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Employee Benefits

A Littler Mendelson Newsletter

IRS Extends 409A Compliance Deadline and Provides Guidance on 409A Reporting

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

The IRS recently issued two notices relating to Section 409A of the Internal Revenue Code. Notice 2007-86 extends until December 31, 2008 a number of Section 409A compliance requirements as well as the Section 409A "good faith compliance" period. Notice 2007-89 provides guidance on reporting and wage withholding for employers and others in connection with deferred income. Below, we discuss the salient aspects of both notices.

Some Background

Section 409A was added to the Code as part of the American Jobs Creation Act of 2004. It applies generally to any plan, program or arrangement that defers compensation, even to a contract that applies to only one individual. With a few exceptions, any compensation that is paid after the 15th day of the third month of the taxable year of the payor or payee (generally, March 15th), whichever is later, following the taxable year in which the compensation was earned is "deferred compensation" that is subject to the new rules.

Generally, section 409A requires that all deferred compensation arrangements be in writing and provides that:

- Irrevocable elections to defer compensation must be made prior to the year in which the compensation will be earned (with exceptions for the first year of the plan, newly hired participants, and deferral of performance-based bonus compensation).
- Deferred compensation must be paid at specific times or under a fixed pay-

ment schedule, except for hardship situations, change of control of the employer, death, disability and other defined exceptions.

- Deferred compensation payments may not be accelerated or further deferred except under certain circumstances.
- Specific rules apply regarding when an employee has "separated from service" and thus may begin to receive deferred compensation without incurring a prohibited acceleration of payments.
- Payments to certain employees of publicly traded companies upon separation from service (i.e., "specified employees") may not begin until six months after separation from service.

The consequences of failing to satisfy the Section 409A requirements are punitive. All deferred compensation of an individual relating to the failure is immediately taxable, an additional income tax of 20% is imposed, and interest is charged at the "nonpayer" rate plus one percent.

Notice 2007-86

Notice 2007-86 comes on the heels of Notice 2007-78. Notice 2007-78 provided that nonqualified deferred compensation arrangements would not be required to be in full documentary compliance with Section 409A until December 31, 2008. Before this relief was granted, the documentary compliance deadline was December 31, 2007. Notice 2007-78, however, did not otherwise extend 409A deadlines relating to operational compliance, so that full operational compliance was still mandated to be

in place by December 31, 2007. The IRS was asked by many professionals in the benefits community to extend other compliance deadlines to December 31, 2008 because of the expansive nature of these rules and the types of arrangements that are covered thereunder. In response, the IRS via Notice 2007-86 now extends most of the transitional relief until December 31, 2008.

Good Faith Operational Compliance

One of the most important extensions under Notice 2007-86 is the extension of the good faith compliance period through December 31, 2008. This means that through December 31, 2008, the final regulations need not be followed but instead, certain earlier guidance may be followed or a “good faith” interpretation of Section 409A may be relied upon.

Compliance with the final regulations will always be deemed to be a reasonable good faith interpretation.

However, the proposed Section 409A regulations may not be relied on for periods after December 31, 2007, except for parts of the preamble having to do with the application of Section 409A to:

- Partners and partnerships;
- Changes in payments elections or conditions; and
- Substitutions of non-discounted stock options and stock appreciation rights for discounted options and rights.

Changes in Payment Provisions

Notice 2007-86 extends earlier guidance that had provided that an arrangement could be amended to provide for a new time and form of payment until December 31, 2007. The Notice extends this deadline to December 31, 2008 and provides that, consistent with previous guidance, any change in the time or form of payout may not cause an amount that would otherwise be payable during a particular year to be paid in a later year or an amount that would otherwise be payable in a later year to be accelerated into the current year. The relief provided in Notice 2007-86 extends to discounted stock options (or other stock rights) under which fixed payment dates must be established to avoid violating Section 409A.

Substitution of Stock Options and Other Stock Rights

Under Section 409A, in order to avoid penalty tax, discounted stock options (or other stock rights) that do not contain fixed payment dates (and that will not be amended to provide fixed payment dates) must, prior to exercise, be replaced with stock rights that contain no discount. Notice 2007-86 extends the deadline for this exchange to take place from December 31, 2007 until December 31, 2008.

Generally, in order for the replacement and exchange to be valid under Section 409A, any cancellation and reissuance of stock rights by December 31, 2008 cannot result in a cash-out (or payment of other property) in the year that the stock right is replaced.

Payment Elections Linked to Qualified Plans

Transition relief had previously permitted payments under a nonqualified deferred compensation arrangement to be linked to a qualified plan payment election through December 31, 2007. This deadline has now been extended to December 31, 2008.

Employers should not be lulled into a false sense of security. There are many areas under Section 409A that require current compliance with the law. These include provisions dealing with timely deferral elections, impermissible types of distributions, prohibited acceleration of payments, the mandated six month “hold” on certain payments to “specified employees” and many other areas. The new guidance, however, does permit employers to have some leeway in the areas it addresses.

Notice 2007-89

Section 409A provides that certain reporting and wage withholding protocols must be followed with respect to nonqualified deferred compensation plans subject to Section 409A. Employers and other payers are required to report (a) amounts deferred annually under a nonqualified deferred compensation plan (employers reporting such amounts in Box 12 of Form W-2, using Code Y, and payers to nonemployees reporting such amounts in Box 15a of Form 1099-MISC) and (b) amounts includible in taxable income as a result of a Section 409A violation (employers - in Box 1

and in Box 12 of Form W-2, using Code Z, and payers to nonemployees - in Box 7 and Box 15b of Form 1099-MISC). However, in Notice 2006-100, the IRS waived the reporting requirement for the 2005 and 2006 tax years with respect to amounts deferred annually under a nonqualified deferred compensation plan subject to Section 409A and provided guidance with respect to the calculation of amounts includible in income as a result of a Code section 409A violation, as well as guidance on reporting and withholding requirements relating to such income inclusion.

The IRS issued Notice 2007-89 on October 23, 2007, extending to the 2007 tax year the reporting relief previously granted in Notice 2006-100, which relieves employers and payers from having to report amounts deferred annually under a nonqualified deferred compensation plan that is subject to Code section 409A. In addition, Notice 2007-89 provides guidance on the 2007 reporting and withholding requirements for (and calculation of) amounts includible in income as a result of a Code section 409A violation, including the requirement that such amount be set forth in Box 1 and Box 12 of Form W-2, using Code Z (or with respect to nonemployees, reporting such amount in Box 7 and in Box 15b of Form 1099-MISC). Finally, Notice 2007-89 provides employers and payers who comply with Notice 2007-89 protection from future additional reporting or withholding for 2007.

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