

Deferred Compensation Plan (Section 409A) Compliance Period Extended Until December 31, 2007

October 5, 2006

The IRS yesterday issued long-anticipated transition guidance (Notice 2006-79) as to the implementation of the new deferred compensation plan rules under Section 409A of the Internal Revenue Code. [As noted in prior Morgan Lewis LawFlashes](#), Section 409A was added to the Internal Revenue Code in the fall of 2004 and imposes a variety of restrictions on nonqualified deferred compensation arrangements with such restrictions effective, in general, on and after January 1, 2005. Deferred compensation arrangements that violate the Section 409A requirements result in the imposition of a 20% additional tax on the individual benefiting from the arrangement, as well as regular income tax liability and a possible penalty interest assessment. As discussed below, under prior interim guidance, the 409A compliance period had been scheduled to expire as of December 31, 2006. Notice 2006-79 extends the operational compliance and document revision deadlines to December 31, 2007, with the expectation that final Section 409A regulations will be issued in the fall of 2006. The Notice provides welcome relief to sponsors of nonqualified deferred compensation arrangements by extending the compliance deadline until December 31, 2007. However, the Notice imposes a much stricter deadline (December 31, 2006) for remedial action with respect to certain below-market option grants made to executive officers of publicly held companies.

Background

In the fall of 2005, the IRS issued transitional guidance under Section 409A in the form of Notice 2005-1 and issued proposed regulation under Section 409A. That Notice generally provided that deferred compensation plan sponsors are permitted until December 31, 2006 to bring plans and arrangements subject to Section 409A into operational compliance with the new laws and to amend the various plan documents to include provisions compliant with Section 409A. It was widely anticipated that final regulations under Section 409A would be issued in the summer or early fall of 2006, in time to facilitate necessary action by companies and participants prior to year end 2006. Because those final regulations have not been issued, the IRS reasonably recognized that the December 31, 2006 deadline was no longer feasible and issued Notice 2006-79.

Key Provisions of the Notice

1. Extended Good Faith Compliance: Plans adopted on or before December 31, 2007 will not be deemed to violate Section 409A so long as such plans are (a) operated in “reasonable, good faith

compliance” with the provisions of Section 409A and applicable guidance issued prior to January 1, 2008; and (b) amended before January 1, 2008 to conform to the provisions of Section 409A and the final regulations.

2. Final Regulations: The IRS expects to issue final regulations under Section 409A in the late fall of 2006 with an effective date of January 1, 2008.

3. New Payment Elections: Except as to certain items discussed below, the remedial structure with respect to plan payment elections set forth in the preamble to the proposed regulations has been continued and extended through to December 31, 2007. As a result, a plan may provide or may be amended to provide for new payment elections as to time of payment or form of payment without being deemed to violate Section 409A, so long as (a) the new elections are made no later than December 31, 2007; and (b) the timing and/or form elected complies with Section 409A. Notice 2006-79 continues the approach taken in the preamble to the proposed regulations that, as to a new payment election made in 2006, the election may not accelerate into 2006 amounts not otherwise payable in 2006, and may not defer amounts otherwise payable in 2006 into years after 2006. Similarly, the Notice states that as to new payment elections made in 2007, the election may not accelerate amounts into 2007 or defer payments otherwise due in 2007 beyond that year. The Notice explicitly permits more than one election during the remedial period, with the result that a participant who made a new payment election in 2005 will be permitted to revise such election in 2006 or 2007 to take into account final regulations.

4. Stock Option Issues: As a general matter, Notice 2006-79 continues prior guidance as to remedial action for discounted stock options or stock appreciation rights (SARs). Thus, the discounted option or SAR may be amended to add fixed payment terms consistent with Section 409A if the amendment and any payment elections are made on or before December 31, 2007. Similarly, with a major exception for certain discounted stock options discussed below, discounted options or SARs may be “repriced” to eliminate the discount if accomplished on or before December 31, 2007 and the transaction does not result in the receipt of cash or vested property in 2007.

5. Public Company Discounted Stock Options: Notwithstanding the above rule permitting the correction of discounted options or SARs no later than December 31, 2007, public companies that are found to have issued discounted options or SARs will be permitted only until December 31, 2006 to correct that noncompliance (i) as to executives or directors subject to Section 16(a) of the Securities Exchange Act of 1934; and (ii) if the company has reported or expects to report an incremental financial statement expense as a result of the discount rights. This fairly draconian provision seems to be addressing perceived “wrongdoing” identified in the so-called stock option backdating investigations. Even though the stricter rule is limited to discounted options granted to officers, the imposition of a December 31, 2006 remedial period deadline poses very difficult compliance problems for many public companies, especially since many companies have not yet even identified the discounted options that must be remedied.

6. Nonqualified Plans Linked to Qualified Plans: Notice 2006-97 continues through December 31, 2007 the prior relief permitting nonqualified plan payment elections to be linked to elections under qualified plans even through the qualified plan elections do not comply with Section 409A. The Notice also extends that relief to elections under Section 403(b) plans, Section 457(b) plans, and certain broad-based foreign plans. Note, however, that as under prior guidance, the relief

granted is transitional only. We expect that the final regulations will require “decoupling” of the nonqualified plan distribution elections for periods after December 31, 2007.

7. Transition Period for Collectively Bargained Plans: A nonqualified deferred compensation plan maintained pursuant to one or more collective bargaining agreements (CBAs) in effect on October 3, 2004 is not required to comply with Section 409A until the earlier of (a) the date on which the last of the CBAs expires (disregarding any post–October 3, 2004 extension of the CBA); or (b) December 31, 2009.

8. Reporting Requirements: It should be noted that the Notice does not address the information reporting requirements imposed by Section 409A, which were suspended pending further guidance for 2005. The reporting requirements may be addressed in separate guidance prior to the issuance of the final regulations.

Conclusion

The general extension of the Section 409A compliance period through December 31, 2007 is most welcome and, if all goes well, will provide companies, plan participants, and administrators more than a full year to digest and implement the final Section 409A regulations. The major exception to that extension is that public company option backdating remedies must be implemented by December 31, 2006 as to Section 16 officers, and that will undoubtedly pose a daunting task. We will supplement this LawFlash as additional Section 409A guidance is issued, and we are happy to assist with Section 409A compliance efforts. For further information, please contact your Morgan Lewis attorney or any of the following:

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