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Employee Benefits

A Littler Mendelson Newsletter

IRS Extends Section 409A Documentation Deadline – Action Still Required By December 31, 2007

By Steven J. Friedman, J. René Toadvine, and Russell D. Chapman

On September 10, the IRS released Notice 2007-78 extending the deadline for documentary compliance with Section 409A of the Internal Revenue Code from December 31, 2007 to December 31, 2008. Section 409A imposes significant rules related to deferred pay arrangements that became effective January 1, 2005. Final regulations relating to these rules were released earlier this year and provide that pay arrangements are required to be in "good faith compliance" with the rules through the effective date of the regulations, January 1, 2008. Additionally, under the rules, certain substantive changes in the form and timing of distributions under a deferred pay arrangement are permitted to be made through December 31, 2007.

Significantly, Notice 2007-78 extends only the date for documentary compliance. As a result, with respect to certain plan rules, there is the need for certain written terms to be in place before 2008. Further, the Notice does not extend the date upon which full operational compliance with these rules is required – that is still January 1, 2008. In other words, the good faith compliance period ends December 31, 2007.

Accordingly, employers still are urged to review all deferred pay arrangements by December 31, 2007 and make any changes needed by such date.

Notice 2007-78 clarifies how the extension of time to amend operates in connection with the rules mandating earlier operational compliance. The most salient aspects of this guidance are discussed below.

Designation of Time and Form of Payment

The Notice mandates that **prior to January 1, 2008**, existing deferred pay arrangements must designate in writing a compliant time and form of payment (e.g., a lump sum upon separation from service). This rule will be complied with even if certain non-compliant forms of payment are embodied in the arrangement and those non-compliant provisions are removed by December 31, 2008.

An example of this would be a plan which provides for a compliant time and form of payout but also contains an impermissible employee election to receive all or a portion of his or her account at any time so long as a portion of the withdrawal is forfeited (e.g., a "haircut" provision). Provided the haircut provision is removed by December 31, 2008 and is not permitted to be utilized before that date, it is not impermissible for its terms to remain in the arrangement currently.

Designations Permissible Regarding Payment Events

The Notice provides that plans may be amended by December 31, 2008, to provide for a payment upon a permissible payment event, such as the service provider's separation from service, disability upon a change in control event, or upon an unforeseeable emergency, as those terms are defined in the

final regulations, as long as the plan is operated in full compliance with the final regulations during the interim, including the selection of a “default” or alternative definition of a payment event under the plan.

For example, the final regulations provide that a “default” definition of whether a separation from service has occurred is when a service provider’s level of services is less than 20% of the level of services provided for the preceding 36 months. An employer is permitted to elect to have another percentage apply, up to 50%. The regulations clarify that if no designation has been made, either the default level or an alternative level could be retroactively adopted by the end of 2008.

Designation of Specified Payment Date or Fixed Payment Schedule

Plans must comply with the final regulations regarding specified payment dates or fixed payment schedule by the original compliance date of December 31, 2007. These provisions relate to payments at a specified time or under a fixed schedule, formula-based or fixed limitations, mirror timing rules based on receipt of payments by the service recipient, reimbursement or in-kind benefit plans and tax gross-up payments. However, the Notice allows plans to add a provision by the end of 2008 that permits such a payment to be made on or before the end of a service provider’s tax year that relates to the event that triggers the payment (such as death, disability or separation from service). Also, the Notice provides that plans may be amended to permit a payment date that is up to 90 days after a permissible payment event.

Retroactive Amendments Relating to Six-Month Delay for Specified Employee Payments

The final regulations clearly provide that any six-month “hold” on payments to a “specified employee” on account of his or her separation from service must be part of a written plan document. Notice 2007-78 provides that, so

long as the plan complies with the specified employee six-month delay requirement before and/or during 2008, and otherwise complies with the final regulations, it may be amended on or before December 31, 2008, to provide for the six-month delay rule.

The final regulations provide for default and alternative provisions in the identification and determination of the specified employee group. For example, the default “specified employee identification date” on which the specified employee group is identified is December 31 of each year. The default “specified employee effective date” is the first day of the fourth month following the “specified employee identification date.” The service recipient may designate a different, alternative “specified employee identification date” under the final regulations. Changes in this date may not take effect for at least 12 months after the change is made.

The Notice clarifies the final regulations by stating that alternative means to identify specified employees (such as the alternative “specified employee identification date” or the “specified employee effective date”) may be used but must be applied consistently. If not, the IRS on audit will determine the specified employee group by reference to the default provisions and assess penalties accordingly.

Thus, unless there is a reasonably compelling justification for a service recipient to use alternative provisions, it may be advisable to use the default provisions under the final regulations to determine specified employees. If alternative provisions are used, the service provider should take extra care and caution to be scrupulously consistent in the application of those alternative provisions. This is particularly the case considering that the exclusion from the list of specified employees of one who should have been included may correspondingly cause the inclusion on the list of an employee who should not have been.

Employment Agreements

In drafting employment agreements, it is important to consider the impact of 409A on any severance benefit that may be paid to the executive upon such executive’s separation from service. Key to this consideration is whether the executive’s right to the severance

pay is conditioned upon the executive incurring an involuntary termination. In such a case, it may be possible to exempt all or part of such payments from 409A under either the short-term deferral rule or the severance pay exception. Under the final regulations, the IRS provides that certain “good reason” terminations will be treated as involuntary terminations. Notice 2007-78 provides that, with respect to an existing employment agreement that provides the executive with a right to a severance payment upon a “good reason” termination, where such right currently is subject to a substantial risk of forfeiture (such as another payout trigger which must be satisfied before the “good reason” trigger can be satisfied) the revision of such “good reason” provision on or before December 31, 2007, to conform with the final regulations will not result in the right ceasing to be subject to a substantial risk of forfeiture. However, where such right to a severance payment currently is not subject to a substantial risk of forfeiture, the modification of such an existing “good reason” provision in an effort to have the “good reason” termination be treated as an “involuntary termination” under the final regulations will not cause the amount to become subject to a substantial risk of forfeiture.

Also, Notice 2007-78 provides that, pending further guidance, if a right to deferred compensation is payable only upon an involuntary termination and under the employment agreement, such deferred compensation will be forfeited at the end of the term of the employment agreement. The grant of deferred compensation under a renewed, extended or renegotiated employment agreement will be deemed to be a new legally binding right to compensation and not a substitute for the previously granted deferred compensation. Conversely, if the deferred compensation was not at all times subject to forfeiture, the grant of deferred compensation under a renewed, extended or renegotiated employment agreement will be deemed to be a substitute for the previously granted deferred compensation.

Cashouts

Pending future guidance, Notice 2007-78 allows a taxpayer to cashout an individual’s deferred compensation benefit after termination of employment once the benefit falls

below a certain level, provided the distribution and acceleration of payment requirements set forth in the Final Regulations are satisfied.

Limited Voluntary Compliance Program

In Notice 2007-78, Treasury and the IRS announce that a limited voluntary compliance program will be established soon that will apply to certain unintentional operational failures to comply with 409A. Much like EPCRS for qualified retirement plans, Treasury and the IRS anticipate that the program will provide methods by which certain compliance failures may be corrected within the tax year in which the failure occurs to avoid 409A and other methods by which certain failures will result in only limited amounts being included in income and subject to penalty taxes under 409A.

Restrictions on Use of Offshore Trusts and Other Arrangements

Finally, Notice 2007-78 provides that certain relief from the 409A rules relating to the use of offshore trusts and other arrangements, which relief was provided by Notice 2006-33, is not being extended. As a result, effective January 1, 2008, taxpayers must comply with a reasonable, good faith interpretation of the 409A rules relating to the use of various funding arrangements.

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