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Littler Mendelson's Employee Benefits Practice Group:

Steven Friedman, *Practice Chair*
212.583.9600

James Boudreau
267.402.3029

Lisa Chagala
925.932.2468

Phil Gordon
303.629.6200

Michael Hoffman
415.433.1940

G. J. MacDonnell
415.433.1940

Darren Nadel
303.629.6200

Nancy Ober
415.433.1940

Adam Peters
415.433.1940

Michelle Pretlow
202.842.3400

Dan Rodriguez
713.951.9400

Rick Roskelley
702.862.8800

Kate Rowan
415.433.1940

Dan Srsic
614.463.4201

Daniel Thieme
206.623.3300

J. René Toadvine
704.972.7000

Kevin Wright
202.842.3400

Employee Benefits

A Littler Mendelson Newsletter

The IRS Extends Transitional Rules for Deferred Compensation – And Reminds Employers of Their Current Obligations

By Steven J. Friedman and J. René Toadvine

On October 4, 2006, the Internal Revenue Service issued Notice 2006-79, which extends the dates for certain transitional relief under Internal Revenue Code Section 409A for deferred compensation arrangements.

Background

Section 409A of the Code requires deferred compensation arrangements to meet certain requirements in order to avoid current income taxation. A 20% excise tax is assessed on deferred amounts that fail to satisfy such requirements.

Section 409A became effective January 1, 2005 and, when enacted, transitional relief was granted to taxpayers with respect to certain aspects of these rules (principally related to documentary compliance and the rules related to the form and timing of distributions) until the end of 2005. Proposed Treasury regulations, issued in 2005, provided an extension of this transitional relief through December 31, 2006. Notice 2006-79 generally provides a further extension of this transition relief through December 31, 2007, except with respect to certain discounted stock options that are subject to backdating concerns. The IRS stated in the Notice that it anticipates that final regulations will be published later in 2006 and that the additional transitional period is being provided so that employers have adequate time to analyze these final regulations and bring arrangements into compliance.

Please note that this extension of transitional relief does not relieve employers of

their obligation to comply with the bulk of the operational provisions of Section 409A, which became effective January 1, 2005. Accordingly, care must be taken to make certain that existing arrangements are not in violation of these rules.

Also, it is important for employers to understand that these rules extend far beyond traditional executive compensation devices. The rules may affect arrangements such as short-term bonuses, long-term incentive plans, severance plans and arrangements, payments under employment agreements, stay bonuses and settlement agreements.

Impact of Transitional Guidance

Plan Amendments

A deferred compensation arrangement must be operated in "good faith" compliance with Section 409A currently, but need not be formally amended to conform with these rules before December 31, 2007. Prior to Notice 2006-79, the deadline for amending arrangements was December 31, 2006. The Notice clarifies that during this good faith compliance period, if there is an impermissible exercise of discretion under the 409A rules, such as an employer retaining the discretion as to the form of a payout of deferred compensation (i.e., lump sum or installments), the entire arrangement will fail to meet the good faith compliance requirements of 409A and the 20% excise tax may be assessed on all plan participants.

Change in Payment Elections

The 409A rules require that payouts of deferred compensation be made at specified dates or be triggered by an event described in Section 409A. Special rules relate to termination payouts made to “key employees” of publicly traded companies. Because documents that embody deferred compensation arrangements often do not reflect the Section 409A rules, the IRS granted transition relief that provided that a deferred compensation arrangement could be amended by December 31, 2006 to provide new payment provisions that comply with 409A, both with respect to the time and form of payout. Notice 2006-79 extends this date to December 31, 2007.

Like prior guidance, the Notice permits an arrangement to be amended by the end of the transition period so long as the amendment does not cause an amount to be payable during the year of the amendment that would not otherwise be payable during such year. Further, the amendment cannot apply to an amount that was otherwise payable in the year of amendment.

For example, assume a deferred compensation arrangement does not satisfy the requirements of Section 409A because it does not contain definite payment provisions. Further, assume that under this arrangement, the employer has historically paid out deferred amounts in annual installments over 5 years. Pursuant to this transition rule, the employer may change its form of payout to lump sum for all deferred amounts; however, a lump sum could not be paid out in the year of the amendment. Accordingly, if such an amendment were contemplated, it may be prudent for the amendment to be implemented this year, rather than 2007, so that lump sums could commence being paid in 2007.

Amendment of Stock Right Payment Terms

Certain equity compensation arrangements may be subject to Section 409A. Notice 2006-79 permits employers to amend the governing documents relating to these arrangements to provide fixed payment terms by December 31, 2007.

Payouts Linked to Qualified Plan Elections

Under 409A, the timing and form of payment of deferred compensation must be specified in the deferred compensation arrangement. Accordingly, an employee is not permitted to link his or her deferred compensation distribution to his or her qualified plan distribution. However, prior transition relief permitted this linkage through December 31, 2006. Notice 2006-79 extends the permissibility of this linkage through December 31, 2007.

Substitution of Non-Discounted Stock Rights for Discounted Rights

Section 409A exempts from its rules certain stock rights issued at fair market value. Accordingly, discounted stock rights are not exempted. Notice 2006-79 extends the transitional period, from December 31, 2006 to December 31, 2007, for discounted stock rights to be replaced (generally through cancellation and re-issuance) with rights issued at fair market value. The cancellation and re-issuance cannot result in an exchange that results in the service provider recovering cash or vested property in the year of the exchange.

Collectively Bargained Arrangements

Notice 2006-79 extends from December 31, 2008 to December 31, 2009, the date upon which a deferred compensation arrangement maintained pursuant to a collective bargaining agreement (in effect on October 3, 2004) must comply with the 409A rules.

Parting Thought

The 409A rules apply to many different types of compensation arrangements that historically have never been viewed by the government or by employers as constituting “deferred compensation.” As a result, employers should conduct a careful review of all their compensation arrangements to determine which compensation arrangements are subject to these rules and, for those that are subject to the rules, to ensure that such arrangements are in full compliance.

Steven J. Friedman is Chair of Littler Mendelson's Benefits Practice Group and a Shareholder in the New York office. J. Rene Toadvine is a Shareholder in the Charlotte office. If you would like further information, please contact your Littler attorney at 1.888.Littler, info@littler.com, Mr. Friedman at sfriedman@littler.com, or Mr. Toadvine at rtoadvine@littler.com.
