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Skadden

Executive Compensation and Benefits Alert

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Four Times Square
New York, NY 10036
212.735.3000

IRS Issues New Section 409A Guidance

In an unexpected development, on June 21, 2016, the IRS issued proposed regulations that clarify and modify the final regulations issued in 2007 and the proposed income inclusion regulations issued in 2008. In many cases, these changes are consistent with the current views of practitioners. In several instances, however, the proposed regulations curtail practices that many practitioners have thought to be compliant with Section 409A. In what may be a small consolation, practitioners will appreciate the liberalization of the rules regarding payments in the event of the death of a plan participant and payments to beneficiaries.

The following is an overview of the most significant provisions of the newly proposed regulations.

- **Limitations on Ability to Change Time and Form of Payment of Unvested Amounts.** The proposed income inclusion regulations issued in 2008 provide that the adverse tax treatment that results from a Section 409A violation in one year will generally not result in adverse tax treatment in later years, provided that the violation does not also occur in those later years. In addition, the proposed income inclusion regulations provide that amounts that are unvested as of the end of the year in which the violation occurred are not subject to Section 409A income inclusion and penalties. The combined application of these rules allows employers to correct clear operational and documentary violations with respect to deferred amounts that are unvested as of year-end without any adverse tax consequences under Section 409A. Some practitioners viewed these rules as an opportunity to change the time and form of payment of unvested deferred amounts whether or not a definitive Section 409A violation could be identified. Although the proposed income inclusion regulations already contain a broad anti-abuse provision that allows the IRS to treat an unvested amount as vested if the facts and circumstances indicate that the employer has a "pattern or practice" of permitting violations with respect to unvested amounts, the anti-abuse standard lacked clarity and was viewed as difficult to apply.

  In the newly proposed regulations, the IRS limits the ability to take advantage of the income inclusion regulations to change the time and form of payment for unvested amounts that do not currently violate Section 409A or to create violations with respect to unvested amounts in order to change the applicable time and form of payment in a noncompliant manner by:

  - clarifying that an unvested amount will be considered vested in any year in which there is a change in a time or form of payment provision not otherwise permitted by

Section 409A unless there is a reasonable, good faith basis for concluding that the original payment provision violated Section 409A and the change was necessary to bring the plan into compliance;

- providing examples of the facts and circumstances that indicate whether a service recipient has a "pattern or practice" of permitting impermissible changes with respect to the time and form of payment of unvested amounts, including: whether the service recipient has taken commercially reasonable measures to identify and promptly correct substantially similar failures; whether substantially similar failures have occurred more often with respect to unvested amounts than vested amounts; whether substantially similar failures occur more often in newer plans; and whether substantially similar failures appear intentional, are numerous or repeat common past failures that have been corrected; and
- providing that if there is existing general guidance for correcting the violation at issue, that correction method must be used to correct that type of failure and any other substantially similar failures with respect to an unvested amount. Other requirements in the existing general guidance for correcting violations, such as the general eligibility, income inclusion and information reporting requirements, will not apply with respect to the unvested amount.

- **Payment in the Form of Restricted Shares.** The final Section 409A regulations issued in 2007 provide that the transfer of restricted property does not constitute deferral of compensation. Accordingly, most practitioners took the view that an employee may elect to receive payment of deferred compensation (which is already subject to Section 409A) in the form of either cash or restricted stock without having to satisfy the subsequent deferral election rules. For example, suppose an employee makes a valid initial deferral election to defer payment of an annual cash bonus originally payable on March 1, 2017, to March 1, 2020. Then, before March 1, 2020, the employee and employer agree to change the form of payment from cash to restricted shares to be granted on March 1, 2020, which would vest ratably over the subsequent three years (2021 to 2023). Under the common view, such election did not result in an impermissible deferral of compensation beyond the specified payment date (because the payment was in fact made on the correct date, albeit in the form of restricted shares). However, some practitioners took the view that such election could only be made in accordance with the requirements of the subsequent deferral election rules (*i.e.*, if the election to receive payment in the form of restricted shares was made prior to March 1, 2019, and no restricted shares vested prior to March 1, 2025), because the issuance of restricted stock delayed the date of income inclusion. The IRS previously declined to issue informal guidance on this question in response to questions posed to the IRS in 2009 by the American Bar Association's Joint Committee on Employee Benefits.

  Under the newly proposed regulations, the IRS has revised the regulations to provide that the use of unvested property (such as restricted shares) to satisfy an obligation under a deferred compensation plan is not considered to be a payment for purposes of Section 409A unless the employee makes an election under Section 83(b) of the Internal Revenue Code to include the excess of the fair market value of the shares over any amount paid for the shares on the date of grant. Thus, in the example above, unless a valid 83(b) election is made as of the grant date of the restricted shares, thereby triggering a taxable event, the restricted shares would not be considered to have been paid until the vesting dates in 2021, 2022 and 2023, resulting in impermissible subsequent deferrals under Section 409A.

- **Payments Upon Death.** Death is one of the permissible payments events for deferred compensation. The final regulations provide that a payment will be treated as being made upon death if the payment is made within a certain time period following the date of death (*e.g.*, on a later date within the same taxable year or, if later, by the 15th day of the third calendar month following the date of death). However, in view of the practical issues that arise following a death (for example, confirming the death and completing probate), the newly proposed regulations extend the time period for payment through December 31 of the first year following the calendar year of death. The plan may allow the payment date within this period to be determined at the discretion of the employee's beneficiary. Plans may be silent on the time of payment, and formal plan amendments are not required to make a payment at any time during the permissible period, even if the plan currently provides for payment no later than the deadline under the prior rules.

- **Payments to Beneficiaries.** The newly proposed regulations clarify that these payment rules for amounts payable upon the death of an employee also apply in the case of the death of a beneficiary who has become entitled to a payment due to the employee's death. In addition, the proposed regulations provide that the death, disability and unforeseeable emergency of a beneficiary who has become entitled to a payment due to an employee's death may be added to the plan as a potentially earlier alternative payment event for amounts previously deferred. Finally, the proposed regulations clarify that a schedule of payments that has already commenced prior to a beneficiary's death, disability or unforeseeable emergency may be accelerated upon the beneficiary's death, disability or unforeseeable emergency.

The newly proposed regulations amending the final Section 409A regulations are proposed to be applicable on or after the date on which they are published as final regulations in the Federal Register. For periods before this date, with certain exceptions described below, the existing final regulations and other applicable guidance apply. However, taxpayers may choose to rely on the proposed regulations before they are finalized. Comments must be received by the IRS by September 20, 2016.

Although the final regulations and other existing guidance continue to apply until the proposed regulations are finalized, the proposed regulations provide that practitioners may not rely on the existing final regulations in certain instances, including the provision relating to payments in the form of restricted shares without a Section 83(b) election.

The proposed income inclusion regulations are proposed to be applicable on or after the date on which they are published as final regulations in the Federal Register. Until the Treasury Department and IRS issue further guidance, compliance with the provisions of the proposed income inclusion regulations, as modified by these newly proposed regulations, will be treated as compliance with the applicable provisions of Section 409A.

Contacts

Neil M. Leff
New York
212.735.3269
neil.leff@skadden.com

Regina Olshan
New York
212.735.2644
regina.olshan@skadden.com

Erica Schohn
New York
212.735.2823
erica.schohn@skadden.com

Joseph M. Yaffe
Palo Alto
650.470.4650
joseph.yaffe@skadden.com

Thomas M. Asmar
Palo Alto
650.470.3194
thomas.asmar@skadden.com

Michael R. Bergmann
Washington, D.C.
202.371.7133
michael.bergmann@skadden.com

Dmitriy Chelnitsky
New York
212.735.2094
dmitriy.chelnitsky@skadden.com

Kristin M. Davis
Palo Alto
650.470.4568
kristin.davis@skadden.com

Berit R. Freeman
New York
212.735.2112
berit.freeman@skadden.com

Timothy F. Nelson
Boston
617.573.4817
timothy.nelson@skadden.com

Shalom D. Huber
New York
212.735.2483
shalom.huber@skadden.com