

Employee Benefits and Executive Compensation

A L E R T

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The IRS Extends the Deadline to Comply with Deferred Compensation Rules

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BACKGROUND

The IRS just released Notice 2007-86 that provides another year for employers to bring their deferred compensation plans into compliance with Internal Revenue Code Section 409A. Section 409A imposes strict requirements on such plans. Failing to comply causes the deferred amounts to become immediately taxable with interest and subject to a 20 percent penalty.

Section 409A became effective on January 1, 2005. Last month, the IRS extended some of the compliance deadlines until the end of 2008. Earlier this week, they provided additional extensions for most other deadlines until December 31, 2008. However, the IRS is still requiring “good faith” compliance with Section 409A now. Good faith compliance means deferred compensation arrangements comply in operation with the statute. For example, payments of deferred compensation may occur only upon certain events allowed by Section 409A.

The problem this creates for employers is the breadth of the statute. “Deferred compensation” is the legally binding right in one year to compensation not paid until a future year. Many compensatory arrangements not traditionally thought of as deferred compensation fit within this definition, such as stock options, severance agreements or other incentive compensation arrangements. Even employment offer letters including promises of bonuses or severance payments can constitute “deferred compensation” under the statute.

HIGHLIGHTS OF IRS NOTICE 2007-86

The latest IRS guidance extends until December 31, 2008 the deadline for formally amending deferred compensation arrangements to comply with Section 409A. This means a “good faith” interpretation of Section 409A, rather than strict compliance with the final IRS regulation, is available for another year. It also extends the favorable transition relief previously announced by the IRS, some of which is discussed below:

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This Alert is a general summary of the IRS guidance and steps employers can take to comply with Section 409A. We suggest that you seek legal advice regarding specific issues. Ater Wynne's Employee Benefits and Executive Compensation Group can assist you in structuring your deferred compensation plans to comply with Section 409A.

Payment and Deferral Elections. Employees have until the end of 2008 to make payment elections consistent with Section 409A. This allows an employee to change the time and form of payment of their existing deferral elections (something Section 409A prohibits) provided that the change does not apply to amounts that otherwise would be received in the year in which the election is made and the change does not accelerate income into the year in which the election is made. For example, changes to the time and form of payments due in 2008 (or that accelerate payments into 2008) must occur before the end of 2007. These changes cannot affect payments due in 2007.

Discounted Stock Options. Stock options or appreciation rights with exercise prices less than fair market value of the underlying stock on the date of the grant are subject to Section 409A penalties upon vesting. Employers may modify or reissue unexercised options or SARs to comply with Section 409A through the end of 2008. Note that insiders of publicly traded companies are not eligible for this transition relief.

Linked Plans. Section 409A prohibits deferred compensation plans from linking the time and form of payment to qualified plans (e.g., a 401(k) plan). The notice allows such links to remain through the end of 2008.

WHAT EMPLOYERS NEED TO DO NOW

- Identify all agreements and arrangements that might be “deferred compensation.”
- Analyze whether the time and form of payment complies with Section 409A.
- If necessary, change payment provisions to comply, considering the IRS guidance.
- Make deferral elections for 2008 compensation.
- Review stock option and stock appreciation right grants to determine if exercise price is at least fair market value, and if not, consider corrective actions.
- Consider on-going compliance with Section 409A and what processes, grants or awards require change.

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