

October 5, 2006

## 409A Transition Relief: Prolonging the Uncertainty

On October 4, 2006, the Treasury Department and IRS provided an extension of existing transition relief for nonqualified deferred compensation arrangements subject to the requirements of Section 409A of the Internal Revenue Code. The long-awaited final regulations under Section 409A are expected to be published later this year and will become effective on January 1, 2008. Accordingly, the new Notice 2006-79 extends the time for amending deferred compensation plans and obtaining participant payment elections through **December 31, 2007**.

### Relief Granted

Specifically, the extended transition relief provides the following:

- **Amendments.** A plan must be amended on or before December 31, 2007 to conform to the provisions of Section 409A and the final regulations.
- **Good Faith Compliance.** To comply with Section 409A, a plan must continue to be operated in reasonable, good faith compliance with the provisions of Section 409A and applicable provisions of Notice 2005-1 prior to January 1, 2008. During the transition period, compliance with the proposed regulations (or the final regulations prior to their effective date) will constitute reasonable, good faith compliance with the statute.  
  
A plan will not be operating in good faith compliance if discretion provided under the plan is exercised in a manner that violates Section 409A. For example, if an employer retains the discretion under the plan to delay or extend plan payments in a manner that violates Section 409A, and exercises that discretion, the plan as a whole has violated Section 409A. If, however, a participant exercises a right in violation of Section 409A, the plan, with respect to that participant only, has violated Section 409A (limiting penalty and tax exposure to that participant).
- **Changes in Payment Elections.** Changes in payment elections or conditions can be extended until December 31, 2007. 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 plan amounts, and that election or amendment will not be treated as a change in the time or form of payment or an acceleration of a payment. With respect to an election or amendment to change a time and form of payment made during 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. A service provider or service recipient may make more than one change or amendment under this relief.
- **Stock Right Amendments.** An outstanding stock right that provides for a deferral of compensation may be amended to provide for fixed payment terms consistent with Section 409A, or to permit holders of discounted stock rights to elect fixed payment terms consistent with Section 409A, and that amendment or election will not be treated as a change in the time and form of payment provided that it is completed by December 31, 2007.
- **Linked Plans.** The ability to link a payment election under a nonqualified deferred compensation plan to an election under a qualified plan has also been extended through 2007. Where a nonqualified deferred compensation plan provided before the application of Section 409A that the time and form of payment to a participant will be the same time and form of payment elected by the participant under a qualified plan, it will not be a violation of section 409A for the plan administrator to make or commence

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payments under the nonqualified deferred compensation plan on or after January 1, 2005, and on or before December 31, 2007, pursuant to the payment election under the qualified plan. However, other provisions of the Internal Revenue Code and common law tax doctrines, such as the doctrine of constructive receipt, continue to apply.

### **Relief for Discounted Stock Rights Limited**

The proposed regulations extended the period during which the cancellation of a discounted stock option or stock appreciation right (each a stock right) and reissuance of a fair market value stock right may occur until December 31, 2006, but only to the extent a cancellation and reissuance in 2006 does not result in the cancellation of a deferral in exchange for cash or vested property in 2006. The period during which the cancellation and reissuance may occur is extended until December 31, 2007, but only to the extent it does not result in the cancellation of a deferral in exchange for cash or vested property in 2007.

The deadline for a stock rights plan to be amended to reflect use of the transition relief is not extended for any stock right that:

1. was granted with respect to stock of a publicly-traded corporation;
2. was granted to a person who was subject to the insider disclosure requirements; and
3. the corporation either has reported or reasonably expects to report a financial expense for a discounted stock right (such as a backdated stock option) that was not timely reported on financial statements or reports..

It is expected that the final regulations will address how outstanding deferrals, including outstanding stock rights, will be affected by the new rules. If you have questions about how these rules affect your company's incentive or equity compensation programs, please contact a member of the Benefits Law Group.



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