

Client Alert: Transition Relief for Code
Section 409A Deferred Compensation
Arrangements Extended Until December 31,
2008

October 25, 2007

On October 22, 2007, the Treasury Department ("Treasury") generally extended, until December 31, 2008, the transition relief under Section 409A of the Internal Revenue Code ("Section 409A") that had previously been scheduled to expire at the end of 2007. This latest release from Treasury (Notice 2007-86) largely supersedes and replaces the much more limited Section 409A transition relief extension that Treasury issued on September 10, 2007 under Notice 2007-78.¹ In its latest release, Treasury acknowledged that many commentators had expressed disappointment with the limited scope of the September release, noting the commentators' concerns that the limited transition relief in that notice "did not adequately address the need for additional time for service recipients and service providers to analyze all of their plans and make informed and reasoned decisions regarding the changes that would be necessary to bring existing arrangements into compliance with the final regulations." Treasury's new release appears to respond to these concerns.

EFFECTIVE DATE OF FINAL REGULATIONS DELAYED UNTIL JANUARY 1, 2009

The new release delays the effective date of the final regulations under Section 409A until January 1, 2009. Until the end of 2007, taxpayers may continue to rely on the prior guidance of Treasury and the IRS under Section 409A (including Notice 2005-1 and the previously issued proposed regulations) for purposes of demonstrating "good faith" operational compliance with Section 409A or, alternatively, taxpayers may choose to rely on the final regulations. During 2008, taxpayers may continue to rely on either Notice 2005-1 or the final regulations for purposes of demonstrating "good faith" operational compliance with Section 409A.

However, after December 31, 2007, taxpayers generally will not be permitted to continue relying on the proposed regulations (other than with respect to the extended transition relief rules thereunder, as discussed below). Beginning January 1, 2009, compliance with the final regulations under Section 409A will become mandatory.

¹ Our prior memoranda addressing last month's Treasury release and prior guidance from Treasury regarding Section 409A can be found on our website at <http://www.simpsonthacher.com>.

EXTENSION OF TRANSITION RELIEF

Changes in Payment Elections. The transition relief under the proposed regulations regarding an employee's or employer's ability to change the time or form of payment elections without regard to the normal limitations under Section 409A (such as the requirement that any redeferral of compensation be for at least an additional five years) has generally been extended through the end of 2008. The limitations that applied to this transition relief during 2006 and 2007 will continue to apply in a similar manner during 2008. Thus, an election made during 2008 to change the time of payment may apply only to amounts that would not otherwise be payable in 2008 and may not cause an amount to be paid in 2008 that would not otherwise be payable in 2008. (For the duration of 2007, election changes may still be made with respect to amounts that would otherwise be paid in 2008 or later.)

Payments Linked to Tax-Qualified Plans. The ability to link a payment election under a nonqualified deferred compensation plan such as a "SERP" to an election under a tax-qualified retirement plan has also been extended through 2008, so long as the plan governing such a linked election has provided for such linkage since October 3, 2004. For example, where a nonqualified deferred compensation plan provided, as of October 3, 2004, that the time and form of payment under the plan will be the same time and form of payment elected by the employee under a tax-qualified retirement plan, the plan administrator may begin payments on or prior to December 31, 2008 pursuant to the payment election under the qualified plan, even if the normal timing of payment election rules under Section 409A have not otherwise been met. However, Treasury continues to caution 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.

Corrective Actions for 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. Treasury has extended the existing transition relief rules permitting the replacement of discount options or SARs 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 paid during the same year in which the cancellation takes place. Thus, if a discount option is cancelled during 2008 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 2009. As was the case under prior transition relief guidance, the extended time period for correcting discount options and SARs does not apply 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, if 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.

Deadline for Documentary Compliance with Section 409A. Treasury has now extended the documentary compliance deadline for Section 409A until the end of 2008. While last month's release from Treasury had also provided for a limited extension of the documentary compliance deadline, that extension came with an important caveat that would have nevertheless required deferred compensation plans to designate in writing prior to January 1, 2008 a "compliant time and form of payment" of deferred compensation under such plans. The new release has eliminated this caveat, and will therefore be much more useful to taxpayers who want to take advantage of the additional time to consider appropriate documentary corrections.

NO EXTENSION OF TRANSITION RELIEF FOR OFFSHORE FUNDED ARRANGEMENTS

Treasury has not extended the prior transition relief rules applicable to certain offshore funded deferred compensation arrangements. Therefore, taxpayers with deferred compensation arrangements subject to Section 409A that are funded through "rabbi trusts" or similar arrangements located outside of the U.S. will generally need to transfer those assets to a location within the U.S. on or before December 31, 2007.

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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