PROPOSED CHANGES TO § 409A REGULATIONS: GREATER CLARITY AND BETTER PLANNING ALTERNATIVES

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As most benefits practitioners are well aware, Section 409A was added to the Internal Revenue Code (Code) in 2004 in connection with the American Jobs Creation Act and was intended to provide strict parameters around the rules governing nonqualified deferred compensation offered by employers (or other service recipients). It was, in part, Congress’s response to the Enron executives accelerating millions of dollars of distributions from their nonqualified deferred compensation plans at a time when the company was faltering. As a result of Section 409A, nonqualified deferred compensation plans are now subject to strict deferral and payment requirements to be tax deferred. A failure to meet such requirements results in the amounts deferred under the plan for the year of failure and all previous taxable years being currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. There is also a 20 percent addition to tax and penalty.

Since its inception, the IRS has issued significant guidance under Section 409A, including close to 400 pages of final regulations and a number of other notices. However, the law in this area continues to evolve, and the most recent proposed regulations provided under Section 409A are intended to clarify and modify certain issues that posed problems for employers.

The proposed regulations:

• Permit the granting of stock rights to a service provider prior to the commencement of services for the entity;
• Extend the severance pay exception to new employees;
• Allow delayed payments due to securities law compliance and additional exceptions to the “short-term deferral rule”;
• Expand the exception for recurring part-year compensation so as to enable it to be used for more secondary education professionals;
• Expansion of the “bona fide dispute” exception to permit such excepted payments to include amounts used for legal fees; and
• Additional flexibility to accelerate or defer the timing of payments of certain kinds deferred compensation.

ADDITIONAL FLEXIBILITY TO USE SECTION 409A EXCEPTIONS

The availability of the rules for transaction-based compensation for stock rights and incentive stock options is expanded under the proposed regulations.

Section 409A allows employers to delay the payment of amounts that are both (1) nonqualified deferred compensation that is subject to Section 409A, and (2) tied to the employer’s stock value in connection with a change in control (transaction-based compensation). Examples of such compensation include payments to be made with respect to options or other stock denominated awards (e.g., stock appreciation rights) that provide for payment of deferred compensation...
or payments determined by reference to transaction price, including transaction bonuses. Without a regulatory exception, Section 409A would require payments triggered by a change of control to be made on a specific payment date as provided for in the award agreement (e.g., the closing date of the transaction). However, the transaction-based compensation exception deems payment of such amounts to have been paid in compliance with the requirements of Section 409A so long as they are paid on the same schedule, terms, and conditions applicable to the stockholders in connection with the change in control; provided, however, that any resulting delay does not exceed five years. This exception is often relied on when a portion of transaction proceeds are paid on a contingent or delayed basis, such as an escrow amount or an earn-out provision. Holders of the transaction-based compensation are allowed to receive such amounts (if paid) at the time they are ultimately distributed to the stockholders, even if this occurs in a subsequent tax year.

The final regulations extended this rule to amounts that are otherwise subject to the requirements of Section 409A—that is, amounts constituting nonqualified deferred compensation. However, statutory stock options and certain other stock rights are generally intended to be exempt from Section 409A and are structured to not provide for an “additional feature of deferral” following cash out, settlement, or exercise. An additional feature of deferral will generally be any delay in payment or settlement of the stock right following the date of exercise. Under the final regulations, it was unclear how the transaction-based compensation exception applied to such Section 409A exempt stock rights. This left practitioners asking: If some of the amounts to be paid with respect to these awards were delayed until the date on which stockholders received the amounts under the transaction, would such delay constitute an additional feature of deferral and, therefore, be a violation of Section 409A?

The proposed regulations clarify that the transaction-based compensation exception applies to all stock rights. The payments received in connection with such awards as a result of a change of control event may, therefore, occur on the same delayed payment schedule as applicable to stockholders generally, and payment on such schedule will not result in the statutory stock option or stock right being treated as having provided for an additional feature for the deferral of compensation. It is noteworthy that the preamble to the proposed regulations identifies the revised provision as a clarification and not a modification of the previously established Section 409A rules. Therefore, prior transactions requiring that the payment of proceeds to holders of exempt stock rights be aligned with the schedule, terms, and conditions upon which the stockholders received such proceeds should not violate Section 409A.

Although this clarification generally aligned with the view taken by many practitioners with respect to the outright purchase or cash out of the identified stock awards, questions remain about other merger and acquisition (M&A) practices. Specifically, the proposed regulations do not address the practice of converting Section 409A exempt stock rights into another form of compensation at the time of closing, such as the right to receive cash or stock that would be paid upon vesting according to the original vesting schedule. These conversions are used by acquirers to avoid large compensation payments from being made at closing to transitioning management or other key employees who might be needed post-acquisition. The proposed regulations do not provide any comfort that these practices can comply with Section 409A.

**ABILITY TO GRANT A SECTION 409A EXEMPT STOCK RIGHT AN INDIVIDUAL COMMENCES EMPLOYMENT**

As noted previously, Section 409A provides that certain stock rights do not constitute nonqualified deferred compensation and, therefore, are not subject to the strict payment date requirements set forth in the final regulations. Section 409A exempt stock rights include statutory stock options described in Code Section 422 and any option provided for under an employee stock purchase plan described in Code Section 423. However, Section 409A does not exempt stock rights issued other than with respect to “service recipient stock,” which includes only those shares of stock issued by an “eligible issuer.” An eligible issuer is “only the [entity] for which the service provider provides direct services on the date of grant of the stock right...,” and certain other related entities (emphasis added). Read literally, this definition required that anyone receiving a stock right intended to be exempt from Section 409A be employed by, or otherwise be providing services to, a covered entity at the time the award is made. These rules have created practical challenges for employers when negotiating employment terms for new hires.
The proposed regulations modify the definition of eligible issuer to allow for pre-employment awards of stock rights. Specifically, the proposed regulations provide that Section 409A exempt stock rights may be granted to a prospective employee so long as:

- It is “reasonably anticipated” that the employee will begin services within 12 months after the date of grant;
- The employee actually begins providing services within the prescribed 12-month period; and
- The award agreement provides that if services do not begin within the provided period, the stock right must be forfeited.

The proposed regulations, however, do not extend this relief with respect to stock rights that might be granted shortly after terminating employment as part of a settlement agreement or other severance arrangement.

NEW ABILITY TO REDUCE PAYMENTS UNDER STOCK RIGHTS DUE TO BAD BEHAVIOR

The final regulations also provide that “service recipient stock … does not include any stock that is subject to a mandatory repurchase obligation (other than a right of first refusal), or a put or call right …, if the stock price under such right or obligation is based on a measure other than the fair market value … of the equity interest in the corporation represented by the stock.” These requirements have caused consternation for employers that paid less when repurchasing stock acquired under a stock right due to bad behavior (e.g., dismissal for cause) or violation of certain covenants (e.g., noncompetition or nondisclosure agreements). It is common for employers to provide that stock held by employees who are dismissed as “bad actors” or who violate certain contractual obligations will be repurchased at the lesser of fair market value as of the date of termination or as of the date of the award. Many practitioners have questioned why this type of provision should not be allowed as part of a stock right.

The proposed regulations address this concern by allowing a measure other than fair market value for certain stock repurchases. The proposed regulations provide that “[t]he stock price will not be treated as based on a measure other than the fair market value to the extent that the amount payable upon the service provider’s involuntary separation from service for cause, or the occurrence of a condition within the service provider’s control such as noncompliance with a noncompetition or nondisclosure agreement (whether or not the condition is specified at the time the stock right is granted), is based on a measure that results in a payment of less than fair market value.” Employers may now safely reduce payments in these instances for bad behavior.

AVAILABILITY OF SEVERANCE PAY SAFE HARBOR FOR NEWLY HIRED EMPLOYEES

The final regulations provide that certain types of severance plans are exempt from Section 409A. Specifically, Section 409A will not apply to “separation pay” that is:

- Paid solely on account of an employee’s involuntary separation from service (including termination for “good reason”);
- Equal to an amount that does not exceed the lesser of two times the employee’s annual compensation or two times the current year’s Code Section 401(a)(17) limit; and
- Paid not later than the end of the second year following the year in which such separation from service occurs.

Annual compensation for these purposes was based upon the “annual rate of pay [received by the employee] for the taxable year … preceding the taxable year in which the [employee] has a separation from service.” As a result of this definition, there was concern that these program exemptions only could apply to the extent that the employee has annualized compensation for the year immediately preceding the year in which the separation from service occurred. In that case, these exemptions could not apply to situations in which an employee begins and ends employment in the same taxable year as there was no prior year annualized compensation on which to base the payment amount.

The proposed regulations clarify that these exemptions for severance pay arrangements apply for employees whose employment begins and ends in the same taxable year. In determining the maximum amount available under these exemptions, the employee’s annualized compensation is determined based upon his rate
of pay for the taxable year in which the separation of service occurs.15

MINOR EXPANSION OF THE SHORT-TERM DEFERRAL RULE

The final regulations included a “short-term deferral” rule providing that amounts paid with only minimal delay between the date on which the amount is no longer subject to a substantial risk of forfeiture and the date on which payment is made will not be considered to be deferred compensation and will, therefore, be exempt from the Section 409A requirements.16 The short-term deferral period ends on the date that is 2½ months after the end of the later of the employer’s or the employee’s taxable year in which amounts vest. If both the employee and employer are calendar year taxpayers (as is often the case), the applicable date is March 15 of the year following the year in which an employee vests in the to-be-paid amount. So long as payment is actually made by such date, the amount will not be considered to be deferred compensation, even if it is paid in the year following the year in which it is earned.

Section 409A generally provides that payments made after the end of the short-term deferral period are considered to be deferred compensation and are subject to Section 409A. However, “[t]he final regulations provide that a payment that otherwise qualifies as a short-term deferral, but is made after the applicable 2½ month period, may continue to qualify as a short-term deferral if the payment is delayed for one of three reasons:

• The taxpayer establishes that it was administratively impracticable for the service recipient to make the payment by the end of the applicable 2½ month period;

• Making the payment by the end of the applicable 2½ month period would have jeopardized the service recipient’s ability to continue as a going concern; or

• The service recipient reasonably anticipates that a deduction for the payment would not be permitted under section 162(m).”17

The proposed regulations expand this exemption to include payments delayed solely as necessary to avoid violating federal securities laws or other applicable laws so long as payment is ultimately made as soon as “reasonably practicable” after the date on which making such payment would no longer cause a violation.18 The expansion of the short-term deferral rule is consistent with when a payment of compensation that is subject to Section 409A will be treated as paid on a specific date.

EXPANDED AVAILABILITY OF EXCEPTION FOR RECURRING PART-YEAR COMPENSATION

In limited employment situations, compensation for services provided during a period of less than 12 months is paid over several months that extend over more than one taxable year. The practice is prevalent with respect to teachers and professors working at educational organizations. The final regulations refer to payments made under this structure as “recurring part-year compensation” that is elected to be paid over a 12-month period instead of the period over which it is earned.19 IRS Notice 2008-62 excludes amounts constituting recurring part-year compensation from the requirements of Section 409A if “(1) the arrangement does not defer payment of any of the recurring part-year compensation beyond the last day of the 13th month following the beginning of the service period, and (2) does not defer from one taxable year to the next taxable year the payment of more than the applicable dollar amount under Code Section 402(g)(1)(B) in effect for the calendar year in which the service period begins.”20 The intent of such rules was to exclude compensation paid for public school teachers and other school-year employees who wish to annualize school-year compensation from the burdens of complying with the formal deferral rules provided for under Section 409A.

The provided-for exception appears to fall short of providing relief for those in certain teaching positions. The dollar limitation provided for under Code Section 402(g)(1)(B) ($18,000 for 2016) may simply be too low to adequately exempt higher compensated professionals from the election requirements under Section 409A. This creates potentially adverse tax consequences to a segment of teaching professionals that was likely not intentional.

The proposed regulations provide that a plan or arrangement under which a service provider receives recurring part-year compensation does not provide for the deferral of compensation if the plan does not defer payment of any of the recurring part-year
compensation to a date beyond the last day of the 13th month following the first day of the service period for which the recurring part-year compensation is paid, and the amount of the service provider’s recurring part-year compensation (not merely the amount deferred) does not exceed the annual compensation limit under section 401(a)(17) ($265,000 for 2016) for the calendar year in which the service period commences.21

EXPANDED EXEMPTION FOR REIMBURSEMENTS TO ENFORCE A PLAN OR AGREEMENT

Employment agreements often provide for reimbursement of attorneys’ fees and expenses in connection with employment disputes. However, the final regulations only provide an exemption from Section 409A for attorneys’ fees and expenses in connection with settlement of certain bona fide claims (e.g., wrongful termination, employment discrimination, the Fair Labor Standards Act, or workers’ compensation statutes). There was no specific provision in the final regulations covering legal fees paid in connection with the employee’s legal enforcement of certain rights and responsibilities arising under the employee/employer relationship, including the enforcement of certain contractual provisions. The proposed regulations expand the exemption under the final regulations to include reimbursement of attorneys’ fees and expenses for any bona fide legal claim against an employer with respect to employment. As a result of this exemption, amounts paid to reimburse an employee for legal fees incurred to enforce contractual provisions or other employment matters need not meet the general rule for timing of reimbursements under the final regulations.22

ADDITIONAL FLEXIBILITY TO ACCELERATE OR DEFER PAYMENTS OF DEFERRED COMPENSATION—PAYMENTS ON ACCOUNT OF DEATH

Section 409A generally identifies certain times and events on which deferred compensation amounts may be paid. As alluded to previously in the article, Section 409A requires fairly strict compliance with the identified payments dates. There is some leeway, however, and amounts are treated as properly paid on the appropriate designated date, if payment is made on the specified date or a later date within the same taxable year or, if later, the 15th day of the third calendar month following the date provided for in the plan or arrangement.23 A service provider’s death is an appropriate payment date for this purpose.

The final regulations did not provide for any flexibility for payments made on account of death. As a result, payments made due to a service provider’s death were required to comply with strict timing requirements. This rule often led to an insufficient period to resolve issues relating to the death of an individual (e.g., confirming the death and completing probate) and still make timely payments.24 The proposed regulations acknowledge these issues and “provide that an amount payable following the death of a service provider, or following the death of a beneficiary who has become entitled to payment due to the service provider’s death, that is to be 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 is treated as timely paid if it is paid at any time during this period.”25 This allows service recipients an additional year to complete the necessary payment without causing an inadvertent violation of Section 409A.

The proposed regulations further relax the rules for payments to be made on account of death by noting that the plan or arrangement is not required to specify any particular payment date during the elongated period and may allow the beneficiary to designate when during the period the amount will be paid. Unlike other parts of Section 409A, the recipient in this instance may designate the taxable year of payment without violating Section 409A.26

GREATER FLEXIBILITY TO ACCELERATE PAYMENTS TO BENEFICIARIES

Section 409A generally prohibits the acceleration of payments to be made from deferred compensation arrangements, which means that payment events or triggers may rarely be added to an arrangement once it is in place. The final regulations do, however, provide that the addition of death, disability, or an unforeseeable emergency to an arrangement of a service provider as a potentially earlier alternative payment event will not violate the anti-acceleration requirements.27 No similar exception was provided with respect to the death, disability, or unforeseeable emergency of a beneficiary who has become entitled to payment as a result of the service provider’s death. The proposed regulations permit accelerated payment on account of events affecting a beneficiary and allow for acceleration upon the death, disability, or unforeseeable emergency of a beneficiary.28
ABILITY TO ACCELERATE PAYMENTS TO COMPLY WITH BONA FIDE FOREIGN ETHICS LAWS OR CONFLICTS OF INTEREST LAWS

The final regulations allow employers to accelerate the payment of deferred compensation to comply with a foreign ethics or conflicts of interest law, but only with respect to foreign earned income from sources within the foreign country that passed the law. The proposed regulations eliminate the restriction on the types of compensation that qualify under this provision. Any type of deferred compensation may be accelerated “as reasonably necessary” to comply with a bona fide foreign ethics or conflicts of interest law.29

ABILITY TO ACCELERATE PAYMENTS TO COMPLY WITH FEDERAL DEBT COLLECTION LAWS

The final regulations generally provide that if a right to deferred compensation is made subject to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, attachment, or garnishment by an employee's creditors, the deferred compensation is treated as having been paid.30 Section 409A provides a de minimis exception to these requirements. Under such exception, payments of deferred compensation may be offset by amounts owed by the employee to the employer so long as the debt is incurred in the ordinary course of the service relationship and only to the extent the offset does not exceed $5,000 in the taxable year.31 The IRS and Treasury Department have determined that the limited offset right designed under the final regulations is in conflict with certain laws regarding debt collection by the federal government, and the proposed regulations allow for accelerated payment to the extent “reasonably necessary” to comply with federal laws regarding debt collection.32

TECHNICAL CORRECTIONS AND CLARIFICATIONS

The proposed regulations make the following technical corrections and clarifications:

• Section 409A applies to nonqualified deferred compensation plans separately and in addition to the rules under Section 457(f) (with respect to deferred compensation plans of tax-exempt organizations) and Section 457A (with respect to certain offshore deferred compensation plans).33

• A person who terminates employment and begins providing services as an independent contractor is treated as having a separation from service for purposes of Section 409A if, at the time of the change, the level of services reasonably anticipated to be provided after the change would result in a separation from service under the rules applicable to employees. This means that if the individual anticipates performing services as an independent contractor at a level that is less than 20 percent of the level of services the individual performed in the capacity of an employee over the 36-month period preceding the change in roles, the individual will have a separation from service upon becoming an independent contractor.34 The proposed regulations clarify that a separation from service may thereafter occur by applying this 20 percent rule based on independent contractor rules.35

• The proposed regulations correct references to the Bankruptcy Code within the final regulations that permit payment upon the termination and liquidation of a plan in connection with bankruptcy.

• Under the final regulations, the term “service provider” is defined to include an individual, corporation, subchapter S corporation, partnership, personal service corporation, or non-corporate entity that would be a personal service corporation if it were a corporation, qualified personal service corporation, and non-corporate entity that would be a qualified personal service corporation if it were a corporation.36

EXISTING PRACTICES THAT VIOLATE SECTION 409A

The IRS and Treasury Department have taken the positions that the following practices violate Section 409A under current law. Plans that must be terminated under plan termination rule. The final regulations allow an employer to accelerate payment of deferred compensation on plan termination not in connection with a change in control under certain circumstances. These requirements include certain actions that must be taken vis-à-vis plans aggregated with the to-be-terminated plan. The final regulations specifically provide that to accelerate payment of deferred compensation in accordance with a plan termination among other things:

• “The service recipient [employer] terminates and liquidates all agreements, methods, programs, and other arrangements sponsored by the service recipient that would be aggregated with any terminated and liquidated agreements, methods,
programs, and other arrangements under §1.409A-1(c) if the same service provider had deferrals of compensation under all of the agreements, methods, programs," and

• “The service recipient [employer] does not adopt a new plan that would be aggregated with any terminated and liquidated plan under §1.409A-1(c) if the same service provider participated in both plans, at any time within three years following the date the service recipient takes all necessary action to irrevocably terminate and liquidate the plan.”

A question that was raised by practitioners under this plan termination rule was whether all plans of the same type that are sponsored by the employer must be terminated, or whether the termination requirement only applies to plans of the same type... in which the employee was actually a participant.

The Treasury Department and the IRS have determined that these provisions are not ambiguous. Nevertheless, to avoid any doubt, the proposed regulations clarify that the final regulations require that all similar deferred compensation plans within the controlled group (i.e., each plan that must be aggregated together) be terminated, regardless of who is a participant in those plans. The proposed regulations further note that the same language is included under the final regulations with respect to the prohibition on the adoption of a similar plan within a three-year period following the referenced plan termination.

WHAT QUALIFIES AS A ‘SEPARATION FROM SERVICE’ IN CERTAIN M&A TRANSACTIONS

Provided that certain conditions are met, the parties to an asset sale can generally designate whether an employee who was providing services to the seller immediately before the sale and who continues to provide services to the buyer immediately after a sale has a separation from service for purposes of Section 409A.

Some practitioners sought to have this flexibility also apply to stock sales that are treated, for corporate income tax purposes, as a deemed asset sale under Code Section 338. In this instance, despite the fact that the transaction involved the purchase of stock, the seller may be taxed as if it actually sold the assets of the business.

The proposed regulations clarify that this special separation from service rule sale is limited to actual asset sales, and not stock transactions that are treated as an asset sale based upon an election under Code Section 338. In a stock sale scenario, regardless of tax consequences, “employees do not experience a termination of employment, formal or otherwise,” and, therefore, employees may not be treated as having a separation from service in such context.

TRANSFERS OF PROPERTY INTERESTS THAT DO NOT QUALIFY AS PAYMENT FOR PURPOSES OF SECTION 409A

Neither Section 409A nor the final regulations generally define a “payment” for purposes of meeting the Section 409A requirements. Some taxpayers have apparently taken the position that transfers of certain property interests qualify as “payment” for purposes of Section 409A even if such transfer does not provide for an inclusion in income. Examples include transfers of restricted stock, stock options, and interests in a Section 402(b) trust (e.g., a secular trust). The proposed regulations clarify that these types of property transfers do not qualify as “payment” for purposes of Section 409A unless they are structured in a manner so that there is immediate income tax.

CORRECTING SECTION 409A VIOLATIONS UNDER PROPOSED INCOME INCLUSION RULES

Proposed income inclusion regulations issued by the IRS in 2008 allow corrections of certain Section 409A violations while nonqualified deferred compensation is unvested during a taxable year. However, IRS officials had made informal comments that this rule was not intended to allow revisions to otherwise Section 409A compliant provisions. There was concern that employers would change payment terms in a manner that would not otherwise be allowed by the final regulations. However, the 2008 proposed income inclusion regulations only included an anti-abuse provision that applied if there is “a pattern or practice” of making corrections under the facts and circumstances.

The preamble to the 2016 proposed regulations states that the correction rules “were not intended to allow... [for] change[s in] time or form of payment provisions that otherwise meet the requirements of section 409A(a) in a manner that fails to comply with section 409A(a), and they were not intended to permit... [the creation of] errors in nonqualified deferred
compensation plans with respect to nonvested amounts with the intention of using those errors as a pretext for establishing or changing a time or form of payment in a manner that fails to comply with section 409A(a).

The following rules will be applied by the IRS when evaluating whether a correction is permitted under the 2008 proposed income inclusion regulations.

- Changes cannot be made to the time or form of payment when the existing provisions of an unvested arrangement meet Section 409A requirements. There must be a “reasonable, good faith basis” for concluding that the original payment provision failed to meet the requirements of Section 409A(a) and that change is “necessary” to bring the plan into compliance.

- The proposed regulations list various facts and circumstances to be considered under the anti-abuse rule including whether the employer has taken “commercially reasonable measures” to identify and correct substantially similar failures “promptly upon discovery,” whether substantially similar failures have occurred with respect to unvested deferred amounts to a greater extent than with respect to vested deferred amounts, whether substantially similar failures occur more frequently with respect to newly adopted plans, and whether substantially similar failures appear intentional, are numerous, or repeat common past failures that have since been corrected.

- Noncompliant payment provisions cannot be corrected under the proposed income inclusion regulations when they are added “as a pretext” for later making changes to payment terms that would otherwise not be permitted under Section 409A. Apparently there is some concern about taxpayers gaming the system by intentionally creating noncompliant provisions that would later be amended.

- Correction of payment provisions are generally to be made in a manner that’s consistent with generally applicable guidance regarding the correction of Section 409A failures. The IRS has issued several Notices outlining appropriate correction actions to be taken with respect to Section 409A failures.

The proposed regulations require that if a correction is specified in such guidance with respect to an identified Section 409A violation, the correction undertaken with respect to such violation must be one of the provided methodologies. Furthermore, the proposed regulations state that substantially similar failures must be corrected in substantially the same manner.

CONCLUSION

There are several helpful changes that employers will want to consider and take advantage of before the proposed regulations are finalized. Employers who do not heed IRS’s warnings about its interpretation of the final regulations do so at their peril. It is advisable for employers to consider current levels of compliance in light of the more limited ability to correct errors.

Notes

1. Treas. Reg. § 1.409A-1(b)(5) defines a “stock right” to include any nonstatutory stock option or any stock appreciation right, but only to the extent such right meets certain requirements and does not provide for the deferral of compensation.

2. Treas. Reg. § 1.409A-3(i)(5)(iv), providing that: “Payments of compensation related to a [change of control event as identified under Treasury Regulation Section 1.409A-3(i)(5)(v) through (ii)(5)(vii)], that occur because a service recipient purchases its stock held by the service provider or because the service recipient or a third party purchases a stock right held by a service provider, or that are calculated by reference to the value of stock of the service recipient (collectively, transaction-based compensation), may be treated as paid at a designated date or pursuant to a payment schedule that complies with the requirements of Section 409A if the transaction-based compensation is paid on the same schedule and under the same terms and conditions as apply to payments to shareholders generally [in the event of a change of ownership]...or as apply to payments to the service recipient [in the event of a sale of a substantial portion of a corporation’s assets], and to the extent that the transaction-based compensation is paid not later than five years after the change in control event...”.

3. Id.


were a corporation, qualified personal service corporation, or noncorporate entity that would be a personal service corporation if it were a corporation.” These proposed regulations clarify § 1.409A-1(b)(3)(i)(E), § 1.409A-1(b)(5)(vi)(F), and § 1.409A-3(i)(5)(iii) of the Final Regulations to reflect that a service provider can be an entity as well as an individual. These proposed regulations also clarify § 1.409A-1(b)(3) of the Final Regulations to correct an erroneous reference to “service provider” that should be “service recipient.”


Prop. Treas. Reg. § 1.409A-4(a), 72 Fed. Reg. 74380 (Dec. 8, 2008). The calculation of the amount includible in income due to a failure to meet the requirements of Section 409A include those amounts of deferred compensation that are not subject to a substantial risk of forfeiture in the year of failure or any preceding year.

Prop. Treas. Reg. § 1.409A-4(a)(1)(ii)(B), 72 Fed. Reg. 74380 (Dec. 8, 2008). “For purposes of determining the amount includible in income under section 409A(a) and paragraph (a) (1) of this section, if the facts and circumstances indicate that a service recipient has a pattern or practice of permitting impermissible changes in the time and form of payment with respect to nonvested deferred amounts under one or more plans, an amount deferred under a plan that is otherwise subject to a substantial risk of forfeiture is not treated as subject to a substantial risk of forfeiture if an impermissible change in the time and form of payment (including an impermissible initial deferral election) applies to the amount deferred or if the facts and circumstances indicate that the amount deferred would be affected by such pattern or practice.”


Id. (third paragraph) providing that amounts will be treated as vested during any taxable year during which “there is a change in a plan provision (including an initial deferral election provision) that is not otherwise permitted under Section 409A and the Final Regulations and that affects the time or form of payment of the amount if there is no reasonable, good faith basis for concluding that the original provision failed to meet the requirements of section 409A(a) and that the change is necessary to bring the plan into compliance with the requirements of section 409A(a).”

Id. (fourth paragraph).

See Notice 2008-113, Notice 2010-6, and Notice 2010-80.