

ADVISORY

SULLIVAN & WORCESTER EMPLOYMENT & BENEFITS ADVISORY

IRS Reverses Course, Again Extends Section 409A Transitional Period

On October 22 the Internal Revenue Service released Notice 2007-86, which revokes important portions of the guidance issued in Notice 2007-78 this past September, and further extends the transition period for Internal Revenue Code Section 409A compliance.

Documentary Compliance. September's Notice 2007-78 extended the deadline for revising plan documents to reflect Section 409A to December 31, 2008, and that remains the rule. However, the new notice revokes the requirement in Notice 2007-78 that written designations of payment dates and methods for nonqualified deferred compensation must be put in place by December 31, 2007, generally postponing that deadline to December 31, 2008 (except for amounts payable in 2008). Nonetheless, it remains the case that elections to defer compensation should be made in writing in timely fashion (see the rule set forth in Question and Answer 23 in our [Question-and-Answer Guide to Code Section 409A](#) on our website). Furthermore, we strongly recommend that plan sponsors now proceed to amend nonqualified deferred compensation plans as necessary to reflect the final regulations in every case where it is practical for them to do so. Notwithstanding the extended December 31, 2008 deadline, good practice is to have documents that reflect unambiguously actual plan operations and the current state of the law.

Operational Compliance. Notice 2007-86 has postponed until January 1, 2009 the effective date of the final Section 409A regulations. Thus, through the end of 2008, plans must operate in reasonable good faith compliance with Section 409A without necessarily following the rules of the final regulations. For periods through December 31, 2007, reasonable good faith compliance can include reliance on the proposed regulations that preceded the final regulations; for all periods through December 31, 2008, good faith compliance can include reliance on Notice 2005-1 and/or the final regulations but generally not the proposed regulations.

Fixing Discounted Stock Options. The deadline has also been extended for taking remedial action with respect to a stock option (or stock appreciation right) whose exercise price is less than fair market value as of the grant date and that would therefore give rise to Section 409A penalty taxes. Except for certain options issued to

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public company insiders, such discounted stock options can be reissued or amended to comply with Section 409A until December 31, 2008. This can be done either by increasing the exercise price or by specifying that the option is only exercisable at times permitted under Section 409A (for example, exercisable only upon the earliest of termination of employment, a change of control or the year of expiration).

Altering Payment Dates and Methods. Under a transition rule, it has been possible for plans to permit participants to change future payment dates and methods for nonqualified deferred compensation by so electing as late as December 31, 2007, provided the change does not affect the payment of any amount otherwise due for payment in 2007 (or accelerate a payment into 2007). That transition rule remains in place. In addition, Notice 2007-86 has now provided a parallel transition rule that will allow an election to be made as late as December 31, 2008 (should the plan sponsor so permit) to change the payment timing and method for nonqualified deferred compensation, provided such amounts are not otherwise payable in 2008 (and are not accelerated into 2008). Several of our clients had planned to give participants one last chance to change their payment elections at the end of this year. They must now consider the pros and cons of sticking with that decision, offering a second opportunity to change elections in 2008 or affording only a single change of election opportunity to be made available in 2008 not 2007.

Conclusion. The extension of transition relief in Notice 2007-86 will make life easier for plan sponsors who are finding it difficult to revise their plan documents and make final decisions on plan design in a timely fashion. With the extension of the good faith compliance period, it will also make it easier to defend against any IRS attack that a nonqualified deferred compensation plan has run afoul of Section 409A during the period from January 1, 2005 through December 31, 2008. Nonetheless, we recommend to our clients that wherever possible they deal with their nonqualified deferred compensation arrangements as if the final regulations are now in effect, and move as rapidly as possible to adopt final plan documentation complying with those regulations.

It should be emphasized that the major substantive rules of Section 409A have been part of the tax law since January 1, 2005, and that reporting and withholding obligations with respect to Section 409A violations remain in effect for 2007 and future periods. On October 23 the IRS released Notice 2007-89, which generally applies in 2007 rules similar to the 2006 rules (which are discussed in an advisory on our website available [with this link](#)) that require reporting, income tax withholding, and payment of penalty taxes with respect to Section 409A violations that occurred in (or remained uncorrected during) 2007.