GROOM LAW GROUP

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IRS Again Extends Section 409A Transition Period

In response to repeated pleas from various law firms and other organizations, on October 22nd, the IRS issued Notice 2007-86, generally extending through 2008 the transition relief that applies in 2007 under Internal Revenue Code section 409A. We summarize below the key portions of the new Notice and its impact on employers and employees.

We also address below Notice 2007-89, which was issued on October 23rd and grants relief from the reporting of annual amounts deferred (Code Y) on 2007 Forms W-2.

Background on Section 409A

On April 10, 2007, the IRS issued final regulations under section 409A (the "Final Regulations").[1] The Final Regulations address in detail the scope of section 409A and provide the rules for deferral elections and distributions under plans subject to section 409A. The Final Regulations did not extend the "transition period" for section 409A compliance. Instead they required full documentary and operational compliance by December 31, 2007.

Following issuance of the Final Regulations, the business and legal communities requested that the IRS extend the transition period so that companies could have more time to make design decisions, have those decisions approved at the appropriate level and then commit the new designs to writing. In response, the IRS last month provided very limited transition relief for 2008 in Notice 2007-78. Interested parties again made clear that further transition relief was needed. Notice 2007-86 is the IRS' response to this second round of requests.

Plan Amendment Deadline and Operational Compliance

Transition guidance that applied prior to 2008 provided that a plan would not be treated as violating the requirements of section 409A if:

- the plan was operated in reasonable good faith compliance with the provisions of the statute and guidance issued by the IRS; and
- the plan was amended by the end of the transition period to conform to the provisions of section 409A.

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[1] 72 Fed. Reg. 19233 (Apr. 17, 2007). For summaries of previous IRS guidance under section 409A, including the Final Regulations, please see http://www.groom.com/_library/ExecutiveCompensation.html.

Notice 2006-79 most recently extended this good faith compliance period and the deadline for amending plans to December 31, 2007. That Notice also provided that compliance with the proposed or final regulations was not required for good faith compliance prior to 2008; however, such compliance would be deemed good faith compliance.

The new Notice extends the deadline for amending plans to December 31, 2008 and effectively continues the reasonable good faith compliance period through 2008 with the following slight modifications:

- A plan must be operated in compliance with section 409A and guidance that is effective before 2008 (i.e., Notice 2005-1, but not the final regulations).
- To the extent an issue is not addressed in such guidance, the plan must be operated consistent with a reasonable good faith interpretation of section 409A.
- Compliance with the final regulations will constitute such reasonable good faith compliance.
- The proposed regulations can not be relied upon for reasonable good faith compliance after 2007.

Other Transition Relief Extended

The new Notice also provides continued relief through 2008 in a number of important areas:

- The transition relief allowing distributions under qualified plans to control distributions under nonqualified plans (so called "piggyback plans") continues. Note that similar relief does not apply to deferral elections under qualified plans.
- Employers and plan participants continue to have the ability to change the distribution provisions for amounts subject to section 409A without complying with certain 409A distribution rules (within certain limits).
- Stock options and stock appreciation rights (SARs) that are subject to section 409A (e.g., discounted options) may generally be replaced with exempt options or SARs or revised to provide fixed payment terms.
  - This relief was available only through 2006 for discounted grants made to section 16 officers and directors of public companies that were not properly accounted for (i.e., appropriate expense not recorded) on a timely basis.

With these extensions, plan sponsors should have time to make and implement all of the necessary design decisions before the new December 31, 2008 deadline.

"Good Reason" Provisions

Two key exemptions from section 409A can apply to severance payments if they are payable only upon involuntary termination (the short-term deferral and the "two times pay" exemptions). The Final Regulations allow terminations on account of "good reason" to be deemed involuntary for purposes of these rules if certain requirements are met. Thus, many employers have considered modifying employment and change in control arrangements that contain good reason payment triggers to meet these requirements. However, IRS personnel have expressed concern as to whether an arrangement may be amended even during the transition period to do so.

Notice 2007-78 issued in September stated that such a modification will work if: (i) amounts payable under an arrangement are currently subject to a substantial risk of forfeiture (e.g., the severance is only payable if a change in control occurs first); and (ii) the modification is made by the end of 2007. The new Notice provides that these changes can be made in 2008 as well.

Other Guidance in Notice 2007-78

The other guidance in last month's Notice 2007-78 on pre-determined cashout features, substitution issues with employment agreements, and the section 409A(b) funding restrictions is not affected by the new Notice. And the IRS reiterates in the new Notice that guidance will be forthcoming as soon as possible on the correction program mentioned in Notice 2007-78.

Relief on Reporting Requirements

Notice 2007-89 was issued on October 23rd and applies to 2007 Forms W-2 the relief from the section 409A reporting requirements that applied to 2006 Forms W-2. Specifically, the reporting of annual amounts deferred (Code Y) will not be required for 2007 Forms W-2, but reporting of amounts includible due to 409A violations (Code Z) will be required.

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Please call one of the following, or the Groom attorney you regularly contact, if you have any questions about these two IRS Notices or their impact on your executive compensation arrangements.

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