

Are You Ready For Section 409b? New Legislation Threatens Dramatic Changes to Most Compensation Arrangements

As many know, Section 409A of the Internal Revenue Code prescribes a number of specific rules relating to deferred compensation, and impacts many arrangements, including stock options, bonus payments, and severance. Employers have spent the last decade diligently complying with Section 409A and its many requirements.

On November 2, 2017, the U.S. House of Representatives released the “Tax Cuts and Jobs Act” that repeals Section 409A, but replaces it with something more ominous – Section 409B. Newly-proposed Section 409B is very straight-forward, but mostly bad news for employers desiring to use conventional compensation arrangements to satisfy business needs.

Under Section 409B, deferred compensation arrangements will be subject to income tax as soon as they are no longer conditioned on the performance of future services. In other words, this tax regime means the following:

- ➔ Options and SARs will be taxed on vesting, even if not exercised;
- ➔ Severance will be taxed upon termination of employment, even if paid over time;
- ➔ Arrangements that vest solely upon the achievement of performance criteria, such as certain types of performance-based restricted stock units, will be taxed at grant; and
- ➔ Arrangements that vest upon a combination of performance and service-based criteria, such as certain restricted stock units, will be taxed as soon as the service-based vesting criteria is satisfied.

The new law provides a transition period that requires existing deferred arrangements, attributable to services performed before January 1, 2018, be included in income before 2026. Accordingly, stock options, severance, and other deferred compensation arrangements will need to be restructured significantly to avoid a mismatch between taxation and actual payments. Although the legislation faces challenges before enactment, it threatens to force significant restructuring of equity compensation and severance, and is worth monitoring closely.