

## Part III - Administrative, Procedural, and Miscellaneous

### Additional Transition Relief under Section 409A

Notice 2006-79

#### SECTION 1. PURPOSE

This notice provides transition relief under section 409A of the Internal Revenue Code (Code), applicable to nonqualified deferred compensation plans. The IRS and Treasury Department are currently in the process of finalizing the proposed regulations under section 409A that were published October 4, 2005. The proposed regulations contained a proposed effective date of January 1, 2007 for the final regulations. Although the IRS and Treasury Department expect to issue the final regulations before the end of 2006, commentators have expressed concern that there will not be sufficient time between the issuance of the final regulations and the proposed effective date for taxpayers to analyze the final regulations and come into compliance with them. Commentators have also raised questions and concerns about certain other aspects of the transition relief

Accordingly, as described in more detail below, this Notice provides further transition relief by:

- Announcing that the final regulations will not become effective until January 1, 2008

- Generally extending through 2007 the transition relief provided for 2006 in the preamble to the proposed regulations except with respect to certain discounted stock rights
- Providing additional transition relief for certain payment elections in linked plans and certain collective bargaining arrangements
- Extending the amendment date for certain plans that took advantage of transition relief provided for 2005

## SECTION 2. BACKGROUND

Section 409A was added to the Code by section 885 of the American Jobs Creation Act of 2004, Public Law 108-357 (118 Stat. 1418). Section 409A generally provides that unless certain requirements are met, amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Section 409A also includes rules applicable to certain trusts or similar arrangements associated with nonqualified deferred compensation, where such arrangements are located outside of the United States or are restricted to the provision of benefits in connection with a decline in the financial health of the sponsor.

On December 20, 2004, the IRS issued Notice 2005-1 (2005-2 I.R.B. 274 (published as modified on January 6, 2005)), setting forth initial guidance with respect to the application of section 409A, and supplying transition guidance in accordance with the statutory provisions. A notice of proposed rulemaking (REG-158080-04, 2005-43 I.R.B. 786 [70 FR 57930]) was published in the

Federal Register on October 4, 2005. The preamble to the proposed regulations clarified and extended certain provisions of the transition guidance provided in Notice 2005-1, generally through December 31, 2006.

Under the proposed regulations, the final regulations were proposed to become effective January 1, 2007. The Treasury Department and the IRS anticipate that the final regulations will be published in 2006. However, in order to allow sufficient time for taxpayers and their representatives to analyze the final regulations and come into compliance, the effective date for the final regulations is expected to be January 1, 2008. Accordingly, this notice provides additional transition relief applicable through December 31, 2007.

### SECTION 3. TRANSITION RELIEF

#### .01. Amendment and operation of plans adopted on or before December 31, 2007

A plan adopted on or before December 31, 2007 will not be treated as violating section 409A(a)(2), (3) or (4) on or before December 31, 2007 if the plan is operated through December 31, 2007 in reasonable, good faith compliance with the provisions of section 409A and applicable provisions of Notice 2005-1 and any other generally applicable guidance published with an effective date prior to January 1, 2008, and the plan is amended on or before December 31, 2007 to conform to the provisions of section 409A and the final regulations with respect to amounts subject to section 409A. For such periods, to the extent an issue is not addressed in an applicable provision of Notice 2005-1 or other published guidance with an effective date prior to January 1, 2008, the plan must

be operated consistent with a good faith, reasonable interpretation of section 409A, and, to the extent not inconsistent therewith, the plan's terms.

Compliance with the proposed regulations, or the final regulations prior to their effective date, is not required. However, for periods before January 1, 2008, compliance with the proposed regulations or the final regulations will constitute reasonable, good faith compliance with the statute. To the extent that a provision of either the proposed regulations or the final regulations is inconsistent with a provision of Notice 2005-1, or a provision of the proposed regulations is inconsistent with a provision of the final regulations, the plan may comply with the provision of the proposed regulations, the final regulations or Notice 2005-1.

A plan will not be operating in good faith compliance if discretion provided under the terms of the plan is exercised in a manner that causes the plan to fail to meet the requirements of section 409A. For example, if an employer retains the discretion under the terms of the plan to delay or extend payments under the plan in a manner that violates section 409A and exercises such discretion, the plan will not be considered to be operated in good faith compliance with section 409A with regard to any plan participant. However, an exercise of a right under the terms of the plan by a participant solely with respect to that participant's benefits under the plan, in a manner that causes the plan to fail to meet the requirements of section 409A, will not be considered to result in the plan failing to be operated in good faith compliance with respect to other participants. For example, the request for and receipt of an immediate payment permitted under the terms of the plan if the participant forfeits 20 percent of the participant's

benefits (a haircut) will be considered a failure of the plan to meet the requirements of section 409A with respect to that participant, but not with respect to all other participants under the plan.

.02. Change in payment elections or conditions on or before December 31, 2007

The transition relief provided in section XI.C. of the preamble to the proposed regulations generally continues to apply through December 31, 2007, with certain clarifications described below, and subject to limitations for certain discounted stock rights also described below. Accordingly, with respect to amounts subject to section 409A, a plan 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 of such amounts and the election or amendment will not be treated as a change in the time or form of payment under section 409A(a)(4) or an acceleration of a payment under section 409A(a)(3), provided that the plan is so amended and elections are made on or before December 31, 2007. With respect to an election or amendment to change a time and form of payment made on or after January 1, 2006 and on or before December 31, 2006, the election or amendment may apply only to amounts that would not otherwise be payable in 2006 and may not cause an amount to be paid in 2006 that would not otherwise be payable in 2006. With respect to an election or amendment to change a time and form of payment made on or after January 1, 2007 and on or before December 31, 2007, the election or amendment 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. So, for example, where an amount would otherwise be payable upon an event, such as a separation from service, an election in 2006 cannot change the amount that would be payable in 2006 if the service provider separated from service in 2006. In addition, a deferral election may be made with respect to an amount that is a short-term deferral within the meaning of proposed §1.409A-1(b)(4), provided that the election is made before January 1, 2008 and before the year in which the amount would otherwise have been paid.

This provision applies to elections or amendments by a service provider, a service recipient, or both a service provider and a service recipient. A service provider or service recipient may make more than one change or amendment under this relief, provided that each such change or amendment is made in accordance with the deadlines and conditions set forth in the applicable transition relief. For example, a service provider that in 2005 elected to change the time and form of payment of deferred compensation to a lump sum payment in 2010, may elect again in 2006 or 2007 to change the time and form of payment in accordance with this paragraph. However, a service provider that in 2005 elected to be paid an amount in 2006 may not in 2006 change the time and form of payment to be paid in a later year.

Similarly, except as provided below with respect to certain discounted stock rights, an outstanding stock right that provides for a deferral of compensation subject to section 409A may be amended to provide for fixed payment terms consistent with section 409A, or to permit holders of such rights

to elect fixed payment terms consistent with section 409A, and such amendment or election will not be treated as a change in the time and form of payment under section 409A(a)(4) or an acceleration of a payment under section 409A(a)(3), provided that the option or right is so amended and any elections are made, on or before December 31, 2007. For this purpose, a stock right will not be treated as payable in a year solely because the stock right is exercisable during that year, if the stock right is also reasonably expected to be exercisable in a subsequent year.

.03 Payments linked to qualified plans

The ability to link a payment election under a nonqualified deferred compensation plan to an election under a qualified plan has also been extended through 2007. In addition, this relief is extended to payment elections under nonqualified deferred compensation plans that are linked to certain additional employer plans, including section 403(b) annuities, section 457(b) eligible plans, and certain foreign broad-based plans. Accordingly, for periods ending on or before 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 beneficiary of the service provider under a qualified employer plan described in proposed §1.409A-1(a)(2), a plan that includes a trust described in section 402(d), a plan described in section 1022(i)(1) or (2) of the Employee Retirement Income Security Act, or a foreign broad-based plan described in proposed §1.409A-1(a)(3)(v), will not violate the requirements of section 409A, provided that the determination of the time and

form of the payment is made in accordance with the terms of the nonqualified deferred compensation plan that govern payment elections, as in effect on October 3, 2004. For example, where a nonqualified deferred compensation plan provides as of October 3, 2004, that the time and form of payment to a service provider or beneficiary will be the same time and form of payment elected by the service provider or beneficiary under a qualified plan, it will not be a violation of section 409A for the plan administrator to make or commence payments under the nonqualified deferred compensation plan on or after January 1, 2005, and on or before December 31, 2007, pursuant to the payment election under the qualified plan. Notwithstanding the foregoing, other provisions of the Internal Revenue Code and common law tax doctrines continue to apply to any election as to the time and form of a payment under a nonqualified deferred compensation plan.

.04 Substitutions of non-discounted stock options and stock appreciation rights for discounted stock options and stock appreciation rights

Notice 2005-1, Q&A-18(d) provides that it will not be a material modification to replace a stock option or stock appreciation right otherwise providing for a deferral of compensation under section 409A with a stock option or stock appreciation right that would not have constituted a deferral of compensation under section 409A if it had been granted upon the original date of grant of the replaced stock option or stock appreciation right, provided that the cancellation and reissuance occurs on or before December 31, 2005. Section XI.H. of the preamble to the proposed regulations extended the period during



which the cancellation and reissuance may occur until December 31, 2006, but only to the extent a cancellation and reissuance in 2006 does not result in the cancellation of a deferral in exchange for cash or vested property in 2006. Except with respect to certain discounted stock rights described in section 3.07 below, the period during which the cancellation and reissuance may occur is extended until December 31, 2007, but only to the extent such cancellation and reissuance in 2007 does not result in the cancellation of a deferral in exchange for cash or vested property in 2007. For example, a discounted option generally may be replaced through December 31, 2007 with an option that would not have provided for a deferral of compensation, although the exercise of such a discounted option in 2007 before the cancellation and replacement generally would result in a violation of section 409A.

Where replacement stock options or stock appreciation rights that would not constitute deferred compensation subject to section 409A are issued in accordance with the conditions set forth in Notice 2005-1, Q&A-18(d), the preamble to the proposed regulations and this notice, such replacement stock options or stock appreciation rights will be treated for purposes of section 409A as if granted on the grant date of the original stock option or stock appreciation right. For a discussion of certain methods that commentators proposed to use to compensate option holders for the value of a lost discount, see section XI.H. of the preamble to the proposed regulations.

.05 Collectively bargained arrangements.

A nonqualified deferred compensation 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 (determined without regard to any extension thereof after October 3, 2004) or December 31, 2009.

.06 Other transition issues

Notice 2005-1, Q&A-21 provided relief with respect to certain initial deferral elections, generally providing that certain requirements would not be applicable to elections made on or before March 15, 2005. One of the conditions of the requirement was that the plan be amended to comply with the requirements of section 409A in accordance with Notice 2005-1, Q&A-19. Notice 2005-1, Q&A-19 generally required that plans be amended by December 31, 2005. The March 15, 2005 deadline for initial deferral elections was not extended in the preamble to the proposed regulations; however, the plan amendment requirement generally was extended to December 31, 2006. Although the initial deferral election relief contained in Notice 2005-1, Q&A-21 only referred to the requirements of Notice 2005-1, Q&A-19, the Treasury Department and the IRS have become aware that many taxpayers interpreted the extension of the plan amendment deadlines as flowing through to the requirements of Notice 2005-1, Q&A-21. To avoid unintentional noncompliance in this area, the deadline for a plan to be amended to reflect use of the relief

provided in Notice 2005-1, Q&A-21 is extended to December 31, 2007.

However, taxpayers retain the burden of demonstrating satisfaction of the requirement by showing that the deferral election was made by the March 15, 2005 deadline, in accordance with the plan terms in effect on or before December 31, 2005 (other than a requirement to make a deferral election on or before March 15, 2005). See Notice 2005-1, Q&A-21.

.07 Transition relief not extended for certain discounted stock rights

The transition relief provided in the preamble to the proposed regulations and described in this notice is not extended for any stock option or stock appreciation right (stock right) that:

(A) was granted with respect to stock of a corporation that as of the date of grant had issued any class of common equity securities required to be registered under section 12 of the Securities Exchange Act of 1934;

(B) was granted to a person who, as of the date of grant, was subject to the disclosure requirements of section 16(a) of the Securities Exchange Act of 1934 with respect to such issuer; and

(C) with respect to the grant of such stock right, such corporation 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 at the date of grant that was not timely reported on financial statements or reports for the period in which the related expense should have been reported under generally accepted accounting principles.

## SECTION 4. APPLICATION OF FINAL REGULATIONS TO OUTSTANDING DEFERRALS

Commentators to the proposed regulations expressed concerns regarding the application of the final regulations, once effective, to outstanding deferrals such as, for example, outstanding stock rights. The Treasury Department and the IRS anticipate addressing these issues in connection with the issuance of the final regulations.

## SECTION 5. EFFECT ON OTHER DOCUMENTS

Nothing in this notice is intended to limit the scope or applicability of the transition relief provided in Notice 2005-1 and the proposed regulations. In addition, this notice is not intended to limit the scope or applicability of the guidance provided in Notice 2005-94, 2005-52 I.R.B. 1208 (transition guidance with respect to 2005 reporting and withholding obligations); Notice 2006-4, 2006-3 I.R.B. 307 (transition guidance with respect to certain outstanding stock rights); Notice 2006-33, 2006-5 I.R.B. 754 (transition guidance with respect to the application of section 409A(b)); or Notice 2006-64, 2006-29 I.R.B. 88 (transition guidance with respect to the application of section 409A to accelerated payments necessary to meet federal ethics requirements).

## SECTION 6. DRAFTING INFORMATION

The principal author of this notice is Stephen B. Tackney of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and the Treasury Department

participated in its development. For further information regarding this notice, contact Mr. Tackney at (202) 927-9639 (not a toll-free call).