

## **IRS Extends Section 409A Document Compliance Due Date Until December 31, 2008 with Significant Limitations; Action Required by December 31, 2007**

**September 12, 2007**

On Monday, September 10, in Notice 2007-78 (the Notice), the IRS granted companies sponsoring deferred compensation plans limited additional transition relief for bringing documents into compliance with section 409A of the Internal Revenue Code of 1986, as amended (the Code). However, the relief granted in the Notice falls well short of the full one-year extension requested by numerous law firms and business groups. Instead, the Notice requires largely permanent election and documentation of applicable payment provisions by December 31, 2007 and extends only the deadline for documentation of plan details from December 31, 2007 to December 31, 2008, subject to significant conditions described below.

Section 409A of the Code imposes a number of complex substantive and procedural requirements on deferred compensation plans, which, under some circumstances, include severance plans, equity compensation plans, executive employment agreements, and other arrangements that do not fall within the typical scope of a deferred compensation plan. Violations of section 409A may cause imposition of a 20% additional income tax to the employee, in addition to income tax at ordinary rates on the income in question, and incremental interest.

Despite the benefit of the documentary compliance extension to December 31, 2008 granted by the Notice, we continue to be concerned that clients and their advisors will be unable to complete the actions necessary under the Notice by December 31, 2007. We believe that it is unlikely that any plan sponsor will be able to avoid taking action between now and December 31, 2007 under this Notice with respect to their deferred compensation plans. In some cases, the required action will necessitate a complete review and potential reconsideration of the relevant plan or arrangement, negotiation of a revision, and review and approval by the relevant committee or corporate board. Accordingly, we suggest that plan sponsors review these requirements carefully and focus immediately on what needs to be done by year end 2007.

### 1. Notice 2007-78 Guidance—In General

The Notice provides limited, additional transition relief for satisfying the documentary compliance requirements of section 409A by extending the deadline until December 31, 2008. Under the guidance, plan sponsors are required to take the following actions no later than December 31, 2007:

- Provide a written designation for each plan of a section 409A compliant time and form of payment.
- Specify a payment date or fixed schedule for payments after a 409A permissible payment event, with certain exceptions.

Details of these conditions are set forth below in Sections 2 and 4, respectively.

The Notice reiterates that, as of January 1, 2008, deferred compensation plans must be operated in compliance with the requirements of section 409A, and that the final section 409A regulations become fully applicable, with little change by the Notice, on that date. As a result, as of January 1, 2008, plan sponsors may no longer rely on a reasonable, good-faith interpretation of section 409A of the Code, but instead will be required to comply with the specific requirements of the final regulations, which are generally more specific and less taxpayer-friendly. Further, the transitional election provisions set forth in IRS guidance, which generally allow taxpayers significant latitude to change distribution elections prior to December 31, 2007, will no longer be applicable.

## 2. Designation of Compliant Time and Form of Payment by December 31, 2007

The Notice requires that, as to any deferred compensation amounts subject to section 409A, a written designation must be made not later than December 31, 2007 specifying a time and form of distribution that complies with section 409A. This written designation requirement requires plan sponsors to make significant decisions as to timing and form of distribution by year-end. The timing and form of distribution selected is binding and thus cannot be changed in 2008 or later years (except pursuant to the second election rules under Section 409A); as a result, this election is an important exercise even in a relatively straightforward case.

As to amounts subject to section 409A held in more typical deferred compensation plans, it may be possible to address the written designation of time and form of payment requirement through a plan amendment of general applicability (either addressing all plans maintained by the plan sponsor in the aggregate or setting forth specific rules on a plan-by-plan basis), providing, for example, that all distributions will be made on termination of employment and in the form of a lump sum. However, even in this fairly straightforward approach, the determination will require significant internal review and significant decisions by plan sponsors that will not necessarily be easy to obtain by December 31, 2007.

The Notice is clear that a plan will only provide for a compliant time and form of payment if the plan provides for an “objectively determinable form of payment” made upon one (or more) of the six permissible distribution events under section 409A: (1) separation from service, (2) change in control, (3) unforeseeable emergency, (4) a specified date or fixed schedule of payments, (5) death, or (6) disability. Neither the employer nor the employee may retain discretion with respect to the form and timing selected.

Viewed in that context, the task facing employers with employment, severance, or change-in-control agreements is daunting. Each of these agreements will need to be reviewed, and a proposed determination addressing form and timing of distributions under each agreement will need to be prepared by the company, reviewed by the compensation committee or the board of

the company (if necessary), and negotiated with the employee covered by the agreement—all by December 31, 2007.

3. Retroactive Adoption of Permissible Payment Event Definitions

The Notice provides plan sponsors with some degree of flexibility with respect to adoption of specific definitions of permissible distribution events. Under the Notice, employers need not adopt specific definitions of these events by December 31, 2007 as long as the final plan documents comply with section 409A by December 31, 2008, and the plan is operated in conformity with the final regulations on and after January 1, 2008. Thus, for example, the employer retains the ability to adopt in 2008 either a default definition or an otherwise compliant definition of the event in question (e.g., good reason or change in control) and that decision need not be reached by December 31, 2007. Put another way, the determination as to timing and form of distribution required to be reached by December 31, 2007 is not required to set forth definitions of the operative events.

4. Designation of a Specified Payment Date or Fixed Payment Schedule

Another requirement specified by the Notice is that the plan must adequately address the specified payment date or fixed schedule for payments after a permissible event not later than December 31, 2007. This requirement may necessitate a specific plan amendment by December 31, 2007 to spell out the relevant timing requirements of section 409A (e.g., to add specific language addressing the exact date of payment or designate that each installment payment is a separate payment for purposes of section 409A). However, the Notice provides relief in a limited number of cases that will allow this amendment to be made by December 31, 2008 (e.g., specification that tax gross-up payments be made by the end of the recipient's tax year next following the tax year in which the related taxes are paid), again, as long as all required document changes are made by December 31, 2008.

5. Six-Month Delay of Payments to Specified Employees

The Notice allows retroactive amendment of deferred compensation plans to insert the six-month waiting period for distributions to specified employees in a public company, provided that the amendment is made by December 31, 2008 and the plan had been operated in conformity with the amendment ultimately adopted. In particular, if the sponsor desires to use any definition with respect to the specified employee definition other than the default definitions set forth in the final regulations under section 409A, the sponsor must be able to demonstrate compliance with the alternative method used.

6. Good-Reason Definition in Employment Agreements

The Notice also provides somewhat helpful comments on the issue of amending good-reason definitions in employment agreements so as to qualify severance payments for exceptions from the six-month wait requirement. The issue is whether modifications to the existing good-reason definition would be viewed as an addition of a substantial risk of forfeiture to an existing payment right, since under the final regulations such an addition would be disregarded.

The Notice provides two answers to the issue: (1) to the extent that the payment right subject to an existing good-reason provision is itself subject to a substantial risk of forfeiture the modification of the good-reason definition will be given effect; however, (2) if the payment right is already vested, then the modification will not be given effect.

7. Substitution Rule for Employment Agreements

The Notice also addresses whether modifications to existing rights to deferred payments in the context of a new or extended employment agreement will constitute a new binding right to compensation (as to which new payment terms can apply) rather than a substitution (as to which any modification could violate section 409A). The Notice concludes that if a right to deferred compensation payable only on involuntary termination under the agreement would be automatically forfeited at the end of the term of employment, then the grant of a new right to deferred compensation in a new or extended employment agreement will not be viewed as a substitute.

8. Predetermined Cashouts

The Notice clarifies that a plan may provide for a lump-sum payment at the relevant payment date under an installment payout only if the present value of the installments is below a specified amount; otherwise, the installment payment schedule will apply. The Notice observes that the final regulations do not clearly permit this sort of payment, but pending further guidance, the IRS will permit this approach if used in an objective, nondiscretionary manner that does not effectively grant either the company or the recipient a right to a late election as to time or form of payment.

9. Voluntary Compliance Program

Responding to a number of commentators who have requested that the IRS implement a voluntary compliance program for section 409A issues that would operate in a manner similar to the voluntary compliance program for qualified plans, the Notice states that the Treasury Department and IRS anticipate instituting such a program to deal with unintentional operational defects under section 409A. The Notice seems to contemplate a limited program that would apply, for example, only to errors sought to be corrected in the same taxable year as made. The program may also permit taxpayers to resolve instances of unintentional noncompliance on a favorable basis.

10. Restrictions of Foreign Trusts and Credit-Downgrade Circumstances

Section 409A(b) generally prohibits use of certain offshore trusts to fund deferred compensation and also prohibits use of nonqualified plan assets in connection with a change in the plan sponsor's credit rating or to pay benefits while the sponsor's qualified defined benefit plan is underfunded or "at risk" or the plan sponsor is bankrupt. Failure to satisfy these requirements results in the trust assets being treated as property transferred to the employees in connection with performance of services (and includible in the employees' income), regardless of whether such assets are subject to the claims of general creditors, along with the imposition of the 409A 20% additional income tax and incremental interest. Notice 2006-33 permitted taxpayers to rely on a reasonable, good-faith interpretation of section 409A(b) in determining whether the use of

a trust or other arrangement causes an amount to be included in income under section 409A, and provided limited transition relief to bring “grace period assets” (i.e., amounts transferred or set aside on or before March 21, 2006) into compliance with section 409A(b) by December 31, 2007.

Notice 2007-78 extends the reasonable, good-faith standard in this area until the IRS issues further guidance. However, as to grace period assets, income inclusion under section 409A will be required as of January 1, 2008 if the plan is not in conformity with a reasonable, good-faith interpretation of section 409A(b) on December 31, 2007.

If you would like assistance evaluating your plans and other arrangements or taking any necessary action, please contact your regular Morgan Lewis attorney or any of the following:

**Chicago**

Brian D. Hector 312.324.1160 [bhector@morganlewis.com](mailto:bhector@morganlewis.com)

**Dallas**

Riva T. Johnson 214.466.4107 [riva.johnson@morganlewis.com](mailto:riva.johnson@morganlewis.com)  
Heath Miller 214.466.4118 [hmillier@morganlewis.com](mailto:hmillier@morganlewis.com)  
Erin Turley 214.466.4108 [eturley@morganlewis.com](mailto:eturley@morganlewis.com)

**New York**

Craig A. Bitman 212.309.7190 [cbitman@morganlewis.com](mailto:cbitman@morganlewis.com)  
Gary S. Rothstein 212.309.6360 [grothstein@morganlewis.com](mailto:grothstein@morganlewis.com)

**Palo Alto**

S. James DiBernardo 650.843.7560 [jdibernardo@morganlewis.com](mailto:jdibernardo@morganlewis.com)  
Zaitun Poonja 650.843.7540 [zpoonja@morganlewis.com](mailto:zpoonja@morganlewis.com)

**Philadelphia**

Robert L. Abramowitz 215.963.4811 [rabramowitz@morganlewis.com](mailto:rabramowitz@morganlewis.com)  
I. Lee Falk 215.963.5616 [ilfalk@morganlewis.com](mailto:ilfalk@morganlewis.com)  
Amy Pocino Kelly 215.963.5042 [akelly@morganlewis.com](mailto:akelly@morganlewis.com)  
Robert J. Lichtenstein 215.963.5726 [rlichtenstein@morganlewis.com](mailto:rlichtenstein@morganlewis.com)  
Vivian S. McCardell 215.963.5810 [vmccardell@morganlewis.com](mailto:vmccardell@morganlewis.com)  
Joseph E. Ronan 215.963.5793 [jronan@morganlewis.com](mailto:jronan@morganlewis.com)  
Steven D. Spencer 215.963.5714 [sspencer@morganlewis.com](mailto:sspencer@morganlewis.com)  
Mims Maynard Zabriskie 215.963.5036 [mzabriskie@morganlewis.com](mailto:mzabriskie@morganlewis.com)  
David B. Zelikoff 215.963.5360 [dzelikoff@morganlewis.com](mailto:dzelikoff@morganlewis.com)

**Pittsburgh**

John G. Ferreira 412.560.3350 [jferreira@morganlewis.com](mailto:jferreira@morganlewis.com)  
R. Randall Tracht 412.560.3352 [rtracht@morganlewis.com](mailto:rtracht@morganlewis.com)

**San Francisco**

Mark H. Boxer 415.442.1695 [mboxer@morganlewis.com](mailto:mboxer@morganlewis.com)  
Eva P. McComas 415.442.1249 [emccomas@morganlewis.com](mailto:emccomas@morganlewis.com)

**Washington, D.C.**

Althea R. Day

202.739.5366

[aday@morganlewis.com](mailto:aday@morganlewis.com)

Daniel L. Hogans

202.739.5510

[dhogans@morganlewis.com](mailto:dhogans@morganlewis.com)

Gregory L. Needles

202.739.5448

[gneedles@morganlewis.com](mailto:gneedles@morganlewis.com)

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