

**IRS EXTENDS TRANSITION RELIEF FOR
SECTION 409A COMPLIANCE**

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On October 4, 2006, the Internal Revenue Service released Notice 2006-79 (the "Notice"). The Notice extends until December 31, 2007 special transition rules for bringing nonqualified deferred compensation plans, arrangements and agreements ("Nonqualified Plans") into compliance with the new requirements of Internal Revenue Code Section 409A.

CODE SECTION 409A

Section 409A imposes major changes on all Nonqualified Plans. If a Nonqualified Plan does not comply with these changes, all amounts deferred and vested under the Nonqualified Plan are currently includible in the employee's taxable income and are subject to an additional 20% penalty tax.

Although the Section 409A changes went into effect on January 1, 2005, the IRS granted various forms of transition relief to give employers time to bring their Nonqualified Plans into compliance with all the required changes. Before Notice 2006-79, this transitional relief was set to expire on December 31, 2006. Recognizing that additional time is required for employers to implement the necessary changes, especially given the continued delay by the IRS in issuing guidance on many Section 409A compliance issues, Notice 2006-79 extends by an additional year (that is, to December 31, 2007) most, but not all, of the transitional relief rules.

THE EXTENDED DEADLINES

Nonqualified Plan Restatements or Amendments

Although compliance with Section 409A is required starting on January 1, 2005, the IRS has extended until December 31, 2007 the deadline by which employers must amend or restate all Nonqualified Plans to reflect the new requirements. As a result, employers have been given an additional year in which to formally revise their Nonqualified Plans to incorporate the required Section 409A changes.

Good Faith Operational Compliance

Employers are also given an additional year, until December 31, 2007, to operate their Nonqualified Plans in good faith compliance with the new Section 409A requirements. As noted above, the Section 409A changes went into effect on January 1, 2005. However, until the IRS issues final regulations, there is

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uncertainty about compliance with many of the new requirements. According to Notice 2006-79, the final Section 409A regulations, when issued, will not become effective until January 1, 2008. Accordingly, for those Section 409A compliance issues that were not previously addressed in IRS Notice 2005-1 (the only binding IRS guidance issued so far under Section 409A), employers can continue to follow a good faith, reasonable interpretation of Section 409A until January 1, 2008. For purposes of this good faith requirement, reliance on the proposed IRS regulations issued in October 2005, or reliance on the final regulations when subsequently issued later this year, is deemed to constitute a good faith, reasonable interpretation of Section 409A.

Payment Elections

One of Section 409A's requirements is that any Nonqualified Plan elections that are available for the form of payment (for example, lump sum or installment) or the time of payment (for example, the day after separation from service, the day the employee attains age 55, and so forth) must be made by the employee prior to the start of the calendar year in which the employee earns the deferred compensation. In addition, subject to a few limited exceptions, accelerating payment of the deferred compensation (for example, changing the date of payment from five years after employment terminates to the date of termination) is prohibited. Notwithstanding these new payment election and prohibited acceleration rules, Notice 2006-79 extends until December 31, 2007 special transition rules that allow employees to make or change Nonqualified Plan payment elections for all deferred compensation earned prior to January 1, 2008. In addition, Notice 2006-79 clarifies that employers can rely on the transition rules as well to modify the payment terms of their Nonqualified Plans.

Stand Alone Payment Elections

The first extended transition rule applies to any stand alone payment form or timing election that is made or changed prior to January 1, 2008. Thus, all Nonqualified Plan participants can be given one final opportunity to elect how and when their deferred compensation benefits earned prior to January 1, 2008 will be paid. Starting on January 1, 2008, changes in the timing and form of Nonqualified Plan payments will be subject to Section 409A's restrictions on payment election changes, which generally require a five-year delay from the original scheduled payment date before the change goes into effect and also prohibit changes that move up the payment date. However, starting on January 1, 2008, Nonqualified Plan participants can still, if permitted by the plan, make payment form and timing elections for subsequently-earned deferred compensation, so long as the election is made prior to January 1 of the year in which the deferred compensation is earned (or in the case of new plan participants who are eligible to commence participation during a calendar year, within 30 days after becoming eligible to participate).

This extended transition rule has a few limitations. Under Notice 2006-79, the transition rule cannot be used in any of the following situations:

- A participant is scheduled to receive a Nonqualified Plan benefit in 2007 and wants to delay the benefit until after 2007.
- A participant wants to change the form of a Nonqualified Plan benefit that is scheduled to be paid in 2007 (for example, from lump sum to installments, and vice versa).
- A participant who is not schedule to receive a Nonqualified Plan benefit in 2007 wants to receive the benefit in 2007.

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These limitations only apply starting on January 1, 2007. As a result, any of the above changes can still be made so long as the change is made no later than December 31, 2006. However, any 2006 election changes remain subject to previous IRS restrictions on 2006 Nonqualified Plan payments. For instance, a participant could not elect to delay a Nonqualified Plan benefit that is scheduled to be paid in 2006 to a later year.

Linked Payment Elections

The second extended transition rule applies where the form and timing of Nonqualified Plan payments are linked to a participant's form and timing election under a qualified retirement plan. These linked elections are typically found in supplemental, nonqualified pension plans that enhance a participant's pension benefit under a qualified defined benefit pension plan. Prior to Section 409A, it was common to tie the form and timing of the supplemental pension benefit to the form and timing of the qualified plan benefit as elected by the participant after retirement. Under Section 409A, this linked payment election feature is no longer possible.

Recognizing that the linked payment election feature was a common practice before the enactment of Section 409A and that employers and plan participants need additional time to adjust to the change, Notice 2006-79 permits the continued use of linked payment elections through December 31, 2007. This extended transition relief, however, is only available for Nonqualified Plans that contained a linked payment election feature on October 3, 2004 (which was the date Section 409A was enacted).

Stock Options

Stock options and stock appreciation rights (SARs) that were not vested as of December 31, 2004 are now subject to the new Section 409A requirements. However, there is an exception for stock options and SARs that, among other things, are issued with an exercise price that is equal to or greater than the fair market value of the underlying stock at the time the option or SAR is granted. In other words, the option or SAR must not be discounted.

Notice 2006-79 extends two transitional rules for options and SARs that were issued at a discount (that is, the exercise price was less than the underlying stock's fair market value at the time of grant) and were not vested as of December 31, 2004:

Modification to Specify Fixed Payment Terms

In order to bring a discounted stock option or SAR into compliance with Section 409A, the option or SAR needs to specify a fixed date when it will be exercised (for example, the first day of the calendar month after the employee vests in the option or SAR). In addition, for certain officers of publicly-traded companies, there must be a six-month waiting period to exercise an option or SAR after terminating employment. Notice 2006-79 extends until December 31, 2007 the deadline for amending discounted stock options and SARs to meet these requirements. Alternatively, the stock option or SAR can be amended to allow the employee to elect a fixed exercise date. However, if such an election is provided, the employee must make the election prior to January 1, 2008.

Substitution of Discounted Options

Instead of modifying a discounted stock option or SAR to make it compliant with Section 409A, an employer and an employee may wish to avoid Section 409A altogether by replacing the stock option or SAR with a non-discounted stock

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option or SAR. Notice 2006-79 extends until December 31, 2007 the deadline to complete the replacement. Under this approach, the exercise price of the new stock option or SAR will need to be equal to or greater than the fair market value of the underlying stock as of the original date of grant of the option or SAR. Thus, if a discounted stock option was granted on December 1, 2004, the replacement stock option granted under Notice 2006-79 will need to have an exercise price at least equal to the fair market value of the underlying stock on December 1, 2004. In order for the extended transition rule to be available, the employee cannot receive during the calendar year of replacement cash or other property to compensate the employee for the loss of the discount.

NO TRANSITION EXTENSION FOR CERTAIN SITUATIONS

The extended transition relief provided by Notice 2006-79 does not apply to the following two situations:

Elections to Defer Compensation

An election under a Nonqualified Plan to defer compensation that is earned in 2007 must still be made prior to January 1, 2007. The only exceptions are for new participants (who can make a deferral election within 30 days of eligibility for compensation earned after the election) and for compensation that qualifies as "performance-based" under the new Section 409A rules (where an election to defer the performance-based compensation is permitted up to the end of the sixth month of the performance period).

Backdated Discount Stock Options

The extended transition relief for discounted stock options does not apply to stock options issued by a publicly-traded corporation to an officer subject to the Securities Exchange Act Section 16 disclosure requirements where the option was backdated (that is, the exercise price was set as of a date that preceded the actual date of grant of the stock option). In that case, in order to avoid violating Section 409A, the option must, prior to January 1, 2007, either be replaced with a non-discounted stock option or revised to comply with the Section 409A fixed payment date and waiting period requirements.