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The 409A Transition Rule Lives to Fight Another Day: IRS Extends Final Section 409A Compliance Date in Notice 2007-86

November 2007

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There's relief and then there's *relief*. Having seen the former in Notice 2007-78 – which provided a rather limited extension of the documentation requirements imposed by Section 409A of the Internal Revenue Code of 1986, as amended (the "Code") – we are in a much better position to appreciate the latter, coming in the form of Notice 2007-86.[1] With the demise of the "transition rule" available under Section 409A looming at year-end, the IRS has now taken mercy on countless non-compliant deferred compensation arrangements in need of its assistance and given the transition rule an extra year of life. In a welcome change of pace, Notice 2007-86 offers a fairly straightforward extension of the Section 409A requirements that were not addressed by Notice 2007-78 and offers some useful guidance for compliance during the transition period. However, while Notice 2007-86 provides a workable path to Section 409A compliance in most instances, it does not solve every Section 409A problem nor does it provide a "free pass" on operational compliance prior to January 1, 2009.

Background

In our prior *Legal Updates,* we have dealt extensively with Section 409A and its intricacies and will therefore limit our summary here to the key issues relevant to Notice 2007-86.[2] In general terms, Section 409A is intended to impose significant restrictions on deferred compensation arrangements of all sorts by limiting the timing of elections to defer compensation by "service providers" (*i.e.*, employees, directors, or contractors), the timing and form of subsequent payments of deferred compensation, and the timing of subsequent changes to either. Violating any of these broad requirements (or any of the more specific requirements included in the proposed regulations and other guidance) not only triggers income tax on the deferred amounts but also triggers an additional 20% income tax and interest at a prescribed rate.

To ease the transition process from the "pre-409A" world to compliance with the foregoing limitations, the IRS created and developed a transition rule in Notice 2005-1, the proposed regulations, and Notice 2006-79 that generally allows changes to the form and timing of deferred compensation payments that would not otherwise be permissible. In addition to allowing a wide variety of "409A first aid" for traditional deferred compensation plans, the transition rule has proven invaluable in addressing stock options and stock appreciation rights that have inadvertently become subject to Section 409A.

While the transition rule is available to correct incipient compliance issues, operational good faith compliance with Section 409A has nonetheless been required since January 1, 2005. The IRS has issued multiple forms of guidance since then to clarify the application of Section 409A and previously indicated that compliance with the proposed regulations *or* the final regulations would be deemed to constitute good faith compliance until the final regulations became effective on January 1, 2008. In response to pleas from the practitioner community, the IRS extended the deadline for documentary compliance (i.e., the adoption of amendments to existing deferred compensation arrangements intended to ensure their compliance with Section 409A) to January 1, 2009 but did not initially extend the transition rule *or* the general deadline for operational compliance with the final regulations beyond January 1, 2008. Practitioners, realizing that there was less to Notice 2007-78 than met the

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eye, sought additional relief from the IRS and, in Notice 2007-86, received what they sought.

Summary of Transition Relief

Extension of Good Faith Compliance Requirement
Under Notice 2007-86, operational compliance with the final regulations is not required until January 1, 2009. In the interim – and as has been the case since 2005 – employers and other "service recipients" are required to operate their non-qualified deferred compensation arrangements in good faith compliance with currently effective guidance (i.e., Section 409A itself and Notice 2005-1) and with the terms of those arrangements to the extent they are consistent with Section 409A. As noted in prior IRS guidance, reliance on the final regulations is considered to be good faith compliance with Section 409A. Notice 2007-86 makes clear that reliance on the proposed regulations will not be considered to be good faith compliance after December 31, 2007 except for a handful of limited issues (e.g., application of Section 409A to partnerships, certain aspects of corrections for stock rights, etc.). The notice provides that compliance with the final regulations prior to January 1, 2009 is not required.

As the IRS has noted in prior guidance, a deferred compensation arrangement will not be considered to be operating in good faith compliance during the transition period if discretion provided by the terms of the arrangement is exercised in a manner inconsistent with Section 409A. For example, if an employer exercises discretion under a deferred compensation plan to delay payments in a manner that is not consistent with Section 409A, the entire plan will be considered not to have been operated in good faith compliance. However, the notice clarifies that an employee's (or other service provider's) exercise of such discretion relative to his or her own interest in the arrangement will not cause Section 409A violations for other participating employees. For example, a single employee's use of an impermissible "haircut" provision (i.e., a provision permitting an elective unscheduled distribution with a penalty) will result in a Section 409A violation for that employee but not for other participants in the arrangement.

Extension of Transition Rule
Of most significance, Notice 2007-86 continues the transition rule through December 31, 2008. The transition rule has proven to be a singularly useful tool in addressing a wide variety of potential compliance issues under Section 409A. In general, the transition rule permits changes to elections as to the time and/or form of deferred compensation payments on a much more flexible basis than is generally permitted by the final regulations. The primary limitations on the transition rule are that it cannot be used to delay the payment of deferred amounts that would otherwise be payable in the current year nor can it be used to accelerate payments due in a later year into the current year. For example, a participant's election to receive a series of installment payments following termination of employment could be modified in 2007 to alter the payment schedule or accelerate the stream of payments into a single lump sum as long as the modification does not delay any payments that the participant would otherwise receive in 2007 (e.g., if he terminated from employment during that year) or accelerate the payments into 2007; thus, the earliest payment date under the modified election would be January 1, 2008. Notice 2007-86 permits amendments to existing payment elections during 2008 but maintains the same general approach: as modified, an election cannot accelerate a payment into 2008 nor can it delay a payment that would otherwise be made in 2008. The transition rule can be used by employers and other service recipients on a plan-wide or individualized basis to correct systemic compliance issues or more isolated problems.

One situation in which the transition rule has proven especially helpful is in dealing with stock options and stock appreciation rights (referred to collectively under Section 409A as "stock rights") that may have inadvertently become subject to Section 409A through underlying issues with the valuation of the related stock or other technical issues. Notice 2007-86 clarifies prior guidance confirming that a discounted stock right subject to Section 409A can be brought into compliance or removed from Section 409A coverage by substituting a non-discounted stock right or by specifying a fixed exercise date and provides that either of these stock right modifications can be implemented under the transition rule as long as they are adopted by December 31, 2008. The notice also indicates that a stock right is not considered to be payable in a particular year simply because it is exercisable during that year as long as it is reasonably expected to be exercisable in later years as well.

A few cautionary points are in order regarding the application of the transition rule to stock rights. First, modifications involving the specification of a fixed exercise date are not available to any employee or service provider who has exercised any discount stock rights granted by an employer or service recipient. In this event, the only correction that is available for the remaining stock rights is an upwards adjustment to fair market value as of the original grant date. Secondly, stock rights

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that are subject to Section 409A but not compliant with it should not be exercised prior to their correction under the transition rule. Non-compliant stock rights that are exercised will violate Section 409A and result in the application of the additional tax and interest penalty and will trigger additional tax reporting requirements for the employer or other service recipient. Note also that correcting non-compliant stock rights by December 31, 2008 is essentially mandatory: if these stock rights are not brought into compliance with Section 409A or amended to remove them from coverage under Section 409A prior to December 31, 2008, they will trigger violations on and after January 1, 2009 as the stock rights vest, regardless of whether the option holder exercises them. In addition, a failure to address vested non-compliant stock rights that were outstanding on December 31, 2006 or that are outstanding on December 31, 2007 will trigger a retroactive violation of Section 409A and require remedial tax withholding and reporting by the employer or other service recipient and additional tax payments by employees or other service providers.

Finally, Notice 2007-86 emphasizes that the extended transition rule is not available to modify stock rights granted to "Section 16" reporting officers of publicly traded companies that have been required to (or are expected to) restate their financial accounting reports to include expenses associated with discounted (or back-dated) stock options. As provided in Notice 2006-79, the deadline for correcting discounted stock options held by Section 16 officers was December 31, 2006.

Other Transition Relief

Notice 2007-86 extends the compliance deadline for "linked" deferred compensation arrangements (i.e., non-qualified arrangements under which the payment elections are linked to distribution elections made under a qualified retirement plan). Linked arrangements may generally continue in operation through December 31, 2008, but any elections as to time and form of payment under such arrangements must be as directed by their terms as in effect on October 3, 2004 (i.e., the non-qualified arrangement provided as of October 3, 2004 that distributions would be linked to distributions made under a qualified retirement plan).

Notice 2007-78 included additional guidance on amendments to deferred compensation arrangements with so-called "good reason" termination provisions and generally required amendments to conform potentially non-compliant good reason definitions with the final regulations by December 31, 2007. Notice 2007-86 extends this deadline to December 31, 2008.

Reporting and Withholding for 2007

Notice 2007-87 does not address the reporting and withholding requirements associated with Section 409A for 2007, but Notice 2007-89 does provide additional information about the IRS's expectations for both service recipients and service providers.[2]

Notice 2007-89 extends the moratorium on reporting and withholding originally announced in Notice 2006-100 for compensation deferred in 2007. The notice also provides additional interim guidance relating to the calculation and reporting of amounts includible in income under various types of deferred compensation arrangements and the calculation of the additional Section 409A tax and interest penalty.

- The notice refines prior guidance for determining the "deferred amount" to which the additional Section 409A tax and interest penalty applies based on the type of arrangement at issue (i.e., account balance plans, non-account balance plans with reasonably ascertainable amounts, stock rights subject to Section 409A, and other types of deferrals).
- The notice explains how employers and other service recipients must report includible amounts for 2007. Deferred amounts includible in income for employees are considered to be "wages" under Code Section 3401(a) and are reportable as a wage payment made on December 31, 2007. Deferred amounts includible in income for service providers who are not employees are considered to be "non-employee compensation" and are reportable on Form 1099-MISC.
- The notice indicates that employees and other service providers are expected to report any deferred amounts that become includible in income during 2007 on their individual income tax returns and to remit the appropriate additional tax and interest penalty. The notice continues the limited relief originally offered under Notice 2006-100 where an employee's employer fails to withhold the appropriate amount from the includible deferred amount.[3]
- As with Notice 2006-100, Notice 2007-89 is interim guidance only. The IRS notes that it is currently preparing additional guidance regarding the income inclusion requirements, the method for determining the amount of the additional Section 409A tax and interest penalty, and the applicable reporting and withholding requirements.

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Footnotes:

[1] A copy of Notice 2007-86 can be found here.

2 For additional discussion about Section 409A, please refer to our prior *Legal Updates* available at www.mofo.com.

[2] A copy of Notice 2007-89 can be found here.

[3] Under this relief, an employee's required tax withholding amounts will be deemed to have been collected and will be credited against the income tax due if his or her employer takes either of the following remedial actions. First, after December 31, 2007 and prior to February 1, 2008, the employer may withhold or recover from the employee the amount of the undercollection and report as "wages" any deferred amounts that were not actually or constructively received but that are includible in income in 2007 under Section 409A. Alternatively, the employer may pay the tax liability on the employee's behalf and report the gross wage amount and withholding for the quarter ending December 31, 2007 (including the includible amount itself and any taxes associated with the employer's payment of the employee's tax liability). The remittance of any such tax payments will be considered to be timely if they are deposited by the due date for the employer's Form 941 for the quarter ending December 31, 2007. This approach will avoid failure to deposit penalties under Code Section 6656.

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