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Summer Reading: More Section 409A Guidance in the Form of Proposed Regulations

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On June 22, 2016, the Department of Treasury and the Internal Revenue Service (the IRS) published proposed regulations (the Proposed Regulations) that clarify or modify certain specific provisions of the final regulations under Section 409A (the Final Regulations) and replace a prior proposed rule regarding the calculation of amounts includable in income in the event of a violation of Section 409A.

The topics addressed in the Proposed Regulations generally validate the common interpretive positions taken by practitioners and employers in complying with the Final Regulations. In addition, certain revisions included in the Proposed Regulations provide sensible agency responses to technical deficiencies in the Final Regulations that have to date thwarted practical business solutions.

As noted in the preamble to the Proposed Regulations, the IRS is not intending to provide a general revision of, or broad changes to, the Final Regulations. Notwithstanding that sentiment however, the Proposed Regulations do provide relief from certain internal inconsistencies in the Final Regulations and from contradictions with the statutory language. As a result, the Proposed Regulations may offer additional flexibility to employers in the design and operation of their nonqualified deferred compensation plans.

In general, the Proposed Regulations, which taxpayers may rely upon immediately, effect the following clarifications and modifications:

- Clarify that the rules under Section 409A apply to nonqualified deferred compensation plans separately and in addition to the rules under Section 457A.
- Modify the short-term deferral rule to permit a delay in payments to avoid violating Federal securities laws or other applicable law.
- Clarify that a stock right that does not otherwise provide for a deferral of compensation may provide for a "repurchase" right at less than fair market value in certain circumstances (i.e., termination for cause or a voluntary termination that is in the control of the service provider).
- Modify the definition of "eligible issuer of service recipient stock" to allow for grants of stock rights to prospective hires.
- Clarify how an exempt "separation pay plan" applies to a service provider hired and fired in the same calendar year.
- Provide that reimbursement of reasonable attorneys' fees incurred to pursue a bona fide legal claim with respect to the service relationship does not provide for the deferral of compensation.
- Modify the rules regarding recurring part-year compensation.
- Clarify that a stock purchase treated as a deemed asset sale under Internal Revenue Code Section 338 is not a sale or other disposition of assets for purposes of determining whether a service provider has a separation from service.
- Clarify that an employee who ceases to provide services as an employee and begins to provide services as an independent contractor can be treated as having a separation from service.
- Provide a general rule to determine when a "payment" is made under Section 409A.
- Modify the rules applicable to amounts payable following death.

- Clarify that the rules for transaction-based compensation apply to stock rights that do not provide for a deferral of compensation and to incentive stock options.
- Provide that the addition of death, disability or unforeseeable emergency of a beneficiary who has become entitled to payment because of a service provider's death as a potentially earlier or intervening payment event will not violate the prohibition of the acceleration of payments.
- Modify the conflict of interest exception to the prohibition on the acceleration of payments to permit the payment of all types of deferred compensation (and not only certain types of foreign earned income) to comply with bona fide foreign ethics or conflicts of interest laws.
- Clarify the provision permitting payments upon termination and liquidation of a plan in connection with a bankruptcy.
- Clarify other rules permitting payment in connection with the termination of and liquidation of a plan.
- Provide that a plan may accelerate the time of payment to comply with Federal debt collection laws.
- Clarify the proposed income inclusion regulations regarding the treatment of deferred amounts subject to a substantial risk of forfeiture.
- Clarify various provisions of the Final Regulations to recognize that a service provider can be an entity.

Many employers may already operate their plans consistent with these clarifications and modifications. We encourage you to contact you relationship attorney with any questions regarding the potential relief provided by the Proposed Regulations.

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