

IRS Provides Limited Extension of Section 409A Compliance Deadline

DrinkerBiddle

Last month, and perhaps in response (at least in part) to a letter from 92 of the largest law firms in the country (including our firm), the Internal Revenue Service issued Notice 2007-78 (the "Notice"). The Notice provides a limited extension of the prior December 31, 2007 deadline for bringing deferred compensation plans and arrangements ("DCPs") into compliance with section 409A of the Internal Revenue Code. The extension does not delay the January 1, 2008 effective date for operating DCPs in accordance with the final regulations (good faith operational compliance applies before 2008). Further, the extension does not delay the need to take a closer look at all DCPs before 2008 for planning opportunities that are not available after 2007 and documentary compliance that is required by December 31, 2007.

1. New Deadline for Full Compliance

As we informed you in our April 2007 Alerts, the IRS's final regulations under section 409A of the Internal Revenue Code require that DCPs be brought into documentary compliance by December 31, 2007 at the latest. Pursuant to the Notice, the new deadline for full documentary compliance is *December 31, 2008*, provided the revised document is consistent with the way the DCP was actually operated in 2008. However, the Notice *did not extend* the December 31, 2007 deadline to take the actions listed below.

2. Decisions/Actions Still Required by December 31, 2007

Despite the extension discussed above, under the final regulations (as modified by the Notice) employers must still make the following major decisions regarding how their DCPs will operate *and* (except as indicated below) reduce those decisions to writing *before the end of 2007*:

- The DCP (or a separate written document that applies to the DCP) must specify a time and form of payment that complies with section 409A (e.g., a single-sum payment upon separation from service). If an employee is given the right to change the time and form of payment of his or her deferred compensation during the current transition period, that change must be elected and documented by the end of 2007 in order to avoid the restrictions on such changes required by the final regulations.
- If the DCP provides for installment payments and it is desired that they be treated as individual payments (rather than as a single payment), this must be stated in the DCP. This designation may be important for determining when and how to make a subsequent deferral of such payments, or for meeting the short-term deferral exception to section 409A for one or more of such payments.
- 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 to reflect a final regulation definition of good reason (including conditions – such as notice to the employer and an opportunity to cure – associated with those definitions) to 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 either be replaced with acceptable options and SARs, or must be revised to provide fixed payment terms that com-

ply 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 so that distributions under the tax-qualified plans do not automatically trigger distributions under the DCPs. (This may or may not require any written change to the DCP.)
- 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. (This may or may not require any written change to the DCP.)

3. Non-Compliant or Absent Terms

Until the new deadline of December 31, 2008, employers may disregard non-compliant terms that are in the DCP, as long as employees are not permitted to use the non-compliant terms. For example, if a DCP that generally provides for payment upon separation from service contains a provision that allows an employee to elect an immediate single-sum payment if the employee is willing to forfeit 10% of its value (a so-called "haircut"), the non-compliant provision may be disregarded as long as no employee is allowed to use it and the DCP is amended to remove the provision by the end of 2008, retroactively to January 1, 2008.

Although the DCP must designate the time and form of payment by the end of 2007, the new definitions required by section 409A and its regulations are not required to be in the DCP until the end of 2008. For example, if a DCP provides by the end of 2007 for payment upon a change in control, the term "change in control" itself need not be defined as required by the regulations until the end of 2008, as long as the DCP is administered in accordance with a compliant definition and the definition is set forth in the docu-

ment by the end of 2008, retroactively to January 1, 2008.

A DCP of a public company is not required to contain the six-month delay rule for the payment of deferred compensation to key employees by the end of 2007 as long as the rule is set forth in the document by the end of 2008, retroactively to January 1, 2008, and the provision accurately reflects how the DCP was administered during 2008.

4. Miscellaneous

Even though the time and form of payment must be designated by the end of 2007, the time of payment may be adjusted in 2008 (within specified limits) without adhering to the rule that requires the change to be made at least 12 months before its effective date and that requires deferral for five additional years. For example, if a DCP provides by the end of 2007 that payment will be made in a single sum upon an employee's separation from service, it may be revised in 2008 to say that the payment will be made within the 60-day period after the employee's separation from service.

Until further guidance is issued, 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 – may be applied only at the original payment date, and need not be applied throughout the stream of payments. Finally, the Notice announces that the IRS and the Treasury Department anticipate establishing a limited voluntary correction program applicable to certain unintentional operational errors under section 409A.

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A number of law firms (96 this time, again including our firm) and the Section of Taxation of the American Bar Association have both requested that the IRS provide a longer extension of some of the documentary deadlines discussed above. The IRS is considering the requests. We will let you know if they are approved.

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