

October 6, 2006

IRS Extends Most Section 409A Deadlines to December 31, 2007; Discount Stock Options Still at Risk

The Internal Revenue Service has extended until December 31, 2007 most documentation deadlines and transition relief under Internal Revenue Code section 409A, the tax code provision which regulates nonqualified deferred compensation. (Notice 2006-79, October 4, 2006). December 31, 2006 remains a deadline for some section 409A purposes. Importantly, December 31, 2006 is the 409A deadline for fixing certain discount stock options granted to Section 16 insiders of public companies.

What to do now?

The December 31, 2007 extension only applies to section 409A *documentation deadlines*: good faith efforts to operate in compliance with section 409A are required right now. We urge clients to deal with the following matters soon:

1. Identify 409A Arrangements. Identify your compensation arrangements that might be regarded as “deferred compensation” under section 409A and consider whether changes are needed. In particular, severance, deal bonus and realization event arrangements deserve special attention.
2. Study Past and Future Option Grant Practices. Discount stock options are generally subject to section 409A, and running afoul of the 409A rules can make discount options a tax disaster for the executive. (“Discount options” are employee stock options priced at a discount to grant date fair market value of the underlying stock.) The recent option backdating scandals have caused many companies to examine their option grant practices. Some are finding that they may have inadvertently granted discount options -- perhaps because the legal grant date occurred after the desired option effective date and/or

IRS Circular 230 disclosure: To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this document is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter that is contained in this document.

1285 Avenue of the Americas
New York, New York 10019-6064
(212) 373-3000

1615 L Street, NW
Washington, DC 20036-5694
(202) 223-7300

Alder Castle, 10 Noble Street
London EC2V 7JU England
(44-20) 7367 1600

Fukoku Seimei Building 2nd Floor
2-2, Uchisawaicho 2-chome
Chiyoda-ku, Tokyo 100-001, Japan
(81-3) 3597-8101

Unit 3601, Fortune Plaza Office Tower A
No. 7 Dong Sanhuan Zhonglu
Chao Yang District, Beijing 100020
People's Republic of China
(86-10) 5828-6300

12th Fl., Hong Kong Club Building
3A Chater Road, Central
Hong Kong
(852) 2536-9933

because they are unable to capably justify option exercise prices as having been set at fair market value (a valuation problem, more likely encountered in private companies). The new SEC executive compensation disclosure rules will require public companies -- and companies going public -- to produce accurate historical records of option grants showing grant dates, grant date fair market values, the recipients who received awards, etc.

Because of these developments, we recommend that clients study their historical option grant practices and consider whether they have adequate documentation to support the claimed grant dates and grant date fair market values of outstanding options. If there is any doubt about these issues, consider whether adjustments need to be made for section 409A purposes and also consider adding new documentation procedures for future option grants -- for example, perhaps create an option procedure logbook in which all option grants can be easily identified, the dates of grant identified, the procedures used to validate prices justified, etc.

Background

Section 409A regulates nonqualified deferred compensation arrangements and was added to the Internal Revenue Code in October 2004. Failure to comply with the section 409A rules can result in deferred compensation being taxed before actual payment and a 20% penalty tax in addition to regular income tax. Before Notice 2006-79, the Service had set December 31, 2006 as the transition deadline for amending covered plans for section 409A.

Section 409A applies to familiar voluntary nonqualified deferral arrangements, like voluntary deferral of annual bonuses. It also applies to many non-elective arrangements and some arrangements traditionally not thought of as involving "deferred compensation" such as phantom stock arrangements, Supplemental Executive Retirement Plans (SERPs), discount stock options, and some severance contracts.

The New Extension

The general section 409A amendment deadline is now extended until December 31, 2007. Until then, the following rules apply:

- deferred compensation arrangements generally must continue to be operated in accordance with the limited IRS guidance issued in early 2005 (Notice 2005-1).
- deferred compensation arrangements must be operated in accordance with a reasonable good faith interpretation of the requirements of section 409A and in accordance with the terms of

the plan (if not in conflict with section 409A). For this purpose, taxpayers may follow Notice 2005-1. Or, they may follow -- but are not required to follow -- the rules set out in the proposed section 409A regulations issued in October 2005 or the final section 409A regulations expected to be issued later in 2006 with a 2008 effective date.

- Plans must be formally amended by December 31, 2007 to comply with section 409A.

Some collectively bargained nonqualified deferred compensation plans in place on October 3, 2004 will not have to comply until December 31, 2009.

Transition Relief: SERPs

The extender relief also continues to allow some flexibility until December 31, 2007 in making elections as to time and form of payment under SERPs and other programs whose payments are directly linked to benefits under a tax-qualified pension or profit-sharing plan, a tax deferred annuity under section 403(b) of the Code or certain governmental or broad-based foreign plans.

Transition Relief: Changing When and How Deferred Compensation Is To Be Paid

Section 409A requires that the time and form of payment of deferred compensation be set in advance, following strict rules. In general, section 409A does not permit taxpayers to revise old arrangements so as to accelerate payment to an earlier date; elections to delay scheduled payments to a later date can be allowed, but again only by following rigid rules.

Under Notice 2006-79, IRS will allow taxpayers to make changes, in 2006 and 2007, to the previously-set time and/or form of payment of deferred compensation, even if these changes accelerate or postpone previously-set payments. (These changes usually will require an agreement by both employer and employee.) However, a written election must be made by **December 31, 2006** if a desired result of the change is to move a previously-scheduled payment out of 2007 to a later year or to bring a payment into 2007 from a later year. Similarly, an election to revise the time and/or form of payment will need to be made by **December 31, 2007** if a desired result of the change is to move income into or out of 2008 or some later year. It is now too late to revise arrangements to bring income into, or push income out of 2006.

Some Discount Stock Options Face A December 31, 2006 Deadline

As mentioned above, section 409A generally applies to stock options whose exercise price is less than grant date fair market value of the underlying stock (with grandfathering for some discount options vested before 2005). The section 409A

transition rules allow several different methods of fixing up discount options to avoid the 409A penalty taxes, and the December 31, 2007 deadline extension is available in most **but not all** cases. **All companies with discount options outstanding should carefully consider the section 409A implications and in some cases very prompt attention will be needed.**

The Notice 2006-79 extender relief **is not applicable** to discount stock options granted by a public company to section 16 insiders if (i) the company did not timely reflect the GAAP accounting cost of the discount in its financial statements AND (ii) the company has subsequently reported or reasonably expects to report a financial expense on account of the discounted grant. This rule may have broader application but at least seems aimed squarely at public companies which have restated or which expect to restate financial statements on account of a discount originally not reported due to backdating or otherwise. Such options will generally need to be fixed up by **December 31, 2006** rather than December 31, 2007.

* * *

Please contact any member of our Executive Compensation and Employee Benefits Group if you have questions about the new extension and transition relief, or are unsure whether you maintain compensation arrangements subject to section 409A or would like more background about section 409A.

Robert C. Fleder
Michael J. Segal
Lawrence I. Witdorhic

© 2006 Paul, Weiss, Rifkind, Wharton & Garrison LLP