IRS Clarifies and Modifies Code Section 409A Guidance

The Internal Revenue Service ("IRS") recently proposed new regulations that are intended to clarify and modify existing IRS guidance regarding the application of Internal Revenue Code section 409A ("Section 409A") to various non-qualified deferred compensation arrangements. The IRS indicated that the clarifications and modifications ". . . will help taxpayers comply with the requirements of section 409A." (The IRS also proposed regulations under Internal Revenue Code section 457(f), which will be of particular interest to tax-exempt and governmental employers. We expect to publish a separate Information Memo on those regulations shortly.)

Section 409A Refresher

Section 409A includes complex requirements that must be satisfied in order to accomplish the effective deferral of compensation that is earned in one year and paid in a later year. Section 409A generally provides that if a non-qualified deferred compensation arrangement fails to satisfy the applicable requirements of Section 409A, all compensation deferred under that arrangement must be included in the affected service provider's current gross income (even if not payable until some later year) to the extent the compensation is not subject to a substantial risk of forfeiture and has not previously been included in gross income. In addition to the resulting ordinary income tax consequences that may be triggered by any such premature income recognition, a failure to satisfy the applicable Section 409A requirements can result in an affected individual being subject to both a special 20 percent excise tax on the amounts required to be included in income and an interest surcharge/penalty on the taxes owed. In certain circumstances, other, compliant nonqualified deferred compensation arrangements may have to be aggregated with the noncompliant arrangement, and the same adverse tax consequences could apply to benefits accrued pursuant to those other arrangements.

For purposes of Section, 409A, the term "non-qualified deferred compensation plan" includes not only "traditional" deferred compensation agreements and plans but also a wide variety of other compensation arrangements where an employee, an independent contractor, or a member of a Board of Directors or a Board of Trustees has a legally binding right to compensation that will be paid in a later tax year. Arrangements that can be subject to Section 409A include offer letters, employment agreements, severance pay arrangements, separation agreements, bonus plans, incentive compensation arrangements, reimbursement arrangements, supplemental benefit plans, excess benefit plans, stock appreciation rights plans, "phantom" stock plans, change-in-control arrangements, retention bonus arrangements, split-dollar life insurance arrangements, consulting agreements, director fee agreements, and other similar plans and arrangements (regardless of the number of people or entities covered).

Given the broad definition of non-qualified deferred compensation plan under Section 409A, the strict rules of application, and the harsh consequences that can apply in the event of even the slightest violation, employers and covered service providers should welcome any guidance that will help make compliance easier.

Newly Proposed Regulations

The newly proposed regulations do not provide any broad or sweeping simplifications to the complex Section 409A rules. Rather, the IRS characterized the new guidance as "narrow" and with "specific purpose." Nevertheless, the new guidance should be helpful in the right circumstances.

Among other changes, the clarifications and modifications include the following:

- Many otherwise covered arrangements can be treated as exempt from the requirements of Section 409A, if payments are completed within a short period of time after the right to the payments is no longer subject to a substantial risk of forfeiture. This exemption is referred to as the "short-term deferral" exemption or "short-term deferral" rule. The proposed regulations modify the short-term deferral exemption to provide that the exemption may still apply if payments are delayed beyond the permitted short-term deferral period in order to avoid a violation of Federal securities laws or other applicable law.

- Stock options and stock appreciation rights can be treated as exempt from the requirements of Section 409A if (among a number of other requirements) the underlying stock is considered "service recipient stock." The term "service recipient stock" generally means the service recipient's common stock, but does not include any stock that is subject to a mandatory repurchase obligation (other than a right of first refusal), or a permanent put or call right, if the stock price under such right or obligation is based on a measure other than the fair market value of the underlying stock. The proposed regulations clarify that an otherwise exempt stock right will not be treated as subject to Section 409A solely because the amount payable under the stock right upon the holder's involuntary separation from service for cause, or the occurrence of a condition within the holder's control, is based on a measure that is less than the fair market value of the underlying stock.
- Certain severance/separation pay plans are exempt from the requirements of Section 409A. Generally, an exempt plan must provide: benefits only upon a covered individual's involuntary separation from service; limit benefits to no more than two times the compensation earned by the individual during year prior to the separation from service; and complete payments by the end of the second year after the year of the involuntary separation from service. The proposed regulations clarify that the separation pay plan exemption can still apply in the case of a covered service provider who had no compensation in the prior year because employment began and ended in the same year. In that circumstance, the proposed regulations provide that the service provider's annualized compensation for the year in which the service provider separates from service may be used for purposes of determining the amount of the maximum (exempt) benefit. This change makes it clear that an otherwise exempt separation pay plan can provide exempt benefits to an employee who is hired and involuntarily terminated in the same year.
- Although Section 409A generally applies to taxable expense reimbursements, the proposed regulations provide that Section 409A will not apply to an arrangement under which an employee or other service provider has a right to the payment or reimbursement of reasonable attorneys' fees and other expenses incurred to pursue a bona fide legal claim against the service recipient with respect to the service relationship.
- In service relationships where services are regularly rendered over periods that begin in one taxable year and end in the next taxable year, and that are less than 12 months long (for example, a teacher providing services during a school year comprised of 10 months), Section 409A will not apply to amounts that are earned in the first year and paid in the next year if (i) payments for the services are completed by the last day of the 13th month following the first day of the service period, and (ii) the service provider's total recurring part-year compensation (not merely the amount deferred) does not exceed the annual compensation limit under Internal Revenue Code section 401(a)(17) ($265,000 for 2016) for the calendar year in which the service period commences. This modification of the recurring part-year compensation rule should mean that the rule/exemption can be applied to more arrangements than before the modification.
- The Section 409A rules regarding when a service provider has had a separation from service have been clarified in the case of a service provider who ceases providing services as an employee and begins providing services as an independent contractor. In those circumstances (which can raise a number of non-Section 409A risks), the service provider is treated as having a separation from service 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.
- The rules applicable to amounts payable following a service provider's death have been liberalized to allow more time to complete the payments without triggering a Section 409A violation.
- With respect to payments to a deceased service provider's beneficiary, amending an arrangement to provide for an accelerated payment in the event of the death, disability, or unforeseeable emergency of the beneficiary will not violate Section 409A's general prohibition on the acceleration of payments.
- Various provisions have been modified to make it clear that, while the typical deferred compensation arrangement involves an individual service provider, Section 409A can apply to arrangements in which the service provider is an entity.

Correcting Non-Vested Deferred Compensation Arrangements

In addition to the clarifications and modifications noted above, the IRS also provided helpful guidance regarding the correction of certain non-compliant deferred compensation arrangements. Specifically, to the extent an amount of deferred compensation is not vested (and will not become vested during the current year), an employer or other service recipient may amend a noncompliant term or provision in the written deferred compensation document in a manner permitted under IRS correction guidance that would otherwise apply to vested amounts, even though the noncompliant term or provision may not have been eligible for correction under that guidance.

For example, a number of the correction methods recognized by the IRS for vested deferred compensation are subject to compliance with strict deadlines by which the permitted correction must be made in order to avoid the full adverse consequences that are triggered by a Section 409A violation. The latest IRS guidance provides that the non-compliance with the strict deadlines will not prevent the correction of a non-compliant arrangement under which amounts remain subject to a recognized vesting (or risk of forfeiture) condition. In addition, the portion of the non-vested deferred amount that is affected by the correction will not be subject to income inclusion, additional taxes, or applicable premium interest under Section 409A, and neither the service recipient nor the affected provider is required to notify the IRS of the correction.

Recommended Action

The proposed regulations do not require service providers and service recipients to take any specific action. However, given the potentially severe adverse consequences that can apply in the case of a Section 409A violation, parties to compensation arrangements that provide for a payment or payments in a future year or future years should consider reviewing those arrangements in light of the latest guidance and correcting any noncompliant arrangements to the extent possible. Correcting a noncompliant arrangement before the right to payments becomes vested can eliminate exposure to the adverse consequences that can apply in the case of a Section 409A violation.

If you have any questions about this memorandum, please contact any member of our Employee Benefits and Executive Compensation Group listed below.

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