

## Legal Updates & News

### Legal Updates

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#### IRS Issues Limited Relief on Section 409A; Year End Action Still Required

September 2007

The IRS recently issued Notice [2007-78](#), which provides additional guidance and limited transition relief on Section 409A of the Internal Revenue Code. There are still actions required by the end of 2007.

#### Related Practices:

- [Corporate](#)
- [Employee Benefits and Executive Compensation](#)
- [Tax](#)

#### Background

Section 409A has generally been in effect since 2005. Employers have been required to administer their nonqualified deferred compensation arrangements in accordance with Section 409A during a transition period that began in 2005. That transition period generally ends December 31, 2007, except as extended in Notice 2007-78. Noncompliant arrangements may subject an employee or other service provider to income tax before any compensation is actually received, and they may result in an additional 20% penalty tax (40% in California).

#### Notice 2007-78

Significant effects of Notice 2007-78 are:

- **Written Compliance Deadline Extended to December 31, 2008**  
Notice 2007-78 provides that nonqualified deferred compensation arrangements must generally be finally amended by December 31, 2008. However, all such arrangements must operate in compliance with the final Section 409A regulations (see our legal update, [IRS Issues Final Section 409A Regulations](#), May 2007) by January 1, 2008.
- **Payment Elections Must be Made by December 31, 2007**  
While the final amendment deadline is December 31, 2008, all arrangements must specify a compliant time and form of distribution by December 31, 2007. Certain noncompliant payment terms may remain in an arrangement (as long as they are not used) during 2008, provided that the payment terms used are compliant. The six-month delay provisions applicable to payments to certain "key employees" need not be documented, as long as the plan is operated in compliance with the rule. To the extent "good reason" definitions triggering payment do not meet the regulatory definitions in some cases they may be amended to comply. After December 31, 2007, that will not generally be possible.
- **Operational Compliance Deadline is Unchanged: January 1, 2008**  
Since 2005, companies have been required to operate their nonqualified deferred compensation arrangements in good faith compliance with the transitional guidance. Full operational compliance with the [final regulations](#) is required by January 1, 2008.
- **Elections to Change Payment Terms and Amendments to Remove an Arrangement From 409A Due by December 31, 2007**  
One of the most valuable aspects of the transition rules, the ability to change certain existing payment elections outside the more restrictive Section 409A rules or to remove an arrangement from Section 409A altogether by amendment, expires December 31, 2007. These provisions permit discounted stock options to be "fixed" by, for example, raising the

exercise price to fair market value on the grant date. Such actions must be completed by year end.

### Action Items

To ensure year end compliance with the Section 409A rules, employers should:

- **Identify** all plans and arrangements subject to Section 409A.
- **Determine** which modifications or amendments are needed to bring the documents into compliance.
- **Adopt** needed changes by December 31, 2007.
- **Fix** discounted stock options.
- **Change** payment elections, if desired.