

## Legal Alert: IRS Provides Limited Relief and Additional Guidance Under Code Section 409A

September 14, 2007

On September 10, 2007, Treasury and the IRS released [Notice 2007-78](#) (the “Notice”), providing limited additional relief and guidance with respect to nonqualified deferred compensation plans under section 409A of the Internal Revenue Code (the “Code”). As described in further detail below, the Notice provides that:

- Service recipients (generally referred to as employers below) generally have until December 31, 2008 to adopt amendments documenting compliance with the requirements of section 409A.
- However, by December 31, 2007, employers must have in place written designations of a time and form of payment for amounts deferred as of the end of this year, which in many cases will limit the benefit of the extension of the general deadline for amendments.
- Plans must be operated in compliance with the final regulations as of January 1, 2008.

The Notice also provides guidance concerning changes to “good reason” termination provisions in employment agreements during the rest of 2007. In addition, it provides relief, until further guidance is issued, permitting the renegotiation of certain provisions in an employment agreement upon the termination of a prior agreement and revising the cash out rules that were included in the final regulations under section 409A.

Finally, the Notice announces that the IRS and Treasury anticipate establishing a limited voluntary correction program for operational errors under section 409A in the near future and that the transition period regarding rules for certain funded arrangements under section 409A(b) will not be extended.

## Delay in Documentary Compliance

The final regulations under Code section 409A provided that all amendments documenting compliance with section 409A were required to be adopted by December 31, 2007. In response to numerous requests from industry groups, benefits practitioners, and others, the Notice extends the time to make amendments and otherwise document compliance with section 409A and the final regulations through December 31, 2008. However, the Notice requires that plans must designate a section 409A-compliant time and form of payment by December 31, 2007.

***Q&A-1: Is full operational compliance with the section 409A final regulations still required for 2008?***

Yes. The Notice makes clear that it does not extend the transition relief provided under Notice 2006-79 and in other guidance. That relief generally expires at the end of 2007. The Notice also states that, except as specifically provided in the final regulations, taxpayers must follow the rules in the final regulations effective January 1, 2008 and can no longer rely on Notice 2005-1, the proposed regulations, or a reasonable, good faith interpretation of the statute.

***Q&A-2: Will there be a retroactive amendment period in 2008 for most plan documentation?***

The Notice provides that all plan provisions required under the final regulations must be set forth in writing no later than December 31, 2008 (see Q&A-3, however, for a discussion of the designation of the time and form of payment that must be made by December 31, 2007). These plan provisions, including provisions specifying the timing for initial and subsequent deferral elections, must apply retroactively to January 1, 2008 and must accurately reflect the actual operation of the plan on and after January 1, 2008.

For example, if a deferred compensation plan in existence on January 1, 2008 operationally provided for subsequent deferral elections to be made starting June 30, 2008, the plan would be required to be amended by December 31, 2008 to reflect that subsequent deferral elections were not permitted from January 1, 2008 through June 29, 2008, but that they were permitted starting June 30, and the terms under which they were permitted.

***Q&A-3: Does the Notice extend the time for designating the time and form of payment under a deferred compensation plan beyond December 31, 2007?***

No. A compliant time and form of payment for amounts that constitute deferred compensation as of January 1, 2008 (“pre-2008 deferrals”) must be specified in writing by December 31, 2007 (unless the final regulations permit the designation by a later date), or the

plan will not comply with section 409A. For amounts deferred in 2008 (“2008 deferrals”), the arrangement must specify a compliant time and form of distribution in writing at a time and in a manner that satisfies the section 409A final regulations. For purposes of both of these rules, however, when determining whether the written terms of the plan comply with the time and form of payment rules, written provisions that do not comply with section 409A are disregarded. For example, if a plan provides for payment upon separation from service or upon the participant’s earlier request, subject to a 10% forfeiture for withdrawals before separation from service, the non-compliant in-service withdrawal rule is disregarded as long as it is not used and it is removed no later than December 31, 2008.

For pre-2008 deferrals and 2008 deferrals, the requirement for a written payment designation can be satisfied through a separate written document, rather than a specific plan amendment. A separate document could be used to set out the time and form of payments for (i) specifically identified arrangements (*e.g.*, the Company X Supplemental Retirement Plan and Excess Plan), (ii) arrangements not specifically identified (*e.g.*, all the plans subject to section 409A in which Employee Z participates), (3) or a combination of the foregoing, as long as the amounts to which each specific time and form of payment apply are objectively determinable. Note that this effectively allows employers to adopt a blanket resolution to cover any severance arrangements, employment agreements or other “plans” that the employer may not have identified by the end of 2007.

Whether the payment terms are set forth in a plan amendment or a separate document, except as otherwise described below in Q&As-4 and 5, the time and form of payments designated for pre-2008 deferrals and 2008 deferrals can be changed only in accordance with the generally applicable rules for making such changes under the final regulations. After the relevant deadlines, additional payment events cannot be added, and events that are designated as payment events (as long as they are permissible under section 409A) cannot be removed, except under the conditions described in the final regulations.

Also, the alternative rule permitting either the employer or the employee to elect to treat installment payments as a right to separate payments (for which separate subsequent deferral elections can be made) must be elected by the applicable deadline or the installments will be treated as a single payment for purposes of the subsequent deferral rules.

***Q&A-4: To meet the requirement that the time of payment be designated by December 31, 2007, must the payment events be defined with specificity?***

Generally, no. The basic requirement to designate a compliant time and form of payment during 2007 is met simply by referring to one of these events, without further elaboration. The Notice addresses the extent to which employers may, during 2008, adopt refinements to plan

provisions that specify payment will be made on (i) separation from service, (ii) change of control, (iii) unforeseeable emergency or (iv) disability. In effect, the Notice permits plan sponsors to decide during 2008 exactly what each of these events means and reflect those decisions in plan amendments made in 2008 that apply retroactively to January 1, 2008.

For example, the definition of “separation from service” in the final regulations includes a default rule that treats a reasonably anticipated reduction in an employee’s services to no more than 20% of the employee’s average service in the prior 36 months as a separation, but the definition also allows flexibility to increase the 20% level to any percentage less than 50%. If during 2008, Employee A permanently reduces his or her service to, say, a 25% level, and the plan calls for payment within 30 days of a “separation from service” without further definition, a decision needs to be made as to the exact definition to be applied. Under the Notice, that decision must be made and implemented in 2008. If the reduction to 25% is to be treated as a separation, the payment to Employee A needs to be made before the end of 2008, and the plan must be retroactively amended in 2008 to reflect that decision. (Note that since the section 409A concept of a “plan” is an individual by individual construct, a decision in 2008 to make a payment to Employee A based on a 25% rule would not preclude a later decision to adopt a 20% rule more generally. The differing treatment for Employee A would, however, need to be reflected in the retroactive amendment.) If, on the other hand, the 20% rule is to apply, no payment would be made to Employee A in 2008 and the plan would either remain silent (triggering application of the 20% default rule) or – and probably preferably – be retroactively amended to specify the 20% rule.

The Notice also makes it clear that a payment event definition that has been incorporated into a plan can be changed during 2008 to any other permissible definition of that event. For example, a plan that had provided for a 25% reduction to trigger a separation from service could, during 2008, be amended to use the 20% default or some greater percentage less than 50%. The only restriction is that, once an event has occurred for any individual and that event either is or is not treated as a payment event, the employer and employee cannot retroactively change the definition for that individual for that event. To facilitate this transition relief, the Notice provides that the availability of payment to a plan participant under a definition that is later changed will not cause the participant to take the amount into income under Code section 451 or the constructive receipt doctrine.

***Q&A-5: Does the Notice provide any relief in the context of specifying a fixed payment date or fixed schedule of payments?***

While the Notice generally requires that the form and time of payment be specified in writing by the end of 2007, there are two limited circumstances in which the written specification may be changed during 2008 without violating section 409A.

First, the final regulations provide that a payment will be considered to have been made on the date or upon the event (*e.g.*, death, separation from service, etc.) specified in the plan if the payment is made before the end of the calendar year that contains the specified date or event or, if later, the 15<sup>th</sup> day of the third month after the end of the employee's taxable year in which the date or event occurs. Nevertheless, employers might be concerned about contractual liability for payments made later than the exact date or event specified. If the employer wishes to deal with this potential liability by providing for payment "as soon as practicable" after the specified date or event, the final regulations require that the plan specify that payment will be made no later than 90 days after the specified date or event or the end of the calendar year in which the event occurs. The Notice provides that the addition, deletion or modification in 2008 of such a limit on the date by which payment must be made will not be treated as a change in the time and form of payment, provided that the employee does not have the right to designate the taxable year of payment. For example, if, as of December 31, 2007, the plan or a written election says payment will be made upon separation from service, the plan can be revised during 2008 to clarify that payment will be made up to 90 days after separation from service.

Second, the final regulations provide that a tax gross-up payment will be considered to be paid in accordance with a fixed payment schedule if it is made by the end of the employee's taxable year following the year in which the employee remits the related taxes. Provided that the plan is operated in compliance with that requirement, the limitation on the date by which the payment must be made can be reduced to writing in 2008 without violating section 409A.

***Q&A-6: Must the six-month delay rule for specified employees be reflected in writing in the plan by the end of 2007?***

No. Treas. Reg. § 1.409A-3(i)(2) requires a six-month delay for payments of deferred compensation made to a specified employee (as defined in Treas. Reg. § 1.409A-1(i)) upon a separation from service. This "six-month delay rule" must be incorporated in writing in any nonqualified deferred compensation plan maintained by a publicly traded company or its affiliates that provides for a payment upon separation from service. The final regulations required that the six-month delay rule be reflected in writing in the plan no later than December 31, 2007.

The Notice provides that a plan may be amended as late as December 31, 2008 to include the six-month delay rule, provided that the amendment is made retroactive to January 1, 2008 and the plan is operated in compliance with the rule as of the effective date of the final regulations. Taxpayers must be able to demonstrate that the six-month delay was applied to any affected deferred compensation payments made after the effective date of the final regulations and before the date of the actual amendment. If the employer does not use the default method for identifying specified employees that is set forth in Treas. Reg. § 1.409A-1(i), the employer

must also be able to demonstrate: (i) what method was used by the employer to identify specified employees; and (ii) that the method was applied consistently to all deferred compensation plans and to all employees.

***Q&A-7: What does the delayed deadline for documentary compliance mean in practical terms?***

The most significant benefit of the Notice may be that for 2007, if necessary, one can simply focus on getting on paper the permissible time and form of payment under a plan. In other words, in addition to allowing delayed documentation of initial and subsequent deferral rules and any other necessary plan provisions, the Notice allows some extra time to work out the finer points of provisions setting forth the times and forms of payment, though the basic time and form decisions must still be made and documented in 2007.

One concern that has been raised by commentators is that Board of Directors approval is often needed for a full-blown plan restatement, and for some companies, the last Board meeting of the year is in October or a similar early date. The Notice may also be helpful in dealing with this problem, because, depending on the circumstances, the company's practices and procedures may permit the simple act of adopting a written designation of payment form and timing without Board approval and, consequently, that can occur much later in 2007.

The relief also seems to mean that certain mistakes in drafting plans to comply with section 409A can be cleaned up in 2008, again with the exception of designating the basic time and form of payment in 2007. This may be of more value than it would initially appear, since a document error resulting from hasty year-end drafting could trigger section 409A taxation under all of the "individual plans" of service providers covered by the document, while an operational error should result in tax only on the individual affected.

Finally, as suggested earlier, the manner in which time and form of payment may be designated this year under the Notice allows a residual blanket designation for any agreements constituting section 409A plans that might not be identified until 2008.

## **Specific Applications of the Final Regulations**

The Notice addresses three specific areas of the final regulations that have raised significant questions from commentators or caused difficulties in practical administration. These areas are: (i) changing "good reason" provisions in existing employment agreements during the remainder of 2007; (ii) extending or renegotiating severance provisions of employment agreements; and (iii) applying the cash-out rules in the final regulations.

***Q&A-8: Can a definition of termination for “good reason” that complies with the final regulations be added to an employment agreement or severance plan to cause severance payments to be excluded from the scope of section 409A?***

In some cases, yes. Under the final regulations, amounts paid upon an involuntary termination of employment can be excluded from the scope of section 409A if one or both of two requirements are satisfied. First, if the amount is payable only on an involuntary termination, the right to the payment may be considered to be subject to a substantial risk of forfeiture until the termination occurs. Accordingly, to the extent that the payment is made before the 15<sup>th</sup> day of the third month after the end of the taxable year in which the termination occurs, it will be excluded from the definition of deferred compensation subject to section 409A under the exception for short-term deferrals.

Second, if the benefit under the arrangement is payable only in the event of an involuntary termination, it is excluded from the scope of section 409A to the extent: (i) the payment does not exceed two times the employee’s annualized compensation for the year preceding the year of the employee’s termination or, if less, two times the limit on compensation that can be taken into account under a qualified plan under Code section 401(a)(17) for the year; and (ii) the plan provides that this amount is to be paid by the end of the second taxable year of the employee following the taxable year in which the employee’s termination occurred. The Notice refers to these conditions as the “two-year, two-time rule.”

The final regulations set forth a safe-harbor definition of “good reason” termination that, if satisfied, would allow the employee’s termination to be considered involuntary and cause the amounts payable to be considered subject to a substantial risk of forfeiture until termination of employment. The regulations also include an alternative description of conditions that should achieve the same result, although it is not a safe harbor. The regulations further provide, however, that an amount will not be treated as being subject to a substantial risk of forfeiture if the condition or conditions giving rise to the substantial risk of forfeiture are added after the beginning of the service period to which the compensation relates or if the period for which the substantial risk of forfeiture applies is extended.

The Notice clarifies that the addition or modification of a “good reason” definition to an arrangement that, before the addition or modification would *not* be considered subject to a substantial risk of forfeiture, will not give rise to a substantial risk of forfeiture for purposes of the short-term deferral exception from section 409A. In contrast, if an arrangement is currently subject to a substantial risk of forfeiture, it can be modified, and the change will not be treated as an impermissible extension of the substantial risk of forfeiture, even if the modified conditions change the period during which there is a substantial risk of forfeiture.

On the other hand, if an arrangement would, but for the definition of “good reason,” otherwise meet the two-year, two-time rule, the addition or modification of a “good reason” provision can be effective to cause the payments (or a portion of the payments) to be exempt from section 409A pursuant to the two-year, two time rule exclusion for involuntary separation pay.

Either the modification of an existing substantial risk of forfeiture or the addition of a “good reason” provision to bring an arrangement within the two-year, two-time rule exception to section 409A must be documented in writing by December 31, 2007 (*i.e.*, this year, not next). Also, the modification must not cause any amounts that otherwise would be payable after 2007 to be payable in 2007, or cause any amounts that otherwise would be payable in 2007 to be paid in a later year.

***Q&A-9: Does the Notice provide any relief addressing renegotiations and extensions of employment agreements?***

Although the final regulations do not expressly address the issue, the IRS and Treasury have indicated that the renegotiation of an employment agreement providing for deferred compensation would typically be considered the substitution of one deferred compensation promise for another, with the result that the payment terms for the deferred compensation could not be changed under a new agreement without satisfying the rules for subsequent deferral elections in the final regulations. While the IRS is continuing to study this issue, the Notice provides some relief allowing changes in payments tied to an involuntary termination. Specifically, if deferred compensation payable upon an involuntary termination is at all times forfeitable at the end of the term of the employment agreement, any deferred compensation provided under an extended, renewed or renegotiated agreement will be not be treated as a substitution for the original arrangement.

For instance, assume an employee has a three-year employment contract that provides for installment payments either upon an involuntary termination or upon the expiration of the term if the employer does not extend, renew or renegotiate the agreement but the employee is prepared to continue providing services. In this case, if the employer and the employee agree to a new contract after the initial three-year term, any renegotiated deferred compensation would be considered a substitution, and if the new contract provided for a lump sum payment, there would be a violation of the anti-acceleration rule. If, on the other hand, the original employment agreement did not provide for payment on non-renewal at the end of the term, but provided for payment only upon an involuntary termination of employment during the term, the renegotiated provision would not be a substitution, and the change to a lump-sum form of distribution would not violate section 409A.

***Q&A-10: Can the cash-out rule in the final regulations for amounts in excess of the Code section 402(g) limit be applied on a “snapshot” basis at the time of a payment event?***

A plan provision triggering a cash-out if the participant’s account balance (or the present value of the accrued benefit) is less than a particular dollar amount could be viewed as an impermissible acceleration but for two exceptions under the final regulations. The first exception permits a cash-out of an account balance or benefit with a present value less than the Code section 402(g) limit for the year (currently, \$15,500).

The second exception permits a cash-out of an account or benefit with a value that is less than any predetermined amount, provided (i) the predetermined cash-out threshold is set at the time of the deferral, and (ii) the cash-out provision applies if at *any time* on or after a payment event the account balance or present value of the remaining payments falls below the cash-out threshold. This “predetermined amount” cash-out rule appears to require that the employer continuously monitor the remaining benefit after a payment event to determine if the value has fallen below the cash-out threshold.

For example, suppose a deferred compensation plan provides for a cash-out if the account balance is less than \$50,000, and the employee has an account balance of \$100,000 being paid in 10 annual installments following a separation from service. The predetermined amount cash-out rule would not apply at the time of separation from service because the account balance is in excess of \$50,000. However, in year 6 of the 10-year installment period, the remaining account balance will fall below \$50,000, and the cash-out rule would apply. This is not, of course, how most plan administrators would prefer to apply a cash-out provision.

The Notice indicates that a predetermined amount cash-out that applies only at the time of the payment event (such as separation from service), rather than continuously after the event, would not meet the requirements of the existing exception under the final regulations. However, the Notice says that this type of cash-out provision *could* be viewed as an objectively determinable and nondiscretionary payment schedule under Treas. Reg. §1.409A-3(b). The Notice states that under this interpretation of the regulations, until further guidance on the topic is issued, a predetermined amount cash-out can be applied solely at the time of the payment event, regardless of whether the account balance or present value of the remaining payments later falls below the cash-out threshold.

The Notice also expresses concern, however, that this type of predetermined amount cash-out provision could be subject to abuse; therefore, the taxpayer must be able to demonstrate that the cash-out was operated in an objective, nondiscretionary manner and without having the effect of giving the employee or the employer the ability to make a late payment election.

The Notice further provides that a cash-out provision with a predetermined amount greater than the section 402(g) limit would not cause an installment or annuity payout to fail to be treated as an installment or annuity payout for purposes of the application of the subsequent deferral rules.

## Voluntary Compliance Program

Since the release of the final regulations, Treasury and the IRS have informally requested comments on the need for a voluntary compliance program correcting unintentional failures to comply with section 409A. The Notice indicates that a limited correction program will be forthcoming “in the near future.” According to the Notice, the program will permit the correction of operational plan failures only, not failures to amend plan documents. The Notice says it is anticipated that the program will permit the correction of unintentional operational failures in the same year that the failures occurred to avoid section 409A, and, for subsequent years, will provide for additional methods for correcting such operational failures that may result in only limited amounts becoming includible in income and subject to additional taxes under section 409A.

## Application of Restrictions on Certain Trusts

Section 409A(b) generally causes assets in a rabbi trust or similar arrangement to be immediately taxable to the employee if the assets are held with respect to vested nonqualified deferred compensation; and

- The assets are held in an offshore trust;
- The assets become restricted to the payment of deferred compensation in connection with a change in the employer’s financial health; or
- The assets are transferred to a rabbi trust or are otherwise restricted to the payment of deferred compensation during periods when the employer’s defined benefit plan does not satisfy certain funding levels.

Notice 2006-33 provided that taxpayers could rely on a reasonable, good faith interpretation of these rules until further guidance is issued. Notice 2007-78 states that taxpayers can continue to rely on a reasonable, good faith interpretation pending further guidance. The Notice also provides that as to “grace period assets” (*i.e.*, certain assets set aside for nonqualified deferred compensation before March 21, 2006), taxpayers still have until December 31, 2007 to bring deferred compensation plans into compliance with the rules noted above, but no additional extension of time is being granted.





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