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Code Section 409A: IRS Announces Limited Extension For Compliance

September 13, 2007

In late 2004, Congress subjected non-qualified deferred compensation to a new system of rules under Code Section 409A, with significant additional income taxes in the event of noncompliance. The IRS previously announced that all affected arrangements would be required to comply in form with Section 409A by the end of 2007. In Information Release 2007-157, released September 10, 2007, the IRS has announced an extension from the end of 2007 to the end of 2008 for written compliance with Section 409A. However, this extension is limited in its scope, as discussed below.

Prior Guidance Inapplicable After 2007: Operational compliance during 2008 may not use pre-Regulation IRS guidance or a good faith reading of the statute. By the end of 2008, full form compliance is required, reflecting the operational compliance methods in effect in the interim.

No Extension to Specify Time and Method of Payment: By the end of 2007, all arrangements must specify at least a permissible payment-triggering event (or the earlier or later of alternative permitted events) and an objectively determinable form of payment, even if the other writing requirements are delayed. Existing, noncomplying language may be disregarded for this purpose. Amendments to satisfy this requirement may be made applicable either to specified arrangements or in general. No discretion over the year of payment is allowed. A right to installment payments must state that it is a right to a series of payments, or it will be treated as requiring a single payment. Changes after 2007 remain significantly restricted.

Operational Definitions of Payment Triggers: Until the end of 2008, any allowable definition of the permitted payment events may be used. For payments other than death or a stated date (i.e., separation, death, disability or unforeseeable emergency), the definition may be changed until the earlier of the occurrence of a payment event or the end of 2008. The definition ultimately adopted in writing must be consistent with the interim operation. For payments on a specified date or according to a fixed schedule, the date or schedule generally must be specified by the end of 2007, but later changes are allowed if the tax year of the payment does not change.

Six-Month Delay for Separation Payments to Key Employees: The requirement to express a six-month delay for certain separation payments to key employees is only operationally required until the end of 2008. During 2008, the arrangement must apply some demonstrable and permissible method to identify key employees.

Good Reason Terminations: "Good reason" terminations which are treated as involuntary may be exempt from Section 409A under short deferral or separation pay exceptions. Until the end of 2007, existing "good reason" termination provisions in employment agreements, if non-vested, may be modified to conform to the safe harbors for "involuntary" terminations.

Changes May Exempt Compensation From 409A Application: Certain existing "transition rules" allow 2007 changes regarding the time or form of payment. The new IRS guidance recognizes that some of these changes may result in the compensation being excluded from 409A, such as by application of the short deferral rule.

Substitutions of Rights: In some circumstances, a substitution of an existing right to deferred compensation can violate Section 409A. Where employment agreements expire, if the new agreement replaces only rights forfeited at the end of the prior agreement term, and which would only have been payable for involuntary separation, then granting a similar right will not be treated as a violative substitute.

Cashouts of Small Benefits: The Regulations provide a limited ability to accelerate cashouts of small benefits, e.g., from installments to a lump sum in the event the present value is below a stated amount. Until further notice, an arrangement may provide for acceleration if the value falls below that level at some date after payments begin (rather than looking only at the value when payments begin), provided that the system is not effectively a method of delaying an election as to the method of payment.

Correction Programs: The IRS expects to have correction programs allowing unintentional violations to be corrected in the same year as the failure without the application of 409A, and other rules to limit the application of 409A for other unintentional failures.

Offshore Trust Funding: The existing rules restrict the use of offshore trusts to fund the payment on non-qualified deferred compensation. Until further guidance, a reasonable, good-faith interpretation of these rules is allowed.