



JONES DAY COMMENTARY

EMPLOYEE BENEFITS & EXECUTIVE COMPENSATION

IRS MISSES OPPORTUNITY TO SIMPLIFY SECTION 409A RULES

The trend of intense tax regulation of executive compensation continued last week when the IRS published 240 pages of proposed regulations interpreting Section 409A of the Internal Revenue Code. The regulations have been much anticipated in light of the sweeping changes to the rules governing nonqualified deferred compensation arrangements mandated by Section 409A and the initial deadline of December 31, 2005 for documentary compliance. Combined with SEC, stock exchange, and institutional investor attention to executive compensation matters, the proposed regulations underline the care with which executives, corporate boards, and their advisers must approach these matters.

While the new rules are helpful in certain aspects (most notably the extension of the deadline for documentary compliance until December 31, 2006), the problem with the new rules is that "there are too many rules." The IRS on several occasions had the opportunity to grant relief in the form of a bright-line exclusion.

Instead, the IRS chose to grant limited relief with multiple requirements and exceptions to each exclusion. The result is unnecessarily complex rules in an area where technical noncompliance will result in severe penalties.

Below are some of the key provisions of the new tax rules:

EXTENSION OF DEADLINE FOR DOCUMENTARY COMPLIANCE

The IRS, in a welcome move, extended the deadline for documentary compliance from December 31, 2005 to December 31, 2006. Taxpayers therefore have until December 31, 2006 to amend formally plans and agreements. Documentary compliance, however, should not be confused with operational compliance. Since January 1, 2005, taxpayers have been required to operate plans and agreements in good faith compliance with Section 409A.

EXTENSION OF CERTAIN TRANSITION RELIEF

Earlier IRS guidance provided certain transition relief during 2005, including the ability without penalty to change payment elections, make initial elections, and terminate participation in plans. In light of the delay in the issuance of the proposed regulations, practitioners had urged the IRS to extend the transition relief provisions. In response, the IRS extended the transition relief provisions in some instances (e.g., ability to change payment elections) until December 31, 2006. By contrast, the IRS declined to extend the transition relief allowing an executive to cancel participation or cancel an election, retaining the original December 31, 2005 deadline.

SEVERANCE PAYMENTS

Practitioners had hoped for a broad exclusion from Section 409A for severance payments made on account of either an involuntary termination of employment or termination for good reason. The proposed regulations, however, provide a limited exclusion for payments on account of an involuntary termination (but not on account of a termination for good reason). Moreover, in the case where the exclusion applies and the payments are scheduled to be made over time, the exclusion applies only if (1) the aggregate payments do not exceed \$420,000 (or, if less, two times the executive's annual compensation) and (2) all payments are made by no later than December 31 of the second calendar year following the year of termination.

REIMBURSEMENT ARRANGEMENTS

Practitioners were concerned that reimbursement arrangements arising on a termination of employment could result in an inadvertent violation of the Section 409A rules. The proposed regulations provide for an exclusion for certain reimbursement arrangements but again limit the exclusion to expenses incurred and reimbursed before December 31 of the second calendar year following the year of termination. If the reimbursement provisions of an employment agreement result in a technical violation, all payments under the agreement are subject to the Section 409A adverse tax consequences, which include a 20 percent penalty tax.

STOCK OPTIONS AND STOCK APPRECIATION RIGHTS

Stock options and stock appreciation rights granted at fair market value are excluded from coverage under Section 409A. Previously, the exclusion for stock appreciation rights was limited. In a positive development, the proposed regulations extend the exclusion for stock appreciation rights to apply regardless of whether the rights are settled in cash and regardless of whether the rights are based upon publicly traded stock. The proposed regulations also provide detailed rules for establishing fair market value in the case of publicly traded and nonpublicly traded companies. For outstanding options and stock appreciation rights granted at a discount in violation of Section 409A, the proposed regulations outline potential corrective actions, with different actions available depending on whether the correction occurs in 2005 or 2006.

BROAD APPLICATION

The proposed regulations confirm that Section 409A applies, subject to certain exceptions, to any plan, agreement, or arrangement that provides for a deferral of compensation. This includes traditional deferred compensation plans, supplemental retirement plans, employment, severance and change-in-control agreements, and certain forms of equity compensation. The proposed regulations also confirm that, except in limited circumstances, one instance of noncompliance can subject many payments to the Section 409A adverse tax consequences, which include a 20 percent penalty tax.

LAWYER CONTACTS

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