Recent Developments for Sections 409A and 457: Proposed Regulations and Chief Counsel Memorandum

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Earlier this summer, the Office of the Chief Counsel of the Internal Revenue Service (IRS) released a Chief Counsel Advice (CCA) memorandum providing insight into how the IRS interprets and applies the provisions of Section 409A of the Internal Revenue Code relating to so-called “back-to-back” arrangements. This comes on the heels of a year of a number of important developments from the IRS pertaining to both Section 409A and Section 457 of the Code. Most notably, on June 21, 2016, the IRS released both the proposed regulations modifying and clarifying existing regulations under Section 409A, and the long-awaited regulations covering Section 457. Further, in addition to the June 2017 CCA memorandum covering back-to-back arrangements, the Office of the Chief Counsel recently issued two other CCA memorandum regarding Section 409A, relating to the substantial risk of forfeiture and the methodologies for pricing a stock option and calculating the amount includible in a taxpayer’s gross income. These proposed regulations and the CCA memorandum are discussed in more detail below.[1]

I. Proposed 409A Regulations

On June 21, 2016, the IRS issued proposed regulations relating to Section 409A, which made numerous clarifications and modifications to the original Section 409A final regulations that were published in the Federal Register on December 8, 2008. In general, these changes add flexibility to existing exemptions, provide technical clarifications and expand the anti-abuse rules. The Proposed 409A Regulations will become effective when they are finalized and published in the Federal Register, but taxpayers may rely on the proposed regulations in the interim.[2]

Additional Flexibility for Applying Existing Exemptions

The Proposed 409A Regulations brought some welcome flexibility for taxpayers looking to rely on exemptions from the strict payment rules dictated by Section 409A.

- *Modification of the conflicts of interest exception.* The 2008 Regulations provide that a plan can permit acceleration of the time or schedule of a payment to the extent reasonably necessary to avoid the violation of a federal, state, local or foreign ethics or conflicts of interest law – but that, with respect to foreign ethics law or conflicts of interest laws, this exception applies only to foreign earned income from sources within the country that promulgated the law. The Proposed 409A Regulations expand the scope of this exception to permit accelerated payment of *any* nonqualified deferred compensation.

[1] In August 2016, the Chief Counsel of the IRS also issued a Generic Legal Advice Memorandum covering a few very technical points regarding Section 457A, including adjustments resulting from changes in accounting methods. Given the specificity and technical nature of the memorandum it is not covered by this alert, but the full text can be found here **GLAM 2016-003**.

[2] Note that, for ease of reference, the term “employer” is used throughout this Client Alert to mean any “service recipient,” and “employee” is used throughout this Client Alert to mean any “service provider,” as such terms are defined in the Internal Revenue Code.

- *Clarification for determining when an employee turned independent contractor has had a separation from service.* The 2008 Regulations provide that in determining whether or not an employee has had a separation from service for purposes of Section 409A, a termination generally occurs if the facts and circumstances indicate that the employer and employee reasonably anticipate that no further service would be performed after a certain date or that the level of *bona fide* services after such date (whether performed as an employee or independent contractor) would permanently decrease to no more than 20% of the average level of *bona fide* services provided over the immediately preceding 36-month period (or full period of service if less), whereas the separation from service of an independent contractor is determined to be the expiration of all contracts with the employer if the expiration is a good-faith and complete termination of the contractual relationship. The 2008 Regulations also provide that employees who are both employees and independent contractors of the employer must have "ceased providing services" in both capacities.

  Some commentators found that this latter requirement created ambiguity where an employee has a separation from service, but, in connection with that separation, enters into a consulting arrangement (and therefore there is not a complete termination of the contractual relationship). The Proposed 409A Regulations delete the quoted language above to avoid confusion, but also clarify that, when an individual moves from employee to independent contractor status and there is no separation from service (because at that time it is not reasonably anticipated that the level of services would dip below the requisite level), the employee will have a separation from service in the future based on the rules that apply to independent contractors, not employees.

- *Expansion of the short-term deferral rules to allow for delayed payments in order to avoid violation of federal securities or other applicable laws*. Under the "short-term deferral" rules of the 2008 Regulations, compensation is not subject to Section 409A if the payment is actually or constructively received before the later of the 15th day of the third month following the end of the employee's or employer's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture. Under the 2008 Regulations, payments made past the relevant date can still qualify as short-term deferral if the payment would otherwise qualify as a short-term deferral, but is delayed because (i) it was administratively impracticable to make the payment by such date, (ii) making the payment by such date would have jeopardized the employer's ability to continue as a going concern or (iii) the employer reasonably anticipates that a deduction for the payment would not be permitted under Section 162(m) of the Code. The Proposed 409A Regulations add a fourth exception to this list – if the payment would violate federal securities laws or other applicable law, and if the payment is made as soon as reasonably practicable following the first date on which the employer anticipates or reasonably should anticipate that making the payment would not cause a violation.

- *Expansion of exemption for reimbursement of legal fees and expenses to enforce a plan or agreement*. Under the 2008 Regulations, an arrangement is not subject to Section 409A where it provides for amounts to be paid as settlements or awards for resolving *bona fide* legal claims based on wrongful termination, employment discrimination, the Fair Labor Standards Act or workers' compensation statutes, including claims under applicable federal, state, local or foreign laws, or for reimbursements or payments of reasonable attorney's fees or other reasonable expenses incurred by the employee related to the *bona fide* legal claims. Commentators noted that this exemption does not explicitly cover attorney's fees and expenses incurred by an employee enforcing a claim against an employer with respect to the service relationship. The Proposed 409A Regulations provide that such fees and expenses would be added to the exemption.

- *Modification of rules regarding recurring part-year compensation*. The 2008 Regulations define "recurring part-year compensation" as compensation paid for services rendered in a position that the employer and employee reasonably anticipate will continue on similar terms and conditions in subsequent years, and will require services to be provided during successive service periods that are shorter than 12 months and that begin in one taxable year and end in the next (*e.g.*, teachers providing services during the 10-month school year). IRS Notice 2008-62 provides that recurring part-year compensation is not subject to Section 409A if it meets certain requirements:

  - payments are not deferred beyond the last day of the 13th month following the first day of the service period; and

  - the deferred amount does not exceed the applicable amount under Section 402(g)(1)(B) of the Code in effect for the calendar year in which the service period begins ($18,000 for 2017).

  Commentators noted that this limit was low and that often these arrangements are not elective, and where they are, the decision is frequently made to manage cash flow. The Proposed 409A Regulations provide that recurring part-year compensation will not be subject to 409A if:

  - payments are not deferred beyond the last day of the 13th month following the first day of the service period (same requirement as the 2008 Regulations); and

  - the amount of the recurring part-year compensation (not merely the amount deferred) does not exceed the annual compensation limit under Section 401(a)(17) of the Code in effect for the calendar year in which the service period begins ($270,000 for 2017).

  A conforming change is also included under the proposed regulations for Section 457.

- *Modification of the rules applicable to payments following death*. Under the 2008 Regulations, death is a permissible payment event for deferred compensation subject to Section 409A. Commentators noted that there was some ambiguity as to whether the death of a beneficiary was also a permissible event where the beneficiary had become entitled to a payment due to the employee's death, and also noted that the time period for payments after death is often not sufficient. The Proposed 409A Regulations confirm that the death of the beneficiary is also a permissible payment event, and provides that a payment following death is timely if made by December 31st of the year following the death of the participant or beneficiary, as applicable. The Proposed 409A Regulations also provide that payments may be accelerated upon death, even if a payment stream has already commenced prior to death.

- *Expansion of exception for acceleration of payments to comply with deferral debt collection laws*. The 2008 Regulations include an exception to the restrictions on the acceleration of payments to permit accelerated payments of deferred compensation in order to pay debt up to a certain limit (generally $15,000). The Proposed 409A Regulations make this exception broader by permitting acceleration of payments to the extent "reasonably necessary" to comply with federal laws.

Technical Clarifications

The IRS and commentators found that numerous items addressed in the 2008 Regulations lacked sufficient clarity, leading to misunderstanding and misinterpretations of the rules by practitioners. The Proposed 409A Regulations serve to clarify a number of these technical points.

- *Clarification that Section 409A applies to nonqualified deferred compensation plans separately and in addition to the rules of Section 457A*. Section 457A applies to "nonqualified entities" (as defined under Section 457A, generally foreign corporations) and provides that compensation deferred under nonqualified deferred compensation plans of such nonqualified entities be includible in gross income once there is no substantial risk of forfeiture. The Proposed 409A

Regulations clarify that the rules of Section 409A apply to such Section 457A plans separately and in addition to any requirements applicable under Section 457A.

- *Clarification that punitive call rights on stock rights will not render a stock right subject to Section 409A*. The 2008 Regulations provide that stock options and stock appreciation rights ("stock rights") on employer stock that meet certain criteria are exempt from the rules of Section 409A. One of the criteria is that the stock is not subject to a mandatory repurchase obligation (other than a right of first refusal) or a permanent put or call right, if the stock price under such right or obligation is based on a measure other than fair market value. The Proposed 409A Regulations provide that the employer stock exemption will still apply if the stock price of a repurchase right is based on a measure other than fair market value in instances where the employee's separation from service is for cause or due to a reason within the employee's control (*e.g.*, the violation of non-compete or nondisclosure covenants).
- *Clarification that stock rights may be granted to prospective employees, not just current employees*. As discussed above, the 2008 Regulations provide that stock rights that meet certain criteria are exempt from the rules of Section 409A. One of the criteria to satisfy such exemption is that the grantee provides direct services to the issuer (or certain affiliates) on the date of grant. Commentators noted that this requirement hindered employers from granting stock as part of an offer of employment. In response, the Proposed 409A Regulations provide that the grant of stock rights to an individual in reasonable anticipation of commencement of employment within 12 months following the date of such grant would also qualify for the stock right exemption, provided that the individual does in fact commence employment within such 12-month period (or if services do not begin within that period, that the stock right is forfeited).
- *Clarification that the separation pay plan exemption is available to new hires*. The 2008 Regulations provide a Section 409A exemption for separation pay plans that provide for severance upon an involuntary termination of service and meet certain requirements. One of these criteria is that the separation pay generally not exceed two times the lesser of the employee's annualized compensation based on the rate of pay for the employee's previous taxable year, or the limit under Section 401(a)(17) for the year of separation ($270,000 for 2017). Commentators noted that this requirement left some ambiguity as to whether the exception could be applied to an individual who was hired in the same year as the separation given that the calculation is based on annualized pay from the previous year. The Proposed 409A Regulations clarify that this exception does apply to new hires, and that in instances where there is no compensation for the previous year, the annualized pay for the taxable year of separation should be used.
- *Clarification of what constitutes an asset sale*. The 2008 Regulations permit the seller and buyer in an asset sale to specify whether a transferring employee has a separation from service. Commentators have asked if this rule could apply to transactions that are treated as "deemed asset sales" under Section 338 of the Code. The Proposed 409A Regulations clarify and make it explicit that transactions that are treated as deemed asset sales under Section 338 of the Code are not a sale or other disposition of assets for purposes of this rule under Section 409A, and thus buyer and seller do not have the flexibility to make such determination.
- *Clarification that a payment is considered made when the income tax obligation arises*. Under the 2008 Regulations, there is guidance on when a "payment" is considered made for purposes of a short-term deferral, but this is not generally applicable to the rest of Section 409A. The Proposed 409A Regulations provide that a payment is made when the taxable benefit is actually or constructively received and results in includible income (*e.g.*, the transfer of restricted stock is only considered a "payment" where the recipient makes a Section 83(b) election to include the value of the award in his or her income).

- *Clarification on rules for transaction-based compensation*. The 2008 Regulations provide for special payment rules for transaction-based compensation. The Proposed 409A Regulations provide that transaction-based compensation may be treated as paid on a designated date or according to a fixed schedule if paid on the same schedule and under the same terms and conditions as the payments to stockholders generally. Similarly, transaction-based compensation meeting such requirements will not fail to meet the requirements of the initial or subsequent deferral rules if paid no later than five years after the change in control event. The Proposed 409A Regulations also clarify that the transaction-based compensation rules apply to statutory stock options and stock rights that did not otherwise have a deferral feature.
- *Clarification of permitted payments upon the termination and liquidation of a plan*. The 2008 Regulations permit the acceleration of deferred compensation made pursuant to the termination or liquidation of a plan if the termination or liquidation occurs within 12 months of a corporate dissolution taxed under Section 331 of the Code or with the approval of a bankruptcy court if certain other conditions are satisfied. The Proposed 409A Regulations clarify that the acceleration of payments pursuant to this rule is subject to the requirement of Section 409A-3(j)(4)(ix)(C), and thus is permitted only if the employer terminates and liquidates all plans of the same category that the employer sponsors, and not merely all plans of the same category in which a particular employee actually participates. The Proposed 409A Regulations further clarify that for a period of three years following the termination and liquidation of a plan, the employer cannot adopt a new plan of the same category as the terminated and liquidated plan, regardless of who participates in the plan.
- *Clarification that a service provider can be an entity as well as an individual*. The Proposed 409A Regulations clarify that for purposes of Section 409A, a “service provider” may be a corporation and not just an individual.

Anti-Abuse Rules

The 2008 Regulations permit the correction of certain plan provisions that fail to comply with the requirements of Section 409A, but the IRS wanted to make clear that these rules were not intended to allow employers to change the time or form of payment provisions that would otherwise comply with Section 409A, or to permit employers to create errors in nonqualified deferred compensation plans with respect to unvested amounts as a pretext for changing the time or form of payment. The Proposed 409A Regulations clarify and modify the anti-abuse rules by:

- prohibiting changes that affect the time or form of payment where there is no reasonable, good faith basis for concluding that the original provision failed to meet the requirements of Section 409A;
- providing a list of facts and circumstances to consider in determining whether the employer has a pattern or practice of permitting impermissible changes (*e.g.*, whether the employer has taken reasonably commercial measures to identify and correct substantially similar failures promptly upon discovery; whether the substantially similar failures occurred more frequently with unvested amounts than with vested amounts; whether the failures occurred more frequently with newly adopted plans; whether the failures appear intentional or numerous; and whether repeat common past failures have already been corrected); and
- providing that corrections, including corrections of substantially similar errors, must be made in compliance with the applicable correction guidance.

II. Proposed 457 Regulations

Section 457, not to be confused with Section 457A, addresses the taxation of compensation deferred under plans sponsored by a state or local government or by a tax-exempt entity. Under Section 457, deferred compensation plans are divided into two categories, "eligible plans" (so-called Section 457(b) plans) and "ineligible plans" (so-called Section 457(f) plans). Section 457(b) plans are similar in some respects to 401(k) plans and allow for the deferral of limited amounts of compensation (generally $18,000 per year for 2017) until an employee retires or terminates employment. Those plans that do not meet the requirements of Section 457(b) are considered ineligible plans, and are instead subject to Section 457(f). Section 457(f) plans are akin to traditional nonqualified deferred compensation plans, and are taxed at the later of the date the participant or beneficiary obtains the legally binding right to the compensation or the date that the compensation is no longer subject to a substantial risk of forfeiture (*i.e.*, upon vesting and not necessarily upon payment), unless the arrangement can be covered under one of the Section 457 exemptions, in which case the compensation is instead taxable upon payment. The final regulations under Section 457 were issued by the IRS on July 21, 2003, but the 2003 Regulations focused on the treatment of Section 457(b) plans and only addressed the treatment of 457(f) plans in a very limited manner. It was not until June 21, 2016 that the IRS issued the proposed regulations under Section 457, which more fully address the treatment of Section 457(f) plans. The Proposed 457 Regulations provide additional exemptions and make clarifications to certain existing exemptions. Some of the most notable portions of the regulations are described below. The regulations will be effective for calendar years beginning after the date the IRS publishes final regulations, but taxpayers may rely on the Proposed 457 Regulations in the interim.

Definition of Deferral of Compensation

Under the Proposed 457 Regulations a plan is generally considered to provide for the deferral of compensation if the participant has a legally binding right during a tax year to compensation that is or may be payable in a later tax year. There is no legally binding right to compensation where the employer may unilaterally reduce or eliminate the compensation.

Definition of a "Substantial Risk of Forfeiture"

As noted above, Section 457(f) plans are taxed at the later of the date the participant or beneficiary obtains the legally binding right to the compensation or the date that the compensation is no longer subject to a substantial risk of forfeiture. It is clear from the 2003 Regulations that the future performance of substantial services, or the requirement that certain conditions be met that are related to a purpose of the compensation (if the likelihood of the forfeiture event is substantial), would both constitute a substantial risk of forfeiture, and that there is no substantial risk of forfeiture where the forfeiture condition is unlikely to be enforced. The Proposed 457 Regulations provide additional guidance on determining what would be considered a substantial risk of forfeiture.

- *Non-Competes.* Unlike Section 409A, which does not consider the requirement for continued compliance with a non-compete agreement a substantial risk of forfeiture, under the Proposed 457 Regulations, compliance with a non-compete agreement may constitute a substantial risk of forfeiture if:
  - the right to the deferred compensation is expressly conditioned, in an enforceable written agreement, upon the employee refraining from the future performance of services;
  - the employer makes reasonable ongoing efforts to verify compliance; and

    - the facts and circumstances demonstrate that the employer has a substantial and *bona fide* interest in preventing the employee from competing and the employee has a *bona fide* interest in his or her ability to engage in the prohibited activities.[3]

- *Rolling risk of forfeiture and additional risks of forfeiture.* The Proposed 457 Regulations allow for the extension of the period covered by a substantial risk of forfeiture (a "rolling risk of forfeiture") and the application of a substantial risk of forfeiture after a legally binding right to compensation exists (*e.g.*, elective deferrals of previously promised compensation) if the following conditions are met:

    - the present value of the amount to be paid upon lapse of the substantial risk of forfeiture (as extended, if applicable) must be materially greater (*i.e.*, more than 125%) than the amount the employee otherwise would be paid absent the substantial risk of forfeiture (or extension, as applicable);

    - the initial or extended substantial risk of forfeiture must be based upon the future performance of substantial services or adherence to a non-compete agreement;

    - the substantial future services must be required for at least two years (subject to earlier payment upon death, disability, or an involuntary termination without cause); and

    - the agreement for the initial or extended substantial risk of forfeiture must be made in writing (a) before the calendar year in which any services giving rise to the compensation are performed for initial deferrals of current compensation, (b) at least 90 days before the date on which the existing substantial risk of forfeiture would have lapsed for extensions and (c) within 30 days after hire for a newly hired employee (but only with respect to amounts attributable to services rendered after the initial deferral or extension is agreed to in writing).

- *Substitution*. The Proposed 457 Regulations clarify that if an amount that is forfeited is replaced by a substitute award or benefit, either in whole or in part, the substitution amount will not be considered subject to a substantial risk of forfeiture unless it meets the requirements of items (ii) through (iv) described in the preceding paragraph.

New and Modified Exemptions

The Proposed 457 Regulations provide new exemptions to the strict timing and payment rules for the taxation of compensation deferred under plans sponsored by a state or local government or by a tax-exempt entity, which are described in more detail below.

- *Short-term deferral exemption.* The Proposed 457 Regulations add a short-term deferral exemption, which tracks the short-term deferral exemption found under Section 409A - payments are exempt if there are no circumstances in which the payment could be made later than the 15th day of the third calendar month following the later of the end of the calendar year or the employer's fiscal year in which vesting occurs. However, the exemptions are not identical as the Section 457(f) short-term deferral exemption applies the broader definition of substantial risk of forfeiture described above.

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[3] **Practice Pointer**: Note that, because non-compete restrictions are generally not enforceable in California, payments conditioned solely on continued adherence to non-competition restrictions that are subject to California law would generally not be considered subject to a substantial risk of forfeiture. In addition, employers should exercise caution in relying on this exemption for non-competes with non-senior employees, as the IRS could challenge whether an employer has a "substantial and *bona fide*" interest in preventing competition beyond the ranks of senior employees.

- *Vacation and sick leave exemptions.* The Proposed 457 Regulations add an exemption for *bona fide* sick and vacation leave plans - plans where the facts and circumstances demonstrate that the primary purpose is to provide participants with paid time off from work because of sickness, vacation, or other personal reasons (factors to consider include whether the amount of leave provided could reasonably be expected to be used in the normal course, whether unused leave can be exchanged for cash or other benefits, restrictions on carrying an accrued amount forward, timing of payment following termination and whether the program is available only to a limited number of employees).
- *Disability plan exemption.* The Proposed 457 Regulations add an exemption for *bona fide* disability pay plans – plans that pay benefits only in the event of a participant's disability. Section 409A has a similar exemption, but the Section 457(f) exemption differs in that the value of any taxable disability insurance coverage provided under the plan will be disregarded if it is included in gross income.
- *Death benefit exemption.* The Proposed 457 Regulations include an exception for *bona fide* death benefit plans - defined as death benefit plans under Treasury Regulation § 31.3121(v)(2)-1(b)(4)(iv)(C) (the applicable FICA tax regulations), which requires that the death benefit must not merely be a replacement of the lifetime nonqualified plan benefit upon the participant's death.
- *Severance pay exemption.* The severance pay exemption already exists under Section 457, and as with the exemption under Section 409A, covers severance upon an involuntary termination of service that does not exceed two times the lesser of the service provider's annualized compensation (based on the calendar year preceding the year in which the employee has the severance from employment, or the current calendar year if there is no compensation from the preceding year), and the amount is paid by the end of the second calendar year following severance from employment. The Proposed 457 Regulations make two exceptions to the rule that the severance must be involuntary: (i) if a separation is voluntary but due to "good reason," or (ii) if the separation pay is only available for a limited time (a "window program").
  - *Good Reason*. Under the Proposed 457 Regulations, a separation is due to "good reason" if it occurs under certain *bona fide* conditions that are pre-specified in writing under circumstances in which the avoidance of Section 457 is not the primary purpose, and the severance of employment must result from the employer's unilateral action resulting in a material adverse change to the working relationship (*e.g.*, reduction in base salary) (other factors to be taken into consideration are whether the severance benefits are the same amount and paid at the same time as involuntary severance and whether the employer has a right to cure). The Proposed 457 Regulations do provide a safe harbor for written agreements that are in place at the time the legally binding right to the payment arises and that meet certain other conditions.
  - *Window Programs*. Under the Proposed 457 Regulations, a "window program" is defined as a program established by an employer to provide separation pay and that is offered for a limited period (typically 12 months or less), and the program must be available to employees who have a severance from employment during such period under specified circumstances. If the employer has a pattern of repeatedly providing similar programs, they generally will not be considered window programs.

III. Chief Counsel Memorandum

Below is a description of the three recent CCA memorandum covering:

- back-to-back arrangements;
- matching contributions and substantial risk of forfeiture; and

- the determination of fair market value and the methodology for calculating adjustments for includible income.

CCA memorandum are not binding and may not be used or cited as precedent, but they are instructive in providing insight into how the IRS interprets and applies the relevant provisions of the Internal Revenue Code.

Back-to-Back Arrangements

On June 23, 2017, the IRS released CCA Memorandum 201725027 covering three issues pertaining to so-called "back-to-back" arrangements. As a general rule, a payment made to one service provider upon the separation from service of another service provider is not a permissible payment event under Section 409A (the permissible payment events under Section 409A are (i) the service provider's separation from service; (ii) the service provider becoming disabled; (iii) the service provider's death; (iv) a fixed time or fixed schedule set out in the plan; (v) a change in ownership or control of a corporation; and (vi) the occurrence of an unforeseeable emergency). However, Reg. § 1.409A-3(i)(6)(i) does provide an exception for "back-to-back" arrangements - where there is a nonqualified deferred compensation arrangement that provides for payments from an "ultimate service recipient" (in this instance, a foreign corporation) to an "intermediate service recipient" (in this instance, a United States taxpayer that manages investment funds, including the foreign corporation) and a corresponding deferred compensation arrangement that provides for payments from the intermediate service recipient to an employee (in this instance, individual investment professionals), and the intermediate service recipient plan provides for a payment upon the occurrence of one of the permitted Section 409A payment events listed above.

- *Issue 1: Payments under the ultimate service recipient plan exceed those made under the intermediate service recipient plan*
  - *Question*: If payments made under the ultimate service recipient plan exceed those made under the initial service recipient plan, does the arrangement qualify as a back-to-back arrangement under Treas. Reg. §1.409A-3(i)(6)?
  - *Background and Analysis*: No. Treas. Reg. §1.409A-3(i)(6) explicitly provides that the amount of the payment under the ultimate service recipient plan must not exceed the amount of the payment under the intermediate service recipient plan. Because the ultimate service recipient plan provides that unvested amounts forfeited by participants are nevertheless to be paid to the intermediate service recipient, in such instances, the intermediate service recipient would receive an amount that is *in excess* of the amount paid to the participant (*i.e.*, in the event of a termination of a participant, the intermediate service recipient receives payment of the participant's full deferred amount but pays only a portion to the participant and keeps the portion that was forfeited). Therefore, the requirements for a permissible back-to-back arrangement are not met.
- *Issue 2: Payment amounts that vary from what is provided in the plan*
  - *Question*: If a deferred compensation plan pays out different amounts than provided for under the terms of such plan, does it meet the requirements of Section 409A(a)(2)(A)?
  - *Background and Analysis*: No. Section 409A(a)(2)(A) requires that the payments be made in the time and in the amount specified in the plan. In this instance, the taxpayer elected to be paid deferred compensation on certain dates and in certain amounts over several tax years. However, in certain tax years, the payments actually made were less, and in other instances were greater, than the amounts called for under the ultimate service recipient plan (*i.e.*, the taxpayer impermissibly accelerated certain amounts and deferred other amounts in violation of Section 409A). As a result, all compensation deferred under the plan for the taxable year

and all preceding taxable years is includible in gross income for the taxable year (to the extent that it is no longer subject to a substantial risk of forfeiture and was not previously included in gross income).

- *Issue 3: Variation in timing of payments of back-to-back arrangements*
  - *Question*: If payments under an ultimate service recipient plan are made at a different time than those amounts under the intermediate service recipient plan, does the arrangement still qualify as a back-to-back arrangement under Treas. Reg. §1.409A-3(i)(6)?
  - *Background and Analysis*. No. Here the plan provided that the intermediate service recipient had the discretion to vest amounts payable to a participant under the intermediate service recipient plan upon a participant's separation from service (which is permissible under Section 409A), and that such amounts would be paid out on the last day of the 13th month following the employee's separation from service. The intermediate service recipient vested and made such payment to the participant, but there was no matching payment made from the ultimate service recipient to the intermediate service recipient (*i.e.*, the amounts were left deferred and remained payable by the foreign corporation); therefore, the ultimate service recipient plan was not operated in accordance with the requirements of a back-to-back arrangement. Accordingly, all compensation deferred under the plan for the taxable year and all preceding taxable years is includible in gross income for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income.

Matching Contributions and Substantial Risk of Forfeiture

On September 29, 2016, the IRS released CCA Memorandum 201645012, addressing the substantial risk of forfeiture of matching contributions for purposes of Section 409A.

- *Issue: Substantial risk of forfeiture of matching contributions*
  - *Question*: Can a salary deferral be subject to a substantial risk of forfeiture under Section 409A if, as part of the imposition of the service requirement through the deferral date, the employer provides a matching contribution resulting in a 25% increase in the present value of the amount deferred?
  - *Background and Analysis*. Yes. Section 409A generally provides that a substantial risk of forfeiture exists if the receipt of deferred compensation is conditioned on the performance of substantial future services or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial. Generally speaking, once the legally binding right to the compensation arises, any addition of a substantial risk of forfeiture would be disregarded, but as discussed earlier with respect to the Proposed 457 Regulations (although we note that the preamble to the Proposed 457 Regulations specifically states that, in this regard, no implication is intended that this 125% standard would apply for purposes of Section 409A), there is a substantial risk of forfeiture where the present value of the amount subject to the substantial risk of forfeiture is “materially greater” (*i.e.*, more than 125%) than the present value of the amount the recipient would have otherwise elected to receive. Thus in this instance where an employee elects to defer salary and the employer provides a matching contribution resulting in a 25% increase in the present value of the amount deferred, there is still a substantial risk of forfeiture and the amount is not includible in income.

Determination of Fair Market Value and Calculating Adjustments to Includible Income

On January 15, 2016, the IRS released CCA Memorandum 201603025, addressing three issues pertaining to the pricing of a stock option and the methodology used for calculating the amount includible in a taxpayer's gross income under Section 409A.

- *Issue: Determining whether common stock is "readily tradable"*
  - *Question:* Is common stock that is traded on an over-the-counter market considered a "readily tradable" security for purposes of Section 409A?
  - *Background and Analysis.* Yes. When determining whether an option has been granted at or above fair market value (as required to meet the stock right exemption under Section 409A), the "readily tradable" standard requires only the ability to buy and sell the stock through a third party. In this instance, where the common stock was traded on over-the-counter markets, the price reported on such market should have been used for setting the exercise price of an option. The taxpayer tried to assert that there were no transactions in actual stock on the over-the-counter market, because the transactions were in contracts to purchase common stock rather than common stock itself, but the CCA memorandum clarifies that such "when-issued" purchases of common stock should be considered "actual transactions in such stock." In this instance the closing auction price per share of common stock on the over-the-counter market on the grant date was greater than the exercise price, and therefore the exercise price was less than fair market value, and an adjustment must be made to the amount includible in gross income.
- *Issue: Determining whether a valuation is reasonable*
  - *Question:* Is an exercise price of an option properly established as of the grant date if it is based on a valuation that predates the grant date and information that may materially affect the value of the corporation becomes available between the valuation date and the grant date?
  - *Background and Analysis:* No. If stock is not readily tradable, the exercise price is only properly established as of the grant date if it is based on the reasonable application of a reasonable valuation method. A reasonable valuation method must take into account all information that may materially affect the value of the corporation as of the grant date, and would not be considered reasonably applied if it were not revised after the valuation date to take into account information that may materially affect the value of the corporation. Pursuant to §1.409A-1(5)(iv)(B), recent arm's length transactions involving the sale or transfer of stock must be considered under a reasonable valuation method. Thus in this instance, even if the common stock traded on the over-the-counter market was not considered "readily tradable," the trading information should have been taken into account in the valuation.
- *Issue: Methodology for calculating proposed adjustments to includible income*
  - *Question:* What portion of the option that was granted below fair market value and thus subject to Section 409A, should be treated as compensation deferred under the option?
  - *Background and Analysis:* Pursuant to §1.409A-1(b)(2), the entire appreciation in value of the stock underlying an option that is subject to Section 409A should be treated as compensation deferred under the option.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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