemed asset sales under Section 338 of the Code, because in a Section 338 deemed asset sale, employees of the seller do not experience a termination from employment with the seller.

Change in Status from Employee to Independent Contractor or Vice Versa

The 2007 Regulations provide that a separation from service occurs if the facts and circumstances indicate that the employer and employee reasonably anticipate that no further services are to be performed after a certain date or the level of services to be performed (whether as an employee or an independent contractor) would permanently decrease to no more than 20 percent of the average level of services performed (whether as an employee or an independent contractor) over the preceding 36-month period. In order to clarify application of this rule to an individual whose status changes from that of an employee to an independent contractor or vice versa, the proposed regulations delete language in the 2007 Regulations which could have been interpreted to the contrary. This means that an individual must separate from service as both an employee and as an independent contractor in order to be treated as having separated from service for purposes of Section 409A.

References to a “Payment being Made”

Addition of a General Rule

The 2007 Regulations provide guidance for when a payment is made for certain purposes (such as for purposes of the short-term deferral rule, changes to the time or form of payment of deferred compensation, the provision of taxable benefits (whether cash or
property), and the cancellation or reduction of deferred compensation in exchange for nontaxable benefits under a welfare, fringe, or other benefit plan), but do not include a rule that generally applies for all purposes under Section 409A to determine when a payment is “made.”

The proposed regulations add a generally applicable rule to determine when a payment is made for purposes of all provisions of Section 409A. The proposed regulations provide that a payment is made, or the payment of an amount occurs, when any taxable benefit is actually or constructively received. Consistent with the 2007 Regulations, under the proposed regulations, the term “payment” includes:

- A transfer of cash, any event that results in the inclusion of an amount in income under the economic benefit doctrine, a transfer of property includible in income under Section 83, a contribution to a trust described in Section 402(b) (a taxable trust) at the time it is includible in income under that section, the transfer or creation of a beneficial interest in a Section 402(b) taxable trust at the time it is includible in income under that section, and the inclusion of any amount in income under Section 457(f).

- The transfer, cancellation or reduction of an amount of deferred compensation in exchange for benefits under a welfare plan, a nontaxable fringe benefit or any other nontaxable benefit.

- A transfer of property that is substantially nonvested (under Section 83(b)) to satisfy an obligation under a deferred compensation plan if the recipient makes an election under Section 83(b) to include in income the fair market value of the property (disregarding lapse restrictions), less any amount paid for the property.

The proposed regulations specify that payment does not occur upon: (i) the grant of an option that does not have a readily ascertainable fair market value; (ii) a transfer of property that is nonvested for which the service provider did not make a valid election under Section 83(b); or (iii) a contribution to a taxable trust described in Section 402(b) or a transfer or creation of a beneficial interest in such a trust, unless the amount is includible in income under Section 402(b).

Clarification Regarding Amounts Includible In Income under Section 457(f)

The 2007 Regulations provide that an amount included in income under Section 457(f) is treated as a payment for purposes of the Section 409A short-term deferral rule, but is generally not treated as a payment for other purposes under Section 409A. Commentators objected to this inconsistency. To reconcile these provisions, the proposed regulations provide that the inclusion of an amount in income under Section 457(f) is treated as a payment for all purposes under Section 409A. Under the proposed regulations, if a 457(f) plan provides for the deferral of compensation under Section 409A:

- Plan terms that specify the conditions to which the payment is subject and when a substantial risk of forfeiture lapses (i.e., when an amount is includible in income) for purpose of Section 457(f) are considered plan terms that provide for the payment of the amount includible in income under Section 409A; and

- All rules under Section 409A applicable to the payment of an amount would apply to inclusion of the amount in income under Section 457(f).

Under certain circumstances, an amount includible in income under Section 457(f) may not be a short-term deferral under Section 409A. For example, under the Section 457 proposed regulations, benefits may be conditioned on compliance with a covenant not to compete to create a substantial risk of forfeiture under Section 457(f), but the benefits would not be subject to a substantial risk of forfeiture under Section 409A. Assuming compliance with the covenant not to compete, amounts payable at the end of the noncompete period are includible in income under Section 457(f) but are considered deferred compensation (and not short-term deferrals) under Section 409A.

Permissible Payments – Death and Transaction-Based Payments

Nonqualified deferred compensation subject to Section 409A may only be paid at a specified time or upon an event set forth in the 2007 Regulations. The proposed regulations modify the rules applicable to payments upon death and payments of transaction-based compensation as follows:

- **Payments upon Death.** The proposed regulations provide that the rules applicable to amounts payable upon an employee’s death apply to amounts payable upon a beneficiary’s death and extend the time period in which distributions can be made following the employee’s or beneficiary’s death. Payments will now be treated as made upon the death of an employee (or a beneficiary who becomes entitled to payment due to the employee’s death) if made at any time beginning on the date of death and ending on December 31 of the calendar year following the calendar year in which the death occurs.

- **Transaction-Based Compensation.** The proposed regulations clarify that the special payment rules applicable to transaction-based compensation (which are certain payments related to enumerated change in control events) apply to stock options and stock appreciation rights.

Prohibition on Acceleration of Payments

With limited exceptions, a plan subject to Section 409A may not permit acceleration of the time or schedule of any payment. The proposed regulations modify a number of these exceptions as described below.
Payments upon Death, Disability, or Unforeseeable Emergency

Under current law, the addition, deletion, or substitution of a permissible payment event generally results in an impermissible acceleration of payment under Section 409A if the addition, deletion, or substitution could result in the payment being made at an earlier date. There is an exception to this rule for an amendment to a nonqualified plan to allow for distribution due to the employee’s death, disability, or unforeseeable emergency. The proposed regulations extend this exception to include the death or disability of an unforeseeable emergency of a beneficiary who becomes entitled to payment due to the employee’s death. The proposed regulations also clarify that a schedule of payments that has commenced may be accelerated upon a change in control event or upon the death, disability, or unforeseeable emergency of the employee or the employee’s beneficiary, if the plan so provides.

Compliance with Foreign Ethics or Conflict of Interest Laws

Prior to issuance of the proposed regulations, a nonqualified deferred compensation plan could provide for acceleration of the time or schedule of a payment to the extent reasonably necessary to avoid a violation of foreign ethics or conflict of interest laws, but only with respect to foreign earned income from sources within the foreign country that promulgated the law. The proposed regulations remove the requirement that the payments relate to foreign income earned from sources within the country promulgating the law, but only permit acceleration as necessary to avoid the violation of bona fide foreign ethics or conflicts of interest laws.

Plan Aggregation Requirements Under the General Rules for Plan Terminations

The 2007 Regulations provide that a plan may be terminated and liquidated and compensation deferred under the plan distributed if, among other things: (i) the employer terminates and liquidates all plans sponsored by the employer that would be aggregated with the terminated plan under the Section 409A plan aggregation rules if the same employee had deferrals of compensation under all such plans; and (ii) for a three-year period, the employer does not adopt a new plan that would be aggregated with the terminated plan under the Section 409A plan aggregation rules if the same employee had deferrals of compensation under all such plans; and (iii) whether substantially similar failures occur more frequently for unvested amounts than vested amounts and with respect to similar failures appear intentional, are numerous, or repetitive.

Amounts Includible in Income

In December 2008, the IRS issued proposed income inclusion regulations under Section 409A. In general, under the proposed income inclusion rules, when a plan that is subject to Section 409A fails to comply with Section 409A, all amounts deferred under the plan as of the end of the tax year of the failure (plus any payments under the plan made during the year), less the portion of the amount deferred under the plan that is subject to a substantial risk of forfeiture or has previously been include in income, are immediately included in income and subject to a 20 percent penalty tax. Because unvested amounts (i.e., amounts subject to a substantial risk of forfeiture) are not included in income upon a failure to comply with Section 409A, certain Section 409A failures may be corrected without penalty while amounts are unvested.

Recognizing the potential for abuse in allowing the correction of failures of unvested deferred compensation (such as an impermissible change in the time and form of payment of unvested amounts), the proposed income inclusion regulations include an anti-abuse rule. Under that rule, if the facts and circumstance indicate a pattern or practice of permitting impermissible changes to the time and form of payment of unvested amounts, such amounts may be treated as vested (possibly resulting in immediate income inclusion).

In an effort to strengthen the anti-abuse rule, the proposed regulations make the following changes to the proposed income inclusion regulations:

1. Clarify that an unvested deferred amount will be treated as vested for a taxable year during which there is an impermissible change in a plan provision that affects the time or form of payment of the amount, unless the employer has made a reasonable, good faith determination that the original provision failed to meet the requirements of Section 409A and the change is necessary to correct the failure.

2. Provide the following examples of the types of facts and circumstances that indicate a pattern or practice of permitting impermissible changes in the time or form of payment of unvested deferred amounts: (i) whether reasonable steps have been taken to identify and correct substantially similar failures promptly upon discovery; (ii) whether substantially similar failures occur more frequently for unvested amounts than vested amounts and with respect to newly adopted plans; and (iii) whether substantially similar failures appear intentional, are numerous, or repetitive.

3. Provide that failures with respect to unvested deferred amounts must be corrected in accordance with applicable IRS correction guidance regarding the type of plan failure, disregarding any requirements
under the guidance unrelated to the failure, such as eligibility requirements, income inclusion, additional taxes, premium interest, and information reporting.

**Drinker Biddle Comment:** Accordingly, a noncompliant plan term may be amended in a manner permitted under applicable correction guidance even though the noncompliant plan term may not have been eligible for correction under that guidance (for example, due to applicable timing requirements). In addition, the portion of the unvested amount that is affected by the correction is not subject to income inclusion, additional taxes, or applicable premium interest, and the IRS does not need to be notified of the correction.

4. Provide that substantially similar failures affecting unvested deferred amounts under another plan sponsored by the employer must be corrected in substantially the same manner.

### Individual and Entity Service Providers

The proposed regulations clarify certain provisions of the 2007 Regulations to reflect that a service provider can be an entity as well as an individual, and that for purposes of Section 409A, the term “service provider” includes an individual, a corporation, a subchapter S corporation, a partnership, a personal service corporation, a noncorporate entity that would be a personal service corporation if it were a corporation, a qualified personal service corporation, and a noncorporate entity that would be a qualified personal service corporation if it were a corporation.

### Effective Date

In general, the proposed regulations are proposed to be effective on or after the date they are published in the Federal Register as final regulations (the “applicability date”). For periods before the applicability date, the existing 2007 Regulations and other applicable guidance apply (without regard to the proposed regulations). However, the preamble to the proposed regulations states that taxpayers may rely on the proposed regulations before they are published as final regulations, and until final regulations are published, the IRS will not assert positions that are contrary to the positions set forth in the proposed regulations.

If you have any questions or would like assistance with any of the matters discussed in this alert, contact the authors or any member of our [Employee Benefits and Executive Compensation Practice Group](mailto:EmployeeBenefitsExecutiveCompensation@dbb.com).

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