

KIRKLAND ALERT

July 7, 2016

IRS Proposed Regulations Clarify Section 409A Deferred Compensation Issues

Taxpayers Can Immediately Rely on Proposed Regulations: On June 21, 2016, the IRS proposed clarifying regulations under Section 409A on which taxpayers may immediately rely.

The proposed regulations are subject to a 90-day notice and comment period, although even if the proposed regulations are ultimately altered, taxpayers can rely on the proposed regulations for transactions effected before the final regulations are published.

Background: Section 409A of the Internal Revenue Code and the lengthy treasury regulations issued thereunder impose strict guidelines on the operation of various employee compensation and benefit plans, including nonqualified deferred compensation plans, employment, consulting, severance and change in control arrangements, and equity- and cash-based incentive plans. Participants in covered arrangements that defer compensation and do not comply with Section 409A (in either form or operation) are subject to significant tax penalties, including early income inclusion of vested compensation, an additional 20 percent penalty tax and interest. Companies, executives and advisers have faced myriad challenges in interpreting the lengthy, cumbersome and sometimes internally inconsistent final and proposed regulations, which have been the subject of periodic amendment, update and extension by the IRS.

1. **Section 409A Exemptions.** Section 409A and the related regulations provide a number of exemptions from application of Section 409A (including short-term deferrals, certain severance programs, stock options granted at fair market value, tax-qualified retirement plans and nontaxable reimbursement benefits). The proposed regulations clarify these exemptions, including the following:
 - *Short-Term Deferrals.* Payments intended to qualify as “short-term deferrals” will continue to qualify even if made beyond the short-term deferral deadline (generally 2½ months following the year in which the compensation is vested) if the delay is required to avoid violating Federal securities laws or other applicable law.
 - *Stock Options and other Equity Awards with Punitive Repurchase Rights.* The inclusion of most “punitive” call rights (which are generally rights to repurchase stock at less than fair market value) will not prohibit stock options and other stock rights from qualifying for exemption.

Taxpayers may immediately rely on these proposed clarifying Section 409A regulations.

- *Stock Options and other Equity Awards to New Hires.* Awards granted to prospective employees in anticipation of a future employment or service relationship, which is reasonably expected to begin and actually begins within 12 months after grant, will be eligible for Section 409A exemption, assuming other requirements are met.
- *Attorneys' Fees.* Reimbursement of reasonable attorneys' fees and other expenses incurred to pursue a bona fide legal claim against an employer are generally exempt from Section 409A.
- *Separation Pay Plans.* Severance pay that is payable only on involuntary termination is exempt from Section 409A if it is paid by the end of the second year following the year of termination and does not exceed the lesser of two times the sum of (i) the employee's base salary at the end of the year before the year of termination or (ii) the limit on compensation under a qualified retirement plan (\$260,000 in 2016). The proposed regulations clarify that, for an employee whose employment begins and ends in the same tax year, the employee's annualized compensation for the year of termination (rather than prior year's compensation) will be used for purposes of determining whether the separation pay plan exception will apply.

2. Permissible Payment Events. Nonqualified deferred compensation can be paid only on certain permissible payment events (i.e., on a specified date or pursuant to a specified schedule or in the event of death, disability, separation from service, change in control or unforeseeable emergency). The proposed regulations contain a number of clarifications, including:

- *Separation from Service — Deemed Asset Sales.* A stock purchase treated as a deemed asset sale under Section 338 is not a sale or other disposition of assets for purposes of determining whether an employee has had a separation from service.
- *Separation from Service — Change in Status.* An employee who becomes an independent contractor (for example, retirement of an executive in conjunction with appointment to the board of directors) will be 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 from employee to independent contractor would result in a separation from service under the rules applicable to employees (i.e., the level of services to be performed would permanently decrease to no more than 20 percent of the average level of services performed over the immediately preceding 36-month period).
- *Death-Related Payments.* Deferred compensation payable in connection with an employee's or beneficiary's death will be considered timely paid if paid at any time during the period beginning on the date of death and ending on December 31 of the first calendar year following the calendar year during which the death occurs.

Nonqualified deferred compensation subject to Section 409A can be paid only on certain permissible payment events (i.e., on a specified date or pursuant to a specified schedule or in the event of death, disability, separation from service, change in control or unforeseeable emergency).

- *Addition of Payment Events.* The addition of the death, disability or unforeseeable emergency of a beneficiary who has become entitled to a payment due to an employee's death as a potentially earlier or intervening payment event will not be considered an impermissible acceleration of payment.

3. Miscellaneous.

- *Application.* As a general matter, Section 409A applies to nonqualified deferred compensation plans separately and is in addition to the rules under Section 457A (which generally applies to foreign corporations unless substantially all of their income is connected with a U.S. trade or business or subject to a comprehensive foreign income tax) and under Section 457(f) (which generally applies to state and local government employers and other (nongovernmental) employers exempt from federal income taxation).
- *Transaction-Based Compensation — Stock Options and other Stock Rights.* The rules for transaction-based compensation, which generally provide that amounts paid in respect of stock options and other stock rights may be treated as paid in compliance with Section 409A if they are paid on the same schedule and under the same terms and conditions as apply to payments to shareholders generally in connection with the transaction, also apply to Section 409A-exempt awards, and any related delay in payment does not result in the award becoming subject to (rather than exempt from) Section 409A.
- *Termination of Arrangements in Connection with a Change in Control.* Termination of plans is permitted only if all plans of the same category that the employer sponsors (commonly referred to as the "409A plan aggregation rules") are terminated and not merely all plans of the same category in which a particular employee actually participates.
- *When Payments are Made.* A "payment" will be considered made not only when cash is actually received, but also when any taxable benefit is actually or constructively received by the employee, including any of the following events: (i) a transfer of cash, (ii) any event that results in the inclusion of income under the economic benefit doctrine, (iii) a transfer of property includable as income under Section 83, (iv) a contribution to a trust described in Section 402(b) at the time includable in income under Section 402(b), or (v) upon the transfer, cancellation or reduction of an amount of deferred compensation in exchange for benefits under a welfare plan, a non-taxable fringe benefit or any other nontaxable benefit.
- *Payments in Connection with a Bankruptcy.* The provision permitting payments upon the termination and liquidation of a plan in connection with bankruptcy is revised to address a previously erroneous cross reference.
- *Entities can be Employees.* The proposed regulations clarify that Section 409A could apply to entities (e.g., corporations and partnerships) in addition to individuals.

Termination of deferred compensation plans is permitted only if all plans of the same category that the employer sponsors (commonly referred to as the "409A plan aggregation rules") are terminated and not merely all plans of the same category in which a particular employee actually participates.

- Clarification of Unvested Exception.* Previous proposed regulations generally permitted the correction without penalty of certain plan provisions that fail to comply with Section 409A while the amounts are unvested, subject to certain anti-abuse provisions. The new proposed regulations clarify the anti-abuse provision and provide that an otherwise unvested amount will be treated as vested for these purposes if the facts and circumstances indicate that an employer has a pattern or practice of permitting impermissible changes in the time or form of payment with respect to nonvested deferred amounts and either (i) an impermissible change in the time or form of payment applies to the amount or (ii) the facts and circumstances indicate that the amount would be affected by the pattern or practice. The proposed regulations also provide that, to the extent existing guidance prescribes a particular correction method for a type of Section 409A plan failure, that correction method (or another permissible correction method) must be used if an employer chooses to correct that type of failure with respect to a nonvested deferred amount. Notably, certain correction programs impose requirements with respect to eligibility, income inclusion, additional taxes, premium interest, and information reporting by the employer or employee, which would not apply in the cases of a correction involving nonvested deferred compensation.

The proposed regulations are subject to a 90-day notice and comment period prior to being published as final and will be applicable on or after the date on which they are published as final regulations, with no additional phase-in period.

Next Steps: Companies should familiarize themselves with the proposed regulations and how they impact existing practice with respect to deferred compensation arrangements.

If you have any questions about the matters addressed in this *Kirkland Alert*, please contact the following Kirkland authors or your regular Kirkland contact.

Scott D. Price
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
www.kirkland.com/sprice
+1 212 446 4851

Michael Krasnovsky
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
www.kirkland.com/mkrasnovsky
+1 212 446 5922

Julia Onorato
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
www.kirkland.com/jonorato
+1 212 909 3007

Kirk R. Porter
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
www.kirkland.com/kporter
+1 212 909 3058

This communication is distributed with the understanding that the author, publisher and distributor of this communication are not rendering legal, accounting, or other professional advice or opinions on specific facts or matters and, accordingly, assume no liability whatsoever in connection with its use. Pursuant to applicable rules of professional conduct, this communication may constitute Attorney Advertising.

© 2016 Kirkland & Ellis LLP. All rights reserved.