

Client Alert

Latham & Watkins Tax Department

IRS and Treasury Extend 409A Transition Period

The IRS and US Department of the Treasury extended many of the transition rules applicable to Section 409A of the Internal Revenue Code (409A) as well as provided additional transition relief in Notice 2006-79 issued on October 4, 2006. As previously discussed in Client Alerts¹ that Latham & Watkins has published on this subject, the American Jobs Creation Act of 2004 enacted 409A, which imposes sweeping new rules for nonqualified deferred compensation arrangements, and called for guidance from the Department of the Treasury. Additional guidance and transition relief were provided by the IRS and US Department of the Treasury in Notice 2005-1 and proposed regulations promulgated on October 4, 2005 under 409A (Proposed Regulations).

Although 409A is generally effective for amounts deferred on or after January 1, 2005, Notice 2005-1 and the Proposed Regulations contained transition guidance through December 31, 2006. Notice 2006-79 provides further transition guidance by:

- Extending the current transition relief described in Notice 2005-1 and the Proposed Regulations, except with regard to certain discounted stock rights;

- Providing that the final regulations under 409A, which are currently being finalized by the IRS and the US Department of the Treasury but have not yet been released, will not become effective until January 1, 2008;
- Providing additional transition relief for certain payment elections in plans linked to tax-qualified plans and certain collective bargaining agreements;
- Extending the amendment date for certain plans that took advantage of transition relief in 2005.

Regardless of these extensions and transition relief, plans must continue to be operated in good faith compliance with 409A through December 31, 2007.

Key Provisions of Notice 2006-79

Plans Must be Brought into Compliance by December 31, 2007 and Operated in Good Faith Compliance in the Interim
2006-79 provides that a plan will not be treated as violating 409A if it is amended on or before December 31, 2007 to conform to 409A and the final regulations, once the final regulations are published. Previous guidance

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required that plans be amended to conform to 409A by December 31, 2006. Due to the lack of final regulations, the extended amendment period provided for in 2006-79 is welcome guidance.

Prior to December 31, 2007, plans must continue to be operated consistent with a "good faith, reasonable interpretation" of 409A, prior guidance published by the IRS and US Department of the Treasury (such as Notice 2005-1) and the plans' own terms. As stated in prior guidance, 2006-79 provides that a plan will not be operating in good faith compliance if discretion provided under the plan's terms is exercised in violation of 409A.

Discounted Stock Right Fixes Permitted Until December 31, 2007 Other than for Certain Stock Rights

2006-79 provides that certain discounted stock rights (e.g., stock options granted with per share exercise prices below fair market value of the issuer's stock on the date of grant) may be amended to provide for fixed payment terms consistent with 409A until December 31, 2007 without violating 409A. Further, outstanding discounted stock rights can be replaced with stock rights that would not be subject to 409A (i.e., because they have an exercise price equal to or greater than the issuer stock's fair market value on the original date of grant of the stock right being replaced) anytime before December 31, 2007, provided that their replacement is not in exchange for cash or vested property in 2007. Prior guidance had called for the expiration of this relief for discounted stock rights on December 31, 2006.

IMPORTANT NOTES: Certain Stock Rights Not Entitled to Transition Relief. This extended transition relief is not available for any stock right (1) that was granted with respect to stock of a publicly traded company (i.e., a company required to register its stock under the Securities Exchange Act of 1934), as amended (the Exchange

Act); (2) that was granted to a person subject to Section 16 of the Exchange Act; and (3) with respect to which the issuer has reported or reasonably expects to report a financial expense as a result of the difference between the stock right's exercise price and fair market value of the issuer's stock on the date of grant which the issuer was previously required report in accordance with Generally Accepted Accounting Principles (GAAP). As a result, discounted stock rights subject to 409A that were granted to Section 16 persons must be amended to conform to 409A by December 31, 2006 in order to avoid violating 409A.

Discounted Stock Rights Must be "Fixed" Prior to Exercise.

Notwithstanding the extended transition relief, prior to a stock right's exercise date a discounted stock right must be amended to comply with 409A or replaced with a stock right that would not be subject to 409A. Failure to make such an amendment or replacement prior to exercise generally will result in a violation of 409A.

Certain Changes in Payment Elections or Conditions are Permitted before December 31, 2007

The preamble to the Proposed Regulations contained relief with regard to changes in time and form of payment elections, which relief was scheduled to expire on December 31, 2006. 2006-79 provide that this transition relief is extended through December 31, 2007. As a result, with respect to amounts subject to 409A, provided the election and any required amendment is made before December 31, 2007, a plan may provide, or be amended to provide, for new payment elections with respect to both the time and form of payment of deferred amounts, and the new election will not be treated as violating 409A. However, with respect to an election or

amendment to change a time and form of payment made on or after January 1, 2007 and before December 31, 2007, the election or amendment can only apply 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.

**Payments under Nonqualified Plans
Linked to Tax-Qualified Plans**

2006-79 extends to December 31, 2007 transition relief for nonqualified deferred compensation plans that are linked to tax-qualified plans, such as 401(k) plans. Until December 31, 2007, an election as to the time and form of a payment under a nonqualified deferred compensation plan that is controlled by a payment election made by the service provider or his or her beneficiary under a tax-qualified employer plan (including, for this purpose, 403(b) and 457(b) plans) will not violate 409A, provided the election is made in accordance with the terms of the nonqualified deferred compensation plan as in effect on October 3, 2004.

Other Transition Issues

2006-79 notes that in accordance with 2005-1, companies permitted initial deferral elections to be made that would not comply with 409A, provided they

were made on or before March 15, 2005. Notice 2005-1 conditioned this relief on plans being amended by December 31, 2005. 2006-79 clarifies that this amendment deadline has been extended to December 31, 2007.

Please contact any member of the firm's Benefit and Compensation Group for assistance with the 409A compliance process.

Endnotes

¹ The Latham & Watkins Client Alerts related to Section 409A may be accessed via the following link: <http://www.lw.com/resource/Publications/ClientAlerts/default.asp?section=3>.

Alert No. 492: *Proposed Regulations under Section 409A – Important Issues for Stock Options*, November 18, 2005

Alert No. 490: *Proposed Regulations under Section 409A of the Internal Revenue Code Require Actions during 2005*, November 4, 2005

Alert No. 426: *Notice 2005-1 Provides Guidance on New Deferred Compensation Rules*, December 30, 2004

Alert No. 411: *Legislation Contains Significant Deferred Compensation Changes*, October 12, 2004

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