

HR ALERT

September 2007

Limited Relief under Code Section 409A Is Issued by the Internal Revenue Service, but Some Decisions Still Must Be Made in 2007

On September 10, 2007, the Internal Revenue Service (“IRS”) published Notice 2007-78. This new notice deals with timing issues related to bringing non-qualified deferred compensation plans and arrangements into compliance with Internal Revenue Code (“Code”) Section 409A. While companies and practitioners no doubt will be grateful for the extension rights granted by the IRS in Notice 2007-78, this notice is noteworthy as much for what it does not do as for what it does do. While full documentary compliance with Code Section 409A has been postponed, as noted below, it still is necessary for many decisions related to bringing covered plans and arrangements into operational compliance with Code Section 409A to be made by the end of 2007.

What Does Notice 2007-78 Do?

Most importantly, Notice 2007-78 extends through December 31, 2008 the deadline to adopt amendments on a retroactive basis to bring covered plans and arrangements into compliance as to form with Code Section 409A. Previously, the deadline had been December 31, 2007. This will be a welcome relief to companies facing a short deadline to get all of their governing documents up to standard. However, and as noted below, full operational compliance with the final

regulations issued by the IRS under Code Section 409A is required on and after January 1, 2008.

In addition to this welcome extension, the IRS also announced in Notice 2007-78 that it anticipates the issuance of guidance in the “near future” establishing the a limited voluntary compliance program allowing companies to correct certain unintended operational failures. The notice indicates that certain such failures could be corrected without the imposition of any sanctions under Code Section 409A if they are corrected in the year in which they occur, and lesser sanctions would apply in the event these unintended operational failures are remedied in subsequent years. It appears this program, if established, would not apply to documentary failures.

As a counterweight to the above extension for plan amendments, Notice 2007-78 requires that each affected plan or arrangement must designate “in writing” on or before December 31, 2007 a compliant time and form of benefit payments attributable to amounts deferred as of January 1, 2008. Amounts deferred after December 31, 2007 will comply with Code Section 409A only if the plan designates “in writing” a compliant time and form of benefit payments under the

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time frames set forth in the final regulations. The notice includes rules as to how to designate the time and form of payments in a timely manner.

The notice contains some helpful transition provisions related to the “good reason” termination rules under affected employment agreements. In particular, the notice indicates that the timely amendment of existing employment agreements to incorporate the rules related to good reason termination in the final regulations under Code Section 409A can be done without adverse consequences. The good reason provisions allow employers to terminate their employment agreements upon the occurrence of specified conditions that materially and negatively affect the employment relationship, and these provisions often are contained in employment agreements. The notice allows existing employment agreements that already are subject to existing good reason termination provisions to be amended to include the standards contained in the final regulations under Code Section 409A without creating any negative consequences under Section 409A. However, in order to take advantage of this rule, the amendments to the employment agreements must be completed on or before December 31, 2007.

What Does Notice 2007-78 Not Do?

Under previous guidance issued under Code Section 409A, companies were operating under a compliance standard that allowed them to operate their plans and arrangements either under the terms of the IRS proposed regulations under Code Section 409A or under a “reasonable, good faith interpretation” of the section. Notice 2007-78 makes it

clear that the good faith compliance standard will not be extended beyond December 31, 2007, and that on and after January 1, 2008 all covered plans and arrangements must be operated in accordance with the final regulations issued this past spring under Code Section 409A.

The notice also states that the special transition rules that allow companies and covered participants to make changes in the form and timing of benefit distributions under limited circumstances will not be extended beyond December 31, 2007. Accordingly, any companies that wish to take advantage of these limited transition rules, or that wish to allow covered participants to do so, must complete that process by the end of 2007.

Other transition rules also have not been extended beyond December 31, 2007, including the rule relating to the substitution of non-discounted equity-based awards for non-compliant discounted awards and the rule that has permitted the linkage of distributions from non-qualified deferred compensation plans to the timing and form of distributions from tax-qualified plans.

The six-month delay requirement relating to payments to certain specified employees is unaffected operationally by the above extension. However, the notice makes it clear that a covered plan need not be amended to include the six-month delay feature before December 31, 2007 so long as the plan is operated in compliance with the rule and the company can demonstrate operational compliance.

While the documentary relief under Notice 2007-78 is welcome news, it is clear that it still is necessary to complete

a review of the impact of Code Section 409A on covered plans and arrangements before December 31, 2007, and that some actions may need to be taken in writing

on or before that date to ensure compliance with Section 409A even if companies elect to take advantage of the extension for amendments.

Congressional Efforts to Cut Back on Use of Independent Contractors

On September 13, 2007, a bill was introduced in the Senate that aims to close a perceived loophole in federal tax law that allows employers to characterize workers as independent contractors rather than employees. Called the "Independent Contractor Proper Classification Act of 2007" (S. 2044), the bill is co-sponsored by several Democratic senators, including Sens. Edward M. Kennedy (D-Mass.), Richard Durbin (D-Ill.) and Barack Obama (D-Ill.). The bill, which was referred to the Senate Finance Committee, seeks to scale back a safe harbor provision in Section 530 of the Revenue Act of 1978 that over the years has offered protection to employers treating workers as independent contractors based upon, among other items, long-standing practice in the industry or the results of a prior employer audit. For years, worker advocates have argued that Section 530

has allowed employers to unfairly deprive workers of the tax and benefits derived from employee status. The bill also would encourage more robust enforcement and review of the worker classification issue by both the Internal Revenue Service and the Department of Labor.

The House also has been studying this issue recently. In May, 2007, the House Ways and Means Select Revenue Measures and Income Security and Family Support subcommittees held a hearing on this issue, and heard testimony that the Government Accountability Office estimates that worker misclassification could reduce federal revenues by up to \$4.7 billion each year. Even with the impending elections, this is an issue that might draw some attention.

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