# Employee Compensation

October 2016 www.blr.com Issue 444

## Contents





# Proposed regulations clarify, modify previous guidance on deferred compensation plans

Any employer that offers nonqualified deferred compensation arrangements needs to be familiar with recently issued proposed regulations related to Internal Revenue Code Section 409A, because all such plans will be impacted by the new guidance, according to an employee benefits and tax attorney.

### Most significant changes

The proposed regulations clarify and modify certain provisions included in final regulations issued in 2007 on the treatment of nonqualified deferred compensation plans and arrangements under Section 409A. The proposed regulations also withdraw and replace a specific provision of 2008 guidance from the Internal Revenue Service (IRS) and the U.S. Department of the Treasury (Treasury) regarding the calculation of amounts that are includable in income under Section 409A.

The proposed regulations, which the IRS and the Treasury have said may be relied on immediately by employers and other taxpayers, address a myriad of topics. "I would say the most significant changes are those dealing with death benefits whereby the death of the participant can be treated as a separate distribution event and the death of a beneficiary will itself be treated as a qualified distribution event," says Scott E. Galbreath, JD, LLM, of The Burton Law Firm (www.lawburton.com).

"The proposed regs also expand the time period for paying death benefits to give the participant's survivors time to get affairs in order, etc.," he says. "Now, there is a full year following the year of death to pay the benefits, and plans don't have to be amended to take advantage of these new rules, but it's still a good idea to avoid confusion."

Galbreath was surprised that the proposed regulations give a beneficiary some discretion regarding when to receive payment after the death of the plan participant. "Section 409A generally prohibits discretion as to the year of payment being given to the employer or payee. This is now an exception to that general rule."

The proposed regulations specify that a payment will be considered to be timely paid if it is paid at any time between the death and December 31 of the first calendar year following the calendar year during which the death occurs.

"I also believe that the changes with respect to stock rights are significant for providing equity type compensation to workers," Galbreath explains. Galbreath provided details about these provisions, such as stock rights buybacks and grant of stock rights before employment.

**Stock rights buybacks.** "The final regulations provide that a stock option is not considered deferred compensation under section 409A if it is not issued at a discount, or in the money, meaning the price paid to exercise the option and purchase the stock can never be less than the fair market value of the stock on the date of grant of the option, and the stock option can have no other deferral feature," he says. "The same is true for stock appreciation rights; the initial value must be at least the fair market value of the stock on the grant date."

*continued on page 2*

*continued from page 1*

When an employee is dismissed for cause or violates a noncompetition or nondisclosure agreement, employers "would like to have their plan provide that the employee must sell the stock right back to them at less than the fair market value of the stock on the grant date. There was a question, under the final regulations, as to whether this would make the stock right subject to section 409A." The proposed regulations clarify that.

"This is a key clarification that now permits employers to buy back stock options or stock appreciation rights under such circumstances for less than the fair market value of the stock on the date of grant," Galbreath explains. "So they could require it to be sold to the employer for zero or forfeited without violating section 409A. This is a big advantage for employers who don't want to allow employees terminated for cause, etc. to receive a windfall but thought buying back at less than fair market value would cause the stock right to be subject to section 409A."

**Grant of stock rights before employment begins.** The proposed regulations allow employers to grant stock rights to an individual before he or she actually is employed by the organization, under certain circumstances.

"This is a key clarification because the final regulations provide that the stock rights could only be exempted from 409A if they were stock rights of the employer for whom the participant was already working. Literally, this meant that a grant of a stock option, for example, to a prospective employee as an incentive, prior to them actually being employed, would be subject to section 409A," Galbreath says.

"Now, the stock option can be issued, provided the option is contingent upon the would-be employee beginning employment within 12 months of the date of grant, and the employee actually does begin employment during that time period."

## Other provisions

In addition to provisions pertaining to compliance with foreign ethics, conflict of interest, and debt collection laws; special payment rules following a change in control; changes in status from employee to independent contractor; and plan terminations, the proposed regulations make a number of other clarifications.

**Applicability to Section 457A plans.** "Like with 457 plans, 457A plans that are subject to section 409A must comply with both 457A and 409A, separately," Galbreath explains. "These are two distinct Code provisions, both of which must be complied with."

**Short-term deferrals.** A payment under a nonqualified deferred compensation plan that otherwise qualifies as a short-term deferral, but is made after the end of the applicable 2½ month period, may still qualify as a short-term deferral if the employer reasonably anticipates that making the payment during the applicable 2½-month period will violate federal securities laws or other applicable law. The payment must be made as soon as possible after the payment could be made without causing a violation.

**Employment-related legal fees and expenses.** A service provider's right to reimbursement for reasonable attorneys' fees and related expenses incurred to pursue an employment-related claim is not considered deferred compensation for Section 409A purposes, he says.

**Recurring part-year compensation.** The proposed regulations modify the recurring part-year compensation rule, recognizing that educational institutions often structure their pay plans to include recurring part-year compensation and that the main goal in designing pay plans this way is to provide uninterrupted cash flow for employees who do not work for a portion of the year, such as teachers.

Galbreath says that, under the proposed regulations, when an employee receives recurring part-year compensation, the plan or arrangement will not be considered deferred compensation if:

- None of the recurring part-year compensation for the year is paid later than 13 months following the first day of the year; *and*
- The amount of the employee's recurring part-year compensation—not just the deferred amount—does not exceed $265,000 (in 2016), the annual limit on the amount of compensation that can be considered under a qualified retirement plan under Code Section 401(a)(17).

**Separation pay plans.** Employers no longer have to worry about whether severance pay would be subject to 409A just because an employee was terminated in the same year that he or she was hired, Galbreath says. For the 409A exception to apply, the separation pay must be paid within 2 years and must meet the so-called two-times exception. "That is, the amount paid cannot be more than two times the lesser of the employee's prior year's annual compensation or the compensation limit for qualified plans under section 401(a)(17)," which would be $530,000 in 2016.

"Under the proposed regs, if an employee is terminated in the same year as hire, the separation pay cannot exceed two times the employee's annualized compensation," he explains. "Prior to the proposed regs, the exception would not be available because the employee had no prior year compensation."

## Consequences of noncompliance

He says that "the ultimate consequence of failing to comply with Code section 409A is that the employee or independent contractor whose compensation is intended to be deferred becomes taxable when no longer subject to a substantial risk of forfeiture—in other words, vested."

Also, there "is the additional 20 percent penalty on such income and, if the tax is not paid timely, interest accrues at a bonus rate that is a full point higher than other tax liabilities. Note that the tax consequences fall on the service provider, the one whose compensation was intended to be deferred until another year," Galbreath says. "So, if a plan includes a provision that was formerly a gray area but has been clarified under the proposed regs, upon an audit, the IRS could seek to impose the proposed regs and the employer, employee, or independent contractor would have to defend their position in the face of the proposed regs. If they are not successful, the workers have the draconian tax results of section 409A noncompliance."

### What to do

The comment period for the proposed regulations ends September 20, 2016. "Given that the proposed regs are fairly generous and most clarifications are taxpayer friendly, I wouldn't expect many changes," Galbreath says. "However, there could be further clarifications of the clarifications."

He offers the following advice for complying with the proposed regulations:

- **Review your nonqualified deferred compensation plans.** "All plans should be reviewed to determine if there are new opportunities under the proposed regs to make the plan design more flexible and the plan terms clear," he says.
- **Regularly self-audit or review your plans.** Employers should "self-audit or review their plans every 2 years to try to catch any operational or document failures, so they can be timely corrected under IRS correction programs," Galbreath says. "Now, with the proposed regs, it is also important for employers to review their plans—not only to ensure they remain in compliance but also to find opportunities to improve the plan design."
- **Be on the lookout for a focus on 409A issues in IRS audits.** Pointing to an IRS audit initiative that began in 2014, Galbreath says that "we are likely to see more 409A issues on audits. This is another reason to have plans reviewed."

## Cognitive performance has implications for defined contribution plans

If you do not already offer automatic enrollment in your defined contribution plan, you might want to consider doing so. Such a move is likely to increase participation in retirement saving and may be particularly beneficial for young workers, an expert says. Here's why.

In its magazine, *The Participant*, State Street Global Advisors (SSGA) (www.ssga.com) recently published an article highlighting "pioneering" research by David Laibson, a Harvard University behavioral economist, on cognitive performance and explaining its implications for defined contribution plan design.

The article describes two types of intelligence identified by Laibson: Fluid intelligence is "the ability to learn and adapt, which declines rapidly over time" and crystallized intelligence, which is "wisdom learned from experience, which increases" as a person ages.

Based on the finding that borrowers in their 50s paid the lowest interest rates for loans and those in the oldest and youngest age categories paid the highest rates, the study concluded that cognitive performance, which includes both fluid and crystallized intelligence, is at its highest when an individual is in his or her 50s, SSGA reports.

"This finding suggests that plan participants at either end of the age spectrum need the most support" when it comes to retirement planning, the article states.

Young people tend to have "quite a bit of fluid intelligence" and "not so much crystallized intelligence," says Fredrik Axsater, global head of defined contribution for SSGA. And, because retirement is not top of mind for them, "automatic enrollment may be particularly important for younger employees," because it can help them start saving for retirement when they otherwise might not do so.

Automatic enrollment already is standard practice for larger plans and should become the norm across all plans, he says.

Meanwhile, since older individuals have less fluid intelligence, it is best for them to make decisions about safeguarding their assets before they reach their 80s or 90s, for example, Axsater explains. He says those discussions should begin at about age 55, so employees can make well-informed decisions around retirement age.

While it is important to educate employees about their retirement saving options throughout their careers and during open enrollment each year, Axsater says employees are more likely to be engaged in those discussions at "inflection points" in their lives, such as when they retire, change jobs, get married, have children, or buy a house—"the bigger, impactful decisions that we make in our lives that also have a financial impact one way or another."

Axsater recommends that employers be on the lookout for those life-changing events and then leverage those opportunities to engage employees in retirement plan discussions—a move that he says can, in turn, also make them more financially savvy when it comes to other aspects of their lives, such as searching for a competitive mortgage rate.

He identifies two main reasons that employers and plan sponsors should take cognitive performance into account and look for opportunities to get employees involved in retirement planning. First, "it's important to people's lives. We have an opportunity to have people retire with dignity, to have the type of retirement they want to have."

Second, from an employer's standpoint, having a holistic benefits offering in place helps with recruiting and retention and, as clients have told him, "helps people retire when they want to retire" rather than staying in a job solely for financial reasons and underperforming.

# This Month's Statistics

| | Latest Period | Current | Prior Report | A Year Ago | 12 Month % Change |
|---|---|---|---|---|---|
| **CPI-U** | July/16 | 240.6 | 241.0 | 238.7 | 0.8% |
| **CPI-W** | July/16 | 234.8 | 235.3 | 233.8 | 0.4% |
| **ECI EMPLOYMENT COST INDEX** | | | | | |
| **Total Compensation** | 2Q/16 | 126.2 | 125.4 | 123.3 | 2.4% |
| **Wages and Salaries—Private Industry** | 2Q/16 | 126.1 | 125.1 | 122.9 | 2.6% |
| **Wages and Salaries—Civilian Workers** | 2Q/16 | 125.4 | 124.5 | 122.4 | 2.5% |
| **Benefits—Private Industry** | 2Q/16 | 126.5 | 126.0 | 124.4 | 1.7% |
| **Average Weekly Gross Wages*** | July/16 | $727.58 | $723.07 | $709.39 | 2.4% |

*seasonally adjusted

(**Source:** Bureau of Labor Statistics, Washington, D.C.)
All figures are national.

## KEY TO STATISTICS

**CPI-U:** Consumer Price Index for all urban consumers; the newer index representative of the buying habits of about 87% of the total U.S. population. (1982–84=100)

**CPI-W:** Consumer Price Index for urban wage earners and clerical workers; the older index covering only about 32% of the U.S. urban population.

**ECI:** Measures change in compensation per hour worked, including wages, salaries, and employer costs of benefits. (6/89=100)

**Average Weekly Gross Wages and Average Hourly Wages:** Data relate to production workers in manufacturing and mining; construction workers; nonsupervisory workers in transportation, public utilities, and wholesale/retail trade; also finance, insurance, real estate, and other services. Accounts for approximately 80% of the total employees on private, nonfarm payrolls.

Patricia M. Trainor, JD, SPHR, *Vice President, Content and Product Development;* Robert L. Brady, JD, *Founder;* Catherine Moreton Gray, JD, *Senior Managing Editor;* Chris Ceplenski, *Product Editor;* Lisa Higgins, *Editor;* Rebecca MacLachlan, *Graphic Designer;* Sherry Newcomb, *Content Production Specialist*; Joan Carlson, Brechin Knapp, *Proofreaders;* Linda Costa, *Quality Control Associate;* Alison Berlin, *Product Manager. Employee Compensation* ISSN #1066-2561/86 is issued by BLR—Business & Legal Resources, 100 Winners Circle, Suite 300, Brentwood, TN 37027. ©2016 BLR®—Business & Legal Resources. E-mail: editors@blr.com.

Issued monthly. Subscription price: $395 annually for complete service. Periodicals postage paid at Old Saybrook, CT 06475-9998 and additional offices. POSTMASTER: Send address changes to *Employee Compensation*, P.O. Box 5094, Brentwood, TN 37024-5094.