

Proposed Section 409A Deferred Compensation Regulations Offer Helpful Clarifications of Current Rules

Treasury Department and IRS issue proposed regulations to address certain specific provisions of the existing Section 409A regulations.

On June 21, 2016, the Department of the Treasury and the Internal Revenue Service issued proposed regulations under Section 409A,¹ which governs nonqualified deferred compensation plans.² The proposed regulations address certain specific provisions of the existing final regulations and proposed income inclusion regulations, and explicitly avoid a general revision of, or broad changes to, the existing regulations.³ While the proposed regulations may be helpful to certain employers, most employers will not need to take any particular action regarding the proposed changes. Comments and requests for a public hearing must be received by September 20, 2016, although taxpayers can rely on the proposed regulations immediately.

Key Clarifications and Modifications

Below is a summary and brief discussion of the clarifications and modifications most likely to impact deferred compensation plan administration.

- Repurchase of Stock Rights at Less than Fair Market Value.
 - *Existing Regulations.* The existing regulations provide that stock options and stock appreciation rights (referred to collectively as “stock rights” in the regulations) granted with respect to “service recipient stock” and meeting certain other conditions do not constitute deferred compensation. For this purpose, service recipient stock generally excludes any class of stock that is subject to a mandatory repurchase obligation or call right for less than the fair market value of the stock (other than any such obligations or rights that lapse over time). However, shares underlying stock rights are often subject to repurchase at less than fair market value under certain conditions.
 - *Proposed Regulations.* The proposed regulations clarify that a stock right will not be treated as deferred compensation solely because the amount payable to repurchase the underlying shares upon an involuntary separation from service for cause, or the occurrence of a condition within the service provider’s control, is less than fair market value. We note that the proposed regulations limit the circumstances in which the amount payable may be less than fair market value, thus creating uncertainty as to whether the stock right exemption allows a below fair market value repurchase price in other circumstances. Hopefully the final regulations will provide that amounts less than fair market value can be paid in all circumstances.

- Stock Rights Granted to Prospective Service Providers.
 - *Existing Regulations.* Under the existing regulations, to take advantage of the Section 409A exemption available for stock rights, a service provider must be employed or engaged by the granting company (or its controlled subsidiary) on the stock right’s grant date. The Treasury Department and the IRS recognized that this requirement potentially hinders employment or contract negotiations because stock rights may not be granted until the service provider commences employment or service with the issuer.
 - *Proposed Regulations.* To address this concern, the proposed regulations provide that “eligible issuers of service recipient stock” (*i.e.*, companies entitled to grant stock rights exempt from Section 409A) include entities for which it is reasonably anticipated that a service provider will begin providing services within 12 months after the grant date, if the person actually begins providing services during that 12-month period (or the award lapses if services do not commence by the deadline). We note that, before granting stock rights to prospective service providers, companies should review their equity plans to determine whether the applicable plan permits granting equity awards to prospective (rather than just current) service providers. In addition, because granting stock rights to prospective service providers may raise securities law and/or accounting issues, companies should assess these requirements in advance of any prospective grants on a case-by-case basis.
- Transaction-Based Compensation Rules as Applied to Stock Options and Stock Rights.
 - *Existing Regulations.* The existing regulations provide that transaction-based compensation (*i.e.*, payments related to certain types of changes in control that are (i) made because a service recipient purchases its stock or a stock right held by a service provider, or (ii) calculated by reference to the value of the service recipient’s stock) may be paid on the same schedule and under the same terms as apply to payments to shareholders generally, but not later than five years after the change in control. Transaction-based compensation payments meeting these conditions are treated as complying with the requirements of Section 409A applicable to deferred compensation (rather than those applicable to compensation exempt from Section 409A).
 - *Proposed Regulations.* The proposed regulations clarify that reliance on the special transaction-based compensation payment rules regarding stock rights and statutory stock options (ISOs) that did not otherwise constitute deferred compensation before the transaction (and were thus exempt from Section 409A) will not change the characterization of these rights to deferred compensation for periods preceding the transaction (which would have adverse tax consequences).
 - *Unanswered Question.* The proposed regulations do not address whether the parties to a change in control transaction may convert an in-the-money stock right into the right to receive payment of the stock right’s intrinsic value (sometimes referred to as the “spread”) in the form of cash installments as and when the stock right would have vested absent the transaction.
- Extension of the Securities Laws Exception to the Short-Term Deferral Rule.
 - *Existing Regulations.* Under the existing regulations, a payment made within 2½ months after the end of the year in which the payment vests is generally exempt from Section 409A as a “short-term deferral,” and a payment that otherwise qualifies as a short-term deferral may continue to qualify as such even if paid after the applicable 2½ month period if the delayed payment results from certain enumerated causes. Similar exceptions apply to delayed payments of deferred compensation under the general time and form of payment rules, but the general time and form of

payment rules also allow payment delays to avoid violating Federal securities laws or other applicable laws.

- *Proposed Regulations.* The proposed regulations extend to short-term deferrals the ability to delay payments that would otherwise violate Federal securities laws or other applicable laws. This clarification should provide Section 409A compliance relief for financial institutions that are required to comply with ever-changing regulations regarding the payment of incentive-based and other compensation.
- *Unanswered Question.* The proposed regulations do not address whether payment terms in a short-term deferral agreement must satisfy the “applicable 2½ month period” deadline at all times from the inception of the agreement, or whether the deadline can instead be measured at the time the payment right vests (e.g., can six months’ continuation severance constitute short-term deferral as to all payments in connection with an April termination (since all payments will be made by year-end), or only with respect to 2½ months’ payments because of the possibility of a late-year termination that existed at the agreement’s inception?).
- Clarification of the Income Inclusion Rules.
 - *Existing Regulations.* The proposed income inclusion regulations (promulgated in 2008)⁴ permit the correction, without income inclusion or additional taxes, of certain plan provisions that fail to comply with the requirements of Section 409A if the correction occurs before the year in which the affected amounts vest. However, the proposed income inclusion regulations state that they were not intended to allow service recipients to change time or form of payment provisions that otherwise meet the requirements of Section 409A in a manner that fails to comply with Section 409A, or to create errors in deferred compensation plans with respect to unvested amounts with the intention of using those errors as a pretext for establishing or changing a time or form of payment in a manner that fails to comply with Section 409A.
 - *Proposed Regulations.* Accordingly, the proposed regulations expand the anti-abuse provision already included in the proposed income inclusion regulations to provide that in order to make changes to an arrangement under this exception without Section 409A inclusion and taxes, the following conditions must apply:
 - A reasonable, good-faith basis for concluding that the original provision was not compliant with Section 409A must exist and the change must be necessary to bring the plan into compliance (i.e., a mere change in the time or form of payment to something more desirable will not suffice for this exception).
 - The service recipient must not have a pattern or practice of permitting impermissible changes in the time or form of payment with respect to unvested deferred amounts (the proposed regulations provide examples of the types of facts and circumstances that indicate this pattern or practice exists).
 - If a particular correction method for a type of plan failure is prescribed in generally applicable guidance, then this method must generally be used to correct that type of failure, and substantially similar failures must be corrected in the same manner (although the service recipient need not comply with requirements under the guidance that are unrelated to the method for correction, such as general eligibility requirements, income inclusion, additional taxes or information reporting).

Other Clarifications and Modifications

In addition to the foregoing clarifications and modifications, the proposed regulations:

- Clarify that the rules under Section 457A, which generally apply to deferred compensation arrangements maintained by certain foreign corporations and domestic or foreign partnerships, apply separately and in addition to the rules under Section 409A
- Clarify the application of the separation pay exemption (often referred to as the “two by two exemption”) to a service provider who was not providing services to the service recipient during the previous year
- Provide that a right to payment or reimbursement of reasonable attorneys’ fees incurred to pursue any bona fide legal claim against a service recipient is not deferred compensation
- Expand the exemption for service providers with annualized recurring part-year compensation, such as teachers
- Clarify that the parties to a deemed asset sale under Section 338 (in contrast to an actual asset sale) may not treat employees as having a “separation from service” under Section 409A based solely on the occurrence of the transaction. Though not explicit in the proposed regulations, we expect that this guidance would likely extend to transactions in which asset-sale elections are made under Section 336(e)
- Clarify that an employee who is terminated and begins performing services as an independent contractor incurs a separation from service if, at such time, the level of services reasonably anticipated to be provided would result in a separation from service under the rules applicable to employees
- Provide a generally applicable rule to determine when a payment is made for purposes of Section 409A
- Modify the rules applicable to amounts payable upon the death of a service provider or his or her beneficiary
- Permit the acceleration of deferred compensation if the acceleration is reasonably necessary to comply with a bona fide foreign ethics or conflicts of interest law, or with Federal debt collection laws
- Clarify that acceleration of a payment under the plan termination and liquidation rules is permitted only if the company terminates all plans of the same category and does not adopt a new plan of the same category as the terminated plan for the next three years
- Clarify that a service provider can be an entity as well as an individual

Conclusion

The proposed regulations were intended to clarify and modify narrow issues under the existing regulations. While these clarifications and modifications may be helpful to certain employers, most employers will not need to take any particular action regarding these changes. Additionally, practitioners have been pushing for guidance on more common and far-reaching issues. For now, those issues remain subject to market interpretation and speculation.

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¹ All "Section" references are to the Internal Revenue Code of 1986, as amended.

² Application of Section 409A to Nonqualified Deferred Compensation Plans, 81 Fed. Reg. 40,569 (proposed June 22, 2016) (amending 26 C.F.R. pt. 1).

³ See *id.* at 40,569.

⁴ Further Guidance on the Application of Section 409A to Nonqualified Deferred Compensation Plans, 73 Fed. Reg. 74,380 (proposed Dec. 8, 2008) (amending 26 C.F.R. pt. 1).