

October 5, 2006

IRS Extends Transition Period Under Section 409A

On October 4th, the IRS issued Notice 2006-79 extending through 2007 most, but not all, of the transition relief that applies in 2006 under Internal Revenue Code section 409A.

Background on Section 409A

Section 409A was added to the Code in October 2004 by the American Jobs Creation Act of 2004 and became effective January 1, 2005. In December 2004, the IRS issued Notice 2005-1 providing guidance on the scope of section 409A and generous transition relief through 2005. Proposed regulations were issued in October 2005 that also addressed the scope of section 409A and provided rules on deferral elections and distributions. The proposed regulations extended most of the transition relief under section 409A through 2006.¹

Plan Amendment Deadline and Good Faith Compliance Period

Notice 2005-1 provided that a plan would not be treated as violating the requirements of section 409A if:

- the plan was operated in good faith compliance with the provisions of the statute and guidance issued by the IRS; and
- the plan was amended by December 31, 2005 to conform to the provisions of section 409A.

The proposed regulations issued last year extended this good faith compliance period and the deadline for amending plans to December 31, 2006. Notice 2006-79 extends the good faith compliance period and the deadline for amending plans to December 31, 2007.

According to the Notice, the IRS is attempting to finalize the proposed regulations by the end of 2006 and the regulations will not be effective until January 1, 2008. Compliance with the proposed or final regulations is not required for good faith compliance prior to 2008. However, compliance with the proposed or final regulations will be deemed good faith compliance.

¹ For more information regarding section 409A, Notice 2005-1, and the proposed regulations under section 409A, please see our summaries at "www.groom.com/_library/ExecutiveCompensation."

Other Transition Relief Extended

The Notice also provides continued relief in a number of important areas:

- The transition relief allowing distributions under qualified plans to control distributions under nonqualified plans (so called "piggyback plans") continues through the end of 2007.
 - The Notice also extends this relief to nonqualified plans that "piggyback" 403(b), 457(b), and certain broad-based foreign plans.
- Employers and plan participants continue to have the ability to change the distribution provisions for amounts subject to section 409A without complying with certain 409A distribution rules until the end of 2007 within certain limits.
 - The Notice provides several clarifications on how this important relief operates, including how the relief would apply to changes to options and amounts payable upon an event, such as separation from service.
- Stock options and stock appreciation rights (SARs) that are subject to section 409A (e.g., discounted options) may generally be replaced with exempt options or SARs or revised to provide fixed payment terms through the end of 2007.
 - This relief will be available *only through 2006* for discounted grants made to section 16 officers and directors of public companies that were not properly accounted for (i.e., appropriate expense not recorded) on a timely basis.

With these extensions, plan sponsors should not have to make all of the design decisions regarding plans subject to section 409A until after the final regulations are published.

Relief Expected on Reporting Requirements

The Notice does not address the reporting requirements related to section 409A that had generally been suspended for 2005 Forms W-2. It is expected, however, that separate IRS guidance will be issued shortly and will provide a similar suspension for 2006 Forms W-2.

New Relief For Collectively Bargained Plans

The Notice provides for the first time transition relief for plans maintained pursuant to one or more collective bargaining agreements in effect on October 3, 2004. Specifically, such plans are not required to comply with section 409A until the earlier of (1) December 31, 2009, or (2) the date on which the last of the collective bargaining agreements terminates.

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Please call one of the following, or the firm attorney you regularly contact, if you have any questions about the new Notice or the impact of section 409A on your executive compensation arrangements.

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