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Client Alert

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IRS Issues Limited Relief Regarding 409A Compliance; Action Still Required By December 31, 2007

The IRS has issued limited transitional relief on the application of Section 409A of the Internal Revenue Code of 1986, as amended, to non-qualified deferred compensation plans. The limited transitional relief, set forth in Notice 2007-78 (the "Notice"), extends to December 31, 2008 the deadline to adopt plan documents that fully comply with Section 409A.

Despite this limited relief, amendments may still need to be made in 2007, and all plans, contracts and other compensatory arrangements will still need to be reviewed by that date to determine what changes are necessary. Prior to January 1, 2008, when the final regulations under Section 409A become effective, each plan must specify in writing the time and form of payment for all payments of "deferred compensation" covered by Section 409A. Thereafter, changes are generally permissible only in accordance with the strict requirements of Section 409A and the final regulations (or as otherwise set forth in the Notice).

- **Accordingly, the broad range of "plans" potentially subject to Section 409A – not only traditional deferred compensation and non-qualified retirement plans, but also long-term incentive and equity-based plans, employment and severance agreements – still must be reviewed and in many cases amended on or before December 31, 2007 to ensure compliance with this requirement.**

- **Additionally, covered plans must be operated in full compliance with the final regulations under Section 409A beginning as of January 1, 2008, and reliance on Notice 2005-1, the proposed regulations, and/or a good faith interpretation of the statute will no longer be permissible. Although in some cases companies will have until December 31, 2008 to make formal retroactive amendments to plan documents, most companies will still need to make plan design decisions prior to 2008.**

The Notice did not extend the transitional relief available through December 31, 2007 allowing new elections to time and form of payments of existing deferred compensation arrangements subject to certain requirements (i.e., no acceleration into 2007 or extension of payment of amounts otherwise payable in 2007). Any such changes, consistent with Notice 2006-79, must be made before the end of 2007. In addition, the Notice did not extend the "good faith" transition period.

In addition, the remedial deadline of December 31, 2007 for "grace period assets" offered by Notice 2006-33, regarding certain assets set aside, transferred or restricted before March 21, 2006 has not been extended. Beginning on January 1, 2008, companies must comply with a reasonable, good-faith interpretation of the statute prohibiting offshore rabbi trusts and similar arrangements and restrictions on assets to protect benefits when an company's financial health changes.

The Notice does clarify certain ambiguities in the final regulations. Furthermore, the Notice indicates that the Treasury Department and the IRS anticipate a "voluntary compliance program" to permit taxpayers to correct certain unintentional operational violations of Section 409A, but only in the same taxable year in which the violation occurs. Guidance regarding the proposed VCP program the IRS indicated is anticipated "in the near future".

Specifying a Compliant Time and Form of Payment

On or before December 31, 2007, plans subject to Section 409A must designate in writing a compliant time and form of payment for payments of deferred compensation – i.e., separation from service, change in control event,

unforeseeable emergency, a specified date or fixed schedule of payments, death or disability. Such designation may be in a separate written document.

The time and form of payment must be objectively determinable. Generally, any impermissible discretion to determine time and form of payment (*i.e.*, discretion regarding year of payment, or an election regarding lump sum versus installments payments) would need to be deleted from deferred compensation plans prior to December 31, 2007. If a payment trigger – for example, payment of deferred compensation upon a change in control event – is not specified in writing prior to December 31, 2007, such payment trigger may not be added to the arrangement in 2008 or later, except in accordance with the strict "subsequent deferral" requirements of Section 409A (i.e., the new trigger may not take effect for one year; payments subject to a fixed schedule must be delayed for an additional five years and must be made one year in advance of time payment would otherwise be made). If a plan does not specify prior to December 31, 2007 whether installment payments are to be treated as a single payment or series of payments for purposes of applying the "subsequent deferral" rules, the default rule of treating installment payments as a single payment will apply.

A plan will not fail to comply with Section 409A during 2008 merely because of certain non-compliant provisions in written plan documents, provided that the plan is operationally compliant with the final regulations. Plan amendments to delete non-compliant provisions, such as a "haircut" provision allowing a participant to elect to accelerate the payment of deferred compensation subject to the forfeiture of a portion of such amount, are not required until the full documentary compliance date of December 31, 2008. Certain minor changes to comply with the final regulations – *e.g.*, amending an existing provision designating a lump sum payment following a "separation from service" to provide that payment may be made on or before the 90 day period following such separation in the sole discretion of the service provider – will not be treated as impermissible changes in the time and form of payment if made on or prior to December 31, 2008.

Definitions such as "separation of service", "change in control event", "unforseeable emergency" or "disability" do not need to be formally amended to comply with the final regulations until December 31, 2008, provided that such amendments are retroactive to January 1, 2008 and accurately reflect the actual operation of the plan during 2008. However, in many instances, companies will need to make policy decisions prior to such deadline for written compliance – for example, determining what level of reduction of services will trigger a "separation of service" applicable to its plans (e.g., either the default rule of less than 20% of services, or some other threshold of between 20% and 50%).

The six month delay rule for payments of deferred compensation upon separation from service applicable to certain key employees of public companies must be set forth in plan documents by December 31, 2008, retroactive to January 1, 2008, and must accurately reflect the actual operation of the plan during 2008. Unless companies specify a different determination date, the determination of who qualifies as a "key employee" will be made as of the default date of each December 31, applicable as of April 1 of the following year.

Amending Good Reason Provisions

The final regulations generally provide that separation payments conditioned on a service provider's involuntary separation from service may qualify for certain delineated exceptions from Section 409A (i.e., the short term deferral rule and the two-time, two-year rule). The final regulations provide that good reason terminations may be treated as involuntary separations from service in certain instances, and provide a safe harbor for this purpose.

Prior to the Notice, some uncertainty existed whether, if an employment agreement was revised to conform with the final regulations' good reason conditions, such amendment could be construed as the addition or modification of a substantial risk of forfeiture condition that may not be respected for purposes of Section 409A . The Notice clarifies that taxpayers may revise a good reason definition to conform with the final regulations so long as the revisions are made on or before December 31, 2007 and provided that a substantial risk of forfeiture exists.

Replacement Employment Agreements

Under the final regulations, any payment that replaces a payment of deferred compensation under a separate arrangement is generally considered deferred compensation subject to Section 409A. It was unclear how this rule applied to the extension of an employment agreement or the negotiation of a new agreement. The Notice provides that the grant of deferred compensation in an extended, renewed or renegotiated agreement is not a substitute for deferred compensation under the previous agreement if, at the end of the employment term of the previous agreement, the right to deferred compensation payable upon an involuntary separation from service is automatically forfeited. On the other hand, if the failure of the employer to renew an employment agreement is a severance-inducing event, a new employment replacing the agreement may be viewed under Section 409A as a substitution for the right to severance in the original agreement and would need to be drafted accordingly.

Predetermined Cashouts

Section 409A permits the lump sum cashout of remaining installment payments if the present value of the remaining payments is lower than a specified threshold. Commentators asked whether a plan may permit the cashout threshold to be applied only at the original payment date, and not at a later time when the remaining payments may fall below the threshold. The Notice clarifies that, until further notice, if the cashout threshold is fixed at the time a permissible payment date is designated,

such provision applying the cashout threshold only at the original payment date may be treated as part of an objectively determinable and nondiscretionary payment schedule. The payment schedule must otherwise meet the requirements of the final regulations, and the taxpayer must be able to demonstrate that such provision operated in an objective, nondiscretionary manner and did not create rights to a late election as to time and form of payment. Until further notice, the classification of the payments under such an arrangement as either a single payment or a series of installment payments for purposes of applying the subsequent deferral rules under 409A is determined as if the cashout threshold were not available.

Summary

Notwithstanding the new December 31, 2008 date, every traditional deferred compensation plan, employment agreement, severance arrangement, and equity plan must be reviewed and most likely amended by December 31, 2007. We would be glad to assist you in reviewing these arrangements.

Please see our Client Alert recently sent out regarding the need to review arrangements for 409A compliance by December 31, 2007, available on our website at http://www.proskauer.com/news_publications/client_alerts/content/2007_09_05.

A more detailed explanation of the final regulations under Section 409A can be found in our Client Alert available on our website at http://www.proskauer.com/news_publications/client_alerts/content/2007_04_30.

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Client Alert

Proskauer's Employee Benefits and Executive Compensation Law Practice Group includes over 50 attorneys with significant and diverse tax, executive compensation and employee benefits law experience. The following individuals serve as contact persons with respect to this Client Alert and would welcome any questions you might have:

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