



JONES DAY
COMMENTARY

EMPLOYEE BENEFITS & EXECUTIVE COMPENSATION

SECTION 409A UPDATE: IRS EXTENDS TRANSITION RELIEF UNTIL DECEMBER 31, 2007

The saga of Section 409A of the Internal Revenue Code ("Section 409A") continues. We have written previously about Section 409A (*see* October 2005 and February 2006 *Commentaries*). The latest chapter is IRS Notice 2006-79, issued on October 4, 2006.

This Notice extends Section 409A transition relief to December 31, 2007, including the deadline for documentary compliance with Section 409A. Prior to the Notice, the deadline was December 31, 2006.

Under Notice 2006-79:

- Most transition relief, as described in Notice 2005-1 and the preamble to the Proposed Regulations issued in September 2005, also has been extended one year. For example, subject to certain rules, a plan may continue to be amended to provide for new payment elections by plan participants through December 31, 2007.

- Even though documentary compliance is not currently required, plans subject to Section 409A must continue to be operated in reasonable, good-faith compliance with Section 409A. Compliance with Notice 2005-1, the Proposed Regulations, or the Final Regulations, once issued, will constitute reasonable, good-faith compliance with Section 409A. Failure to comply in good faith will subject a plan participant to the Section 409A penalties, including taxation at vesting and a 20 percent penalty tax. The IRS has reminded employers that they are required currently to withhold when items are includible in employees' income under Section 409A.
- Options with an exercise price less than fair market value on grant (*i.e.*, discount options) remain subject to Section 409A. Transition relief for discount options generally was extended until December 31,

2007. However, Notice 2006-79 terminates, as of December 31, 2006, the transition relief for discount options granted to Section 16 officers of a public company where the discount results from option backdating that resulted in or will result in an accounting expense that should have been, but was not, reported in an earlier accounting period.

Despite the extended transition relief for another year, we see Notice 2006-79 as a call to action in a couple of respects.

First, for public companies that are reviewing option timing practices, the Notice creates a strong incentive to complete those reviews promptly. If such a company finds timing problems for a prior period, one of the many issues that will need to be addressed is the potential Section 409A impact. Corrections that can avoid the Section 409A penalties need to be completed this year.

Second, it seems fairly clear at this point that the IRS will maintain in the Final Regulations the structure and complexity of the Proposed Regulations (presumably with some of the thorniest issues addressed in yet more rules). Thus, for companies that generally have taken a wait-and-see approach to Section 409A compliance (an approach that we think has had merit up to this point), we think it is time to engage in a more active response. The not quite 15 months between now and December 31, 2007, is not a long time to review and revise all of the plans, agreements, and other arrangements

that are subject to what will be a very complex and burdensome Code Section 409A regime.

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