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# Strasburger Tax Strategies

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## 409A News Flash: Treasury and IRS Do About Face And Fully Postpone Effective Date of Final 409A Regulations Until January 1, 2009

### 409A "Good Faith" Compliance Period For Operational As Well As Documentary Compliance Now Extended Through December 31, 2008

On Monday, October 22, 2007, the Treasury Department and the Internal Revenue Service acceded to private sector pleas to fully postpone until January 1, 2009 the effective date of the final regulations under IRC § 409A published on April 10, 2007 (the "Final 409A Regulations"). Thus, taxpayers will now generally be entitled in 2008, as they have been in 2005, 2006, and 2007,<sup>1</sup> to rely for compliance with IRC § 409A on a "reasonable good faith" interpretation of the provisions of IRC § 409A, Notice 2005-1, and other generally applicable guidance.

Notice 2007-86 provides that, for periods before January 1, 2008, compliance with either the proposed IRC § 409A regulations<sup>2</sup> or the Final 409A Regulations will be considered reasonable good faith compliance with IRC § 409A, and that, for periods after December 31, 2007 and before January 1, 2009, compliance with the provisions of the Final 409A Regulations will be considered reasonable good faith compliance with IRC § 409A; however, compliance with either the proposed IRC § 409A regulations before 2008 or the Final 409A Regulations in 2008 or before is not required for reasonable good faith compliance with IRC § 409A before January 1, 2009.

Treasury and IRS had earlier postponed, until December 31, 2008, the requirement to amend nonqualified deferred compensation plans to bring them into formal documentary compliance with the requirements of the Final 409A Regulations,<sup>3</sup> but had not extended the January 1, 2008 effective date for operational compliance with the Final 409A



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Regulations. The resulting split deadlines for operational and documentary compliance with the Final 409A Regulations were widely criticized. The latest guidance, Notice 2007-86, again synchronizes the deadlines for operational and documentary compliance with the requirements of the Final 409A Regulations.

### **Notice 2007-86 Revokes the Notice 2007-78 Requirement to Designate the Time and Form of Payment of a Nonqualified Deferred Compensation Benefit In Writing Before January 1, 2009**

Reasonable good faith compliance with IRC § 409A will generally require that payment of a nonqualified deferred compensation plan benefit only be made based on one of the six permissible IRC § 409A payment events (separation from service, death, disability, change in control, unforeseeable emergency, or a date specified at the time of deferral). However, Notice 2007-86 revokes the requirement of Notice 2007-78 that nonqualified deferred compensation plans that, because they are unwritten or loosely written, do not now specify in writing the time and form of payment of any deferred amount, be amended to do so by January 1, 2008. Barring further changes, however, time and form of payment will need to be specified in writing by January 1, 2009 as part of a 409A-compliant written plan document.

### **As in 2005, 2006, and 2007, New Payment Elections can be Made in 2008**

Under prior guidance, a previously specified date and manner of payment of nonqualified deferred compensation could be changed before the end of 2007 without the change's being required to comply with IRC § 409A's rules for payment election changes.<sup>4</sup> Notice 2007-86 extends until December 31, 2008 the ability to make such special transition period changes.

Notice 2007-86 repeats the rule of prior guidance that no payment election change made in 2007 can accelerate income into, or defer income out of, 2007, and extends this rule into 2008 by providing that no 2008 payment election change may accelerate income into, or defer income out of, 2008. Notice 2007-86 also makes it clear that a prior grace period change can be changed again before January 1, 2009, as long as the change does not accelerate income into, or defer income out of, the year in which the change is made.

As under prior guidance, any payment election change made

in 2005, 2006, 2007, or 2008 under the above rules must be reflected in the governing plan document by the December 31, 2008 deadline for 409A documentary compliance.

### **Most Non-409A-Compliant Discounted Stock Options and SAR's can Still be Corrected In 2007 or 2008**

Prior guidance made clear that, generally, stock options or stock appreciation rights that are subject to IRC § 409A (i. e., generally, options or SAR's that have vested or will vest after 2004 and that were issued with exercise prices that were less than the underlying stock's fair market value at their grant date) may retroactively be made compliant with IRC § 409A by modifying them in certain ways before being exercised. The possible modifications generally involve either retroactively increasing the option's or SAR's exercise price so that it equals or exceeds the underlying stock's fair market value on the grant date, replacing with a fixed "deemed" exercise date what would otherwise be the optionee's right to choose when to exercise the option or SAR, or resetting the option's or SAR's expiration date so that the option or SAR expires shortly after vesting. Notice 2007-86 generally extends the deadline for such modifications to December 31, 2008. However, non-409A compliant discounted stock options and SAR's that previously did not qualify to be corrected still do not qualify. Generally, these are discounted stock options or SAR's of Section 16 officers of public companies that were discounted as a result of backdating.

Notice 2007-86 reiterates the rule of prior guidance that, if the retroactive repricing method is used to bring a previously discounted option or SAR into IRC § 409A compliance, the optionee or holder of the repriced option or SAR can be compensated for the lost discount with cash or stock, as long as the cash is not paid, or the stock does not vest, until a calendar year following the calendar year in which the option or SAR is repriced.

### **Good Faith Compliance With IRC § 409A Before 2009 Does not Include Following a Plan Provision That Permits Non-409A-Compliant Discretion as to Time of Payment**

Since they are not required to be amended to comply with IRC § 409A before January 1, 2009, nonqualified deferred compensation plan documents may misleadingly continue to contain provisions that give the service provider, service recipient, or both the power to exercise discretion in a way

that is inconsistent with the requirements of IRC § 409A. For example, a nonqualified deferred compensation plan may provide the service recipient with impermissible discretion to accelerate or postpone payment, or may provide that in circumstances other than a 409A-compliant unforeseeable emergency, a participant may choose to receive an immediate payment of all or a portion of his or her plan benefit, if the participant agrees to forfeit a portion of the amount that would otherwise be paid (a so-called "haircut"). Notice 2007-86 notes that any exercise of non-409A-compliant discretion, even if provided for in the plan's governing document, will not be considered reasonable good faith compliance with IRC § 409A and may subject service providers to the tax penalties of IRC § 409A.

### **Relief for Payment Elections "Linked" to Qualified Plan Payment Elections Generally Extended Through End of 2008**

Prior guidance provided transitional relief until January 1, 2008 for non-409A-compliant payments of nonqualified deferred compensation based on payment elections under qualified (i.e., under IRC § 401(a), § 403(b), or § 457(b)) retirement plans or under certain broad-based foreign retirement plans. Notice 2007-86 generally extends this relief through December 31, 2008.

### **Deferral Elections Made by March 15, 2005 With Respect to 2005 Compensation Will Not Violate the Requirements of Notice 2005-1 Even if Plan not Amended to Include Such Elections Before December 31, 2008**

Q&A-21 of Notice 2005-1 provided relief from the general deferral election timing rule of IRC § 409A(a)(4)(B) (i.e., from the requirement that an election to defer compensation must generally be made by the service provider before the beginning of the taxable year of the service provider in which the compensation will be earned), but only for elections made by March 15, 2005 with respect to 2005 compensation. The March 15, 2005 deadline for making such elections has never been extended by prior guidance, and is not extended by Notice 2007-86. However, Q&A-21 of Notice 2005-1 can be interpreted as requiring that in order to qualify for its relief, a plan had to be amended by December 31, 2005 specifically to provide for the March 15, 2005 deferral election deadline. Notice 2007-86 provides that plans that otherwise met the requirements for the extension under Q&A-21 of Notice 2005-1 will qualify for the March 15, 2005 deadline for deferring 2005 compensation

as long as they are amended to provide for the special March 15, 2005 election deadline by the generally applicable December 31 2008 documentary compliance deadline.

### **Notice 2007-78 Transitional Relief for Amending "Good Reason" Provisions Extended Through End of 2008**

The Final 409A Regulations contain several favorable provisions for payments made on account of a service provider's involuntary termination of service and provide that under some circumstances a voluntary termination for "good reason" will be treated as an involuntary termination. Although the question of whether a voluntary termination for "good reason" is equivalent for IRC § 409A purposes to an involuntary termination may be determined based on the facts and circumstances of a particular agreement and termination, the Final 409A Regulations also contain a safe harbor definition of "good reason." Service recipients and service providers seeking certainty may want to modify an existing "good reason" definition to conform to the Final 409A Regulations' "safe harbor" definition. Some practitioners noted, however, that a service provider's voluntarily agreeing to an amendment to an existing agreement to impose a more rigorous definition of "good reason" could be interpreted as running afoul of yet another rule contained in the Final 409A Regulations and other IRC § 409A guidance, namely the rule against a service provider's voluntarily agreeing to reduce the extent to which an amount was previously vested. Notice 2007-78 indicated that, provided that the amount that is the subject of the arrangement was subject to a substantial risk of forfeiture, the arrangement's definition of "good reason" could be amended by December 31, 2007 to come within the Final Regulations' safe harbor definition of "good reason" without the parties' having to worry that the amendment would run afoul of the rule against a service provider's voluntarily agreeing to extend a vesting date. Notice 2007-86 extends this relief for changes made to "good reason" definitions before January 1, 2009.<sup>5</sup>

### **Relief Continues for Some Employment Agreement Renewals and for Some Cashouts Based Only on Initial Payment Date Amounts**

Notice 2007-78 provided that, generally, until further notice, a renewal of the term of an employment agreement providing for a severance payment only upon involuntary termination (not treating, for this purpose, a service recipient's failing to agree to enter into a new agreement

upon the expiration of the old as an involuntary termination) will not be treated as producing a non-409A-compliant postponement of a payment under the Final Regulations' rules regarding substituted payments.<sup>6</sup> Notice 2007-78 also provided relief, until further notice, for plans that provide for a lump sum cashout of a minimum benefit determined only at the time of what would otherwise be the commencement of a series of installments, and not also at the time of payment of any subsequent installment, provided certain safeguards to prevent the use of this exception to evade the payment timing requirements of IRC § 409A are met. Notice 2007-78's relief regarding these two issues remains in place under Notice 2007-86.

### **No Extension of Relief for Offshore and "Rabbi Trusts"**

Notice 2007-86 does not provide any additional transitional relief for nonqualified deferred compensation plans affected by IRC §§ 409A(b)(1) and (b)(2) (i.e., the rules against the use of offshore trusts or similar funding arrangements, or the use of funding devices using financial health triggers). In particular, as provided in Notice 2006-33, there is no extension of the December 31, 2007 deadline for repatriating or taking other appropriate action to bring so-called "grace period" assets (i.e., assets set aside or restricted in, or transferred to, noncompliant arrangements before March 22, 2006) into compliance with the requirements of IRC §§ 409A(b)(1) and (2).

### **Treasury and IRS Committed to Implementing "Limited Voluntary Correction Program" for Inadvertent Violations of IRC § 409A**

Treasury and IRS reiterate in Notice 2007-86 their commitment to implement as soon as possible a voluntary correction program for inadvertent IRC § 409A violations. Since the exact nature and extent of this "limited" voluntary correction program are not yet known, we quote the description of the program contained in Notice 2007-78:

The Treasury Department and the IRS anticipate issuing guidance in the near future establishing a limited voluntary compliance program that will apply to certain unintentional operational failures to comply with § 409A. The Treasury Department and the IRS anticipate that such guidance will provide methods by which certain unintentional operational failures may be corrected in the same taxable year in

which the operational failure occurred to avoid application of § 409A, and other methods by which certain unintentional operational failures may result in only limited amounts becoming includible in income and subject to additional taxes under § 409A.

### **Notice 2007-86 Provides Breathing Room, But Attention to 409A Compliance Still Vital Over Next 14 Months**

By providing employers and other service recipients with an additional year to come into full compliance with the Final 409A Regulations, Notice 2007-86 makes feasible what might otherwise have been a nearly impossible task. However, Notice 2007-86 and other recent guidance do not simplify, or make less restrictive or punitive, any of the rules of IRC § 409A and the Final 409A Regulations. All payers and payees of nonqualified deferred compensation or of amounts that may be nonqualified deferred compensation are urged to continue their 409A compliance efforts. This is especially the case for taxpayers that have arrangements such as discounted stock options or SAR's, or payment elections that may need to be modified, that require individualized attention and communications efforts during the remainder of the IRC § 409A transition period.

Our prior Strasburger Tax Strategies newsletter that generally describes the scope and requirements of IRC § 409A, as well as a general approach to ensuring IRC § 409A compliance, may be found [here](#). It has been updated to reflect the change in the effective date of the Final 409A Regulations under Notices 2007-78 and 2007-86.

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<sup>1</sup>See Section II of Notice 2005-1, Section 3.01 of Notice 2006-79, and Section XII of the Final 409A Regulations' Preamble.

<sup>2</sup>REG-158080-04, 2005-2 CB 786 [70 FR 57930], October 4, 2005.

<sup>3</sup>Notice 2007-78, published September 10, 2007.

<sup>4</sup>That is, the change did not need to be made at least one year in advance of the previously scheduled payment date and generally could accelerate payment as well as postpone it, and any postponement did not need to be for a minimum of five years.

<sup>5</sup>Note that by specifically providing relief for changes made to "good reason" definitions before 2009, Notice 2007-86, like Notice 2007-78 before it, lends credence to the concern that, absent this time-limited relief, a change from one "good reason" definition to another would run afoul of the rule of Treas. Reg. § 1.409A-1(d)(1) against "the addition of

any risk of forfeiture after the legally binding right to the compensation arises, or any extension of a period during which compensation is subject to a risk of forfeiture." This is unfortunate, since the change from one "good reason" definition to another, where both definitions constitute substantial risks of forfeiture, and where the period during which the compensation is subject to a substantial risk of forfeiture is not changed, would not appear realistically to risk a non-409A-compliant acceleration or postponement of payment, which presumably is all that the rule of Treas. Reg. § 1.409A-1(d)(1) is intended to prevent.

<sup>6</sup>Absent this relief, there apparently might be an argument that, for example, an executive nearing the end of the term of a three-year employment agreement providing for a severance payment upon involuntary termination who renews the agreement for a new three-year term has postponed receipt of the severance payment by a non-409A-compliant three years. We think it unlikely that this relief is actually necessary.

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