



## IRS Extends 409A Transition Relief and Provides Guidance on 2007 Reporting and Withholding

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The Internal Revenue Service (IRS) recently announced that it has again extended the transition relief applicable to nonqualified deferred compensation plans (NQDC plans) under section 409A of the Internal Revenue Code of 1986, as amended (Section 409A). Notice 2007-86, which was issued on October 22, 2007, generally extends through December 31, 2008 the prior Section 409A transition relief that was set to expire on December 31, 2007. Also, on October 23, 2007, the IRS issued Notice 2007-89, which provides guidance to employers and payers on their reporting and wage withholding requirements for the 2007 calendar year with respect to amounts includible in gross income under Section 409A, and continues to waive the reporting requirement under Section 409A for the 2007 calendar year for deferrals of compensation not actually includible in gross income under that section.

Although this latest extension gives employers more time to bring their NQDC plans into compliance, employers should by no means “relax” and put all of their Section 409A issues on the back burner until the last quarter of 2008. Instead, employers should use the extra time to identify and analyze their existing NQDC plans and arrangements and make informed, reasoned decisions regarding the changes needed to bring such plans and arrangements into Section 409A compliance.

### Prior Transition Relief

In December 2004, the IRS issued Notice 2005-1, which was the first guidance with respect to the application of Section 409A. Notice 2005-1 gave plan sponsors until December 31, 2005 to amend their NQDC plans

to comply with Section 409A. The proposed regulations under Section 409A that were issued in October 2005 (the Proposed Regulations) extended the amendment deadline and provided additional transition relief through December 31, 2006, both of which were further extended through December 31, 2007 in Notice 2006-79, issued in October 2006. The final regulations under Section 409A (the Final Regulations), which were issued in April 2007, required NQDC plans to comply in writing to the requirements of Section 409A no later than December 31, 2007, and operate in conformance with Section 409A and the Final Regulations beginning January 1, 2008.

In response to comments that the December 31, 2007 deadline for amending NQDC plans to comply with Section 409A and the January 1, 2008 effective date of the Final Regulations did not give plan sponsors sufficient time to bring plans into compliance, the IRS issued Notice 2007-78 on September 10, 2007 to provide additional transition relief with respect to some, but not all, of the document compliance requirements in the Final Regulations. However, Notice 2007-78 did not extend the effective date of the Final Regulations and still required that NQDC plans designate a Section 409A-compliant time and form of payment no later than December 31, 2007.

### Extension of Prior Transition Relief

Acknowledging concerns that the relief provided in Notice 2007-78 did not adequately address the need for additional time for employers to address all of their Section 409A issues and bring their plans into compliance with the Final Regulations, on October 22, 2007 the IRS issued Notice 2007-86, which extends through December 31, 2008 the transition relief currently set to expire on December 31, 2007 to the extent set forth below.

#### Plan Amendments

The document compliance deadline for amending NQDC plans to conform to the provisions of Section 409A(a) and the Final Regulations has been extended through December 31, 2008. The limited transition relief for document compliance provided in Notice 2007-79, which required NQDC plans to specify a compliant time

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and form of payment no later than December 31, 2007 no longer applies.

Notice 2007-86 also extends to December 31, 2008 the deadline for amending NQDC plans to take advantage of the initial deferral election transition relief described in Q&A-21 of Notice 2005-1, which provided relief for certain initial deferral elections made on or before March 15, 2005, provided that the NQDC plan was amended on or before December 31, 2005 to provide for such election. Earlier transition relief did not extend this amendment deadline, but the IRS has now recognized that many taxpayers have misinterpreted such prior relief and, in order to avoid unintentional noncompliance in this area, has expanded the new transition relief to include this amendment. The taxpayer retains the burden, however, to demonstrate that the initial deferral election was, in fact, made by March 15, 2005.

#### *Good Faith Operational Compliance*

NQDC plans are not required to be operated in compliance with the Final Regulations until January 1, 2009. Prior to January 1, 2009, NQDC plans must be operated in compliance with Section 409A and the applicable provisions of Notice 2005-1 and any other applicable guidance under Section 409A with an effective date prior to January 1, 2008 (which does not include the Final Regulations). To the extent that an issue is not addressed in Notice 2005-1 or other applicable guidance, the NQDC plan must be operated consistent with a “good faith, reasonable interpretation” of Section 409A. For periods prior to January 1, 2008, compliance with either Notice 2005-1, the Proposed Regulations or the Final Regulations will constitute reasonable, good faith compliance with Section 409A. After December 31, 2007, however, compliance with the Proposed Regulations will no longer constitute reasonable, good faith compliance with Section 409A.

#### *Change in Payment Elections*

NQDC plans may provide or be amended to provide for new payment elections for both the time and form of payment any time prior to December 31, 2008 without the election or amendment being treated as a change in the time and form of payment or an acceleration of payment, provided that the plan is amended and the elections are made on or before December 31, 2008. As was the rule in 2007, changes in payment elections made in 2008 cannot apply to amounts that were scheduled to be paid in 2008 and cannot accelerate a payment into 2008 that was scheduled to be paid in a later year.

#### *Payments Linked to Qualified Plans*

The ability to link a payment election under a NQDC plan to an election under a qualified plan has been extended for payments with annuity starting dates through December 31, 2008. Notice 2007-86 also extends this transition relief to include payments under NQDC plans that are linked to section 403(b) annuities, section 457(b) eligible plans and certain foreign broad-based plans.

#### *Substitution of Non-Discounted Stock Options and Stock Appreciation Rights (SARs) for Discounted Stock Options and SARs*

With the exception of certain discounted stock rights described below, it will not be a material modification for purposes of Section 409A to replace, on or before December 31, 2008, a stock option or SAR that provides for a deferral of compensation (e.g., a discounted option) with a stock option or SAR that would not have constituted a deferral of compensation under Section 409A if it had been granted on the original grant date of the replaced option or SAR. This relief, however, is not available where the replacement of a stock option or SAR results in the cancellation of a deferral in exchange for cash or vested property in 2008, such as in the cash-out or exercise of a discounted option. This relief is also not available for a discounted stock right if:

- the right was granted with respect to stock of a publicly traded corporation whose stock is registered under section 12 of the Securities Exchange Act of 1934 (the 34 Act);
- the grantee was a reporting person under section 16(a) of the 34 Act at the time of grant; and
- the corporation either has reported or expects to report a financial expense in connection with the grant because the stock right was issued with an exercise price less than the fair market value of the underlying stock on the date of grant and was not timely reported on the financial statements or reports under generally accepted accounting principles.

#### *Good Reason Provisions in Employment Agreements.*

To the extent that the right to payment subject to an existing “good reason” provision is currently subject to a substantial risk of forfeiture, the modification of the good reason provision to conform to the definition of “good reason” in the Final Regulations will not be treated as the extension of the substantial risk of forfeiture, provided

the modification is made no later than the new end of the transition period, *i.e.*, December 31, 2008.

### Other Prior Guidance Not Affected

Except as described in this Alert, the other provisions of Notice 2007-78 remain unchanged, including (i) the relief from the substitution rule when employment agreements are revised or extended (which applies by its terms until further guidance is issued), (ii) the provision allowing the de minimis cashout rule to be applied solely at the time of the original payment (which likewise applies by its terms until further guidance is issued) and (iii) the guidance relating to certain trusts and other arrangements subject to Section 409A(b) (which does not extend the existing transition relief from Section 409A(b) beyond December 31, 2007, but generally allows taxpayers to rely on a reasonable, good faith interpretation of that section until further guidance is issued).

### 2007 Reporting and Withholding Requirements

In November 2006, the IRS issued Notice 2006-100, which provided guidance to employers and payers on their reporting and withholding obligations with respect to deferrals of compensation and amounts includible in gross income under Section 409A during calendar years 2005 and 2006.

Generally, Notice 2007-89 extends to the 2007 tax year the guidance on Section 409A reporting and withholding for the 2005 and 2006 tax years that was provided in Notice 2006-100. Accordingly, for 2007, the following rules continue to apply:

#### *2007 Annual Deferrals*

An employer is not required to report amounts deferred during the year under a NQDC plan in box 12 of Form W-2 or in box 15a of Form 1099-MISC. (Reporting in boxes 3 and 5 of deferrals that are included in FICA wages under Section 3121(v), of course, continues to be required.)

#### *Amounts Includible in Gross Income Under Section 409A*

For 2007, amounts includible as gross income under Section 409A (and not included in income in a prior year) must be reported as wages paid on line 2 of Form 941, Employer's Quarterly Tax Return, and in box 1 of Form W-2. An employer must also report such amounts as Section 409A income in box 12 of Form W-2 using Code Z. Such amounts are treated as supplemental wages for purposes of determining the amount of income tax

withholding. Although the notice is unclear on this point, it appears to allow income tax to be withheld at a flat 25% rate regardless of whether the employer has paid the employee any regular wages during the calendar year.

For non-employees, amounts includible as gross income for 2007 under Section 409A must be reported as non-employee compensation in box 7 of Form 1099-MISC and as Section 409A income in box 15b of Form 1099-MISC.

#### *Calculation of Includible Amount*

Generally, the amount that is includible in gross income under Section 409A and subject to reporting and withholding is the portion of the total amount that remains deferred under the plan that, as of December 31, 2007, is not subject to a substantial risk of forfeiture and has not been included in income in a prior year, plus any amounts paid or made available to the service provider under the plan during 2007. The method for determining the amount that remains deferred as of December 31, 2007 varies depending on the type of plan in the same manner as described in Notice 2006-100.

### Material Available On-Line

The following material is available with the indicated file sizes:

- **Notice 2007-86** [31K]
- **Notice 2007-89** [47K]
- **Notice 2007-78**, extending the deadline for some, but not all, document compliance amendments. [68K]
- **Final section 409A regulations, T.D. 9321**, as published in the April 17, 2007 Federal Register. [416K]
- **Notice 2007-34**, application of section 409A to certain split-dollar life insurance arrangements. [27K]
- **Notice 2006-100**, transition guidance regarding 2005 and 2006 reporting and withholding. [95K]
- **Notice 2006-79**, additional transition relief. [61K]
- **Notice 2006-64**, interim guidance regarding payments necessary to meet federal conflict of interest requirements. [47K]
- **Notice 2006-33**, transition guidance regarding section 409A(b). [77K]

- **Notice 2006-4**, transition guidance regarding certain stock rights. [59K]
- **Notice 2005-94**, transition guidance with respect to 2005 reporting and withholding. [49K]
- **Proposed section 409A regulations**, as published in the October 4, 2005 Federal Register. [272K]
- **Notice 2005-1**, initial and transition guidance. [201K]
- **Text of section 409A**, as enacted as part of the American Jobs Creation Act of 2004 (Conference Committee Report, H.Rpt. 108-755, pp. 221-227). [65K]
- **Conference Committee explanation for section 409A** (Conference Committee Report, H.Rpt. 108-755, pp. 706-724). [80K]
- Our **September 2007 Tax Bulletin**, discussing Notice 2007-78. [232K]

- Our **May 2007 Tax Bulletin**, discussing the final section 409A regulations. [184K]
- Our **October 2005 Tax Bulletin**, discussing the October 2005 proposed regulations. [219K]

#### Important Information for Readers

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