IRS releases proposed IRC Section 409A regulations

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The U.S. Department of the Treasury recently issued proposed regulations to supplement the existing regulations on the application of IRC Section 409A to nonqualified deferred compensation plans. Many of the changes are administrative in nature and clarify gaps in the prior regulations. Some of the more significant changes follow.

The proposed regulations make clear that the rules of Section 409A apply separately from, and in addition to, the rules of IRC sections 457(f) and 457A with respect to ineligible deferred compensation plans of government and nonprofit employers. In particular, the proposed regulations provide that events resulting in the inclusion of compensation in income under Section 457 are treated as payments for purposes for Section 409A.

The short-term deferral rule excludes payments from Section 409A to the extent they are made no later than the 15th day of the third month following the latter of the end of the service provider's calendar year or the service recipient's taxable year in which the right to payment is no longer subject to a substantial risk of forfeiture. The proposed regulations provide that payments that otherwise qualify as short-term deferrals will not be disqualified if the service recipient delays making payment because the payment would violate federal securities laws or other applicable laws, the delay was not reasonably foreseeable at the time the compensation was deferred and the payment is made as soon as practicable thereafter.

The "two-times annual salary" limitation for excluded involuntary severance pay plans may apply where the employee is hired and terminates employment in the same year, using annualized pay for the year of termination to apply the rules.

The rules regarding recurring part-year compensation that does not result in a deferral of compensation are clarified.

Under the proposed regulations, the stock underlying otherwise exempt stock rights may be subject to call or mandatory repurchase rights at less than fair market value following termination for cause or violations of restrictive covenants. In addition, otherwise-exempt stock rights may be granted within 12 months before a service provider commences providing services. In addition, the proposed regulations provide that a stock purchase that is deemed an asset purchase under IRC Section 338 is not a sale or other disposition of assets for purposes of determining whether a service provider has a separation from service.

The proposed regulations provide that a plan under which a service provider has a right to payment or reimbursement of expenses and reasonable attorney fees incurred in a bona fide legal dispute against the service recipient with respect to the employment relationship does not provide for a deferral of compensation.

The rules relating to the timing of accelerated payments upon death, disability or unforeseeable emergency to the service provider will also apply to a beneficiary who becomes entitled to the payment as the result of the death of a service provider. In addition, a plan may be amended to provide for payment following death of the service provider or beneficiary before December 31 of the year following the year in which the death occurs. In addition, a plan may provide for the acceleration of the time of payment to comply with federal debt collection, foreign ethics or conflicts of interest laws.

If a service recipient terminates a plan in a permissible plan termination proceeding, the proposed regulations make clear that the service recipient must terminate all similar type plans, regardless of whether service providers in the terminated plan participate in any of the other plans.

Under the proposed regulations, a service provider/employee who experiences a separation from service and then is retained as an independent contractor may still be considered to have had a separation if the parties reasonably expect that any additional services to be provided will be minimal and fall below the 20 percent safe harbor level.

Clarification is also provided with respect to calculating the amount to be included in income in the event that a provision of Section 409A is violated.

The proposed regulations will take effect ninety days after they are published as final. However, these clarifications may be relied upon in the interim, and the IRS will not challenge positions taken under these proposed regulations.

Service recipients should review their plans and procedures to make sure they are in compliance with these new rules.

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