

Client Alert: Transition Relief for Code Section 409A Deferred Compensation Arrangements Partially Extended Until December 31, 2008, Subject to Key Limitations

September 11, 2007

On September 10, 2007, the Treasury Department ("Treasury") generally extended, until December 31, 2008, the deadline for amending deferred compensation arrangements to be in "documentary compliance" with Section 409A of the Internal Revenue Code ("Section 409A"), provided that *prior to January 1, 2008*, the deferral arrangements designate in writing a compliant time and form of payment of the deferred compensation. Yesterday's release by Treasury (Notice 2007-78) also provided additional guidance and relief with respect to issues related to employment agreements and technical issues related to minimum balance cashout provisions. Finally, Treasury and the IRS announced their intention to adopt a limited voluntary compliance program that will permit taxpayers to correct limited unintentional operational violations of Section 409A, and thereby reduce the amount of additional taxes owed.¹

In issuing the extension, Treasury has partially addressed concerns raised by many taxpayers and legal practitioners (including Simpson Thacher) in comment letters sent to Treasury and the IRS noting the administrative, legal and technical difficulties in bringing plans into full compliance with Section 409A by the previously scheduled December 31, 2007 deadline. However, Treasury apparently did *not* accede to the many requests for a full delay of the January 1, 2008 effective date of the final regulations under Section 409A (which were issued in April 2007). Additionally, Treasury has *not* extended beyond December 31, 2007 the transition relief rules currently in place related to changes in payment elections and certain offshore funding arrangements. Therefore, taxpayers may still need to take significant steps before the end of 2007 in order to avoid the potentially onerous additional 20% penalty tax (plus interest) that will apply to deferred compensation arrangements that violate Section 409A.

NO DELAY IN EFFECTIVE DATE OF FINAL REGULATIONS

Until the end of 2007, taxpayers may continue to rely on the prior guidance of Treasury and the IRS under Section 409A (including Notice 2005-1 and the previously issued proposed regulations) for purposes of demonstrating "good faith" operational compliance with Section 409A or, alternatively, taxpayers may choose to rely on the final regulations prior to their effective date of January 1, 2008. However, effective January 1, 2008, compliance with the final regulations will become mandatory, even though taxpayers may delay amending their formal written plan documents to actually reflect

¹ Our three prior memoranda addressing Section 409A can be found on our website at <http://www.simpsonthacher.com>.

the final regulations until December 31, 2008. Therefore, even though plan documents may be amended in 2008, taxpayers will need to familiarize themselves with the final regulatory requirements under Section 409A by year-end in order to ensure continued operational compliance with Section 409A.

NO EXTENSION OF TRANSITION RELIEF BEYOND 12/31/07 REGARDING CHANGES IN PAYMENT ELECTIONS

Prior transition relief under Section 409A with respect to the ability to change the time and form of payment elections (without regard to the normal limitations under Section 409A, such as requiring that any re-deferral election be for at least an additional five years) is still scheduled to expire at the end of 2007. These transition relief rules have NOT been extended by Treasury. Therefore, unless changes to existing deferral elections are made prior to December 31, 2007, a taxpayer's future ability to make payment election changes will need to comply with the more stringent general statutory and regulatory requirements under Section 409A.

DOCUMENTARY COMPLIANCE REQUIREMENTS

While Treasury has extended the documentary compliance deadline for Section 409A until the end of 2008, the extension comes with an important caveat that requires plans to designate in writing prior to January 1, 2008 a "compliant time and form of payment" of deferred compensation. Generally, a "compliant time and form of payment" for purposes of Section 409A would include payments payable upon one or more of the following:

- (i) a separation from service;
- (ii) a change in control event;
- (iii) an unforeseeable emergency;
- (iv) a specified date or fixed schedule of payments;
- (v) death; or
- (vi) disability.

Thus, if a plan currently provides for payment to be made at a time of the employer's choosing over a period of several years, the plan would need to be amended prior to the end of 2007 to provide for a generally compliant payment schedule or event. However, plans that provide for payments to be made upon events such as a "separation from service," a "change in control," an "unforeseeable emergency" or "disability" generally will have until the end of 2008 to retroactively amend applicable plan document definitions to reflect specific Section 409A requirements and definitions, so long as the plan is operated in a manner consistent with the ultimately amended language on and after January 1, 2008.

Additionally, Treasury has provided that an otherwise noncompliant plan provision (such as an early withdrawal "haircut provision") may be disregarded for purposes of determining that a plan provides for a "compliant time and form of payment" prior to January 1, 2008, so long as the noncompliant plan provision is not actually utilized and is ultimately removed from the plan by December 31, 2008.

MODIFICATION OF "GOOD REASON" PROVISIONS UNDER EMPLOYMENT/SEVERANCE ARRANGEMENTS

Certain taxpayers may wish to amend "good reason" definitions under existing employment or severance arrangements prior to December 31, 2007 in order to characterize a termination for "good reason" as an involuntary separation from service for purposes of Section 409A. While such amendments generally are not *required* under Section 409A, amending a "good reason" definition in such a manner may be desirable in order to qualify the payments for certain exemptions under Section 409A that are specifically applicable to payments made on account of involuntary separations from service. Notice 2007-78 generally clarifies that an amendment to an existing "good reason" definition prior to December 31, 2007 will be respected (despite the general rule under Section 409A that disregards a purported extension of a forfeiture condition), so long as the payment right covered by the existing "good reason" definition is subject to a substantial risk of forfeiture immediately prior to the amendment.

SUBSTITUTION OF RIGHTS UNDER EMPLOYMENT AGREEMENTS

Under Section 409A, payments made in substitution of a forfeited right to deferred compensation may be characterized as a changed payment election with respect to the prior deferral arrangement (which would therefore need to comply with the general rules under Section 409A regarding re-deferral elections). Notice 2007-78 clarifies that, until further guidance, an extension of an employment agreement, or negotiation of a new employment agreement, will not be treated as a substitution for rights to deferred compensation contained under a prior agreement, *so long as* the right to receive deferred compensation under the prior agreement was payable only upon an involuntary separation from service.

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