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Updates to the 409A Rules

The Treasury Department and the IRS last week proposed changes to final and proposed regulations under Section 409A of the Internal Revenue Code. Compliance with 409A is required to avoid disadvantageous federal income tax treatment for a broad range of nonqualified deferred compensation arrangements. While not dramatically altering how the 409A rules work, the proposed changes offer generally helpful clarification in some areas and added flexibility in others.

Below is a summary of the most significant changes.

When is a "Payment" Made?

Current regulations do not contain a uniform rule for determining when a "payment" is made: some taxable events are treated as a "payment" for some purposes and not others, and the treatment of other payments is unclear. The proposal introduces a single rule, applicable for all purposes, that looks generally to when an event results in currently taxable income. Under the proposed rules, for example, a deferred amount subject to Section 457(f) of the Code (relevant to tax-exempt and governmental employers) will count as a "payment" on the vesting date and not the actual payout date for purposes of determining both whether the arrangement is exempt from 409A as a "short-term deferral" and whether, if it is not exempt, it satisfies 409A's detailed timing-of-payment rules. Under the proposed rules, a transfer of unvested property (*e.g.*, restricted stock) is not a "payment" unless the service provider makes a so-called "83(b) election" to include the value in current income.

Payments upon Death

Existing 409A rules permit payment, including acceleration of payment, in the event of death, but in practice administration of the rules can present timing difficulties because the employer may not know that death has occurred until long after the 409A payment deadline. The proposed rules address this problem by allowing a payment at death to be paid at any time designated by the payor or payee up to and including December 31 of the calendar year following the calendar year in which death occurs. Employers may amend plans to provide for this new flexibility (or administer unamended plans consistent with the new rule) without having to comply with the rules under 409A governing changes to the timing of payments.

Separately, the proposed rules would extend the payment-at-death rules to payments upon the death of a beneficiary and would similarly permit payments to a beneficiary to be made in connection with the beneficiary's disability or an unforeseeable emergency.

Stock Rights

Forfeited stock rights. Current 409A rules contain an exemption for stock options and stock appreciation rights (stock rights) that satisfy specified requirements, among them a requirement that the exercise price not be less than the grant-date fair market value of the underlying stock and a corollary requirement that, with limited exceptions, the underlying stock not be subject to a mandatory repurchase obligation based on a measure other than fair market value. Some practitioners worried that the prohibition against mandatory repurchases other than at fair market value might bar forfeitures and claw-backs – *e.g.*, for a violation of a noncompete. The proposed rules alleviate this concern for situations where the triggering event is a for-cause termination or a condition within the service provider's control such as the breach of certain restrictive covenants, if less than fair market value is paid.

Granting stock rights to prospective employees. Currently, the provision described above that exempts stock rights from the reach of 409A applies only to a stock right granted to someone providing direct services to the issuer or a subsidiary *on the date of grant*. The proposed rules would exempt grants to someone not yet at work if the grantee is reasonably expected to start work within 12 months and actually does so. In practice this change may have only a limited impact, because the securities laws limit a company's ability to offer equity to prospective employees, and the "incentive stock option" (ISO) tax rules, where relevant, separately require that a grantee be employed on the date of grant.

Transaction-based compensation. The parties to acquisition transactions often want to re-set payment terms for the target's incentive pay arrangements, in particular those tied to stock value. One reason is to align the treatment of awards based on stock or stock value (so-called "transaction-based compensation") with the treatment of actual shareholders in the transaction. For transaction-based compensation subject to 409A, the "re-set" may not fit neatly within the limitations 409A imposes generally on changes in payout terms for deferred amounts. Existing 409A regulations address this problem for change in ownership transactions by treating revised payout terms (for transaction-based compensation) as 409A-compliant to the extent they do not push payments out more than five years beyond the transaction, if they also mirror the payout terms for shareholders. It was not clear from the existing regulations whether this relief also covered otherwise exempt stock rights, which are subject to more punitive treatment in the case of impermissible extensions. The proposed rules make it clear that the relief applies in this case also. However, it does not provide the broader flexibility that a number of practitioners had hoped to see addressed explicitly in the regulations – for example, the flexibility to restructure stock rights as unvested cash-out promises or restricted stock units that yield payments, if at all, over the original vesting term of the award rather than on the same terms that apply to shareholders.

Proposed Income Inclusion Rules

A separate portion of the release adjusts 409A proposed regulations issued in late 2008 (but not yet finalized) that prescribe how to measure the income required to be taken into account in the case of noncompliance with 409A. The new proposal does not revamp the 2008 proposed rules generally but makes several important changes or clarifications. The 2008 proposed rules provided that accelerated income inclusion could be avoided for an unvested arrangement out of compliance with 409A if the arrangement was brought into compliance before the beginning of the year in which vesting occurred, although the 2008 proposed rules also contained an anti-abuse provision intended to limit the scope of this relief. The new proposal gives examples of objectionable patterns and practices that will render the relief unavailable. It also makes it clear that parties cannot use the relief provision as the basis for changing payout terms that were not themselves the source of noncompliance. Finally, and perhaps most importantly, the new proposal requires taxpayers to follow existing correction rules (issued by the IRS outside of the regulations) if available.

Separation Pay Plans

Current 409A rules contain an exemption for severance that does not exceed the lesser of two dollar amounts, one of which turns on the individual's prior-year pay. The "prior year" rule makes the exemption unavailable for someone hired and terminated in the same calendar year. The proposed rules address this case by permitting annualized current-year pay to be used if the terminated individual had no prior-year pay from the employer.

Short-Term Deferrals

The proposed rules provide that payment under an otherwise qualifying arrangement can continue to qualify as an exempt short-term deferral even if made after the applicable 2½ month period if the employer reasonably anticipated that making the payment on its original schedule would have violated federal securities laws or other applicable law.

Plan Terminations

The proposed rules further clarify that, with respect to the plan termination rules that require plans of the same type to be terminated, an employer must terminate and liquidate all plans of the same 409A category that the employer sponsors, and not only those plans in which an affected service provider actually participates. They also clarify that in the case of a plan termination that currently requires that a new plan not be adopted for three years following plan termination, the employer cannot adopt a new plan that would be aggregated with the old, regardless of which service providers participate in the new plan. The proposed rules also fixed an erroneous citation to a provision of the Bankruptcy Code.

Other Provisions

The proposed rules also provide, in some cases by way of clarification, that:

- The rules under 409A apply separately and in addition to those under Section 457A and Section 457(f), with respect to plans subject to those sections.
- When a separation from service occurs depends on the level of continuing services, even in the case of an employee who transitions to independent contractor status or *vice versa*. (The existing regulations were susceptible of being read to mean that an employee who becomes an independent contractor does not have a separation from service until he or she is neither an employee nor an independent contractor.)
- A plan under which a service provider has a right to payment of reasonable attorneys' fees and other expenses incurred to enforce a *bona fide* legal claim against an employer with respect to his or her service relationship does not provide for a deferral of compensation.
- A stock purchase treated as a deemed asset sale under Section 338 is not treated as an asset sale for purposes of determining when a service provider has a separation from service.
- Recurring part-year compensation (relevant, for example, to teachers) that meets certain requirements will not provide for a deferral of compensation.
- A plan can provide for an offset to the extent reasonably necessary to comply with federal laws regarding debt collection with respect to federal claims.
- Nonqualified deferred compensation may be accelerated without regard to the source of the compensation (U.S. or non-U.S.) if reasonably necessary to comply with a bona fide foreign ethics or conflicts of interest law.
- For purposes of the provisions dealing with stock rights, a service provider can be an entity as well as an individual.

Effective Date

The proposed rules would apply only when finalized, but taxpayers may rely on them before that date.

For more information about these proposed rules, please contact any member of Ropes & Gray's [executive compensation & employee benefits] practice group.