

Client Alert

IRS Proposes to (Helpfully) Clarify Deferred Compensation Rules – Reduces Risk of Inadvertent Penalties under Section 409A

September 21, 2016 – The IRS recently issued proposed regulations under Internal Revenue Code Section 409A. When adopted, these regulations will reduce the risk that Section 409A will penalize deferred compensation arrangements. While there are many specific changes, this Client Alert only covers the changes we believe are most applicable to our clients.

The proposed regulations:

- Clarify that a “payment” under Section 409A is considered made when it becomes taxable to the employee or service provider. A “payment” includes a transfer of cash or property and also certain taxable trust contributions. The definition of a “payment” is a key element in determining whether deferred compensation is exempt from, complies with or violates Section 409A.
- Expand the rule that exempts “stock rights” (stock options and stock appreciation rights) from Section 409A:
 - to clarify that earn-outs and escrows that cash-out exempt “stock rights” after a change of control transaction do not become subject to Section 409A, notwithstanding the resulting delay in the cash-out payments;
 - to cover anticipatory grants of "stock rights" to individuals who actually start providing services within 12 months of the grant date. Previously, an individual had to be employed *on* the grant date to qualify for the exemption; and
 - to confirm that a forfeiture of stock rights without payment following a termination for “cause” or breach of a restrictive covenant will not violate Section 409A. Previously, there was a question whether stock rights forfeited for anything less than fair market value would remain exempt from Section 409A.

- Clarify that an employee or service provider who is fired after working less than a full year can still fall under the “severance exemption” -- an exception where total severance payments are less than \$530,000 (as adjusted for inflation).
- Clarify that a “separation from service” occurs (so that deferred compensation can be paid without penalty) where an employee transitions to independent contractor status and where the *reasonable expectation at the time* is that the level of independent contractor services will drop below 20% of the level of services previously provided as an employee.
- Clarify that in a “deemed asset sale” (i.e., a stock purchase where there is an election to treat the transaction as an asset sale for tax purposes), buyers and sellers do not have flexibility to treat employment transfers as a termination of employment. In an *actual* sale of employer assets, buyers and sellers can treat transferred employees as having terminated employment, and thus be eligible for early payment of deferred compensation without penalty.
- Expand the rules relating to a “service provider’s” death to: (x) also apply to the death of any beneficiary of the service provider; and (y) extend the time for completing payments on death until the end of the second year following death in order to accommodate issues such as confirming the fact of death and completing probate.
- Clarify that an employer that has filed for bankruptcy is permitted to accelerate payments under a deferred compensation plan, but only if the employer terminates and liquidates all plans of the same type. Previously, it was unclear whether employers needed to terminate all deferred compensation plans of the same type or only those types of plans in which cashed-out employees participated. In addition, the proposed regulations clarify that, for the exception to apply, the employer cannot adopt a new plan of the same category in the three-year period following such a plan termination, regardless of which employees participate in the plan. Previously, there was some thinking that, as long as the employees who were cashed-out in the plan’s termination were excluded, a new deferred compensation plan could be established within the following three years.
- Expand the exemption for legal fees paid to an employee (or other service provider) under a contractual reimbursement right in the context of settling a bona fide employment-related claim. The exemption previously only applied to those claims based on wrongful termination, employment discrimination, the Fair Labor Standards Act, or workers’ compensation statutes, including claims under applicable Federal, state, local, or foreign laws.
- Modify anti-abuse provisions to prevent employers from making changes to deferred compensation plans that may have been permitted under a strict reading of Section 409A but were never intended by the IRS, including provisions that:
 - clarify that deferred compensation is subject to Section 409A’s penalty provisions if there is a “correction” to the timing or the form of any payment where there is

no reasonable, good faith basis for determining that the payment being “corrected” did not comply with Section 409A;

- provide examples illustrating employer pattern of permitting impermissible changes to amounts of deferred compensation; and
- provide that, if general IRS guidance specifies a particular method for correcting a failure, that method *must* be used, and that the same correction method *must* also be used for substantially similar failures.

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