



WASHINGTON REPORT

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Subject: **IRS Notice 2007-86 - Extension of 409A Compliance Deadline and Transition Rules - Additional Analysis**

Major References: [IRS Notice 2007-86](#)

Prior AALU Washington Reports: 07-94; 07-89; 07-83; 07-81; 07-76; 07-72; 07-66; 07-50; 07-48; 07-44; 07-41; 07-38; 07-34; 06-131; 06-118; 06-114; 06-96; 06-70; 06-37; 06-16; 06-06; 06-02; 04-173

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As reported in our Washington Report No. 07-94, the Internal Revenue Service issued Notice 2007-86, which extends the deadline for complying with the final Code section 409A regulations and the transition rules for one full year - until December 31, 2008. Notice 2007-86 revokes and supersedes the limited Notice 2007-78 "extension." The earlier Notice provided an extension only with respect to certain documentation requirements -- the transition rules were not extended and plans had to be operationally compliant with the final regulations no later than January 1, 2008. (See our Bulletins Nos. 07-83 and 07-81.) In response to various efforts by AALU and others, Notice 2007-86 effectively implements a full one-year extension of the compliance deadline and transition rules through December 31, 2008. We here offer a detailed analysis of that extension and its ramifications.

Background

On April 10, 2007, the IRS issued final regulations under section 409A (see our Bulletins Nos. 07-50, 07-48, 07-44, 07-41 and 07-38), which imposes new rules on nonqualified deferred compensation

arrangements. The new rules statutorily apply to amounts deferred (earned and vested) on or after January 1, 2005, and to amounts deferred before then if the arrangement is materially modified after October 3, 2004. As originally issued, the final regulations were generally applicable for taxable years beginning on or after January 1, 2008. Before the final regulations become applicable, plan sponsors are generally permitted to comply with the new rules under a reasonable, good faith compliance standard, taking into account the interim guidance issued by the IRS, including the transition rules.

On September 10, 2007, the IRS issued Notice 2007-78, which extended the deadline for satisfying the written plan requirement under the final regulations until December 31, 2008 (i.e., a one-year extension). However, many plans were still required to designate in writing by the end of 2007 a compliant time and form of payment. In addition, although Notice 2007-78 generally extended the deadline for complying with the written plan requirement until the end of 2008, it did not extend the effective date of the final regulations or any of the transition rules that were scheduled to apply through the end of 2007. As a result, all arrangements subject to the new rules would need to be operationally compliant with the final regulations no later than January 1, 2008.

The reaction to the limited relief provided by Notice 2007-78 was immediate and consistent - there was a consensus on the part of plan sponsors and the general employee benefits community that the relief was not sufficient and that additional time was needed in order to provide an orderly and thoughtful business process for complying with the final regulations. In addition, many believed that an extension of the compliance deadline would actually enhance, rather than adversely affect, compliance.

Most interested parties, including the AALU, requested a full extension of the compliance deadline for one additional year. That is, they asked that the applicable date of the final regulations and all of the existing transition rules be extended for one additional year - until the end of 2008. The IRS granted such relief in Notice 2007-86.

Extension of Final Regulations' Compliance Date

The new rules imposed by section 409A generally apply to amounts deferred on or after January 1, 2005. The final regulations were originally issued to be applicable for taxable years beginning on or after January 1, 2008. Notice 2007-86 extends the final regulations' effective date for one full year until January 1, 2009. With respect to amounts deferred on or after January 1, 2005 and before the effective date of the final regulations, taxpayers must comply with the new rules under a reasonable, good faith compliance standard, taking into account the interim guidance issued by the IRS, including the transition rules, which are discussed further below.

For periods before January 1, 2008, compliance with either the proposed or final regulations will constitute reasonable, good faith compliance with the new rules. In an exception to a "full" extension of the transition rules, Notice 2007-86 provides that, for periods after December 31, 2007 and before January 1, 2009 (i.e., essentially calendar year 2008), only compliance with the final regulations will constitute reasonable, good faith compliance - compliance with the proposed regulations will no longer constitute reasonable, good faith compliance after 2007.

The final regulations are generally more favorable to taxpayers and less restrictive than the proposed regulations. Therefore, this inability to continue to rely on the proposed regulations should not be significant for most taxpayers, but it will require a review of a plan's current compliance approach by the end of this year to make sure that the plan is not relying on a provision in the proposed regulations that is more favorable or less restrictive than the final regulations. Based on informal discussions with a primary

drafter of Notice 2007-86 (and the proposed and final regulations), AALU understands that there were no specific provisions in the proposed regulations that the IRS was targeting in their refusal to extend the "reliance period" of the proposed regulations. AALU understands that it was primarily done to simplify the provisions that could be relied on in 2008; with an understanding that most of the differences between the final and proposed regulations are more favorable to taxpayers and should not require significant changes, if any, to a plan's compliance approach for the 2008 year.

Extension of Transition Rules

Before the issuance of Notice 2007-86, there were a number of transition rules that were scheduled to expire at the end of 2007. Notice 2007-86 generally extends these transition rules for a full year - through the end of 2008. The transition rules that were extended are summarized separately below:

(1) **Amendment of Plans:** An arrangement that is subject to section 409A must meet a number of new requirements, including a written plan requirement. As originally issued, the final regulations provided that all arrangements that are subject to section 409A must be in writing and in full compliance with the final regulations by December 31, 2007. Notice 2007-86 extends the compliance deadline for this written plan requirement for one full year until December 31, 2008. Until then, a plan generally must be operated in reasonable, good faith compliance with the new rules (as discussed above). All plans subject to section 409A will have to be amended by the end of 2008 to be fully compliant with the new rules.

(2) **Changes in Time and Form of Payment:** There is an existing transition rule which allows new payment elections to be made during the transition period provided that a change made in a particular tax year does not cause a payment to be accelerated into or deferred out of the tax year in which the change is made (i.e., the "in and out rule"). This transition rule was extended by Notice 2007-86 until the end of 2008. Thus, an arrangement subject to section 409A can provide for a new time and form of payment through the end of 2008 so long as the in and out rule is satisfied.

This extension may require action to be taken by the end of 2007. For example, if an arrangement subject to section 409A currently provides for a payment to be made in 2008 and either the employer or employee (or both) want to change it to a different form or to commence in a different year, the change would have to be made by the end of 2007 to satisfy the in and out rule. If the change is not made until 2008, the in and out rule would not be satisfied. Note that even if a payment is not definitively scheduled for 2008 (e.g., it is payable upon a separation from service or some other permissible event that is not scheduled or expected to occur in 2008), a change would have to be made in 2007 if the event ultimately occurs in 2008 (e.g., the employee unexpectedly experiences a separation from service in 2008).

It should also be emphasized that this transition rule does not provide relief from other tax rules that may apply, including, but not limited to, the constructive receipt doctrine (which provides that an amount is includible in a taxpayer's gross income if he or she has access to an amount that is not subject to substantial limitations or restrictions). Section 409A imposes new, additional rules on nonqualified deferred compensation arrangements; all of the tax principles that applied to such arrangements prior to the enactment of section 409A continue to apply. Accordingly, in making new time and form of payment changes under the transition rule, taxpayers should make sure that the changes do not trigger adverse tax consequences under any of the other tax rules that may apply (e.g., constructive receipt).

This particular transition rule also included a special provision for the deferral of amounts that otherwise would qualify as a short-term deferral that is excepted from the requirements of section 409A (i.e., it is generally payable within 2-1/2 months of the end of the taxable year in which the amount is no

longer subject to a substantial risk of forfeiture). Under this special rule as it applied prior to Notice 2007-86, a deferral election could be made with respect to an amount that was a short-term deferral, provided that the election was made before January 1, 2008 and before the year in which the amount would otherwise have been paid. This special transition rule was extended by Notice 2007-86 to apply to deferral elections made before January 1, 2009 and the year in which the amount would otherwise be paid.

(3) Payments Based on Elections Under Qualified Plans: Payment elections under a nonqualified deferred compensation arrangement that mirror or depend upon payment elections under a qualified retirement plan generally do not satisfy the payment election rules under section 409A because such elections generally are not made at the time the deferral election is made. There is an existing transition rule that allows such payment elections to continue in effect through the end of 2007, provided that the determination of the time and form of payment is made in accordance with the terms of a nonqualified deferred compensation arrangement that were in effect on October 3, 2004. Notice 2007-86 extends this transition rule through the end of 2008.

(4) Substitution of Non-Discounted Stock Rights for Discounted Stock Rights: Notice 2007-86 also extends through the end of 2008 a special transition rule that allows discounted stock rights that do not comply with section 409A to be replaced with non-discounted stock rights that are excepted from the new rules; provided certain requirements are satisfied (e.g., the transition rule does not apply if the stock right is exercised before the replacement). It should be emphasized that this extended transition rule does not apply to insiders of publicly-traded companies that were expected to restate their financial statements to reflect the discounted options (e.g., in connection with the option back-dating controversy). The insiders generally had to replace any discounted options by the end of 2006.

Notice 2007-86 generally revokes and supersedes the limited transition relief provided by Notice 2007-78 and generally provides a full one-year extension of the final regulations' compliance deadline and existing transition rules. However, Notice 2007-78 also included additional guidance regarding the application of the final regulations to employment agreements (see our Bulletin 07-83), which guidance was not revoked and was clarified in certain respects by Notice 2007-86.

Application of Section 409A(b) (Funding Restrictions)

Section 409A(b) imposes new rules regarding the funding of deferred compensation arrangements. Assets that are located outside of the United States or that become restricted to the payment of deferred compensation in connection with a change in the employer's financial health would be taxable to the participants when transferred outside of the United States or set aside. In addition, with respect to a plan sponsor that maintains a defined benefit pension plan, if any assets are transferred to a trust, set aside, reserved or restricted to the payment of nonqualified deferred compensation during a restricted period, any assets so set aside or restricted would become immediately taxable to certain top executives. For this purpose, the term "restricted period," with respect to the defined benefit pension plan, means: (i) the period of time when the defined benefit plan sponsor is a debtor in bankruptcy; (ii) six months before or after the date that an underfunded defined benefit plan is terminated; and (iii) any period of time during which a defined benefit plan is "at risk" under the new funding rules added by the Pension Protection Act of 2006.

Following the enactment of section 409A there was considerable uncertainty about the application of the general effective date rule for section 409A to the funding rules in section 409A(b). Literally it appeared that assets already in an offshore trust (or restricted under section 409A(b)(2)) were grandfathered. A provision in the Gulf Opportunity Zone Act of 2005 ("GOZA") made it clear that Congress intended otherwise. The provision in GOZA, as further clarified by Notice 2006-33 (See our

Bulletin No. 06-37), clarifies that the funding rules in section 409A(b) do not include any grandfather; the funding rules apply to assets in an offshore trust (and section 409A(b)(2) restricted assets) as of January 1, 2005.

Notice 2006-33 alleviated the effective date problem by providing two transition rules. First, until further guidance is issued, taxpayers may apply a reasonable, good-faith interpretation of section 409A(b). Second, for set-asides or assets restricted on or before March 21, 2006 (“grace-period assets”), section 409A(b) will not be violated if the plan comes into conformity with the applicable rules by December 31, 2007. This transition rule for grace-period assets includes post-March 21, 2006 earnings on those assets.

Notice 2007-78 provided additional guidance with respect to both of the transition rules provided in Notice 2006-33. First, Notice 2007-78 indicated that the IRS intends to issue further guidance regarding the application of section 409A(b) and, until such guidance is issued, taxpayers can continue to rely upon a reasonable, good faith interpretation of section 409A(b). Second, Notice 2007-78 indicated that the transition rule for grace period assets would not be extended beyond December 31, 2007, and therefore, after December 31, 2007, taxpayers must comply with a reasonable, good faith interpretation of section 409A(b) with respect to all assets in arrangements that are subject to section 409A(b). The notice also clarified that if a plan is not in conformity with a reasonable, good faith interpretation of section 409A(b) on December 31, 2007, the taxpayer would trigger the income inclusion and additional tax provisions of section 409A(b) on January 1, 2008. Notice 2007-86 does not change any of the guidance or effective dates with respect to the new funding rules.

Anticipated Limited Voluntary Compliance Program

The IRS also announced in Notice 2007-78 that it is expecting to establish a limited voluntary compliance program in the near future that would apply to certain unintentional operational failures to comply with section 409A. Such program would provide methods by which certain unintentional operational failures may be corrected in the same taxable year in which the operational failure occurred to avoid application of section 409A, and other methods by which certain unintentional operational failures may result in only limited amounts becoming includible in income and subject to additional taxes under section 409A. Notice 2007-86 confirms that the IRS anticipates establishing this compliance program as soon as possible.

Any AALU member who wishes to obtain a copy of Notice 2007-86 may do so through the following means: (1) use hyperlink above next to “Major References,” (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* and select *Current Washington Report* for linkage to source material or (3) email Erik Ruselowski at ruselowski@aalu.org and include a reference to this *Washington Report*.

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