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IRS Extends Transition Relief for Code Section 409A Deferred Compensation Arrangements Through 2007

October 5, 2006

On October 4, 2006, the Treasury Department ("Treasury") released IRS Notice 2006-79, generally extending through the end of 2007 the previously issued transition relief under Section 409A of the Internal Revenue Code (the "Code"), with a notable exception in the case of certain discounted stock rights granted to "insiders" of publicly held companies. Notice 2006-79 also confirmed that while the IRS and Treasury intend to issue final regulations under Section 409A before the end of 2006, the final regulations will not become effective until January 1, 2008 and taxpayers may therefore continue to rely on the previously issued Notice 2005-1 and/or the existing proposed regulations under Section 409A until then.[1]

"GOOD FAITH" OPERATIONAL COMPLIANCE

Deferred compensation plans subject to Section 409A will not need to be brought into "documentary" compliance with Section 409A (i.e., through plan amendment) until December 31, 2007, so long as the plans continue to be *operated* in reasonable, good faith compliance with Section 409A. While compliance with the proposed regulations or the final regulations will not be required until January 1, 2008, compliance with either the proposed or final regulations will automatically be deemed to constitute reasonable, good faith compliance with Section 409A. Additionally, to the extent of any inconsistencies between the proposed regulations, the final regulations and Notice 2005-1, plans may choose to comply with any of the foregoing.

CHANGES IN PAYMENT ELECTIONS

The transition relief under the proposed regulations with respect to the ability to change the time or form of payment elections (without regard to the normal limitations under Section 409A, such as having to re-defer for an additional five years) has generally been extended through the end of 2007. The limitations that applied to this transition relief during 2006 will continue to apply in a similar manner during 2007. Thus, an election made during 2007 to change the time of payment 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. (For the duration of 2006, election changes may still be made with respect to amounts that would otherwise be paid in 2007 or later.)

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[1] Our February 11, 2005 and October 17, 2005 memoranda addressing Notice 2005-1 and the proposed regulations under Section 409A can be found at http://www.simpsonthacher.com/content/publications/pub498.pdf and http://www.simpsonthacher.com/content/publications/pub527.pdf, respectively.

Notice 2006-79 also clarifies that both service providers and service recipients (i.e., employers and employees) may make payment election changes in reliance upon this transition relief provision.

PAYMENTS LINKED TO QUALIFIED PLANS

The ability to link a payment election under a nonqualified deferred compensation plan such as a "SERP" to an election under a qualified plan has also been extended through 2007, provided that the plan governing such a linked election has provided for such linkage since October 3, 2004. Thus, for example, where a nonqualified deferred compensation plan provides as of October 3, 2004 that the time and form of payment will be the same time and form of payment elected by the employee under a qualified plan, the plan administrator may commence payments on or prior to December 31, 2007 pursuant to the payment election under the qualified plan, even if the normal timing of election rules under Section 409A have not otherwise been met. However, the Notice cautions that other provisions of the Code and common law tax doctrines (e.g., constructive receipt principles) will continue to apply to any timing elections made under a nonqualified deferred compensation plan.

DISCOUNT OPTIONS AND SARS

"Discount" stock options and stock appreciation rights ("SARs") – that is, options and SARs granted with an exercise price that is less than the fair market value of the underlying stock on the grant date – generally run afoul of Section 409A. The proposed regulations permitted the replacement of discount options or SARs during 2006 with new options or SARs that meet Section 409A requirements (e.g., by establishing an exercise price that is not less than the fair market value of the underlying stock as of the original grant date of the replaced option or SAR), so long as the replacement arrangement does not result in the cancellation of a discount option or SAR in exchange for cash or vested property during 2006. Thus, if a discount option is cancelled during 2006 in exchange for a new Section 409A compliant option, any separate payment intended to make the optionee "whole" for the lost discount element of the option may not be paid to the optionee prior to 2007. Subject to the exception noted below, this transition relief has been extended to apply in a similar manner during 2007 – that is, a discount option may be replaced during 2007 with a new Section 409A compliant option, so long as the optionee does not receive any additional payment with respect to the lost discount element prior to 2008. Notice 2006-79 also clarifies that any exercise of a discounted option subject to Section 409A before the cancellation and replacement of that option will generally result in a violation of Section 409A.

One notable exception to the extension of transition relief with respect to discount options and SARs applies in the case of awards granted with respect to the stock of a public company to individuals who, as of the date of grant, were considered "insiders" under Section 16 of the Securities Exchange Act of 1934. The extension of transition relief under Notice 2006-79 will *not* apply to any such discount option or SAR grant to the extent that the company either has reported or reasonably expects to report a financial expense that was not timely reported under GAAP due to the issuance of the discount option or SAR. This limitation under the Notice appears to be specifically targeted to companies that have engaged in "backdating" of awards. ***Therefore, any such discount options or***

SARs must be replaced or otherwise modified to comply with Section 409A no later than December 31, 2006, in order to avoid subjecting the optionholder to the 20% penalty tax plus interest under Section 409A.

COLLECTIVELY BARGAINED ARRANGEMENTS

Lastly, Notice 2006-79 provides that any nonqualified deferred compensation arrangement maintained pursuant to one or more collective bargaining agreements in effect on October 3, 2004 is not required to comply with Section 409A until the earlier of the date on which the last of such collective bargaining agreements terminates (determined without regard to any extensions after October 3, 2004) or December 31, 2009.

If you have any questions regarding these important developments, please do not hesitate to contact any of the following or your Simpson Thacher relationship partner:

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