
IRS Extends Transition Relief under Section 409A; Will Require Reporting and Withholding for 2006

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Overview

On October 4, 2006, the Internal Revenue Service issued Notice 2006-79, which extends the existing transition relief under Section 409A of the Internal Revenue Code related to nonqualified deferred compensation plans. The notice includes the following relief:

- The effective date of the final regulations is extended until January 1, 2008.
- The transition relief for operational and documentary compliance for all nonqualified deferred compensation arrangements is extended until December 31, 2007—except with respect to certain discounted stock options and stock appreciation rights subject to retroactive repricing concerns.

In addition, on October 5, 2006, the Internal Revenue Service announced that in 2006 employers will have to report and withhold on deferred compensation amounts required to be included in income because of violations of Section 409A.

Extension of Final Regulation Effective Date

The proposed regulations issued under Section 409A were expected to be finalized during 2006 and were proposed to become effective January 1, 2007. The IRS Notice states that the final regulations will be published in 2006. However, in order to allow taxpayers sufficient time to study the final regulations and bring plans into compliance, the effective date for the final regulations has been extended to January 1, 2008. Compliance with the proposed regulations, or the final regulations once issued, is not required until the regulations are effective. A nonqualified deferred compensation plan adopted on or before December 31, 2007, will not be treated as violating Section 409A on or before December 31, 2007, if: (i) the plan is operated through December 31, 2007, in reasonable, good faith compliance with the provisions of Section 409A, with applicable provisions of Notice 2005-1, and with any other generally applicable guidance published with an effective date before January 1, 2008; and (ii) the plan is amended on or before December 31, 2007, to conform to the provisions of 409A and the final regulations. For periods before January 1, 2008, compliance with the proposed regulations or the final regulations will constitute reasonable, good

faith compliance.

Transition Relief for Payment Elections

The IRS Notice also provides that nonqualified deferred compensation plans 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, as long as the plan is so amended and elections are made on or before December 31, 2007. An election or amendment made during 2006 to change a time or form of payment may apply only to amounts not otherwise payable in 2006, and may not cause an amount to be paid in 2006 that would not otherwise be payable in 2006. An election or amendment made during 2007 to change a time or form 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.

Limited Transition Relief for Correction of Discounted Stock Options and Stock Appreciation Rights

The period during which a company may correct stock options and stock appreciation rights (collectively, stock rights) that were granted or that vest after January 1, 2005, and that have an exercise price that is less than the fair market value of the company's stock on the date of grant has also been extended to December 31, 2007, subject to certain limitations. If such stock rights are not corrected by either fixing the payment terms or increasing the exercise price to fair market value as of the date of grant, such stock rights will violate Section 409A and be subject to the penalty tax. The additional transition relief does not apply to any stock right that:

- was granted by a company—the stock of which was publicly traded at the time the stock right was granted;
- was granted to a Section 16 officer with respect to such company; and
- with respect to the grant of the stock right, the company either has reported or reasonably expects to report a financial expense due to the issuance of a stock right with an exercise price lower than the fair market value of the underlying stock on the date of grant that was not timely reported in the financial statements or reports for the period in which the related expense should have been reported under generally accepted accounting principles.

As a result of this limitation, discounted stock rights for Section 16 officers should be corrected prior to December 31, 2006.

Other Guidance

The IRS Notice includes the following additional transition relief with respect to collectively bargained arrangements, payments linked to qualified plans and 2005 deferral elections:

- An arrangement maintained pursuant to one or more collective bargaining agreements in effect on October 3, 2004, is not required to comply with the provisions of Section 409A on or before the earlier of the date on which the last of such collective bargaining agreements terminates, or December 31, 2009.

- The ability to link a payment election under a nonqualified deferred compensation plan to an election under a qualified plan has been extended through 2007, and this relief is extended to payment elections under Section 403(b) annuities, Section 457(b) eligible plans and certain foreign broad-based plans.
- Taxpayers who took advantage of relief provided under Notice 2005-1 to make deferral elections for 2005 on or before March 15, 2005, have until December 31, 2007, to amend those arrangements to comply with Section 409A.

Reporting and Withholding

The IRS announced that it will issue guidance before the end of 2006 that will require employers to report and withhold in 2006 with respect to nonqualified deferred compensation amounts required to be included in income as a result of violations of Section 409A. The reporting and withholding obligations under Section 409A are currently suspended, pending the issuance of IRS guidance on those obligations. The IRS reminded employers that they may be required to file corrected information returns and to furnish corrected payee statements once the reporting and withholding guidance is issued.

For more information on this or other tax matters, please see our prior [tax publications](#), or contact:

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