Notice 2007-78

I. PURPOSE

This notice provides transition relief and additional guidance on the application of § 409A of the Internal Revenue Code to nonqualified deferred compensation plans. This transition relief and additional guidance includes:

- Extension to December 31, 2008, of the deadline to adopt documents that comply with § 409A, subject to limited requirements regarding the timely written designation of a time and form of payment.
- Guidance and additional relief addressing certain issues raised by the application to employment agreements and cashout features of § 409A and the final regulations.
- Announcement that the Treasury Department and the IRS anticipate issuing guidance containing a limited voluntary compliance program that will permit taxpayers to correct certain unintentional operational violations of § 409A and thereby limit the amount of additional taxes due under § 409A.
- Announcement that the relief from the application of § 409A(b) (which prohibits the use of certain types of arrangements to pay for nonqualified deferred
compensation) provided in Notice 2006-33 with respect to certain “grace period assets”, which expires December 31, 2007, is not being extended, so that after December 31, 2007, taxpayers must comply with a reasonable, good faith interpretation of § 409A(b) with respect to all assets in arrangements subject to § 409A(b).

II. BACKGROUND

Section 409A provides certain requirements applicable to nonqualified deferred compensation plans. If a plan does not meet those requirements, participants in the plan are required to immediately include amounts deferred under the plan in income and pay additional taxes on such income.

The Treasury Department and the IRS issued final regulations under § 409A in April 2007 (72 Fed. Reg. 19234 (April 17, 2007)). The final regulations apply to taxable years beginning on or after January 1, 2008. In general, the final regulations require that the material terms of a nonqualified deferred compensation plan be in writing. See § 1.409A-1(c). Commentators stated that taxpayers anticipate difficulties in formally amending existing plans to comply with the final regulations by the January 1, 2008 deadline. In addition, a number of commentators have raised questions regarding the application of the final regulations to certain types of plans. This notice is issued in response to these comments and questions.

III. 2008 TRANSITION RELIEF

A. In General

Section 409A generally applies to amounts deferred under a nonqualified deferred compensation plan to the extent the amounts deferred under the plan were not
earned and vested before January 1, 2005. The final regulations are applicable for taxable years beginning on or after January 1, 2008, and a nonqualified deferred compensation plan must meet the requirements set forth in the final regulations as of the first day of the taxable year. This section provides certain limited transition relief, until December 31, 2008, with respect to the plan document requirements. The transition relief in this notice is not an extension of any of the transition relief provided in Notice 2005-1, 2005-1 CB 274, the preamble to the proposed regulations under § 409A, 70 Fed. Reg. 57930 (Oct. 4, 2005), or Notice 2006-79, 2006-43 IRB 763. Accordingly, except where otherwise provided in the section of the preamble to the final regulations entitled “Effect on Other Documents,” taxpayers may not rely upon Notice 2005-1, the proposed regulations, or a reasonable, good faith interpretation of the statute for taxable years beginning on or after January 1, 2008. In addition, after December 31, 2007, taxpayers may not change the time and form of payment except as permitted under the final regulations and this notice, and no change in the time and form of payment after December 31, 2007, may result in an amount that was deferred as of December 31, 2007, qualifying for an exclusion from the definition of deferred compensation under the final regulations. See § 1.409A-1(a)(1).

B. Retroactive Amendment Period

The written provisions of a plan may fail to meet the requirements of § 409A, the final regulations, and any other applicable guidance, because the plan includes a provision that causes the plan to fail to satisfy the requirements of § 409A, or because the plan fails to include a written provision that is required to satisfy the requirements of § 409A. (For purpose of this notice, § 409A, the final regulations, and any other
guidance applicable to a plan or a deferred amount is referred to collectively as “the § 409A guidance.”) However, under the transition relief provided in this notice, except as otherwise provided in section III.C of this notice addressing the designation of the time and form of payment of deferred amounts, a nonqualified deferred compensation plan will not violate the requirements of § 409A on or before December 31, 2008 merely because the written provisions of the plan fail to meet the requirements of the § 409A guidance, provided that the plan is operated in accordance with the requirements of the § 409A guidance and is amended on or before December 31, 2008 to comply with the § 409A guidance retroactively to January 1, 2008.

A plan is treated as having been amended to comply with the § 409A guidance retroactively to January 1, 2008, only if the written plan, as amended, contains all of the written provisions required by the final regulations and accurately reflects the operation of the plan on and after January 1, 2008, through the date of the amendment, including the terms and conditions under which any initial deferral elections or subsequent deferral elections were permitted, and how the operation of such plan met the requirements of the § 409A guidance on and after January 1, 2008, through the date of the amendment. For additional guidance related to the adoption of new plans, or the adoption of an amendment to an existing plan increasing amounts deferred under the plan, see § 1.409A-1(c)(3)(i) and (vi).

C. Transition Relief - Designation of a Compliant Time and Form of Payment

This section provides guidelines under which, for periods on or before December 31, 2008, a nonqualified deferred compensation plan will be treated as meeting the requirement to timely designate a time and form of payment of an amount deferred
under the plan. Nothing in this section alters the requirement that the plan be operated
in accordance with the requirements of the § 409A guidance (including this notice) on
and after January 1, 2008, and be amended on or before December 31, 2008, to
comply with § 409A and the applicable guidance retroactively to January 1, 2008. For
example, nothing in this notice alters the taxpayer’s burden to demonstrate that any
initial deferral election or subsequent deferral election was made in a manner that
complied in operation with the § 409A guidance. In addition, nothing in this section
alters the restrictions on changes in the time and form of payment on or before
December 31, 2007 under the transition rules set forth in Notice 2005-1, the preamble
to the proposed regulations, Notice 2006-79, and the preamble to the final regulations.

1. How to Designate the Time and Form of Payment

Unless a later date is permitted under the final regulations, if there have been
deferrals of compensation under a plan as of January 1, 2008, but the deferred
compensation has not been paid, the plan will not comply with § 409A after December
31, 2007, unless the plan designates in writing before January 1, 2008, a compliant time
and form of payment of such deferred compensation. Amounts deferred after
December 31, 2007, and before January 1, 2009, will not comply with § 409A unless the
plan designates in writing a compliant time and form of payment of such amounts on or
before the applicable deadline under the final regulations (See § 1.409A-2(a) for the
rules governing initial deferral elections). For purposes of this section, a plan will
designate a compliant time and form of payment of an amount if the written plan terms,
disregarding any written plan provisions that do not comply with the § 409A guidance
(including this section), provide a compliant time and form of payment as described in
section III.C.2 of this notice. For example, if a plan provides for a payment upon a separation from service, but permits the service provider to elect an immediate lump sum payment subject to a forfeiture of a specified portion of the deferred amount (a haircut provision), the haircut provision may be disregarded and the plan will be treated as providing for a payment upon a separation from service, provided the haircut provision is not utilized, and that the haircut provision is removed and the time and form of payment is otherwise fully compliant with the regulations by December 31, 2008. Also, for purposes of this section, a separate written document may be adopted that provides a time and form of payment for amounts deferred under arrangements that are specifically identified (for example, amounts deferred under the Company X Salary Deferral Plan), or that provides a time and form of payment for amounts deferred under arrangements that are not specifically identified (for example, amounts deferred under any arrangement with the service recipient providing the service provider deferred compensation subject to § 409A), or a combination (for example specifying a time and form of payment for amounts deferred under the Company X Salary Deferral Plan, and another time and form of payment for amounts deferred under all other arrangements with the service recipient providing the service provider deferred compensation subject to § 409A), provided that the deferred amounts to which each designated time and form of payment applies are objectively determinable.

2. **How to Designate a Compliant Time and Form of Payment**

   For purposes of this section III.C, a plan will only provide for a compliant time and form of payment for a deferred amount if the plan provides for an objectively determinable form of payment payable upon:
(1) A separation from service;
(2) A change in control event;
(3) An unforeseeable emergency;
(4) A specified date or fixed schedule of payments;
(5) Death; or
(6) Disability.

For example, a plan may provide that an amount deferred under the plan will be paid in the form of a life annuity commencing on the later of the service provider’s separation from service or attaining age 65. However, a plan may not provide that an amount deferred under the plan will be paid during the three years following the service provider’s separation from service (with the exact timing of the payment during the three-year period determined at the discretion of the service recipient), because that plan term would not provide a compliant time and form of payment. Similarly, a stock option that is subject to § 409A could not provide the service provider the discretion to exercise the stock option over more than one taxable year, because that plan term would not provide a compliant time of payment. See § 1.409A-3(c) for rules on when a plan may designate alternative specified dates or payment schedules with respect to particular payment events.

If the objectively determinable form of payment is a series of installment payments, as defined in § 1.409A-2(b)(2)(iii), the series of installment payments is treated as a single payment unless the plan designates in writing on or before the deadline by which the time and form of payment must be set forth in writing under section III.C.1 of this notice (the section III.C.1 deadline), that the series of installment
payments is to be treated as a right to a series of separate payments. On and after the
section III.C.1 deadline, the treatment of a series of installment payments as a single
payment or as a series of separate payments may not be modified except as permitted
under the final regulations.

The plan may specify any combination of payment events that is permissible
under the final regulations, including that a deferred amount is to be paid upon the
earliest of these events or the latest of these events. However, if a payment event is
not specified in writing as a potential payment event on or before the section III.C.1
deadline, the addition of that payment event as a potential payment event is subject to
the anti-acceleration provisions under §1.409A-3(j) and the subsequent deferral
election provisions under §1.409A-2(b). For example, a plan providing for the payment
of an amount upon the earliest of a service provider’s death, disability, or separation
from service would provide for a compliant time and form of payment. However, the
modification of the provision after the section III.C.1 deadline to provide for the payment
of the amount upon the earliest of a service provider’s death, disability, or separation
from service, or a change in control event, would be an impermissible acceleration of
the payment. Similarly, if a payment event is specified in writing on the section III.C.1
deadline as a potential payment event, the removal of the payment event after the
applicable deadline as a potential payment event is subject to the anti-acceleration
provisions under §1.409A-3(j) and the subsequent deferral election provisions under
§1.409A-2(b).

3. Retroactive Adoption of Permissible Payment Event Definitions
For purposes of this section, *separation from service* means any event that may qualify as a separation from service under § 1.409A-1(h), *change in control event* means any event that may qualify as a change in control event under § 1.409A-3(i)(5), *unforeseeable emergency* means any event that may qualify as an unforeseeable emergency under § 1.409A-3(i)(3), and *disability* means any event that may qualify as a disability under § 1.409A-3(i)(4). For example, a plan providing only that a payment will be made upon a separation from service (or similar term such as termination of employment) may be treated as providing for a payment upon a separation from service as defined in § 1.409A-1(h). However, the plan must be operated in accordance with the final regulations, so that a payment due upon the service provider’s separation from service could only be made upon an event that met the requirements of the definition of separation from service set forth in §1.409A-1(h), and the plan must be amended by December 31, 2008 to accurately reflect the application of the provisions during 2008 and to fully comply with the requirements of the final regulations. Similarly, a plan providing that a payment will be made upon the service provider’s disability may be treated as providing for a payment upon a disability as defined in § 1.409A-3(i)(4). However, the plan must be operated in accordance with the final regulations, so that a payment due upon the service provider’s disability could only be made upon a disability that met the requirements of the definition of disability set forth in § 1.409A-3(i)(4), and the plan must be amended by December 31, 2008 to accurately reflect the application of the provision during 2008 and to fully comply with the requirements of the final regulations.
For a deferred amount, a plan will not be treated as failing to meet the requirements of § 409A and the final regulations merely because the plan fails to specify in writing the definition of a payment event that is a separation from service, a change in control event, disability, or unforeseeable emergency, applied under the plan on or before December 31, 2008, provided that the definition applied is permissible under the final regulations and the plan is amended on or before December 31, 2008, to accurately reflect the application of the provision during 2008 and to fully comply with the requirements of the final regulations. For example, § 1.409A-1(h)(1)(ii) provides that whether a termination of employment that is a separation from service has occurred is determined based on whether the facts and circumstances indicate that the employer and employee reasonably anticipated that no further services would be performed after a certain date or that the level of bona fide services the employee would perform after such date (whether as an employee or as an independent contractor) would permanently decrease to no more than 20 percent of the average level of bona fide services performed (whether as an employee or an independent contractor) over the immediately preceding 36-month period (or the full period of services to the employer if the employee has been providing services to the employer for less than 36 months). Section 1.409A-1(h)(1)(ii) further provides that a plan may treat another level of reasonably anticipated permanent reduction in the level of bona fide services as a separation from service, provided that the level of reduction required must be designated in writing as a specific percentage, and the reasonably anticipated reduced level of bona fide services must be greater than 20% but less than 50% of the average level of bona fide services provided in the immediately preceding 36 months. A plan is
not required to set forth in writing as of January 1, 2008 whether this alternative
definition has been adopted, and may provide that a payment is to be made upon a
separation from service of an employee without designating whether the required
reduction in the level of services is 20%, 50%, or some other reduction in the level of
services available under the final regulations. However, not later than December 31,
2008, the written terms of the plan, including the designation of the payment date, must
be both fully compliant with the final regulations and consistent with the application of
such designated payment event on and after January 1, 2008.

If a payment event that is a separation from service, a change in control event,
an unforeseeable emergency, or a disability, has been timely designated, a later
adoption of an alternative definition of the designated payment event, as applicable (or if
an alternative definition has been adopted, an adoption of the default definition or
another alternative definition), on or before December 31, 2008, will not be treated as a
change in the time or form of payment, regardless of whether the adoption of the
alternative definition would result in a payment being made at an earlier or later date
than under the default definition or the previously designated definition (for example, an
alternative definition is adopted during 2007, and a new alternative definition is adopted
during 2008). Solely for purposes of effecting the relief provided in this section III.C.3,
the availability of a payment to a service provider had the service recipient not been
permitted to adopt an alternative definition will not be treated as causing the amount to
be includible in income under § 451 or the doctrine of constructive receipt. However,
once an event has occurred in 2008 and been treated as a payment event (or as not
qualifying as a payment event), the service recipient and service provider may not
retroactively alter the definition of the payment event applicable to such deferred amount.

For example, assume that as of December 31, 2007, a plan provided for a deferred amount to be paid as a lump sum payment on or before the 30th day following an employee's separation of service whose level of services for the past 3 years has been 40 hours per week. Assume further that on April 1, 2008, the participating employee (who is not a specified employee) permanently reduces his level of services from 40 hours per week to 10 hours per week. If the amount is paid on or before December 31, 2008, the payment would be consistent with the adoption of a definition of separation from service that is consistent with the requirements of the final regulations for a separation from service, which in this case would be a permanent reduction in the level of services to a level at or below 25% of the level of services previously provided. As of December 31, 2008, the plan would be required to be amended retroactively with respect to that deferred amount to reflect a definition of separation from service consistent with that treatment. In contrast, if the amount is not paid on or before December 31, 2008, the failure to make a payment would be consistent with a definition of separation from service that did not include a reduction in the level of services to a level at or above 25% of the level of services previously provided. As of December 31, 2008, the plan either would be required to apply the default definition of separation from service in the final regulations or would be required to be amended retroactively to reflect a definition of separation from service consistent with that treatment, and any change in the definition of separation from service with respect to such deferred amount after the participating employee's permanent reduction
in the level of services on April 1, 2008, would be subject to the anti-acceleration
provisions of § 1.409A-3(j) and the subsequent deferral election provisions of § 1.409A-
2(b).
4. How to Designate a Specified Payment Date or a Fixed Schedule of Payments

For purposes of section III.C.1, the designation of a specified payment date or a fixed schedule of payments, including the use of a specified payment date or a fixed schedule of payments after a permissible payment event or the lapse of a substantial risk of forfeiture, must meet the requirements of § 1.409A-3(i)(1). Accordingly, the plan must meet the requirements of § 1.409A-3(i)(1) by December 31, 2007, for any amount that will be paid in accordance with:

1. § 1.409A-3(i)(1)(i) (specified time or fixed schedule in general);
2. § 1.409A-3(i)(1)(ii) (payment schedules with formula and fixed limitations);
3. § 1.409A-3(i)(1)(iii) (payment schedules determined by timing of payments received by the service recipient);
4. § 1.409A-3(i)(1)(iv) (reimbursement or in-kind benefit plans); and
5. § 1.409A-3(i)(1)(v) (tax gross-up payments)

However, a payment schedule that would otherwise qualify as a fixed schedule of payments under § 1.409A-3(i)(1)(v) (tax gross-up payments), except that the arrangement does not require that the payment be made by the end of the service provider’s taxable year next following the service provider’s taxable year in which the service provider remits the related taxes, will be treated as designating a fixed schedule of payments if the plan is amended on or before December 31, 2008 to provide for such a requirement, and the plan is operated in compliance with such requirement for periods after December 31, 2007 through the date of the amendment.

In addition, for a specified payment date or a fixed schedule of payments, the addition or deletion of a designated payment provision that meets the requirements of
§ 1.409A-3(b) or § 1.409A-3(i)(1)(i), as applicable, and does not affect the taxable year in which the payment will be made, is not treated as a change in the time and form of payment if the addition or deletion is made on or before December 31, 2008. For example, if a plan provides for an immediate lump sum payment upon death, the addition of a plan provision on or before December 31, 2008, providing that the payment will be made on or before the end of the service provider’s taxable year in which the event occurs will not be treated as a change in the time and form of payment. The addition, deletion or modification of a provision that provides that a payment (including a payment that is part of a schedule) is to be made during a designated period objectively determinable and nondiscretionary at the time the payment event occurs if the designated period is not more than 90 days and the service provider does not have a right to designate the taxable year of the payment (other than an election that complies with the subsequent deferral election rules of § 1.409A-2(b)), also will not be treated as a change in the time and form of payment. For example, if a plan provides that a payment will be made in a lump sum payment upon separation from service, a modification of the plan on or before December 31, 2008, to provide that the payment will be made on or before the 90th day following the separation from service, determined at the sole discretion of the service recipient, is not treated as a change in the time and form of payment. However, plan provisions designating the time and form of payment must be fully compliant with the final regulations as of December 31, 2008.
5. Retroactive Amendments and the Six-Month Delay on Payments to Specified Employees

Section 1.409A-3(i)(2) provides that in the case of any service provider who is a specified employee (as defined in § 1.409A-1(i)) as of the date of a separation from service, the requirements of § 1.409A-1(a)(1) permitting a payment upon a separation from service are satisfied only if payments may not be made before the date that is six months after the date of separation from service (or, if earlier than the end of the six-month period, the date of death of the specified employee). Section 1.409A-1(c)(3)(v) generally requires that the delay requirement be a written provision of any plan providing for a payment upon separation from service to a specified employee. Provided that such payments are delayed in accordance with § 1.409A-1(a)(1), a plan will not be treated as failing to meet the requirements of § 1.409A-1(c)(3)(v) provided that the plan is amended on or before December 31, 2008, retroactively to January 1, 2008, to contain the requirement, and the written plan provision accurately reflects the operation of the plan through the date of the amendment. Taxpayers must demonstrate that the required delay was applied to affected payments. Accordingly, if the service recipient has used any provisions other than the default provisions of § 1.409A-1(i) to identify specified employees, taxpayers must demonstrate the method by which the service recipient identified any specified employees, and that such method of identifying specified employees was applied consistently to all plans and all service providers.
IV. APPLICATION OF FINAL REGULATIONS AND ADDITIONAL RELIEF

A. Employment Agreements - Good Reason Provisions

Whether a separation from service is involuntary generally is important for the application of the exception from the definition of deferred compensation contained in § 1.409A-1(b)(4) (the short-term deferral rule). Under the short-term deferral rule, an arrangement that provides for a payment within certain limited periods following the lapse of a substantial risk of forfeiture may not constitute deferred compensation. Section 1.409A-1(d) provides that if a service provider’s entitlement to an amount is conditioned on the occurrence of the service provider’s involuntary separation from service without cause, the right is subject to a substantial risk of forfeiture if the possibility of forfeiture is substantial.

Whether a separation from service is involuntary is also important for the application of the exclusion for certain separation pay arrangements under § 1.409A-1(b)(9). That provision excludes from deferred compensation a right to certain amounts that are payable within a limited period of time following an involuntary separation from service, and is available only if the amounts are payable upon an involuntary separation from service (often referred to as the “two-year, two-time rule”).

Section 1.409A-1(n) provides a definition of an involuntary separation from service. Section 1.409A-1(n)(2)(i) provides that as a general rule a service provider’s voluntary separation from service will be treated as an involuntary separation from service if the separation from service occurs under certain limited bona fide conditions, where the avoidance of the requirements of § 409A is not a purpose of the inclusion of these conditions in the plan or of the actions by the service recipient in connection with
the satisfaction of these conditions, and a voluntary separation from service under such conditions effectively constitutes an involuntary separation from service. Section 1.409A-1(n)(2)(ii) contains a safe harbor setting forth a set of conditions often referred to as the “safe harbor good reason conditions”. The safe harbor states that if a plan provides that a voluntary separation from service will be treated as an involuntary separation from service if the separation from service occurs under certain express conditions, a separation from service satisfying the conditions set forth in the plan will be treated as an involuntary separation from service if the necessary conditions (or set of conditions) satisfy the requirements of the regulations.

Commentators have stated that to ensure qualification for one or both of the short-term deferral rule or the two-year, two-time rule, taxpayers have considered modifying employment arrangements that currently provide for a payment upon a voluntary separation from service under certain conditions (often referred to as “good reason conditions”), including modifying the good reason conditions under which an employee could voluntarily terminate employment and receive payments. Some taxpayers want to replace the existing good reason conditions in their agreements with a set of safe harbor good reason conditions qualifying under § 1.409A-1(n)(2)(ii). Other taxpayers want to add only some of the safe harbor good reason conditions (for example, adding a requirement that the employee provide notice to the employer that the good reason condition has been satisfied). Other taxpayers have proposed removing a condition from an existing agreement, because the condition is not a condition found in the good reason safe harbor.
The modification of these arrangements raises issues regarding whether a substantial risk of forfeiture condition has been added or modified in a manner that would not be respected under Notice 2005-1, Q&A-10, proposed § 1.409A-1(d) or final § 1.409A-1(d). Notice 2005-1, Q&A-10 provides that any addition of a substantial risk of forfeiture after the beginning of the service period to which the compensation relates, or any extension of a period during which compensation is subject to a substantial risk of forfeiture, in either case whether elected by the service provider, service recipient or other person (or by agreement of two or more of such persons), is disregarded for purposes of determining whether such compensation is subject to a substantial risk of forfeiture. See also proposed and final § 1.409A-1(d).

The Treasury Department and the IRS understand that taxpayers may desire to conform existing good reason conditions to the requirements of the definition of an involuntary separation from service under the regulations. Accordingly, to the extent that a right to a payment subject to an existing good reason condition is subject to a substantial risk of forfeiture, the modification of the good reason condition on or before December 31, 2007 to conform to some or all of the conditions set forth in § 1.409A-1(n)(2) will not be treated as an extension of the substantial risk of forfeiture. However, if the right to a payment subject to existing good reason conditions is not subject to a substantial risk of forfeiture, the modification of such condition to include one or more of the conditions set forth in § 1.409A-1(n)(2)(ii), or to remove one or more of the existing good reason conditions, will not cause the amount to be treated as subject to a substantial risk of forfeiture.
As provided by Notice 2006-79, for amounts subject to § 409A, a plan may provide, or be amended to provide, for new payment elections on or before December 31, 2007, with respect to both the time and form of payment of such amounts and the election or amendment will not be treated as a change in the time or form of payment under § 409A(a)(4) or an acceleration of a payment under § 409A(a)(3), provided that the plan is so amended and elections are made on or before December 31, 2007. With respect to an election or amendment to change a time and form of payment made on or after January 1, 2007, and on or before December 31, 2007, the election or amendment may apply only to amounts that would not otherwise be payable in 2007 and may not cause an amount to be paid in 2007 that would not otherwise be payable in 2007. An election of a new time and form of payment under these transition rules may cause an amount to be excluded from coverage under § 409A. In the case of a right to a payment of deferred compensation, the modification of the time and form of the payment such that the payment will only be made upon an involuntary separation from service may result in the exclusion of such right, or a portion of such right, from the definition of deferred compensation under § 1.409A-1(b)(9) (the two-year, two-time rule), to the extent the amended arrangement otherwise met the requirements for the exclusion. In modifying the arrangement, however, taxpayers should ensure that the amendment does not affect amounts that otherwise would be payable in 2007 (for example, because a separation from service occurred during 2007).

B. Employment Agreements – Application of Substitution Rule

Commentators have asked about the conditions under which rights to deferred compensation under an extension of an employment agreement, or a negotiation of a
new employment agreement, will constitute a new legally binding right to compensation rather than a substitution for rights to deferred compensation contained under a previous agreement. Until further guidance, if a right to deferred compensation payable only upon an involuntary separation from service (as defined under § 1.409A-1(n)) at all times under an employment agreement would automatically be forfeited at the end of the term of the employment agreement, then the grant of a right to deferred compensation in an extended, renewed or renegotiated employment agreement will not be treated as a substitute for the right that was forfeited at the termination of the prior employment agreement. For example, if an employment agreement at all times provides that an employee has a right to deferred compensation if the employee is involuntarily separated from service without cause during the three-year term of the employment agreement, but that deferred compensation will become payable at the end of the original three-year term of the employment agreement if the employee is available to perform services and the employer does not extend, renew, or replace the employment agreement, and at the end of the three-year term of the employment agreement the employee has not been involuntarily separated, the right to deferred compensation in a renewed, extended or renegotiated employment agreement may be viewed as a substitute for the right to deferred compensation in the original agreement. However, if the employment agreement had not provided that any deferred compensation would become payable at the end of the original three-year term of the employment agreement if the employee had been available to perform services and the employer had not extended, renewed or replaced the employment agreement, and the employee had not been involuntarily separated during the three-year term of the
employment agreement, then a right to deferred compensation under an employment agreement covering services after the end of the original three-year term would not be treated as a substitute for the right to the deferred compensation upon an involuntary separation from service during the original three-year term.

C. Predetermined Cashouts

Section 1.409A-2(b)(2)(iii) provides a limited ability to provide for the cashout of all remaining installments under an installment payment provision when the present value of the remaining payments falls below the predetermined threshold. Section 1.409A-2(b)(2)(ii) provides a similar rule with respect to annuity payments.

Commentators asked whether a plan may provide for a lump sum payment at the payment date only if the present value of the payments at that date is below a predetermined amount, but continue to make any properly elected installment payments or annuity payments if the present value of the payments at the original payment date is above the predetermined amount, even if the present value of the remaining payments falls below the predetermined amount at a future date. In other words, the cashout threshold would apply only at the time of the original payment date, and not at any future date.

Section 1.409A-2(b)(2)(ii) and (iii) does not provide for this type of payment. However, commentators have asked whether such a provision would be treated as an objective, nondiscretionary payment formula for purposes of § 1.409A-3(b). Section 1.409A-3(b) provides that a plan may provide that a payment upon a qualifying payment event is to be made in accordance with a schedule that is objectively determinable and nondiscretionary based on the date the event occurs and that would qualify as a fixed
schedule under § 1.409A-2(i)(1) if the payment event were instead a fixed date, provided that the schedule must be fixed at the time the permissible payment event is designated.

The use of this type of a cashout provision may, in certain circumstances, be subject to manipulation, so that this type of provision is not an objectively determinable and nondiscretionary schedule of payments. However, until further guidance, a taxpayer may treat such a provision as part of an objectively determinable and nondiscretionary payment schedule if the payment schedule would otherwise meet the requirements of the regulations, including that the cashout threshold be fixed at the time the permissible payment event is designated, and if the taxpayer can demonstrate that the provision operated in an objective, nondiscretionary manner and did not operate so as to provide either the service provider or the service recipient with rights having substantially the effect of a right to a late election as to the time and form of payment. Any subsequent change in a cashout threshold applicable to a deferred amount is subject to the rules governing subsequent deferral elections and the acceleration of payments.

If such a provision is used in conjunction with an installment payment or annuity, the payment schedule generally would not meet the definition of an installment payment or annuity under § 1.409A-2(b)(2)(ii) and (iii), because the payment schedule would not necessarily provide for substantially equal payments over the service provider’s lifetime or other predetermined period of time, but instead a lump sum payment if the threshold were not met and periodic payments if the threshold were met. However, until further guidance, the classification of the resulting schedule of payments if the cashout
threshold is exceeded at the applicable payment date, whether or not such schedule of payments is intended to be an installment payment or life annuity, is determined as if the lump sum payment cashout threshold were not available. Accordingly, the resulting schedule of payments if the threshold is met must otherwise meet the requirements of § 1.409A-3, and if the resulting schedule of payments qualifies as a life annuity under § 1.409A-2(b)(ii), or as a series of installment payments treated as a single payment under § 1.409A-2(b)(2)(iii), the schedule of payments will be treated as a single payment for purposes of the subsequent deferral rules.

V. ANTIMICIPATED LIMITED VOLUNTARY COMPLIANCE PROGRAM

The Treasury Department and the IRS anticipate issuing guidance in the near future establishing a limited voluntary compliance program that will apply to certain unintentional operational failures to comply with § 409A. The Treasury Department and the IRS anticipate that such guidance will 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 § 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 § 409A.

VI. APPLICATION OF § 409A(b) (RESTRICTIONS ON CERTAIN TRUSTS AND OTHER ARRANGEMENTS)

Section 409A(b)(1) and (2) generally prohibits the use of offshore trusts in connection with amounts payable under a nonqualified deferred compensation plan, and also prohibits the use of restrictions on assets to protect the payment of benefits under a nonqualified deferred compensation plan in connection with a change in the
service recipient’s financial health. Section 409A(b)(3) generally also prohibits the transfer of assets to a trust or other arrangement for purposes of paying nonqualified deferred compensation to an applicable covered employee during, or the use of restrictions on assets to protect the payment of benefits under a nonqualified deferred compensation plan in connection with, a restricted period with respect to a single-employer defined benefit plan. For this purpose, a restricted period with respect to a single-employer defined benefit plan generally means any period during which the plan is in at-risk status (as defined in § 430(i), which was added by the Pension Protection Act of 2006), any period the plan sponsor is a debtor in a bankruptcy filing, and the 12-month period beginning on the date which is 6 months before the termination of the defined benefit plan if, as of the termination date, the plan is underfunded. Section 409A(b) provides generally that if these requirements are not met, the assets are treated for purposes of § 83 as property transferred in connection with the performance of services whether or not such assets are available to satisfy claims of general creditors, and that the taxpayer is liable for the additional § 409A taxes on the resulting income inclusion.

Notice 2006-33 provides that until further guidance is issued, taxpayers may rely upon a reasonable, good faith interpretation of § 409A(b) to determine whether the use of a trust or other arrangement causes an amount to be included in income under § 409A(b). The Treasury Department and the IRS intend to issue further guidance regarding the application of § 409A(b). Until such guidance is issued, taxpayers may continue to rely upon a reasonable, good faith interpretation of § 409A(b) to determine whether the use of a trust or other arrangement causes an amount to be included in
income under § 409A(b), including the application of § 409A(b)(3) to transfers of assets during restricted periods.

Notice 2006-33 also provides that with respect to assets set aside, transferred or restricted on or before March 21, 2006 so as to be subject to inclusion under § 409A(b)(1) or 409A(b)(2) (grace period assets), taxpayers will be treated as not having triggered the inclusion or additional tax provisions of § 409A(b) if the nonqualified deferred compensation plan comes into conformity on or before December 31, 2007, with the requirements of § 409A(b) and any guidance issued before such date. Nothing in this section curtails this relief; however, this relief is not extended beyond December 31, 2007. Accordingly, for grace period assets, a taxpayer will trigger the income inclusion and additional tax provisions of § 409A(b) if the nonqualified deferred compensation plan is not in conformity with a reasonable, good faith interpretation of § 409A(b) on or after December 31, 2007. If with respect to grace period assets the nonqualified deferred compensation plan is not in conformity with a reasonable, good faith interpretation of § 409A(b) on December 31, 2007, the taxpayer will trigger the income inclusion and additional tax provisions of § 409A(b) on January 1, 2008.

VII. DRAFTING INFORMATION

The principal author of this notice is Stephen Tackney of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the Treasury Department and the IRS participated in its development. For further information regarding this notice, contact Stephen Tackney at (202) 927-9639 (not a toll-free call).