

eBenefits Alert: IRS Offers Minimal Relief for 409A Compliance

September 1, 2007

On September 10, the IRS issued Notice 2007-78 which provided some very limited relief for compliance with the regulations under Internal Revenue Code Section 409A. The final 409A regulations become effective on January 1, 2008. Notice 2007-78 permits certain plan document changes to be made on or before December 31, 2008 so long as they are made retroactively effective to January 1, 2008. However, not all plan provisions are permitted this extended period.

The following plan terms must still be amended to comply with 409A by December 31, 2007:

- Plans must state in writing by December 31, 2007, a distribution method compliant with 409A. 409A requires plans to provide an objectively determinable form of payment, payable on: (1) separation from service; (2) a change in control; (3) an unforeseeable emergency; (4) a specified date or fixed schedule of payments; (5) death or (6) disability.
- Plans must be amended by December 31, 2007 to eliminate provisions that allow discretion to distribute plan benefits over more than one taxable year.

The following plan terms must be amended by December 31, 2008:

- Plans must operate using 409A compliant definitions of "separation from service," "change in control," "unforeseeable emergency," or "disability." However, plans can be amended until December 31, 2008 to reflect the definition used.
- Plans may revise their distribution terms during 2008, on a limited basis, to add a provision permitting distributions to be made after the distribution event by the end of the participant's taxable year (in which the event occurs) or within 90 days following the event.
- Plans of publicly-held companies have until December 31, 2008 to include the six-month delay rule in their plan documents, provided the plan is operated in compliance with the rule.

In addition to some plan documentation relief, the Notice also provides clarification with respect to application of the cash-out rule. Under the cash-out rule, plans may permit amounts otherwise payable in installments or an annuity to be cashed out in a lump sum if the present value of the remaining payments falls below a specified dollar threshold. The Notice provides that until further guidance is issued, plans may determine whether a cash-out will occur on a one-time basis at the payment commencement date, rather



than on a continuous basis during the payout period.

The Notice also provides some relief with respect to the modification of "good reason" definitions in employment agreements. Many practitioners would prefer to modify current "good reason" definitions in these agreements to comply with the 409A safe harbor standards. However, making such a modification raises issues regarding whether the agreement will be treated as having added a substantial risk of forfeiture condition. Previous guidance under 409A has stated that the addition of a substantial risk of forfeiture condition after the beginning of the service period to which the compensation relates will be disregarded for purposes of determining whether such compensation is subject to a substantial risk of forfeiture. The Notice clarifies that modifications to existing "good reason" definitions in employment agreements to conform to some or all of the 409A "good reason" safe harbor standards will be respected, provided the modification is made by **December 31, 2007**, the severance benefit is otherwise subject to a substantial risk of forfeiture at the time of the modification, and payment of the severance benefit would not otherwise have occurred in 2007.

Notably, the Notice does not extend the transition rule allowing changes in payment methods or the transition rule permitting plans to be amended to fall within an exemption to 409A. These transition rules will expire on December 31, 2007.

Finally, the Notice announces forthcoming guidance regarding a voluntary compliance program to correct inadvertent 409A operational defects. This program will allow plan sponsors to self-correct certain unintentional operational errors in the same taxable year and will provide methods to limit adverse tax consequences in the case of other unintentional operational failures.

Unfortunately, the relief provided does not preclude the need to complete a thorough review of all arrangements subject to 409A by year-end. Arrangements must be reviewed and amended to insure compliance with those requirements that must be met by December 31, 2007. Thus, despite the relief offered, employers should likely proceed with making all necessary changes by December 31, 2007. If you would like assistance with 409A compliance, please contact a member of the Gray Plant Mooty Employee Benefits and Executive Compensation group.

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