



eActionAlert

IRS Gives Limited Extension to Fully Amend Nonqualified Deferred Compensation Plans

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In April 2007, the Internal Revenue Service (“IRS”) published final Regulations under Section 409A of the Internal Revenue Code of 1986 (the “Code”). IRS guidance under Section 409A imposes several requirements on nonqualified deferred compensation plans (“NQDCPs”), including proper plan documentation by December 31, 2007. If a NQDCP does not meet those requirements, the amounts deferred under the plan, unless subject to a substantial risk of forfeiture, are included in participants’ current income – and subject to an additional 20% federal income tax, interest and penalties.

In response to requests from the largest law firms in the country for an extension of the documentation requirements, the IRS has just issued Notice 2007-78, which extends the deadline for amending NQDCPs to December 31, 2008. This eAlert discusses what you must do in order to take advantage of that extension as well as other aspects of the Notice.

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Extension of Documentation Deadline

Overview

The document compliance deadline extension under the Notice is rather limited in that the plan must be operated in full compliance with the Regulations beginning January 1, 2008, and amended to comply with those rules by December 31, 2008. That is “reasonable good faith” compliance applies only through the end of 2007 and the IRS will require full operational compliance beginning January 1, 2008.

By December 31, 2007, for each deferred compensation plan or arrangement, the plan sponsor must:

- (1) provide a written designation of a “409A compliant” time and form of payment, and
- (2) specify a payment date or fixed schedule of payments to be made after a 409A-permissible payment event occurs.

Compliant Time and Form of Payment

Except as specifically permitted by the Regulations and the Notice, the time and form of payment must be specified in writing by December 31, 2007 and may not be changed after that date (except pursuant to the “second election” rules under the Regulations). Changing either may result in the amounts deferred under the plan as of that date to be included in participants’ current income. Thus, the NQDCP sponsor must decide upon an “objectively determinable form of payment” to be made upon at least one of the following six permissible distribution

events under the Regulations: separation from service, change of control, unforeseeable emergency, a specified date or fixed schedule of payment, death or disability.

Designation of a Specified Payment Date or Fixed Payment Schedule

Also by December 31, 2007, the company must designate, in writing, a date of payment or specify that each installment is a separate payment that complies with the 409A Regulations. This means that the plan document must set forth one of the six aforementioned events on which deferred compensation will be distributed as well as the allowable forms of distribution. If this amendment is not made timely, a later addition or elimination of a payment event may not cause payments to be accelerated to an earlier tax year and must comply with the "subsequent deferral election" provisions of the Regulations.

Retroactive Adoption of Definitions Specific Payment Events

The Notice provides a little flexibility with respect to the adoption of specific definitions of permissible distribution events. The company is not required to adopt specific definitions of these events until December 31, 2008; provided however,

- (1) the final plan document complies with the Regulations by that date and
- (2) the plan is operated in compliance with those Regulations on and after January 1, 2008.

For example, the document need not specifically define "separation from service" until December 31, 2008. (A separation from service could be defined, for example, as a 30% reduction of duties, compared with the participant's duties for the prior 36 months.)

Some Other Issues

Substitution Rule for Employment Contracts

The Notice discusses whether modification of an existing right to payments from a plan will be treated as a new "binding right" to compensation deferred under the plan (in which case the new payment terms are allowed) or instead treated as a substitution (in which case the new terms would violate 409A).

The Notice provides that if a right to deferred

compensation payable only upon involuntary termination of employment under the agreement would be forfeited automatically at the end of the term of the agreement, then a new right to deferred compensation in a new or extended agreement will be treated as a new binding right (rather than as a substitution) and, therefore, it will not violate 409A.

Change in Corporate Finances or Underfunded Qualified Defined Benefit Plans

Code Section 409A(b) prohibits the use of offshore trusts to fund NQDCPs as well as the use of restrictions on NQDCP assets (whether or not held in trust) in connection with the deterioration of the company's financial condition in order to protect plan benefits. The statute also prohibits these actions:

- (1) when the NQDCP sponsor is in bankruptcy proceedings,
- (2) while the plan sponsor's qualified defined benefit plan is "at risk" as defined in the Pension Protection Act of 2006, and
- (3) during the six-month periods before and after the termination of the company's qualified defined benefit plan if it is underfunded as of the termination date.

If these rules are not followed, under Code Section 83, the NQDCP assets will be treated as property transferred to covered employees in connection with their performance of services. The amounts involved will be subject to income taxes, the additional 20% tax and, if otherwise applicable, penalties and interest.

Prior IRS guidance allowed plan sponsors to use a reasonable, good faith interpretation of Section 409A(b) in determining whether NQDCP assets must be included in participants' income. The Notice extends this reasonable, good faith standard until the Service issues further guidance on Code Section 409A(b). However, effective January 1, 2008, NQDCP assets will be included in current income if the plan is found not to have complied with a good faith interpretation of the statute on or after December 31, 2007.

Specified Employees of Public Companies

Code Section 409A(a)(2)(b) provides that payment of NQDCP benefits to a “specified employee” (generally, a “key employee” as defined in Code Section 416 regarding top-heavy qualified pension plans) of a publicly traded company due to that employee’s separation from service must not be made until six months after the date of termination.

The Notice allows for the retroactive amendment of deferred compensation plans to insert the required six-month delay. To take advantage of this relief, the amendment must be made by December 31, 2008 and the plan must be operated throughout 2008 in accordance with the amendment that is ultimately adopted.

Stock Options and Stock Appreciation Rights (SAR’s)

The Notice does not change the rules on when a deferred compensation arrangement can be amended in order to make it to comply with or be exempt from 409A. For example, if a discounted stock option or SAR is amended by increasing its exercise price to the per share fair market value as of the grant date, the option or right is not subject to 409A after the amendment is made. The Regulations require that the amendment be made by December 31, 2007. The Notice does not provide any relief on this issue. Therefore, the amendment must be adopted and effective by December 31, 2007.

Voluntary Compliance Program

The Notice states that the IRS will implement a new voluntary compliance program. Similar to certain aspects of the voluntary compliance program used to correct mistakes in the administration of qualified pension plans, the new program would allow for the correction of unintentional operational errors under Section 409A.

What this Means to You and M&A’s Recommendations

If you want to take advantage of the extension of the documentation deadline, you should identify all plans and arrangements that are subject to 409A and review each with your ERISA counsel immediately in order to determine exactly what must be done to properly designate times and forms of payment that comply with the Regulations and to implement your decisions timely.

You also need to ensure that each deferred compensation plan or arrangement is operated in compliance with the Regulations, even if such compliance is not yet documented in writing. Therefore, you also need to understand the requirements of the Regulations because the plan must be operated in compliance with those rules in 2008 and decisions you make now cannot be changed after December 31, 2007.

If any stock options were granted with an exercise price that is below the per share fair market value as of the grant date then, by December 31, 2007, you must amend those options to increase the exercise price so that the options will be exempt from Section 409A.

We strongly recommend that you begin the process to comply with the fast-approaching deadlines as soon as possible. Reviewing deferred compensation plans, making significant decisions and amending the plans is time-consuming. Changing the plans’ provisions may require negotiations with participants and will need approval by the board of directors or a committee of the board.

M&A is an employee benefit consulting and management firm and, as such, we do not practice law. However, if you have any questions about Notice 2007-78 or any of the information contained in this eAlert, please contact your Senior Consultant at (877) 564-4300.