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Executive Compensation

View From Groom: Recent IRS 409A Guidance Will Impact Employers

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Last month, the IRS issued proposed regulations clarifying 19 mostly narrow issues under existing Code section 409A regulations. Eighteen topics were addressed under the comprehensive final section 409A regulations issued in 2007, and one issue was addressed under the proposed section 409A regulations on the impact of 409A violations issued in 2008. The new IRS guidance generally formalizes informal guidance provided by IRS personnel in recent years.

The new IRS guidance should not require employers to make immediate changes to their plans that are subject to section 409A. However, the new guidance will have a significant impact on employers in certain situations. As described in more detail below, the proposed regulations will:

- Limit the flexibility employers will have when correcting problems for unvested amounts subject to section 409A (e.g., severance and restricted stock units).

- Allow employers more flexibility with making payments upon the death of a participant or beneficiary.

- Limit the ability of employers to replace stock options or stock appreciation rights (SARs) with replacement equity awards, as often occurs in a merger and acquisition context.

Taxpayers may rely on this guidance immediately, and the IRS will not assert positions contrary to the guidance.

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Correction of Unvested Amounts. The new regulations tighten significantly the correction opportunity afforded prior to the year of vesting under existing proposed rules in Prop. Reg. 1.409A-4. Under the prior proposal, noncompliant deferred compensation amounts could be brought into compliance with section 409A prior to the year of vesting, subject to an anti-abuse rule. The new proposed regulations add considerable specificity in terms of anti-abuse requirements, including that

1. the arrangement must be noncompliant with section 409A prior to the change,

2. there is no pattern or practice of permitting similar failures,

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3. the correction generally be consistent with prescribed corrections under IRS corrections guidance (such as in IRS Notice 2010-6), and

4. that a method of correction be consistently applied.

In this regard, the requirement to conform to correction methods specified in IRS corrections guidance can be expected to significantly alter how many of these corrections are performed.

For example, where more than one payment schedule is possible, Notice 2010-6 often forces use of the longest payment schedule. In certain instances, impermissible discretion over payment timing must be revoked at least one year prior to the occurrence of the distribution event. Correction of a failure to include a six-month delay on payments to key employees provision may require payment delay by up to eighteen months. In addition, there are certain errors that simply are not correctable under Notice 2010-6 (mostly involving impermissible employee discretion over payment timing). Thus, the application of Notice 2010-6 correction rules will significantly reduce the availability, and usefulness, of the correction opportunity for unvested amounts under Prop. Reg. 1.409A-4.

Beneficiaries Treated Like Participants. The new regulations still do not flatly state that beneficiaries are treated the same as participants for all section 409A purposes. However, the new guidance helpfully provides for that treatment in the following additional situations.

Death of a Beneficiary: *The death of a beneficiary, like the death of a participant, can now clearly serve as a permissible payment event.*

- *For example*, a plan could provide that installment payments being made to a participant continue to be made on the same schedule to a beneficiary after the participant's death, but upon the death of the beneficiary remaining benefits are paid in a lump sum.

Intervening Events: *Currently the regulations allow a plan to provide for a change in timing for payments that have already commenced based on an intervening event that constitutes a permissible payment trigger under section 409A.*

- *For example*, a plan could provide that payments that commence upon a separation from service will be accelerated and paid in a lump sum upon a participant's death.

The new guidance provides that such an intervening event plan provision may be based on the death, disability or unforeseeable emergency experienced by a beneficiary.

The current regulations also allow the death, disability or unforeseeable emergency of a participant to be added to a plan as a potentially earlier intervening payment event for previously deferred amounts. The new guidance allows the same treatment for the death, disability or unforeseeable emergency of a beneficiary.

New Payment Flexibility on Death. Many employers have struggled with the current section 409A rules around the timing of payments following death. Many plans subject to section 409A provide for payments to be triggered by the death of a participant and paid a short time after death (e.g., within 90 days of death). Often employers have trouble meeting the timeframe specified for payment in their plan documents because they do not hear about a death immediately and/or it takes some time to determine and locate the appropriate beneficiary or beneficiaries. The proposed regulations provide the following very helpful relief on this front.

Post-Death Payment Period: A plan can now provide that a payment triggered by a death (of a participant or a beneficiary) will be made or commence during any period falling within the timeframe from (1) date of death to (2) December 31 of the year following the year of death. Normally this type of post-event period can last no more than 90 days.

The new rules also state that any such period specified in a plan can be changed within this permissible range without running afoul of the section 409A rules on changes in payment timing.

- *For example*, if a plan currently provides for a lump sum payment within 90 days of a participant's death, the plan can be revised to provide for a lump sum payment within 180 days of a participant's death.

While such a change will provide an employer with welcome flexibility, it could delay payments to a beneficiary. So, consideration should be given to potential contractual claims that may be raised about such a change.

Deemed Timely Payment: Regardless of any post-death payment period specified in a plan, payments will be treated as made or commencing on time as long as the payment is made or commences between (1) date of death, and (2) December 31 of the year following the year of death. Further, the payment recipient may elect the year of payment without running afoul of the section 409A rules (although the normal constructive receipt rules may be an issue with such an election).

- *For example*, a plan provides for a lump sum payment within 90 days of a participant's death. A participant dies on October 1, 2016. There will be no section 409A error as long as the lump sum payment is made by December 31, 2017.

Again, consideration should be given to contractual issues that may be raised if a payment upon death is made significantly later than the timeframe specified in the plan.

Payment of Deferred Compensation Defined. The new regulations add specific provisions defining what is, and is not, treated as a payment of compensation for purposes of section 409A. In this regard, the new regulations specify that an amount is treated as paid or received for purposes of section 409A when a taxable benefit is actually or constructively received, such as a transfer of cash, a transfer of property taxable under section 83 or a transfer to a ''secular'' trust taxable under section 402(b), or income inclusion under section 457(f) (affecting ineligible deferred compensation of tax-exempt employers). Amounts taxable under section 83 or 402(b) generally are not treated as ''paid'' until includible in income (generally on vesting or pursuant to an 83(b) election). Notably, the transfer of an option that does not have a readily ascertainable fair market value (such as a typical compensatory option) is not treated as a ''payment'' for this purpose.

The new definition raises some interesting questions about whether and when nonqualified deferred compensation might be cancelled in exchange for a non-

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discounted stock option otherwise exempt from section 409A (on the theory that in such case, the deferred compensation was never ''paid''). Also, it appears to confirm that a deferred compensation obligation could be settled on the otherwise applicable payment date by delivery of vested property, such as a partnership profits interest.

Equity Award and Transaction Related Clarifications. A number of the changes in the new regulations impact equity awards and transactional matters. Notably, the new regulations did not specifically address the longstanding issue with converting unvested in-the-money exempt stock options and SARs to restricted stock units (RSUs) in connection with a transaction. This frequently used and generally non-abusive strategy raises issues under the existing anti-extension rules for exempt stock options and SARs because literally, an exempt stock award is exchanged for a legally binding right to future compensation (RSUs) in such instances. However, the time of income recognition under the RSUs typically matches the earliest exercise date for the relinquished stock award, and so in its simple form, the exchange does not alter payment timing in a manner that seems inconsistent with the purposes of section 409A. Unfortunately, the changes to the correction relief for non-vested amounts under Prop. Reg. 1.409A-4, as well as the definition regarding implied time of ''payment'' with respect to unvested property, may put further pressure on this issue and increase the need for definitive guidance, as confidence in an unvested amounts ''fix'' may be harder to achieve, and using restricted stock as a work-around to address ''extension'' concerns associated with replacing an in-the-money stock option or SAR is perhaps less clearly a safe alternative to RSUs in this context.

■ Delayed Settlement of Short-term Deferral Amounts – The rules clarify that delayed settlement of amounts (such as restricted stock units) to comply with federal securities laws or other applicable law will not cause the amounts to fall out of the short-term deferral exception. For industries with a frequently changing regulatory landscape impacting payment timing for compensation, such as financial services, this is an important clarification.

■ Exempt Stock Options and SARs May Be Granted in Advance of Employment – The new rules clarify under the definition of ''eligible issuer'' that exempt stock options and SARs may be granted up to 12 months in advance of an individual's start date, and still qualify for the stock rights exemption.

■ Exempt Stock Options and SARs May Be Subject to Call Right Less than FMV Spread – Under the revised regulations, it is clarified that an employer's right to call a stock option or SAR for less than the fair market value spread of an otherwise exempt stock award, upon certain limited conditions such as termination for cause or violation of a post-termination covenant, is not inconsistent with the exemption of that stock right under section 409A.

■ Deemed Asset Sale not Treated as Asset Sale for Separation from Service Rules –The new rules confirm that a deemed asset sale pursuant to a section 338(h)(10) election to treat a stock sale as an asset sale is not treated as an asset sale for purposes of the rule that allows the employer to elect to treat all, or none, of the affected participants as incurring a separation from service in connection with a sale of assets.

■ Exempt Stock Options and SARs Eligible for Transaction Based Compensation Rules – The rules also confirm that exempt stock options and SARs are eligible for the extended settlement relief afforded to other stock-based compensation in connection with a change in control, so that such stock rights can be settled on the same terms applicable to shareholders generally, without affecting the prior exemption from section 409A.

Other Important Clarifications. The regulations address a few more items that come up on a fairly regular basis, but the guidance largely confirmed what was fairly clear in the current rules.

■ Separation from Service for Employees – The IRS made clear that when an individual moves from employee status to independent contractor status, whether he experiences a ''separation from service'' at that time depends on the employee rules. If there is no separation at that point, the preamble provides that the independent contractor rules apply in determining whether a separation occurs thereafter. Interestingly, this proposed change, along with the commentary in the preamble, seems to suggest that for an employee who transitions to independent contractor status without triggering a separation from service, section 409A deferred compensation accrued by the employee while an employee will not then become payable until a complete termination of the independent contractor relationship. Accordingly, continuing deferral of amounts payable on ''separation from service'' in that case would be required even with respect to a relatively small ongoing contractual service commitment, and ongoing deferral of such amounts could be achieved through discretionary extensions of the contractual service relationship.

■ Termination and Liquidation of Plan – The rules make even clearer that if an employer takes advantage of the plan termination and liquidation rules for one plan, all plans of the same type (e.g., nonqualified elective deferral plans) maintained in the controlled group must be terminated. The IRS also corrected a Bankruptcy Code cite in this portion of the regulations.

■ Two Times Pay Exemption for Severance – The current regulations exempt certain severance arrangements limited to ''two times pay.'' The new regulations describe how this exemption applies to individuals hired and terminated in the same year.

Other Clarifications. Finally, the new rules provide some minor but generally helpful clarifications as follows.

■ Legal Fee Reimbursements – The exemption from section 409A for reimbursement of certain legal fees was expanded.

■ Partial Year Compensation – The exemption from section 409A for employees regularly working less than 12 months per year (e.g., teachers) was expanded.

■ Foreign Ethics Rules – The permissible acceleration of payments due to foreign ethics rule was expanded.

■ Federal Debt Collection Laws – The permissible acceleration of payments rules were expanded to address Federal debt collection laws.

■ Interaction with Section 457A – The rules confirmed that section 409A and section 457A, which applies to certain overseas deferred compensation arrangements, are separate sets of rules that apply independently.

■ Entities Covered – The rules clarified that the section 409A rules may apply to entities as well as individuals.

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These many section 409A clarifications are generally helpful for employers. And while most employers will not need to leap into action to address them, the proposed regulations will have significant impacts in certain situations.

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