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Proposed Section 409A Regulations Facilitate Common Pay Practices

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The Internal Revenue Service (IRS) has proposed a number of updates to current regulations governing nonqualified deferred compensation under Section 409A of the Internal Revenue Code of 1986, as amended. The proposed updates clarify a number of ambiguities that raised compliance concerns with standard practices relating to stock option grants and settlements, bonuses and severance payments. The proposed regulations would also permit changes in the timing of payments complicated by securities law compliance or recipient deaths. Finally, the proposed regulations seek to penalize repeat offenders and promote use of the correction methodologies described in the IRS's Section 409A correction program.

Background

Section 409A regulates a broad range of group and individual arrangements that provide employees and consultants (hereinafter, "service providers") a legally binding right to receive payments or benefits in a later tax year, including cash and equity incentives, severance rights and non-qualified retirement benefits. Violation of the documentary and operational requirements of Section 409A triggers a 20% federal tax additional tax on the service provider, in addition to other applicable taxes. The IRS's proposed regulations do not meaningfully reduce Section 409A's scope or complexity. Instead, the proposal incrementally expands certain Section 409A exemptions and payment timing grace periods while also increasing the scope of the income inclusion rules used to calculate Section 409A penalties.

Expanded Stock Option Exemptions

Generally, stock options granted to a service provider are exempt from Section 409A if the option's exercise price is at least 100% of the fair market value of the underlying stock on the grant date. The proposed regulations would clarify the scope of the stock option exemption in a number of helpful ways.

- **Grants to Prospective Hires.** The exemption would expressly cover nonqualified stock options granted prior to a service provider's start date as long as it is reasonably expected that service will commence within twelve months and the option is forfeited if service does not commence in that timeframe.

- **Below FMV Repurchase Rights.** The exemption would expressly cover stock options even if the stock acquired upon exercise of the option is subject to repurchase by the employer at a price that is less than the stock's fair market value in the event that the optionee is terminated for cause or breaches a restrictive covenant.

- **Delayed Settlement in M&A Context.** Payment of deferred compensation in exchange for exempt stock options will not be considered violative of Section 409A if paid over the same time period (of up to five years) and on the same terms as payment of merger consideration to the selling stockholders. This enables inclusion of exempt stock options in a merger earnout or escrow. The IRS's proposal does not address whether an unvested exempt stock option may be converted into an unvested cash-settled substitute award, which, by definition, will not be paid on the same conditions as applies to the selling stockholders.

Flexibility for Special Payment Situations

Generally, Section 409A imposes penalties in the event of any change to the payment schedule of nonqualified deferred compensation, subject to limited exceptions. The proposed regulations would provide latitude to revise or deviate from the payment schedule in certain circumstances where abuse is unlikely.

- **Delayed Settlement for Securities Law Compliance.** The proposed regulations would allow stock units and other equity incentive awards that are intended to be exempt from Section 409A as "short-term deferrals" (i.e., paid within 2½ months after the end of the year in which the payment is no longer subject to a substantial risk of forfeiture) to be settled after the timeframe set forth in the relevant award agreement if the delay is due to an inability to deliver shares in compliance with securities laws (such as the mandatory deferral of incentive compensation under the Dodd Frank Act) or other applicable law. The proposal does not address whether the lapse of a valid Form S-8 registration (due, for instance, to failure to keep financials current) would be sufficient to trigger this leniency.

- **Delayed Settlement on Account of Death.** The proposed regulations would allow nonqualified deferred compensation payable in connection with a service provider's death to be paid at any time up to December 31st of the year after the death.

- **Accelerated Settlement to Beneficiaries.** The proposed regulations would permit an agreement providing for the payment of nonqualified deferred compensation to a beneficiary of a service provider (such as after the service provider's death) to be amended to accelerate payment upon the beneficiary's death, disability or unforeseeable emergency.

Expanded Severance Exemption

- **Severance Exemption in Year of Hire.** The Section 409A exemption for "separation pay plans" would be expanded to cover individuals terminated in their year of hire. This exemption currently is available with respect to severance of up to two times the service provider's prior year pay (subject to an annually adjusted limit). For new hires, the exempt severance limit would relate to the service provider's annualized first year rate of pay rather than prior year pay.

Restrictions on Correcting Section 409A Failures

Pursuant to the income inclusion regulations proposed under Section 409A in 2008, a breach generally does not result in any penalties in any year in which the service provider's outstanding benefits remain unvested (i.e., subject to a substantial risk of forfeiture). This guidance has been interpreted to effectively permit employers the ability to correct nonqualified deferred compensation errors at any time and in any manner, as long as correction is completed prior to the year in which the compensation vests. The IRS proposal would constrain this flexibility in certain cases.

- **History of Failures Increases Exposure.** Income inclusion and Section 409A penalties would apply to amounts subject to a substantial risk of forfeiture if the employer has a history of allowing similar failures to occur, such as a practice of not promptly identifying and correcting all errors of a similar type.

- **Formal, Uniform Correction is Mandatory.** Income inclusion and Section 409A penalties would apply to amounts subject to a substantial risk of forfeiture if the relevant failure could have been, but was not, corrected using a methodology described under the IRS's formal correction program (other than a requirement to report the error, pay a penalty or recognize the compensation as taxable income).[1] The same adverse effects would apply if the amounts were informally corrected in a manner inconsistent with the methodology applied by the employer in similar circumstances.

Effective Date

The IRS's proposal is currently subject to public review and comment and, subject to any interim changes, will generally take effect upon publication of the final regulations. Until final regulations are issued, taxpayers may rely on the proposed regulations.

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[1]The IRS's formal self-correction program is set forth in Notices 2008-113, 2010-6 and 2010-80.

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