



McDermott
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Review of Section 409A Proposed Regulations

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July 12, 2016

Section 409A Proposed Regulations Agenda

- Expanded Availability of Exemptions
- Additional Flexibility to Accelerate or Defer Payments
- Practices that Violate Section 409A
- Technical Corrections
- Effective Date
- Other Changes?

Expanded Availability of Exemptions Granting Stock Rights Prior to Commencing Services

- *Final regulations*: required employee to provide services at grant date
- Inability to make immediate grants can complicate hiring process
- *Proposed regulations*: allow option grants before start date
- Conditions for pre-hiring grant
 - services are “reasonably anticipated” to commence within 12 months
 - services begin within 12 months
 - stock rights forfeited if services do not commence within 12 months

Expanded Availability of Exemptions Reducing Payments under Stock Rights for Bad Behavior

- *Final regulations:* limit definition of “service recipient stock”
 - does not include the repurchase of stock other than at FMV
- Common to see less generous repurchase provisions for bad leavers
 - lesser of FMV or the purchase price for bad leavers
- *Proposed regulations:* permit repurchases at less than fair market value due to:
 - for cause termination
 - breach of a non-compete or non-disclosure covenant

Expanded Availability of Exemptions

Treatment of In-the-Money Stock Options on Change in Control

- Alternatives under final regulations
 - immediate cash out of option spread
 - replacement options to acquire buyer's stock
- Other possibilities
 - pay option spread over period that stockholders are paid purchase price
 - pay option spread in cash after CIC under original vesting schedule
 - convert option spread into RSUs

Expanded Availability of Exemptions Treatment of Stock Options on Change in Control

- *Proposed regulations:* allow for option spread to be paid out over time
 - payments on the same schedule as stockholders
 - payments completed within five years
- IRS did not address converting options into cash or RSUs
- Conversions not abusive when same vesting is retained

Expanded Availability of Exemptions Involuntary Severance Pay Safe Harbor for New Hires

- *Final regulations*: provide an exemption for involuntary severance pay
- Exemption requires that payments be limited
 - 2x limit based on annualized compensation from the prior year
- *Proposed regulations*: annualized compensation for the year of employment termination can now be used for a new hire
- Proposed change also applies to the exemption for window programs

Expanded Availability of Exemptions

Other Exemptions

- Reimbursements for expenses to enforce an employment agreement
- New exemption for “part year compensation”
 - pay earned over less than one year and paid over more than one year
 - extended 13 month period from beginning of the service period
 - recurring part year compensation cannot exceed §401(a)(17) limit
- Delayed payment to comply with applicable law does not result in loss of short term deferral status

Additional Flexibility to Accelerate or Defer Payments Payments Due to Death

- *Final regulations:* payment date to beneficiary cannot be changed
- Difficulties in plan administration
 - paying benefits by end of year in which death occurs
 - accommodating beneficiary requests for different payment
- *Proposed regulations:* more post-death payment options
 - no violation if payment to beneficiary is made in year following death
 - beneficiary can request accelerated payment after participant's death
 - death, disability, unforeseeable emergency
 - death of a beneficiary can be a payment event

Practices That Violate Section 409A

Certain Plan Corrections

- *2008 proposed regulations*: allow correction of noncompliant plan provisions
- Ability to correct subject to an anti-abuse rule
- Prohibits a “pattern or practice” of making corrections
- Facts and circumstances analysis

Practices That Violate Section 409A

Certain Plan Corrections

- *2016 proposed regulations*: clarify requirements for correction
- Need for “reasonable, good faith basis” that provisions aren’t 409A compliant
- Change must “necessary” for compliance
- Non-compliant provisions cannot be added as a “pretext” for later making a change
- Corrections must be made in a manner consistent with other correction guidance (e.g., Notice 2010-6)
- Substantially similar errors must be corrected in a similar manner

Practices That Violate Section 409A

Certain Plan Corrections

- Additional listed factors to consider under facts and circumstances analysis
 - “commercially reasonable measures” to identify errors
 - errors corrected promptly upon discovery
 - frequency of error with respect to unvested versus vested deferred amounts
 - frequency of errors with respect to new plans versus existing plans
 - are substantially similar errors numerous or repeat common past failures

Practices That Violate Section 409A

Interpretation of Plan Termination Rule

- *Final regulations*: allow accelerated payments upon a plan termination prior to a change in control
- Plan aggregation rule applies under plan termination rule, but what plans must be terminated
 - plans of a similar type in which the employee is a participant, or
 - all plans of a similar type regardless of who is a participant in them
- *IRS position*: the plan termination provisions is not “ambiguous” - all plans must be terminated to qualify for exemption

Practices That Violate Section 409A

Transfers That Do not Qualify as a Payment

- *Final regulations:* do not define what is a “payment” under §409A
- Possible forms of payment other than cash:
 - stock options
 - restricted stock and restricted stock units
 - interest in secular trust
- *Proposed regulations:* transfer of property must result in current tax to count as a §409A “payment”