

IRS Provides Additional Guidance on Year-End Amendment Deadline under 409A and Limited Transition Relief for 2008

The IRS on September 10 provided narrowly drawn relief from the requirement that all “nonqualified deferred compensation plans” (a term that includes agreements and other arrangements whether or not previously reduced to writing) formally comply with Section 409A of the Internal Revenue Code by the end of this year. Notice 2007-78 gives parties until December 31, 2008 to amend all required plan language fully. Disappointingly, the Notice *does not* extend other critical transition rules into 2008, nor does it relieve parties of the need to designate in writing payment form and timing choices by the end of 2007. The Notice's interpretations of some existing rules will come as an unwelcome surprise to many employers and employees. Under the Notice:

- **Action still needed by year-end 2007.** Every nonqualified deferred compensation plan must still designate in writing by December 31, 2007 rules for the form and timing of payment that comply with 409A. The written designation may be made in a separate document; for example, an employer could adopt a single interim document that designates the required payout terms for all its plans. Employers should promptly review their plans to determine what steps are required to “designate” payment choices. Many practitioners had urged the IRS to grant broader relief because of the practical need to negotiate any change in payment terms. This very real problem remains, particularly for employment agreements and other negotiated arrangements.
- **Limited relief for formal compliance.** A plan need not – yet – formally amend or eliminate all written plan provisions that do not comply with 409A (for example, a provision allowing participants to withdraw deferrals subject to a “haircut”) or thoroughly spell out certain defined terms. Most of these clean-up tasks may be accomplished by the end of 2008. However, the plan must be operated in the meantime in accordance with 409A. Also, payout terms cannot be amended after 2007 to bring a plan within a 409A exemption.
- **“Good reason” quit provisions.** The 409A final regulations issued in April provide some relief for plans that pay severance only on an involuntary termination or a “good reason” quit that is tantamount to an involuntary termination. For example, severance qualifying for this relief could, in most cases, be paid to an officer of a public company without any six-month delay. The Notice states that an existing “good reason” condition that is not already narrow enough to impose a “substantial risk of forfeiture” on the employee’s right to payment *cannot effectively be amended* into a definition that qualifies for this relief. Plans should be reviewed promptly to ensure that payment terms are appropriately designated by December 31, 2007 in those cases where existing “good reason” definitions do *not* impose a substantial risk of forfeiture.
- **End-of-term payments under employment agreements.** Employment agreements often provide for separation benefits if the employer decides not to renew the agreement. The Notice provides that, in such a case, a renewal of the contract, at least where the separation pay would have constituted “deferred compensation,” may result in a “substitution” for the original deferred-compensation promise. This rule could, for example, limit the parties’ ability to change the time and form of payment in the subsequent agreement.

- **Potential Voluntary Compliance Program for Operational Failures.** The Treasury and the IRS anticipate establishing “in the near future” a limited voluntary compliance program to correct, in the same taxable year in which they occur, “certain unintentional operational failures” under 409A and to provide other methods to limit the tax exposure under 409A resulting from unintentional operational failures. Notably, it appears that this voluntary compliance program will not provide any way to mitigate formal document failures, including a failure to comply with the year-end deadlines discussed in this Alert.

Contact Information

For more information concerning Notice 2007-78, please contact a member of the Tax & Benefits Department.

