



Electronic Dispatch

Employee Benefits Law Action Memo

September 2007

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RECENT IRS GUIDANCE PROVIDES PARTIAL RELIEF FROM DECEMBER 31, 2007 AMENDMENT DEADLINE FOR NONQUALIFIED DEFERRED COMPENSATION PLANS Action Still Required Before the End of the Year

The Internal Revenue Service ("IRS") recently announced that it has extended the deadline by which nonqualified deferred compensation plans must be amended to fully comply with final regulations issued under Internal Revenue Code ("Code") Section 409A ("Final Regulations") from December 31, 2007 to December 31, 2008. However, the extension does not cover all plan amendment requirements, and employers will still need to take action prior to January 1, 2008 in order to ensure that their nonqualified deferred compensation plans comply with the Final Regulations.

Among other things, nonqualified deferred compensation plans must be amended by December 31, 2007 to the extent necessary to ensure that all time and form of payment provisions and applicable elections are in writing and comply with the Final Regulations. Additionally, the current "good faith" compliance period ends on December 31, 2007; full operational compliance with the Final Regulations is required as of January 1, 2008. Accordingly, while the IRS guidance provides some limited relief for employers, it is still important for employers to undertake a review of all of their existing nonqualified deferred compensation arrangements to identify all such arrangements that are subject to Code Section 409A, and take steps to amend such arrangements to comply with the requirements of the Final Regulations in order to avoid serious tax consequences for the individuals who are covered by the arrangements.

Background

Section 409A of the Code generally provides that, if a nonqualified deferred compensation arrangement fails to satisfy the requirements of Code Section 409A, compensation deferred under that arrangement for all years will be currently includible in gross income to the extent it is not subject to a substantial risk of forfeiture, and it has not previously been included in gross income. Penalties and excise taxes also apply if the nonqualified deferred compensation arrangement does not satisfy the requirements of Code Section 409A and the Final Regulations. Among other things, the Final Regulations provide that the deadline to adopt Code 409A-compliant amendments is December 31, 2007. As the December 31, 2007 deadline approaches, many commentators have expressed concern to the IRS of the difficulties in complying with the deadline, given the complexity of the Final Regulations and the onerous tax consequences that apply with respect to non-compliant plans. In response to these concerns, the IRS issued Notice 2007-78 ("Notice"), extending the deadline for full document compliance.

Plan Amendments or Elections Still Required Prior to 2008

The Notice provides that the extension of the amendment deadline does not apply to plan provisions and applicable elections regarding the time and form of payment. Accordingly, plans generally must be amended and applicable elections made in writing by December 31, 2007 to provide for a Code Section 409A-compliant time and form of payment. A permissible payment event that is added to a plan after December 31, 2007 will be subject to the anti-acceleration and subsequent deferral rules of the Final Regulations.

Operational Compliance Still Required For 2008

The Notice did not extend the time by which nonqualified deferred compensation plans must be in full operational compliance with the Final Regulations. Operational compliance is still required beginning as of January 1, 2008. The current "good faith" compliance period

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ends on December 31, 2007.

Additional Guidance Provided in the Notice

Modification of Employment Agreements – The Notice addresses how employers may modify existing employment agreements to provide for certain safe harbor “good reason” termination provisions under which an employee could voluntarily terminate employment and have certain severance payments treated as being made pursuant to an involuntary termination for purposes of Code Section 409A. In some circumstances, such treatment may allow payments to qualify for an exception from the Code Section 409A requirements.

The Notice also suggests that, in certain circumstances, the renewal of an employment agreement with a deferred compensation component could be deemed to be the actual payment of the deferred compensation.

Predetermined Cashouts – The Notice permits, pending further guidance, a plan provision that provides for the full cashout of a taxpayer’s deferred compensation benefit following termination of employment once the value of the taxpayer’s benefit falls below a predetermined level, provided (a) the cashout threshold is fixed at the time the payment event is designated, and (b) the taxpayer can demonstrate that the provision was operated in an objective, nondiscriminatory manner that did not operate to provide the service provider or the employer with the ability to make a late election as to time and form of payment.

Limited Voluntary Compliance Program – The Notice announced that the IRS anticipates that it will establish a limited voluntary compliance program that will apply to certain unintentional operational failures to comply with Code Section 409A. Under the program, such failures may be corrected in the same taxable year in which the failure occurred in order to avoid additional taxation under Code Section 409A.

Restrictions on Use of Offshore Trusts and Certain Other Arrangements – Code Section 409A contains certain restrictions regarding the use of offshore trusts and other arrangements in connection with amounts payable under a nonqualified deferred compensation plan. The Notice addresses prospective compliance requirements with respect to such restrictions.

Actions For Plan Sponsors Prior To December 31, 2007

The partial relief from the December 31, 2007 plan amendment deadline does provide employers with a limited reprieve from the plan document requirements contained in the Final Regulations. However, employers still need to take immediate action with respect to their nonqualified deferred compensation arrangements to ensure that such arrangements are compliant by the end of the 2007. To the extent they have not already done so, employers should identify all nonqualified deferred compensation arrangements that may be subject to Code Section 409A, keeping in mind that the scope of Code Section 409A is extremely broad, and covers many arrangements that employers may not have traditionally viewed as providing for deferred compensation (e.g., employment agreements). Such arrangements should be reviewed for compliance, and amended as necessary by December 31, 2007 to provide for compliant time and form of payment provisions and applicable elections. Full document compliance will be required by December 31, 2008. Employers also should be prepared for full operational compliance beginning January 1, 2008.

If you have any questions, please contact John Godsoe (716-566-2850, jgodsoe@bsk.com) or any of the other members of our Employee Benefits Law Practice Group listed below.

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