

IRS Further Extends Compliance Deadline to December 31, 2008 for Nearly All of Section 409A

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As discussed in our Alert earlier this month, Notice 2007-78 was issued by the Internal Revenue Service in September to provide a limited extension of the deadline for bringing deferred compensation plans and arrangements (“DCPs”) into compliance with section 409A of the Internal Revenue Code. On October 22, 2007, the IRS issued Notice 2007-86 (the “Notice”) that extends the deadline for almost all compliance actions under section 409A to December 31, 2008. The new extension delays the effective date for operating DCPs in accordance with the final regulations to January 1, 2009 (good faith operational compliance is required before 2009). Further, the new extension generally eliminates the need to make compliance decisions or to achieve documentary compliance by the end of 2007, with two significant exceptions:

- If an employee is given the right to change, or an employer desires to change, the time and/or form of payment and that change will accelerate the payment of deferred compensation into 2008 or delay a payment scheduled to be made in 2008, the change must be elected (by the employee or the employer, as applicable) *by the end of 2007*. (As described below, elections that do not affect 2008 payments may be made during 2008.)
- A DCP with associated assets that were, on or before March 21, 2006, set aside or transferred offshore or made subject to restrictions in the event the employer’s financial health drops to a certain level, must be brought into compliance with section 409A *by the end of 2007*.

1. New Deadline for Full Compliance

The IRS’s final regulations under section 409A required that DCPs be brought into documentary com-

pliance by December 31, 2007 at the latest. Pursuant to the Notice, the new deadline for full documentary compliance is *December 31, 2008*, provided the DCP is operated in good faith compliance with section 409A through that date. The Notice explains the extent to which compliance with the IRS’s original guidance under section 409A (Notice 2005-1) or with the final regulations constitutes good faith compliance during 2008.

The Notice states that it is not good faith compliance if discretion provided under the terms of a DCP is exercised in a manner contrary to section 409A. Thus, if an employer retains discretion under the DCP to delay or extend payments in a manner contrary to section 409A *and exercises such discretion*, the DCP will fail to be in compliance with regard to all participants in the DCP. However, if a participant exercises a right under a DCP (solely with respect to the participant’s own deferred compensation) in a manner that causes the DCP to fail section 409A, the IRS will not treat the DCP as failing section 409A with respect to the other participants in the DCP.

2. Decisions/Actions Now Required by December 31, 2008

Under the new extension, employers now have until the end of 2008 to make the following major decisions about how their DCPs will operate *and* to reduce those decisions to writing:

- The DCP must specify a time and form of payment that complies with section 409A (*e.g.*, a single-sum payment within the 30-day period after separation from service), along with any applicable new definitions required by section 409A and the final regulations by the end of 2008.

- If an employee is given the right to change, or an employer desires to change, the time and/or form of payment of deferred compensation under the transition rules, that change must be elected and documented by the end of 2008 in order to avoid the restrictions on such changes required by the final regulations. This includes the right to make a deferral election with respect to an amount that is otherwise a “short-term deferral.” A change made in 2008 cannot accelerate the payment of deferred compensation into 2008 and cannot delay a payment scheduled to be made in 2008. Similar rules apply for 2007.
- If the DCP provides for installment payments and they are intended to be treated as individual payments (rather than as a single payment), this must be stated in the DCP by the end of 2008.
- If the DCP provides for severance payments in the case of an employee’s voluntary separation from service for certain good reasons and those good reasons (or other conditions) are sufficiently material to constitute a substantial risk that the employee will forfeit the severance payments, the good reasons may be revised by the end of 2008 to reflect a permissible definition of good reason (including conditions – such as notice to the employer and an opportunity to cure – associated with those definitions). Taking this action would provide more certainty that a voluntary separation from service for good reason will be treated like an involuntary separation.
- Discounted options and discounted stock appreciation rights (“SARs”) must, before they are exercised and by the end of 2008, either be replaced with acceptable options and SARs, or must be revised to provide fixed payment terms that comply with section 409A. (However, as announced in previous guidance, the time for correcting a back-dated discounted option or SAR issued by a public company to certain directors, officers and principal stockholders expired at the end of 2006.)

- DCPs and tax-qualified plans must be de-linked by the end of 2008 so that distributions under the tax-qualified plans do not automatically trigger distributions under the DCPs. The Notice extends this rule and relief under it to links between a DCP and additional employer plans, including section 403(b) annuities, section 457(b) eligible deferred compensation plans, and certain broad-based foreign plans.

3. Miscellaneous

- As announced previously, until further guidance is issued, a DCP may apply the cash-out rules in the final regulations – that allow installment or annuity payments to be cashed out if the present value falls below a predetermined amount – only at the original payment date; the cash-out requirement need not be applied throughout the stream of payments.
- The Notice provides that the IRS and the Treasury Department anticipate issuing guidance as soon as possible about the limited voluntary correction program that will apply to certain unintentional operational errors under section 409A.
- Separately, the IRS issued Notice 2007-89 on October 23, 2007, to provide guidance to employers/payers on (i) how to report and withhold on amounts includible in gross income under section 409A for 2007, and (ii) how to report deferrals of compensation under section 409A for 2007. It also provides guidance to employees and other service providers on how to report and pay tax on amounts includible in their gross income under section 409A for 2007. We will summarize this guidance for you in a separate Alert in the near future.

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Please call or email any member of our Employee Benefits and Executive Compensation Team if you have any questions regarding this further (and almost certainly last) extension.

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