The
ERISA
Industry
Committee

ERIC

HR POLICY ASSOCIATION
The Association of Senior Human Resource Executives

SUPPLEMENTAL RECOMMENDATIONS

OF

THE ERISA INDUSTRY COMMITTEE

AND

THE HR POLICY ASSOCIATION

TO THE TREASURY DEPARTMENT

AND

THE INTERNAL REVENUE SERVICE

FOR GUIDANCE

UNDER INTERNAL REVENUE CODE § 409A

REGARDING

NONQUALIFIED DEFERRED COMPENSATION

APRIL 19, 2005

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The ERISA Industry Committee ("ERIC")[1] and the HR Policy Association ("HR Policy")[2] are pleased to submit the following recommendations for guidance under Internal Revenue Code § 409A, regarding nonqualified deferred compensation. Section 409A was added to the Internal Revenue Code by § 885 of the American Jobs Creation Act of 2004 (the "AJCA"). Section 409A overhauls the federal income tax treatment of a wide variety of nonqualified deferred compensation arrangements.

On November 3, and 23, 2004, ERIC submitted recommendations regarding a number of pressing issues under § 409A. Likewise, on October 29, 2004, and December 1, 2004, HR Policy submitted recommendations on § 409A issues of importance to its members. This submission supplements ERIC's and HR Policy's prior recommendations and takes into account the publication by the Treasury Department and the Internal Revenue Service[3] of Notice 2005-1 on December 20, 2004, providing initial guidance under § 409A.

ERIC and HR Policy very much appreciate the timely and thoughtful guidance that the Treasury provided in Notice 2005-1. The following recommendations address issues that were not addressed by Notice 2005-1 as well as aspects of Notice 2005-1 that, in our judgment, deserve further consideration.

A. Background

Section 409A covers a wide variety of nonqualified deferred compensation plans. Because deferred compensation plans are designed to achieve important business objectives, the

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[1] ERIC is a nonprofit association committed to the advancement of the employee retirement, health, incentive, and compensation plans of America's major employers. ERIC's members provide comprehensive benefits to tens of millions of active and retired workers and their families and beneficiaries. ERIC's members' plans are the benchmarks against which industry, third-party providers, consultants, and policy makers measure the design and effectiveness of employee benefit, incentive, and compensation plans. ERIC's members are engaged daily with meeting the demands of both their enterprise and the needs of employees while dealing with an increasingly complex web of benefit and compensation laws. ERIC, therefore, is vitally concerned with proposals affecting its members' ability to provide employee benefits, incentive, and compensation plans, their costs and effectiveness, and the role of those plans in the American economy.

[2] HR Policy is a public policy advocacy organization representing senior human resource executives of more than 240 of the largest corporations doing business in the United States. HR Policy's member companies employ more than 19 million employees worldwide. HR Policy's purpose is to ensure that U.S. employment policy supports the competitive goals of its member companies and their employees. As the senior executives responsible for executive compensation, HR Policy members have a substantial interest in ensuring that changes to executive compensation law and policy are workable and support the attraction and retention of the best talent possible.

[3] In the interest of simplicity, we use "Treasury" hereafter to refer to both the Treasury Department and the Internal Revenue Service.

members of ERIC and HR Policy have a vital interest in the development of rules under § 409A that will allow these plans to continue to achieve their objectives.

The plans covered, or potentially covered, by § 409A include not only traditional deferred compensation plans, but also individual contracts and agreements, employment agreements, supplemental retirement plans, severance plans, and equity plans, including restricted stock unit plans and some stock option and stock appreciation rights plans. The plans covered by § 409A include both "top-hat" plans that apply to small groups of senior executives and broad-based plans covering thousands of employees. The deferred compensation plans covered by § 409A include both plans that allow employees to elect to defer compensation and plans that require deferral. They include plans that apply to outside directors and other independent contractors as well as plans that apply only to employees.

The treatment of an employer's deferred compensation plans is frequently a major consideration in business acquisitions and dispositions, corporate reorganizations, the staffing of joint ventures, and other business transactions. Furthermore, because most major corporations operate globally, many of these plans also have international objectives and implications (*e.g.*, preserving an employee's retirement benefits when the employee is transferred from one country to another).

Although the business objectives vary from plan to plan, all of the plans help companies to achieve critical business goals. For example, they help employers to attract and retain talented people; they encourage and reward individual and group performance that advances a company's short-term and long-term business objectives; they help to align the interests of employees with the interests of shareholders; they help employers to provide appropriate levels of retirement income to employees whose benefits have been curtailed by the tax law limits on qualified plans; they help employees to move from one position to another (and often from country to another) without losing benefits; and they help employers to manage the size and composition of the workforce.

The issues raised by§ 409A are extremely important to U.S. and global businesses. If major issues under § 409A are not addressed, or are not addressed properly, companies doing business in the U.S. could be badly harmed.

Although § 409A will necessarily require major changes in the design and administration of deferred compensation plans, the Treasury has the authority to implement § 409A in a practical and appropriate way. The following recommendations are designed to bring to the Treasury's attention important issues that major employers have identified under § 409A and the practical and appropriate steps that the Treasury can take to address those issues.

B. Highlights

Among the recommendations made in this submission are recommendations regarding:

- Severance and other employment-termination payments;

- Stock options and stock appreciation rights;
- Supplemental defined benefit plans (such as benefit restoration plans);
- Performance-based compensation;
- The deferral election rules;
- The distribution rules, including the six-month delay rule for key employees;
- Deferrals governed by prior law; and
- Transition rules.

C. Discussion

1. Definition Of Nonqualified Deferred Compensation Plan

a. Discretion To Reduce Or Eliminate Compensation

(1) *Recommendation:* The Treasury should revise the third sentence of Q&A-4(a) in Notice 2005-1[4] to provide as follows: "However, if the facts and circumstances indicate that the discretion to reduce or eliminate the compensation lacks substance and that there is no prospect that such discretion will be exercised, a service provider will be considered to have a legally binding right to the compensation."

Rationale: The first three sentences of Q&A-4(a) currently state:

> "[1]A plan provides for the deferral of compensation only if, under the terms of the plan and the relevant facts and circumstances, the service provider has a **legally binding right** during a taxable year to compensation that has not been actually or constructively received and included in gross income, and that, pursuant to the terms of the plan, is payable to (or on behalf of) the service provider in a later year. [2] A service provider does not have a legally binding right to compensation if that compensation may be unilaterally reduced or eliminated by the service recipient or other person after the services creating the right to the compensation have been performed. [3] However, if the facts and circumstances indicate that the discretion to reduce or eliminate the compensation is available or exercisable only upon a condition that is unlikely to occur, or **the discretion to reduce or eliminate the compensation is unlikely to be exercised**, a service provider will be

[4] Each reference to a "Q&A" is to a provision of Notice 2005-1.

considered to have a legally binding right to the compensation" (emphasis added).

The first two sentences of Q&A-4(a) establish a clear legal standard: the existence of a "legally binding right" to receive compensation in the future. On the other hand , the third sentence is ambiguous and a potential source of uncertainty and controversy under § 409A. Even more disconcerting is the possibility that the third sentence could be misinterpreted by some to undermine the bright-line, "legally binding right" standard that the two preceding sentences establish.

The third sentence can be read to provide that the service recipient's (or other person's) discretion to reduce or eliminate the compensation should be disregarded unless it is **likely** that the discretion to reduce or eliminate the compensation will be exercised. This would be the wrong standard as a matter of policy, and it is not how we read the sentence.

The objective of the third sentence appears to be state that the ostensible discretion to reduce or eliminate compensation should be disregarded where that discretion is a sham or mere "window dressing" (*i.e.*, lacking in substantive significance). We have no objection to making this clear: if an ostensible grant of discretion is a sham, it is appropriate to disregard the service recipient's (or other person's) ostensible discretion.

On the other hand, we do not think it is appropriate to disregard the authority to reduce or eliminate compensation based on someone's subjective assessment that it is more likely than not that the discretionary authority to reduce or eliminate the compensation will not be exercised. This would convert the clear "legally binding right" standard that the first two sentences establish into a breeding ground for uncertainty and controversy and would make it difficult, if not impossible, for many employers and employees to determine with confidence whether § 409A applies to their compensation plans. Because reasonable people can differ in their assessment of whether a given future event is likely or unlikely to occur, reasonable people can disagree over whether a given service recipient is likely (or unlikely) to exercise its discretion to reduce or eliminate compensation. The applicability of § 409A should not turn on such subjective judgments.

The dictionary definition of "unlikely" is ". . . seemingly lacking in any prospect of success . . .." *Webster's Third New International Dictionary* (1993). Based on this definition, if there is any prospect that discretion will be exercised to reduce or eliminate compensation, the service provider should not be considered to have a legally binding right to the compensation. If there is any such prospect, the service provider might have a hope or expectation of receiving compensation in a future year, but he or she would have no "legally binding right" to the compensation. Q&A-4(a) should be clarified so that it cannot be misinterpreted to provide that a legally binding right to compensation is considered to exist unless it is "likely" that the service recipient (or other person) will exercise the discretion to reduce or eliminate the compensation.

(2) *Recommendation:* The Treasury should make it clear that the rule set forth in the preceding recommendation applies to a performance-based compensation arrangement under which a party, such as the board of directors' compensation committee, has the discretion to reduce or eliminate the performance-based compensation.

Rationale: The rationale for the preceding recommendation applies regardless of whether the compensation is performance-based. If a party has the discretion to reduce or eliminate the compensation, the employee does not have a "legally binding right" to the compensation regardless of whether the compensation is performance-based.

(3) *See* 4.a(7), below.

b. Short-Term Deferral Rule

(1) *Recommendation:* The Treasury should retain the short-term deferral rule in Q&A-4(c). Q&A-4(c) provides that, until further guidance is issued, a deferral of compensation does not occur if, absent an election to defer the payment to a later period, the terms of a plan require payment by, and an amount is actually or constructively received by the service provider by, 2-1/2 months after the later of (i) the end of the service provider's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture or (ii) the end of the service recipient's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture.

Rationale: The short-term deferral rule draws a sensible distinction between deferred compensation and payments that are made promptly after they are earned. Although Section I.A of Notice 2005-1 suggests that the Treasury might wish to impose a more restrictive rule in the future, we recommend that the short-term deferral rule be retained.

We understand that the Treasury is concerned that the short-term deferral rule might be abused by the use of forfeiture provisions that the parties do not intend to enforce. Any such abuses should be addressed by requiring the substantial risk of forfeiture to be meaningful, not by discarding the short-term deferral rule altogether.

(2) *Recommendation:* The Treasury should withdraw the penultimate sentence of Q&A-4(c). That sentence provides as follows: "Notwithstanding the foregoing, if an election is provided to the service provider with respect to the taxable year in which payment of the compensation will occur, and the service provider elects a taxable year later than the taxable year in which he or she obtained a legally binding right to the payment, the arrangement constitutes a deferral of compensation subject to § 409A, including the deferral election timing rules of § 409A(a)(4)."

Rationale: Q&A-4(c) already provides that the short-term deferral rule applies only if, among other things, "at all times the terms of the plan require payment" and "an amount is actually or constructively received by the service provider" within the period prescribed by the short-term deferral rule. There is no need to impose an additional timing requirement on top of these requirements: the penultimate sentence invites the question whether the terms of the plan were mandated by the service recipient or by the service provider -- an inquiry that will be typically be difficult to resolve and that will inject needless uncertainty and controversy into the application of the short-term deferral rule.

c. Sign-On And Guaranteed Bonuses

(1) *Recommendation:* The Treasury should issue guidance that makes it clear that if an employer promises to pay a sign-on bonus to a newly hired employee, contingent on the employee's completion of a specified period of service, the arrangement should not be treated as a deferred compensation plan as long as the bonus is required to be paid (and is paid) within the time allowed by the short-term deferral rule in Q&A-4(c).

Rationale: If the sign-on bonus is paid within the time allowed by the short-term deferral rule, it is not deferred compensation. *See* ¶ 1.b(1), above.

(2) *Recommendation:* The Treasury should issue guidance that makes it clear that if an employer promises a newly hired employee that the employer will pay the employee an annual bonus of a least a specified amount during each of the employee's first four years of employment, with each year's bonus being contingent on the employee's completion of a specified period of service during that year, the arrangement will not be treated as a deferred compensation plan as long as each bonus is required to be paid (and is paid) within the time allowed by the short-term deferral rule in Q&A-4(c), with the deadline for payment of each year's bonus being measured by reference to the end of the employee's taxable year (or, if later, the end of the employer's taxable year) in which the employee's right to the bonus ceases to be subject to a substantial risk of forfeiture.

Rationale: If each annual bonus is paid within the time allowed by the short-term deferral rule, it is not deferred compensation. *See* ¶ 1.b(1), above.

d. Ongoing Severance Plans

(1) *Recommendation:* A severance arrangement that falls within the Department of Labor safe harbor for severance plans (29 C.F.R. § 2510.3-2(b)) should not be treated as providing nonqualified deferred compensation.

Rationale: The Department of Labor safe harbor differentiates a severance plan from a pension or deferred compensation plan. Although it is often difficult to distinguish a severance plan from a pension or deferred compensation plan, there is no reason to draw the line in a place that differs from where the Department of Labor has drawn it.

(2) *Recommendation:* A severance plan that provides benefits only in the event of *involuntary* termination of employment, and that does not give employees an election to change the plan's payment schedule, should not be treated as providing nonqualified deferred compensation.

Rationale: A plan that provides benefits only in the event of involuntary termination of employment, and that does not give employees an election to change the payment schedule, is not the kind of plan at which § 409A is directed. It is well established that, for federal tax purposes, such plans are *not* deferred compensation plans.[5]

e. Ad Hoc Severance Arrangements And Settlements

(1) *Recommendation:* An ad hoc severance arrangement that is negotiated with an employee in connection with the employee's termination of employment should not be treated as a deferred compensation plan if severance pay is distributed within the time allowed by the short-term deferral rule in Q&A-4(c).

Rationale: As long as the arrangement is ad hoc (*i.e.*, the employee has no legally binding right to severance pay, and any claim that the employee has to severance pay is subject to a substantial risk of forfeiture, until the severance agreement is executed) and as long as the severance pay is distributed by the end of the applicable 2-1/2 month period, the short-term deferral rule should prevent the severance arrangement from being classified as a deferred compensation plan.

(2) *Recommendation:* The Treasury should make it clear that an ad hoc voluntary or involuntary severance plan (including a voluntary window program) is not treated as a deferred compensation plan for purposes of § 409A where the plan provides that (i) an eligible employee is entitled to benefits only if he or she terminates employment on a specified date (or within a specified period) and (ii) all benefits under the plan (other than medical and life insurance benefits) will be paid within the time allowed by the short-term deferral rule.

Rationale: Because of the ad hoc nature of this arrangement, the severance pay relates only to services performed *after* the arrangement is created, and as long as (i) the right to severance pay is subject to a substantial risk of forfeiture until the minimum period of service required by the plan has been completed and (ii) the severance pay is distributed within the time allowed by the short-term deferral rule, there is no deferral of compensation. If ad hoc bonus payments are not deferred compensation -- and clearly they are not -- then neither are ad hoc severance payments. *See* Treas. Reg. § 31.3121(v)(2)-1(b)(4)(v); *see also* ¶¶ 1.d(2) & 1.e(1), above.

(3) *Recommendation:* Payments made to settle a bona fide employment-related grievance or lawsuit (whether actual or threatened) should not be treated as deferred compensation for purposes of § 409A.

Rationale: Section 409A was not intended to restrict the terms on which bona fide employment disputes can be settled. Even though such disputes are often settled pursuant to an agreement that provides for payments over a period of years, these payments represent consideration for the release of a claim rather than deferred compensation within the

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[5] *See, e.g., Wellons v. Commissioner*, 31 F.3d 569 (7th Cir. 1994); *Lima Surgical Associates, Inc. v. United States*, 944 F.2d 885 (Fed. Cir. 1991); Treas. Reg. §§ 31.3121(v)(2)-1(b)(4)(iv), -1(b)(5), *Example (9)*; PLR 200127047 (Sept. 8, 2000); TAM 199903032 (Oct. 2, 1998).

meaning of § 409A. If the Treasury reaches a contrary conclusion, it should, at the very least, make clear that the advance election requirement in § 409A(a)(4) does not apply in these circumstances since the employee does not elect under such settlement agreements to defer the receipt of compensation that is otherwise payable to the employee.

(4) *Recommendation:* The Treasury should make clear that a settlement of employment-related claims entered into by an employer and a *former* employee is not a deferred compensation plan for purposes of § 409A.

Rationale: Payments made to a former employee to settle employment-related claims (alleging, for example, age, gender, or race discrimination) represent payments made to settle an actual or potential lawsuit, rather than compensation for services. *See* ¶¶ 1.e(3), above, and 1.f(1), below.

f. Consideration For A Release

(1) *Recommendation:* The Treasury should make clear that when payments are made in connection with an employee's termination of employment, solely in exchange for a release of claims against the employer, the payments are not deferred compensation for purposes of § 409A.

Rationale: Such payments are made in order to secure the release; they are not compensation for services. *See also* ¶ 1.e(4), above.

g. Stock Appreciation Rights

(1) *Recommendation:* A stock appreciation right or other similar equity-based arrangement ("SAR") should be excluded from the definition of a nonqualified deferred compensation plan as long as (i) the SAR provides a benefit that does not exceed the excess of the fair market value of the underlying shares on the date of exercise over the fair market value of the underlying shares on the date of grant ("market-value SARs") and (ii) the SAR does not provide for the deferral of compensation other than the deferral of recognition of income until the SAR is exercised.

Rationale: Our recommendation is similar to the temporary rule in Q&A-4(d)(iv) for SARs granted under a program in effect on or before October 3, 2004. A market-value SAR with no payment deferral feature is economically and functionally equivalent to a nonqualified stock option with an option price equal to the fair market value of the option shares on the date of grant and with no payment deferral feature. Since undiscounted options with no payment deferral features are not treated as providing deferred compensation under § 409A, it makes no sense to treat market-value SARs with no payment deferral features differently. *See* Q&A-4(d)(ii) & (iii).

Two additional requirements set forth in Q&A-4(d)(iv) apply to SARs that are not covered by the temporary rule: (a) the stock of the service recipient subject to the SAR must be traded on an established securities market (the publicly traded requirement) and (b) only such traded stock of the service recipient may be delivered when the SAR is exercised (the stock settlement requirement).

Although most ERIC and HR Policy members are public companies, ERIC and HR Policy believe that a company that does not meet the publicly traded requirement should have the option of using a reasonable valuation method to value its stock for purposes of the SARs that the company issues. ERIC and HR Policy recommend that the Treasury should allow a nonpublic company to use any reasonable valuation method, rather then attempt to prescribe the valuation method or methods that every nonpublic company must use.

One indication of the reasonableness of a valuation method should be the consistency with which the company uses that method. If the company consistently uses the same valuation method for both compensatory and noncompensatory purposes (such as for purposes of valuing charitable contributions and for purposes of issuing stock to (and redeeming stock from) persons who are not service providers to the company), the valuation method should be conclusively presumed to be reasonable. If the company meets a consistency or other similar requirement to demonstrate the reasonableness of its valuation method, the Treasury can be assured that the company's SARs do not provide a benefit greater than the excess of the fair market value of the underlying shares on the date of exercise over the fair market value of the underlying shares on the date of grant.

We see no justification for the stock settlement requirement: as long as the SAR provides a benefit that does not exceed the excess of the fair market value of the underlying shares on the date of exercise over the fair market value of the underlying shares on the date of grant, it should not matter what medium is used to deliver that benefit (*e.g.,* shares or cash). When an optionee simultaneously exercises a stock option and sells the option shares, the optionee realizes a cash benefit -- just as if he or she had exercised a SAR payable in cash.

(2) *Recommendations: See* ¶¶1.h(1), h(2), below.

h. Stock Options

(1) *Recommendation:* The Treasury should make clear that an extension of the option exercise period under a nonstatutory option does not cause the option to fail to qualify for the exclusion in Q&A-4(d)(ii) from the definition of deferred compensation.

Rationale: Q&A-4(d)(ii) provides that a nonstatutory option does not provide for a deferral of compensation if (i) the option exercise price may never be less than the fair market value of the underlying stock on the date the option is granted; (ii) the receipt, transfer, or exercise of the option is subject to taxation under § 83; and (iii) the option does not include a deferral feature other than the deferral of recognition of income until the later of the exercise or disposition of the option under Treas. Reg. § 1.83-7.

From time to time, the period during which an option may be exercised is extended after the option is granted but before the option expires. An extension of the exercise period merely prolongs the period during which the option may be held before being exercised; it does not defer the recognition of income beyond the exercise date. As Q&A-4(d)(ii) recognizes, the fact that an option postpones the recognition of income until the option is exercised does not cause the option to provide for a deferral of compensation. Consistent with this principle, an extension of the exercise period does not provide for the deferral of compensation.

Extension of the option exercise period is analogous to the acceleration of vesting of deferred compensation: each allows the service provider to obtain a benefit that he or she would otherwise forfeit if the extension or acceleration were not granted. Q&A-15(a) makes clear that the acceleration of vesting does not violate § 409A. Consistent with that conclusion, an extension of the option exercise period should not alter the option's status under § 409A.

The requirement that the option price not be less than the value of the underlying stock on the date of grant assures that the option is not a vehicle to provide disguised deferred compensation. Extending the option exercise period does not weaken that assurance: it does not allow the option exercise price to be less than the fair market value of the underlying stock on the date of grant. As long as the extension occurs before the option expires, the extension does not change the date of grant or the value of the stock on the date of grant.

The same analysis should apply to an extension of the exercise period under a SAR.

(2) *Recommendation:* The Treasury should modify the conditions that Q&A-4(d)(ii) requires a nonstatutory stock option to meet in order to avoid being deemed to provide deferred compensation. The modifications are necessary in order to take into account joint ventures and corporate transactions that cause outstanding options that were granted with respect to the stock of the service recipient to be converted to options to purchase stock of another corporation.

Rationale: Q&A-4(d)(ii) provides that a nonstatutory option to purchase stock of the service recipient does not provide for deferred compensation if the option meets certain conditions. Q&A-5 defines "service recipient" as the person for whom the services are performed and all persons with which that person is aggregated under Code § 414(b) and (c). In addition, Q&A-4(d)(ii) provides that the substitution of a new option for an outstanding option pursuant to a corporate transaction or the assumption of an outstanding option will not be treated as a new grant or as a change in the form of payment *if* the requirements of § 1.424-1 are met. *See* Treas. Reg. §§ 1.421-1(i)(2) ("related corporation"), 1.424-1(a)(2) ("eligible corporation").

Nonstatutory stock options are commonly granted to employees of a joint venture by the owners of the joint venture. Because the owners of a joint venture commonly own less than 80% of the joint venture, the joint venture owner commonly does not qualify as a "service recipient" or an "eligible corporation" with respect to the joint venture's employees; 50-50 joint ventures and 33-33-33 joint ventures are not unusual. In addition, joint venture owners often transfer employees to the joint venture, and the transferred employees often hold options that had been previously granted to them by the joint venture owner. Under Q&A-4(d)(ii), all of these options -- both options that were newly granted to joint venture employees and outstanding options held by employees who are transferred to the joint venture -- would suddenly become subject to, and invariably violate, § 409A.

In addition, outstanding nonstatutory options are commonly affected by corporate transactions that prevent the options from meeting the restrictive conditions imposed by Q&A-4(d)(ii). For example, consider the case of a parent company that sells 49% of the stock of a subsidiary to a third party at a time when employees of the subsidiary hold nonstatutory options to buy stock of the parent. Or consider the case of a corporation that is purchased by two buyers (*e.g.*, on a 50-50 basis) where outstanding nonstatutory options of the corporation that has been purchased are converted into options to buy stock of each of the two new owners. Under Q&A-4(d)(ii), the outstanding options would suddenly become subject to, and invariably violate, § 409A.

The current rules regarding stock options will severely interfere with joint ventures and many business transactions. The deficiencies in Q&A-4(d)(ii) must be remedied.

The same analysis should apply to SARs.

(3) *Recommendation:* The Treasury should issue guidance on the application of § 409A to stock option and SAR payment deferral features.

Rationale: Many employers have issued stock options providing that, subject to certain conditions, an optionee may elect to exercise the option by surrendering company stock in payment of the option price and to have the company delay delivery of the "gain" shares that are due to the optionee (rather than deliver them promptly following exercise of the option). Likewise, employers have issued SARs that allow the grantee to elect, under certain conditions, that any gain realized upon exercise of the SAR will be delivered on a deferred date or dates (rather than promptly following exercise of the SAR).

Because of the aggregation rule imposed by Q&A-9, under which all plans that are neither account balance nor nonaccount balance plans are treated as a single plan for each participant, and in view of the severe penalties that are triggered by a violation of § 409A, it is critical that employers understand whether and how § 409A applies to stock options and SARs with payment deferral features.

We understand that some Treasury personnel have informally questioned whether payment deferral features of this kind are effective under Code provisions *other than* § 409A. We do not ask that the Treasury's guidance under § 409A address those questions: the guidance can state that the Treasury is not addressing these questions. We ask only that, to give employers and employees the ability to avoid massive penalties under § 409A, the Treasury give employers guidance on whether and how § 409A applies to stock options and SARs with payment deferral features.

i. Nonqualified Employee Stock Purchase Plans

(1) *Recommendation:* A nonqualified employee stock purchase plan under which the option price is no less than the lowest option price allowed by IRC § 423 should not be treated as a nonqualified deferred compensation plan. This recommendation calls for a change in Q&A-4(d)(ii), which requires the exercise price under a nonqualified option to be no less than the value of the underlying shares on the date of grant.

Rationale: Both Q&A-4(d)(iii) and the Statement of Managers (pp. 524-25) make clear that § 409A does not change the tax treatment of options granted under a qualified stock purchase plan governed by § 423. The same result should apply to a nonqualified employee stock purchase plan under which the option price is no less than the lowest option price permitted by § 423. The relatively modest 15% discount permitted by § 423 is much less than the discounts available under deeply-discounted option plans that might be used to provide deferred compensation.

j. Perquisites

(1) Recommendation: Post-employment perquisites should be excluded from the definition of nonqualified deferred compensation, as long as the perquisite (i) provides (either in kind or by cost reimbursement) a business-related benefit, (ii) is not a cash equivalent (other than a cost reimbursement covered by clause (i)) or property of a kind traditionally held for investment, and (iii) is nontransferable (unless it is a permitted cash reimbursement).

Rationale: Many companies provide retired senior executives with post-employment perquisites such as the use of an office, secretarial assistance, and access to company-provided cars and aircraft. Section 409A was not intended to apply to such fringe benefits, which are governed by IRC §§ 61(a)(1) and 132. If § 409A applied to such perquisites, it would be extraordinarily difficult to value them (*e.g.*, the present value of a retiree's potential future use of a company-provided car or aircraft) or to assure that they are provided in a fixed amount or on a fixed schedule for purposes of § 409A.

We recognize that Treasury officials believe that any exclusion for post-employment perquisites should not be susceptible to abuse: the exclusion should not become a vehicle to cover, for example, home mortgage expenses, meal expenses, and other personal expenses. We believe that potential abuse will be precluded by the three conditions that we have proposed:

- The perquisite must provide (either in kind or by cost reimbursement) a business-related benefit. This rules out reimbursements for personal expenses (such as home mortgage and meal expenses), but covers such traditional perquisites as the use of an office, secretarial assistance, access to company-provided cars and aircraft, and outplacement, retirement, and financial counseling assistance and services.

- The perquisite must not be a cash equivalent (other than a cost reimbursement covered by the preceding paragraph) or property of a kind traditionally held for investment. This rules out gift certificates, travelers' checks, stocks, bonds, and the like.

- The perquisite must provide a benefit that is nontransferable (unless it is a permitted cash reimbursement). This rules out non-cash benefits that can be converted to cash by sale or assignment.

(2) Recommendation: Business-related reimbursement payments made to active and retired directors and employees for business-related expenses (such as indemnification payments, reimbursements for business travel expenses and additional tax liability incurred while

working abroad, and certain tax gross-up payments) should be treated as expense reimbursement payments rather than as deferred compensation.

Rationale: Companies typically indemnify their directors and employees against liabilities and costs (including legal expenses) that the directors and employees incur as a result of their business-related activities. Similarly, companies commonly reimburse their directors and employees for certain employment-related expenses, such as relocation expenses, business travel expenses, and additional housing costs and tax costs incurred while assigned to work temporarily in costly locations. In addition, companies sometimes make tax-gross-up payments to reimburse directors and employees for income tax liabilities that the directors and employees incur by reason of receiving perquisites from the company.

In many cases, expenses incurred by a director or employee in one year are not reimbursed until well into the next year (and beyond the 2-1/2 month period allowed by the short-term deferral rule). Delays occur for a variety of reasons, including the fact that some expenses (such as legal expenses and additional tax expenses) cannot be determined until well into the following year and the fact that some expenses (such as relocation and business travel expenses) relate to a move, a trip, or other activity that begins in one year and ends in the next. Section 409A was not intended to apply to such reimbursements. The Treasury should treat such reimbursements as expense reimbursements or a payroll practice, not as deferred compensation.

k. Dividends On Restricted Stock And Dividend Equivalents

(1) *Recommendation:* The Treasury should make it clear that dividends paid currently on restricted common stock and dividend equivalents paid currently with respect to restricted common stock units or with respect to options to purchase common stock are not treated as deferred compensation for purposes of § 409A.

Rationale: Dividends and dividend equivalents that are paid currently with respect to restricted stock, restricted stock units, and stock options on common stock are not deferred compensation for at least two reasons. First, they do not represent compensation to which the service provider has a legally binding right until the year in which the dividend is declared; because that year is the same year as the year in which the dividend or dividend equivalent is paid, there is no deferral of compensation. *See* Q&A-4(a). Second, even if the right to receive future dividends or dividend equivalents could be viewed as creating a legally binding right before the year in which a dividend is declared, that right is typically subject to a substantial risk of forfeiture until the dividend is declared (*e.g*, a provision that the service provider's right to future dividends or future dividend equivalent payments is forfeited as soon as the employee stops working for the employer). As long as the dividend or dividend equivalent is required to be (and is) distributed in the year the dividend is declared (or within the applicable 2-1/2 month period), the dividend or dividend equivalent is -- like a contingent bonus that is paid currently -- excluded from the definition of deferred compensation by the short-term deferral rule in Q&A-4(c).

(2) *Recommendation:* The Treasury should make it clear that dividends that are credited with respect to restricted common stock, and dividend equivalents that are credited with respect to restricted common stock units or with respect to options to purchase common

stock, are not treated as deferred compensation for purposes of § 409A, *even if they are not paid currently*, provided that, in accordance with the short-term deferral rule, (i) the dividends or dividend equivalents are subject to a substantial risk of forfeiture and (ii) an amount equal to the accumulated dividends or dividend equivalents is required to be (and is) distributed to (or on behalf of) the service provider in the year in which the dividends or dividend equivalents are no longer subject to a substantial risk of forfeiture or within the 2-1/2 month period allowed by the short-term deferral rule.

Rationale: The rationale for this recommendation is similar to the rationale for the preceding recommendation. Before the dividends or dividend equivalents are declared, they do not represent deferred compensation because the service provider does not have a legally binding right to a dividend or dividend equivalent. Second, even after the dividends or dividend equivalents are credited, they do not represent deferred compensation if, in accordance with the terms of the short-term deferral rule, they are required to be (and are) distributed in the year in which they are no longer subject to a substantial risk of forfeiture or within the following 2-1/2 months.

(3) *Recommendation:* *See* ¶ 4.h(1), below.

l. Split-Dollar Life Insurance

(1) *Recommendation:* The Treasury should make it clear that split-dollar life insurance arrangements are not deferred compensation plans for purposes of § 409A.

Rationale: Split-dollar life insurance arrangement are subject to a separate tax regime under Notice 2002-8 and Treas. Reg. §§ 1.61-22, 1.83-3(e), and 1.7872-15. It makes no sense to impose § 409A on top of that regime. Just as the Treasury has made it clear that § 409A does not apply to restricted stock and other arrangements governed by § 83, the Treasury should also make clear that § 409A does not apply to split-dollar life insurance arrangements.

In some cases, this outcome also might be prescribed by Q&A-3(c), which excludes a bona fide death benefit plan from the definition of "nonqualified deferred compensation plan." Q&A-3(c) defines "death benefit plan" as a plan providing death benefits as defined in § 31.3121(v)(2)-1(b)(4)(iv)(C). Because some split-dollar life insurance arrangements provide only death benefits within the meaning of this regulation, they appear to be excluded from the definition of "nonqualified deferred compensation plan" by Q&A-3(c).

m. Compensation For Post-Employment Services

(1) *Recommendation:* Compensation for a retired executive's post-employment service as a non-employee director or consultant should not be treated as deferred compensation for the retired executive's prior service as an employee.

Rationale: Compensation for bona fide current service as a director or consultant is compensation for current service, not deferred compensation for prior service as an employee. In the terms used by the Notice, the service provider does not have a legally binding right, during a taxable year, to compensation that has not been actually or constructively received and included in gross income and that is payable in a later year (*see* Q&A-4(a)) and, even if the service provider had such a legally binding right, the compensation would be excluded from the definition of deferred compensation by the short-term deferral rule in Q&A-4(c).

2. Deferrals Governed By Prior Law

a. Vesting Of Prior Deferrals

(1) *Recommendation:* The Treasury should make it clear that the fact that benefits are "earned and vested" on December 31, 2004, does not mean that those benefits must be treated as "wages" under § 3121(v)(2).

Rationale: The regulations under § 3121(v)(2) make it clear that amounts deferred under a nonaccount balance plan are not required to be included in wages until the "resolution date" -- which can occur long after benefits are earned and vested. *See* Treas. Reg. § 31.3121(v)(2)-1(e)(4).

(2) *Recommendation:* The Treasury should make clear whether AJCA § 885(d)(1) "grandfathers" stock options and SARs that, on December 31, 2004, had payment deferral features and were fully vested and exercisable.

Rationale: Prior to the enactment of the AJCA, many employers issued stock options providing that, subject to certain conditions, an optionee could elect to exercise the option by surrendering company stock in payment of the option price and to have the company delay delivery of the "gain" shares that were due to the optionee (rather than deliver them promptly following exercise of the option). Likewise, employers issued SARs that allowed the grantee to elect, under certain conditions, that any gain realized upon exercise of the SAR would be delivered on a deferred date or dates (rather than promptly following exercise of the SAR). Many of these options and SARs were fully exercisable on December 31, 2004.

Because of the aggregation rule imposed by Q&A-9, under which all plans that are neither account balance nor nonaccount balance plans are treated as a single plan for each participant, and because of the severe penalties that are triggered by a violation of § 409A, it is critical that employers understand whether and how § 409A applies to stock options and SARs that, on December 31, 2004, had payment deferral features and were fully vested and exercisable.

We understand that some Treasury personnel have informally questioned whether payment deferral features of this kind were effective under the law in effect before the enactment of § 409A. We do not ask that the Treasury's guidance under § 409A address those questions: the guidance can state that the Treasury is not addressing these questions. We ask only that, to give employers and employees the ability to avoid massive penalties under § 409A, the Treasury give employers guidance on whether § 409A applies to stock options and SARs that on December 31, 2004, had payment deferral features and were fully vested.

b. Rabbi Trusts

(1) *Recommendation:* The Treasury should make it clear that funds accumulated before January 1, 2005, in a rabbi trust that does not comply with § 409A may continue to be held in that trust without violating § 409A as long as the trust is used to fund only benefits that were earned and vested before January 1, 2005.

Rationale: AJCA § 885(d)(1) provides that the amendments made by § 885 apply to amounts deferred after December 31, 2004. The Statement of Managers provides (p. 527) that for this purpose an amount is considered deferred before January 1, 2005, if the amount is "earned and vested" before that date. Accordingly, § 409A does not apply either to amounts earned and vested before January 1, 2005, or to a rabbi trust associated with those benefits.

c. Material Modifications

(1) *Recommendation:* A supplemental DB plan[6] should not be considered to be materially modified merely because the plan provides additional benefits as a result of an amendment that alters the benefits provided by the related tax-qualified plan (for example, in the case of a benefit restoration plan, an amendment that adds an early retirement window benefit to the tax-qualified plan or, in the case of a supplemental defined benefit plan, an amendment that reduces (on a prospective basis) the benefits provided by the qualified plan). Likewise, a defined contribution spillover plan[7] should not be considered to be materially modified merely because the spillover plan accepts additional deferrals as a result of an amendment to the tax-qualified plan that the spillover plan supplements.

Rationale: In these circumstances, the nonqualified plan is not altered; it continues to provide benefits that the qualified plan does not provide. Any additional benefits provided by the nonqualified plan result from changes made to the related tax-qualified plan, not from changes to the nonqualified plan.

(2) *Recommendation:* A supplemental DB plan should not be considered to be materially modified merely because the plan is amended to conform to changes made to the related tax-qualified plan. Likewise a defined contribution "spillover" plan should not be

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[6] For this purpose, a "supplemental DB plan" refers to (1) a nonqualified "benefit restoration" plan that provides benefits that a particular qualified defined benefit plan cannot provide because of certain limits or restrictions that the restoration plan identifies (*e.g.*, the § 415 limits on benefits, the § 401(a)(17) limit on compensation, and the qualified plan's definition of compensation or service) and (2) any other nonqualified "supplemental" plan that provides a gross benefit that is reduced (or offset) by the benefits paid by one or more designated qualified plans.

[7] For this purpose, a "defined contribution spillover plan" refers to a plan that is coordinated with deferrals under the employer's qualified defined contribution plan and that allows participants to make deferrals that the qualified plan limits prevent them from making under the qualified plan.

considered to be materially modified merely because that plan is amended to conform to changes made to the related tax-qualified plan.

Rationale: The outcome should be the same as in ¶ 2.c(1), above, since the two situations are the same in substance. The only difference is that in ¶ 2.c(1), the amendments were made solely to the qualified plans and the changes in the benefits provided by the nonqualified plans occurred automatically (because the nonqualified plans automatically reflected the changes made to the qualified plans), whereas in this case conforming changes must be made to the nonqualified plans to keep them consistent with the qualified plans.

(3) *Recommendation:* A defined contribution plan should not be considered to be materially modified merely because the plan adds a phantom investment fund that provides a rate of interest that does not exceed a reasonable rate of interest within the meaning of Treas. Reg. § 31.3121(v)(2)-1(d)(2)(C).

Rationale: In these circumstances, the plan's benefits are not materially increased. Participants' deferral and distribution rights -- the chief concerns of § 409A -- are not affected by the addition of a new investment option that provides a reasonable rate of interest. As long as the new phantom investment fund offers no more than a reasonable rate of return, the addition of the fund does not increase the value of the benefits that the plan provides. (Q&A-18(a) reaches the same conclusion with respect to the rate of return on a predetermined actual investment.)

(4) *Recommendation:* If a plan is materially modified with respect to certain benefits but not with respect to others, only the benefits affected by the material modification are affected by the material modification rule in AJCA § 885(d)(2)(B).

Rationale: If the material modification does not affect certain benefits under the plan (*e.g.*, the benefits earned by certain participants or the benefits earned before a specified date), the unaffected benefits should continue to be grandfathered just as if they had been provided under a separate plan. Q&A-18(b), however, establishes a *presumption* that the grant of an additional benefit under an existing arrangement after October 3, 2004, constitutes a material modification.

Q&A-18(b) provides that the grant of an additional benefit that consists *solely of a deferral of additional compensation* will be treated as a material modification only as to the additional deferral of compensation *if* the plan identifies the additional deferral of compensation and provides that § 409A applies to the additional deferral of compensation. Q&A-18(b) thus fails to make clear what, we hope, the drafters intended: if a plan is materially modified with respect to certain benefits but not with respect to others, only the benefits affected by the material modification are considered to be modified.

(5) *Recommendation:* A nonqualified plan should not be considered to be materially modified merely because the employer establishes a rabbi trust to hold funds that can be used to pay benefits under the plan, as long as the terms of the trust agreement do not cause there to be a transfer of property under IRC §§ 83 and 409A(b).

Rationale: Because the rabbi trust does not give participants any additional benefits, rights, or features, the establishment of the trust is not a material modification. *See* Statement of Managers, p. 526; Q&A-18(a).

(6) *Recommendation:* A bonus deferral plan should not be considered to be materially modified merely because an employer elected to declare (and make payable) in 2004 bonuses that are customarily paid in 2005.

Rationale: The employer has not modified the bonus deferral plan in this case. The employer's action merely increased its employees' 2004 compensation. Just as an increase in salary levels does not modify a salary deferral plan, an increase in bonuses does not modify a bonus deferral plan.

3. Transition Rules

(1) *Recommendation:* The Treasury should designate December 31, 2006, as the end of the good-faith compliance period and as the date by which plans must be amended to comply with § 409A. This recommendation calls for a change in Q&A-19.

Rationale: Although we very much appreciate the transition period established by Q&A-19, we are very concerned that employers will not be able to operate and amend all of their plans in full compliance with § 409A by December 31, 2005, the end of the Q&A-19 transition period. A one-year extension is imperative.

The need for more time is attributable to a number of factors, including the following:

- The delay in the issuance of guidance on critical issues: although Notice 2005-1 addressed many important issues, it did not address a great many critical issues -- leaving employers in a "holding pattern" until the Treasury issues additional guidance;
- The breadth of § 409A: it applies to a great many kinds of plans, arrangements, and agreements, including defined benefit, defined contribution, and equity plans;
- The large number of § 409A-covered plans, arrangements, and agreements sponsored by many major employers;
- The wide variety of plan designs adopted in § 409A-covered plans, which makes amending those plans a challenging and time-consuming process;
- The need to obtain approval of many of the required amendments by boards of directors, compensation committees, shareholders, and, for most individual agreements and certain other plans, employees;

- The interactions between many § 409A-covered plans and employers' tax-qualified plans, which will likely require tax-qualified plans to be amended in many cases;

- The need to amend even plans that are potentially exempt from § 409A in order to qualify for the terms of the applicable exemptions (*see, e.g.*, Q&A-4(c), (d), -19(d)); and

- The limited resources that employers can devote to these matters.

(2) *Recommendation:* If -- contrary to our recommendation -- the Treasury takes the position that discounted options under nonqualified employee stock purchase plans are subject to § 409A, the Treasury should exempt unvested discounted stock options that were outstanding on October 3, 2004, from the application of § 409A. Likewise the Treasury should exempt from § 409A stock options with deferred payment features that were outstanding on October 3, 2004.

Rationale: Options under nonqualified stock purchase plans, and nonqualified options with deferral features were granted under the reasonable good faith belief that they would not be taxable until exercised (or until payment was made in the case of an option with a deferral feature). The Treasury should allow such options to be taxed in accordance with prior law.

(3) *Recommendation:* The Treasury should make clear that, under the good faith compliance standard in Q&A-19, a plan that meets the requirements of Q&A-19 during 2005 (and during any extension of the "good faith" compliance period) will not later be deemed to violate § 409A because of good faith actions taken in 2005 (and any extended good faith compliance period) that prove to be inconsistent with Treasury guidance issued later this year (or thereafter) and that cannot be reversed or changed.

Rationale: This rule seems to be implicit in the good faith compliance standard, but it is not stated explicitly in Q&A-19. Many irreversible, good faith actions will be taken during 2005 in the administration of deferred compensation plans. For example, distributions will be made (or delayed) based on the good faith belief that the distributee is not (or is) a "specified employee." Many of these actions will prove to be consistent with the Treasury's subsequently-announced views, but some will not, and many of these actions will be irreversible. For example, a delayed distribution cannot be "undelayed," and most distributions cannot be reversed. It would be pointless to have a good faith compliance period if good faith conduct could be penalized after the end of the good faith compliance period.

(4) *Recommendation:* The Treasury should revise the definition of "material modification" in Q&A-18 to make the definition consistent with the text of the statute and the established definition of "material modification."

Rationale: Q&A-18 adopts a definition of "material modification" that is far more expansive than is justified by either the text of the statute or prior usage of that term. According to Q&A-18, "a modification of a plan is a material modification if a benefit or right existing as of October 3, 2004 is enhanced or a new benefit or right is added."

The statute's use of the term "*materially* modified," rather than "modified," shows that Congress did not intend to refer to *any* enhancement or *any* new benefit or right. In order to be covered by the statute, the enhancement or new benefit or right must be *material* – that is, "of real importance" or "great consequence." *See Webster's Third New International Dictionary* (1993).

The definition of "material modification" in Q&A-18 is remarkably similar to the definition of "modification" in Treas. Reg. § 1.424-1(e)(4)(i) ("any change . . . that gives the optionee additional benefits"). This strongly supports our view that Q&A-18 mistakenly reads "materially" out of the statute.

The Statement of Managers for the AJCA observes (p. 526) that the "addition of any benefit, right or feature is a material modification." Taken out of context, this observation might seem to support Q&A-18. However, the Statement of Managers actually shows why Q&A-18 is wrong. The very same paragraph of the Statement of Managers uses the following examples to explain what a material modification is: the adoption of a "haircut" withdrawal provision and the acceleration of the plan's vesting schedule -- modifications that are clearly of substantial importance.

We urge the Treasury to take a more discriminating approach than the nearly all-encompassing approach taken in Q&A-18. *See also* Treas. Reg. § 1.162-27(h)(1)(iii) (defining "material modification" as an increase in the amount of compensation -- other than an increase the reflects the time value of money, a cost-of-living increase, or qualified performance-based compensation).

(5) *Recommendation:* The Treasury should exercise its authority under § 885(f) to provide that no interest or penalties will be imposed under § 409A(a)(1)(B) before January 1, 2006, on a participant in a nonqualified deferred compensation plan if, before January 1, 2006, the plan operates in accordance with its terms as in effect on October 3, 2004, even though those terms do not comply with § 409A.

Rationale: Given the compressed time period between the date the AJCA was enacted and its January 1, 2005, effective date, and given the time required to prepare much-needed Treasury Department guidance, many employers will not have enough time to comply with § 409A during 2005. In these circumstances, it would be extremely unfair to penalize employees who have acted in good faith in 2005, since most employees have no influence or control over the terms or administration of the deferred compensation plans in which they participate.

(6) *Recommendation:* The Treasury should revise the rule prescribed by Q&A-17(a) for nonaccount balance plans to conform to the text of the statute and the legislative history.

Rationale: In general terms, Q&A-17(a) provides that the amount of compensation deferred before January 1, 2005, under a nonaccount balance plan is the present value as of December 31, 2004, of the amount to which the participant would be entitled under the plan if the participant voluntarily terminated employment on December 31, 2004, and received a full payment of benefits from the plan on the earliest possible date allowed under the plan following termination of employment, to the extent the right to the benefit is earned and vested as of December 31, 2004.

Q&A-17(a) is inconsistent with both the statutory text and the legislative history. While Q&A-17(a) limits the "grandfathered" benefit to a single present value amount, the statute grandfathers the participant's entire benefit as of December 31, 2004 (to the extent it was earned and vested as of that date). Specifically, AJCA § 885(d) provides that § 409A applies to "amounts deferred after December 31, 2004," and that it applies to "amounts deferred in taxable years beginning before January 1, 2005," only if the plan under which the deferral was made is materially modified after October 3, 2004. Similarly, the Statement of Managers provides (pp. 526-27) that § 409A "is effective for amounts deferred in taxable years beginning after December 31, 2004" and that for purposes of the effective date "an amount is considered to be deferred before January 1, 2005, if the amount is earned and vested before such date."

The following example shows the inconsistency between Q&A-17(a) and the statute. Assume that a 55-year-old participant, with over 25 years of service, was fully vested in his or her benefit under a nonaccount balance plan that was frozen as of December 31, 2004. The plan (i) set age 65 as its normal retirement age, (ii) provided that the accrued benefit was subject to a full actuarial reduction if benefits began between ages 55 and 62, and (iii) provided that, for a participant with at least 25 years of service who waited until age 62 to start receiving benefits, the benefit was subject to no actuarial reduction at all.

Because the participant's unreduced benefit at age 62 was fully earned and vested as of December 31, 2004, the terms of the statute and the legislative history make it clear that the participant's entire benefit is exempt from § 409A. By contrast, Q&A-17(a) grandfathers only the present value of the actuarially reduced age-55 benefit, and subjects the remainder of the participant's accrued benefit to § 409A -- even though it was fully earned and vested on December 31, 2004. Because this outcome is contrary to the statute and the legislative history, the Treasury should revise Q&A-17(a).

4. Deferral Election Rules

a. First-Year-Of-Eligibility Rule

(1) *Recommendation:* The Treasury should issue guidance making it clear that the aggregation rule in Q&A-9 does not apply for purposes of the first-year-of-eligibility rule in § 409A(a)(4)(B)(ii).

Rationale: Q&A-9 provides that, with respect to each service provider, all compensation deferred under an account balance plan is treated as deferred under a single plan, all compensation deferred under a nonaccount balance plan is treated as deferred under a separate single plan, and all compensation deferred under other plans (*e.g.*, discounted stock options and certain other forms of equity compensation) is treated as deferred under a separate single plan. If this aggregation rule applied for purposes of the first-year-of-eligibility rule, the first-year-of-eligibility rule would be made meaningless in many cases in which it was intended to apply. The definition of "deferred compensation plan" is so broad that a great many (if not most) employees will participate in each of the three categories of deferred compensation plans (account balance, nonaccount balance, and other plans). If the aggregation rule applied, it would deprive employees of the right that they were intended to have to make deferral elections in accordance with the first-year-of-eligibility rule when they become eligible to participate in a plan for which they had not previously been eligible.

For example, supposed that an employer maintains two nonqualified account balance plans and that one is performance-based while the other is not performance-based. Each plan provides for three-year award periods. If an employee is transferred in the middle of an award period from a position covered by the nonperformance-based plan to a position covered by the performance-based plan, and becomes eligible for an award under the performance-based plan, the employee should be permitted to make a deferral election under the performance-based plan in accordance with the first-year-of eligibility rule. *See* ¶ 4.a(2), below.

The result should be the same if an employee is transferred in the opposite direction. If an employee is transferred in the middle of an award period from a position covered by the performance-based plan to a position covered by the nonperformance-based plan, and becomes eligible for an award under the nonperformance-based plan, the employee should also be permitted to make an election under the nonperformance-based plan in accordance with the first-year-of eligibility rule. *See* ¶ 4.a(3), below.

(2) *Recommendation:* The Treasury should provide that in the first year in which an employee becomes a participant in a performance-based compensation plan, the 12-month and 6-month periods in § 409A(a)(4)(B)(iii) are shortened.

Rationale: Because the first-year-of-eligibility rule in § 409A(a)(4)(B)(ii) applies only to compensation attributable to services performed *after* the participant makes a deferral election, the rule does not solve the problem posed by an employee who enters a performance-based compensation plan during the last six months of the performance period (so that the performance-based compensation rule does not apply) and where the performance-based compensation is attributable in part to services performed before the participant's initial deferral election (so that the first-year-of-eligibility rule does not apply). The Treasury should allow a new participant in these circumstances to make an initial deferral election as long as the amount of the performance-based compensation and the new participant's right to receive any performance-based compensation are substantially uncertain at the time the election is made. Section 409A(a)(4)(B)(i) gives the Treasury regulatory authority to establish this rule.

In the alternative, the Treasury should permit the plan to apply a pro rata approach and to allow a new participant to elect to defer a fraction of the bonus, where the numerator is the portion of the bonus period that runs from the date of the election until the end of the bonus period and the denominator is the entire bonus period. We emphasize, however, that the approach that we recommended in the preceding paragraph is far superior to a pro rata approach: because most existing administrative systems recognize that bonuses accrue from the date of entry into the plan, rather than from the date of a deferral election, it will be far easier for employers to implement the first approach than the pro rata approach.

(3) *Recommendation:* The Treasury should provide that in the first year in which an employee becomes a participant in a non-performance-based bonus plan, the employee

may elect to defer payment of the bonus even though the employee enters the plan, and makes the deferral election, after the beginning of the period in which the bonus is earned.

Rationale: Because the first-year-of-eligibility rule in § 409A(a)(4)(B)(ii) applies only to compensation attributable to services performed *after* the participant makes a deferral election, the rule does not solve the problem posed by an employee who enters a non-performance-based bonus plan where the bonus is attributable in part to services performed before the participant's initial deferral election (so that the first-year-of-eligibility rule does not apply). The Treasury should allow a new participant in these circumstances to make an initial deferral election as long as the amount of the bonus and the new participant's right to receive a bonus are substantially uncertain at the time the election is made. Section 409A(a)(4)(B)(i) gives the Treasury regulatory authority to establish this rule.

In the alternative, the Treasury should permit the plan to apply a pro rata approach and to allow a new participant to elect to defer a fraction of the bonus, where the numerator is the portion of the bonus period that runs from the date of the election until the end of the bonus period and the denominator is the entire bonus period. As we pointed out in connection with the preceding recommendation, however, we emphasize that the approach that we recommended in the preceding paragraph is far superior to a pro rata approach: because most existing administrative systems recognize that bonuses accrue from the date of entry into the plan, rather than from the date of a deferral election, it will be far easier for employers to implement the first approach than the pro rata approach.

(4) *Recommendation:* If a severance plan is treated as providing nonqualified deferred compensation -- for example, because the plan allows eligible employees to elect to defer payment of their severance benefits -- and the employer announces the creation of a new ad hoc severance plan in connection with a reduction in force (or announces a reduction in force that triggers eligibility for an existing severance plan that applies only if there is a reduction in force), the first-year-of-eligibility rule in § 409A(a)(4)(B)(ii) will apply to employees who may become eligible for severance pay as a result of the creation of the ad hoc plan (or the employer's announcement of a reduction in force).

Rationale: Because the creation of a new ad hoc plan (or the employer's announcement) will make certain employees eligible for severance benefits for the first time, the first-year-of-eligibility rule applies. In these circumstances, a newly eligible employee should be permitted to make a deferral election within the 30-day period prescribed by § 409A(a)(4)(B)(ii) as long as the election is made before the last day on which, under the severance plan, an individual must be employed in order to be eligible to receive severance pay. In these circumstances, the election will be made with respect to compensation for services to be performed after the election is made, as § 409A(a)(4)(B)(ii) requires. *See* ¶ 4.a(1), above.

(5) *Recommendation:* If a voluntary window plan is treated as providing nonqualified deferred compensation -- for example, because the plan allows eligible employees to elect to defer payment of their window benefits -- and the employer announces the creation of a new nonqualified window plan in connection with a reduction in force (or announces a reduction in force that triggers eligibility for an existing nonqualified window plan that applies only if there is a reduction in force), the first-year-of-eligibility rule in § 409A(a)(4)(B)(ii) will

apply to employees who may become eligible for window benefits as a result of the employer's announcement.

Rationale: Because the employer's announcement will make certain employees eligible for window benefits for the first time, the first-year-of-eligibility rule applies. In these circumstances, a newly eligible employee should be permitted to make a deferral election within the 30-day period prescribed by § 409A(a)(4)(B)(ii) as long as the election is made before the last day on which, under the window plan, an individual must be employed in order to be eligible to receive window benefits. Under these circumstances, the election will be made with respect to compensation for services to be performed after the election is made, as § 409A(a)(4)(B)(ii) requires. *See* ¶ 4.a(1), above.

(6) *Recommendation:* In applying the first-year-of-eligibility rule in § 409A(a)(4)(B)(ii) to a severance plan (or to an ad hoc voluntary termination plan) that is deemed to provide deferred compensation, the 30-day period starts running, in the case of an involuntary severance plan, on the day the employer notifies the employee of his or her termination (or, in case of an ad hoc voluntary plan, the day the employee volunteers to terminate employment).

Rationale: Since the employee does not become eligible for benefits until the employee is notified of his or her severance (or until the employee volunteers to terminate employment), the 30-day period does not start running until that time. Before that time, the employee does not know whether he or she will ever be eligible for benefits and therefore cannot make an informed election regarding the schedule on which benefits will be paid.

(7) *Recommendation:* The Treasury should issue guidance explaining how the deferral election rules in § 409A(a)(4) apply to an arrangement that initially does not provide for the deferral of compensation (because the service provider does not yet have a legally binding right to deferred compensation), but that, in a subsequent year, *does* provide for the deferral of compensation because, in the subsequent year, the service provider acquires a legally binding right to compensation that has not been actually or constructively received. The guidance should make clear that, in these circumstances, a deferral election meets the requirements of § 409A(a)(4) if is made before the service provider acquires a legally binding right to the compensation.

Rationale: It makes no sense to require a service provider to make a deferral election with respect to compensation to which the service provider has no legally binding right. Assume, for example, that in Year 1, an employer makes a non-binding statement that it hopes to award an executive a bonus in Year 3 and that in Year 3 the employer awards a bonus to the executive. In these circumstances, the executive should be permitted to make a deferral election with respect to the bonus at any time (in Year 1, Year 2, or Year 3) before the executive has a legally binding right to the bonus. The Treasury can reach this conclusion based on either the first-year-of-eligibility rule in § 409A(a)(4)(B)(ii) or the Treasury's rulemaking authority in § 409A(a)(4)(B)(i).

b. Prior-Year-Election Rule

(1) *Recommendation.* The Treasury should issue guidance that makes it clear that the prior-year-election requirement in § 409A(a)(4)(B)(i) does not apply to an ad hoc severance pay agreement that an employer negotiates at arms' length with an employee in connection with the employee's termination of employment if the agreement specifies the payment schedule and does not give the employee an election to change the payment schedule.

Rationale: Section 409A(a)(4)(B)(i) applies only if a participant has an election to defer compensation that he or she otherwise had a right to receive. By contrast, in the case of a negotiated severance pay agreement that is negotiated at arms' length, the employee does not have a right to receive the severance pay until the employee enters into the agreement with the employer, and the employee does not make a deferral election by engaging in arms-length negotiations with the employer regarding the employee's termination of employment.

(2) *Recommendation:* The Treasury should issue guidance providing that the prior-year-election rule in § 409A(a)(4)(B)(i) does not require an employee's initial deferral election to be made before the beginning of the year in which a compensation award is granted if the employer does not inform the employee, before the beginning of the year, that he or she will receive an award in the following year (as often happens, for example, in the case of restricted stock unit awards) and if the election meets requirements that are consistent with the objectives of § 409A.

Rationale: Section 409A was not intended to require employees to be clairvoyant or to be able to make knowledgeable deferral elections with respect to awards (of unknown size) that might (or might not) be made to them in a future year. Since § 409A(a)(4)(B)(i) authorizes the Treasury to create exceptions to the prior-year-election rule, the Treasury should allow deferral elections to be made with respect to such unpredictable awards of compensation after the award is made as long as the deferral election meets requirements that are consistent with the objectives of § 409A. For example, the election could be required to be made at least a specified period before the otherwise applicable payment date and/or to call for a deferral of at least a specified minimum duration. *Cf.* § 409A(a)(4)(C) (redeferral elections).

(3) *Recommendation:* The Treasury should issue guidance providing that an employee may make an initial deferral election after the beginning of a multi-year, non-performance based award period (*i.e.*, after the beginning of the period during which the award vests or is earned) without violating the prior-year-election rule in § 409A(a)(4)(B)(i) as long as the election meets requirements that are consistent with the objectives of § 409A.

Rationale: Many employees are not in a position to make deferral elections before the beginning of a multi-year award period. In some cases, the employee does not know that he or she will receive an award or what the size of any award will be. In other cases, the length of the award period is so great that it is premature for the employee to make an appropriate deferral decision. Since § 409A(a)(4)(B)(i) authorizes the Treasury to create exceptions to the prior-year-election rule, the Treasury should allow deferral elections to be made with respect to such multi-year awards after the award period begins as long as the deferral election meets requirements that are consistent with the objectives of § 409A. For example, the election could be required to be made at least a specified period before the otherwise applicable payment date and/or to call for a deferral of at least a specified minimum duration. *Cf.* § 409A(a)(4)(C) (redeferral elections).

(4) *Recommendation:* The Treasury should issue guidance providing that an employee may make an initial deferral election after the beginning of a deferral period that is mandated by the plan (rather than elected by the participant) without violating the prior-year-election rule in § 409A(a)(4)(B)(i) as long as the election meets requirements that are consistent with the objectives of § 409A.

Rationale: Some compensation plans require employees to defer receipt of their awards for a minimum period of time. Because of the mandatory deferral feature, many employees are not in a position to make deferral elections before the beginning of the year in which the award is earned. In some cases, the employee does not know that he or she will receive an award or what the size of the award will be. In other cases, the length of the mandatory deferral period is so great that it is premature for the employee to make an appropriate deferral decision. Since § 409A(a)(4)(B)(i) authorizes the Treasury to create exceptions to the prior-year-election rule, the Treasury should allow deferral elections to be made with respect to mandatorily deferred awards after the award period begins as long as the employee's deferral election meets requirements that are consistent with the objectives of § 409A. For example, the election could be required to be made at least a specified period before the otherwise applicable payment date and/or to call for a deferral of at least a specified minimum duration. *Cf.* § 409A(a)(4)(C) (redeferral elections).

(5) *Recommendation:* The Treasury should make clear that § 409A(a)(4) does not bar a deferred compensation plan from temporarily preventing an employee from making elective deferrals under the plan to the extent that a temporary suspension of deferrals is mandated by a provision in the employer's § 401(k) plan that meets the requirements of the hardship distribution safe harbor in the regulations under Code § 401(k).

Rationale: We are not aware of any evidence to show that, when Congress added § 409A to the Code, it intended to prevent a § 401(k) plan from adopting the hardship distribution safe harbor in the § 401(k) regulations. Both the existing § 401(k) regulations and the recently revised § 401(k) regulations provide that a hardship distribution is deemed necessary to satisfy an immediate and heavy financial need of the employee if, *inter alia*, the employee is prohibited from making deferrals under all of the employer's plans, *including nonqualified deferred compensation plans*, for a temporary period after receipt of the hardship distribution. *See* Treas. Reg. § 1.401(k)-1(d)(2)(iv)(B)(4); *id.* § 1.401(k)-1(d)(3)(iv)(E), (F), 69 Fed. Reg. 78,162-63 (Dec. 29, 2004).

The requirements of § 409A(a)(4) might be reconciled with the requirements of the § 401(k) safe harbor in either of two ways. First, pursuant to its authority under § 409A(a)(4)(B)(i), the Treasury could simply allow the employer to implement the § 401(k) safe harbor without violating § 409A(a)(4). Alternatively, the Treasury could interpret the § 401(k) safe harbor to allow the suspension period under a nonqualified deferred compensation plan to begin, not immediately, but at the beginning of the first taxable year that starts after the employee receives the hardship distribution.

c. Performance-Based Compensation

(1) *Recommendation:* If SARs and stock options with deferred payment features are treated as deferred compensation, each SAR and deferred-payment option should be treated as providing performance-based compensation for purposes of § 409A(a)(4)(B)(iii) as long as the SAR and the option provide a benefit based solely on appreciation in the underlying shares after the date of grant of the SAR or option (in addition to the benefits flowing from the deferral feature under the option). This recommendation calls for a change in Q&A-22, which states, without explanation, that "bonus compensation" (the term being used temporarily in lieu of "performance-based compensation") does not include any amount based solely on appreciation in the service recipient's stock.

Rationale: The Statement of Managers provides (p. 522) that performance-based compensation may be required to meet certain requirements similar to those under IRC § 162(m), but will not be required to meet all of the requirements under § 162(m). Thus, Congress intended that "performance-based compensation" be defined no more restrictively under § 409A than it is under § 162(m). Because SARs and stock options granted at fair market value are treated as performance-based compensation for purposes of § 162(m) (*see* Treas. Reg. § 1.162-27(e)(2)(vi)), they should receive the same treatment under § 409A.

(2) *Recommendation:* A bonus should not fail to be treated as performance-based compensation merely because the amount of the bonus can be affected (positively or negatively) by a subjective judgment made by the employer (or by a committee chosen by the employer).

Rationale: The Statement of Managers provides (p. 522) that "performance-based compensation" will be defined by the Treasury to include compensation that is "(1) variable and contingent on the satisfaction of preestablished organizational or individual performance criteria and (2) not readily ascertainable at the time of the election." Although this statement of intent generally restates the requirements imposed by the regulations under § 162(m), we understand that the Statement of Managers deliberately omitted the requirement imposed by the § 162(m) regulations that the performance criteria be "objective." *See* Treas. Reg. § 1.162-27(e)(2)(i). Accordingly, employers should be permitted to exercise subjective judgment in determining the amount of performance-based compensation for purposes of § 409A. *See* Q&A-22 (reaching the same conclusion with respect to "bonus compensation").

(3) *Recommendation:* Consistent with the preceding recommendation, if a bonus plan provides that bonuses will be paid under the plan only if certain preestablished performance criteria are met, bonuses paid under the plan will be treated as "performance-based compensation" even though the *amount* of each eligible employee's bonus is based entirely on a subjective judgment regarding that employee's performance.

Rationale: *See* ¶ 4.c(2), above.

(4) *Recommendation:* The Treasury should permit performance criteria to be established within the first 90 days of the performance period (but not after the expiration of 25%

of the relevant period of service), consistent with the regulations under § 162(m). *See* Treas. Reg. § 1.162-27(e)(2)(i).

Rationale: This is consistent with the Statement of Managers, quoted in ¶ 4.c(2), above.

(5) *Recommendation:* The Treasury should provide that the corporate governance requirements imposed by § 162(m) (*e.g.*, shareholder approval of performance measures and administration by a committee of outside directors) do not apply under § 409A.

Rationale: Section 409A applies to a far larger group of employees and employers than does § 162(m), and there is no suggestion in the legislative history that Congress intended to require broad-based plans and plans sponsored by nonpublic companies (including unincorporated entities and nonprofits) to comply with governance requirements that were designed for plans covering the top executive officers of publicly-held corporations. *See* Q&A-22 (reaching the same conclusion with respect to "bonus compensation").

d. Fiscal-Year Plans

(1) *Recommendation:* The Treasury should allow both bonus-deferral and salary-deferral plans to operate on a fiscal-year basis.

Rationale: Because many employers maintain bonus plans that are based on financial performance during a fiscal year, their bonus-deferral plans commonly operate on a fiscal-year basis. The Treasury should make clear that the election-timing rules in § 409A(a)(4) may be applied to a fiscal-year plan on the basis of the fiscal year rather than the calendar year. In these circumstances, efficient and effective plan administration will be facilitated if the employer's salary-deferral program also can be operated on a fiscal-year basis. It would be costly to the employer and confusing to employees if an employer that maintains a fiscal-year bonus-deferral plan were required to maintain a salary-deferral plan for the same group of employees on a calendar-year basis. The Treasury has the authority to provide a separate rule for fiscal year plans under § 409A(a)(4)(B)(i), which states that a deferral election must be made no later than the close of the taxable year preceding the year in which the related services are performed "or at such other time as is provided in regulations."

e. Deferral Of Commission Payments

(1) *Recommendation:* The Treasury should issue guidance providing that an election to defer the receipt of a commission payment may be made at any time before the year in which the commission-earner's right to the commission payment becomes nonforfeitable.

Rationale: Because commission payments are subject to many contingencies, such as the customer's payment of the sales price from which the commission is derived, and are often paid over a period of many years, it is unrealistic to expect commission-earners to make deferral elections before the year in which he or she begins to perform the services that generate the commission. For one thing, it is frequently unclear when the commission-related services begin. Second, it is extremely difficult, if not impossible, to predict the commission-related services that will begin in the following year. Third, in a great many cases, the lengthy periods over which services are performed and commissions are paid make it impractical for commission-earners to make deferral elections in the year before his or her related services start. *See* IRC § 162(m)(4)(B) (recognizing the special nature of commission income). The Treasury has the authority to provide a separate rule for commission payments under § 409A(a)(4)(B)(i), which states that a deferral election must be made no later than the close of the taxable year preceding the year in which the related services are performed "or at such other time as is provided in regulations."

One approach that the Treasury should consider is to allow a deferral election to be made with respect to commission income if the election (i) is made at least one year before the otherwise applicable payment date and (ii) results in a deferral of at least five years. *See* ¶ 4.b(2), above.

f. Spillover And Similar Plans

(1) *Recommendation:* The Treasury should clarify how § 409A applies to elections to defer compensation under defined contribution spillover plans (as defined in footnote 7, above).

Rationale: Because of the prevalence of defined contribution spillover plans, it is important for the Treasury to clarify promptly how § 409A applies to them. In providing such guidance, the Treasury should address several different types of arrangements, including the following:

- An arrangement under which the rates at which salary deferrals are made under both the spillover plan and the related qualified plan are fixed at the beginning of each year;

- An arrangement under which the rates at which deferrals of salary and bonuses that would otherwise be **paid** during the year are fixed under both the spillover plan and the related qualified plan at the beginning of each year -- even though the bonuses were earned (in whole or in part) in a prior year;[8]

- An arrangement under which the rate at which deferrals are made under the spillover plan is fixed at the beginning of the year, but the rate at

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[8] This arrangement allows an employee to elect to defer receipt of a bonus after the beginning of the period in which the bonus is earned. Section 409A(a)(4)(B)(i) authorizes the Treasury to allow such an election. If the Treasury fails to do this, deferral elections under spillover plans will become unduly complicated, since it will be necessary, as a practical matter, to bifurcate employees' deferral elections (between salary and bonus) and to make elections to defer bonus compensation under the spillover plan long before the beginning of the year in which the deferred amount will actually be credited to the employee under the spillover plan.

which deferrals are made under the related qualified plan is not -- so that a change in the employee's deferral rate under the qualified plan can indirectly affect the time when deferrals begin to be made under the spillover plan (thereby affecting the amount deferred under the spillover plan -- though not the rate at which those deferrals are made);

- An arrangement under which an employer with a § 415 excess plan allows participants to change their deferral and/or after-tax contribution rates under the employer's qualified plan, so that the amount deferred under the § 415 excess plan can be indirectly increased (or reduced) by a mid-year increase (or a reduction) in the employee's deferral or contribution rate under the qualified plan; and

- An arrangement under which an employer maintains a qualified plan that allows participants to change the rate at which they make § 401(k) deferrals and after-tax contributions throughout the year and a spillover plan that accepts deferrals from eligible executives who are prevented from making deferrals or contributions under the qualified plan by the ADP or ACP limit imposed by § 401(k) and (m) -- so that an increase in the eligible employee's deferrals or contributions to the qualified plan could indirectly result in a greater deferral rate (and more deferrals) under the mirror plan.

In our judgment, § 409A(a)(4) should not prohibit any of the arrangements described in the five preceding paragraphs. Section 409A(a)(4)(B)(i) authorizes the Treasury to designate the date by which deferral elections must be made. We urge the Treasury to grant spillover plans the flexibility they need to operate effectively and in tandem with the employer's qualified plans.

(2) *Recommendation:* The Treasury should issue guidance making it clear that a "match make-up" plan does not violate § 409A(a)(4) merely because a participant may make mid-year changes in his or her deferral and/or contribution elections under the employer's related qualified savings plan.

Rationale: Some employers, including a number of our members, maintain nonqualified match make-up plans. These plans are similar to defined contribution spillover plans except that they do not accept employee deferrals or contributions. Match make-up plans are credited with amounts ("matching credits") equal to the employer matching contributions that would have been made to the employer's tax-qualified savings plan if (i) the qualified plan had not been subject to certain Internal Revenue Code limits (*e.g.*, §§ 401(a)(17), 402(g), 415) specified by the match make-up plan and (ii) the participant had continued to defer and/or contribute to the qualified plan at the rate in effect when the participant's deferrals or contributions were halted by an applicable limit.

If the qualified plan allows a participant to make mid-year changes in his or her deferral and/or contribution rate, the participant may be able to make mid-year changes under the qualified plan that affect whether (and to what extent) the participant will be credited with matching credits under the match make-up plan: the higher the participant's deferral and/or contribution rate(s) under the qualified plan, the sooner the participant will start to receive matching credits under the match make-up plan and the greater those credits will be.

We believe that a match make-up plan does not violate § 409A(a)(4) because **participants do not defer their own compensation under the nonqualified plan.** The § 409A(a)(4) advance election requirement is designed to restrict an individual's ability to elect to defer the receipt of compensation that would otherwise be available to the individual currently. By contrast, the arrangement that we have described does not offer a choice between deferred compensation and some other benefit. The arrangement offers a choice between (i) making deferrals and/or after-tax contributions to the employer's qualified plan and receiving benefits under the qualified and match make-up plans and (ii) making no such contributions and receiving in exchange no benefits of any kind from the employer. Section 409A(a)(4) is not implicated by thus kind of arrangement.[9]

We urge the Treasury to confirm that match make-up plans are not subject to the restrictions imposed by § 409A(a)(4).

(3) *Recommendation:* The Treasury should clarify that a supplemental DB plan that supplements a tax-qualified contributory defined benefit plan (a "qualified contributory DB plan") does not violate the requirements of Code § 409A(a)(4) merely because an employee may cease (or start) making *after-tax* contributions to the qualified contributory DB plan at any time during the year -- provided that the employee does not receive anything of value from the employer, directly or indirectly, in return for not making contributions to the qualified contributory DB plan.

Rationale: Under this arrangement, the supplemental DB plan provides that an eligible employee accrues benefits thereunder only while the employee makes contributions to the qualified contributory DB plan. To the extent that an eligible employee does not contribute to the qualified contributory DB plan, the employee's service and compensation are disregarded in calculating the employee's benefits under both the qualified contributory DB plan and the supplemental DB plan. The gross benefit to which an employee is entitled under the supplemental DB plan is offset by the benefit to which the employee is entitled under the qualified contributory DB plan, including both the employer-provided and employee-provided portions of the benefit.

This arrangement raises an issue under Code § 409A(a)(4), which provides, in general, that, effective January 1, 2005, an election to defer the receipt of compensation must be made *before* the start of the calendar year in which the related services are performed (or at such other time as provided in regulations). An argument can be made that because an employee's mid-year decision to start (or stop) making contributions to the qualified contributory DB plan can affect the employee's accrual of benefits under the supplemental DB

[9] Even if § 409A(a)(4) were relevant, § 409A(a)(4)(B)(i) authorizes the Treasury to designate the date by which deferral elections must be made and thus allows the Treasury to give match make-up plans the ability to continue to operate.

plan in the middle of a year, this arrangement causes the supplemental DB plan to violate the requirements of § 409A(a)(4).

The Treasury should make it clear that the supplemental DB plan does not violate the requirements of § 409A(a)(4). The § 409A(a)(4) advance election requirement is designed to restrict an individual's ability to elect to defer the receipt of compensation that would otherwise be available to the individual currently. By contrast, the arrangement that we have described does not offer a choice between deferred compensation and some other benefit. The arrangement offers a choice between (i) making after-tax contributions and receiving benefits under the qualified contributory and supplemental DB plans and (ii) making no such contributions and receiving in exchange no benefits of any kind from the employer -- under the qualified contributory DB plan, the supplemental DB plan, or any other plan or arrangement.[10] This is a choice to receive benefits or forgo them. It is not the kind of election that § 409A(a)(4) addresses.

g. § 401(k) Wrap Plans

(1) *Recommendation:* The Treasury should clarify how § 409A applies to § 401(k) wrap plans under which compensation is deferred initially under a nonqualified plan and later transferred to (and deferred under) the employer's § 401(k) plan to the extent permitted by the ADP and other limits that apply to the § 401(k) plan.

Rationale: The Treasury should make it clear that the transfer of funds from the § 401(k) wrap plan to the qualified § 401(k) plan does not cause the wrap plan to violate the distribution restrictions in § 409A(a)(2) or the anti-acceleration rule in § 409A(a)(3). Such transfers are **transfers**, not distributions. The wrap arrangement serves the benign purpose of assuring that the § 401(k) plan does not violate the applicable statutory limits. A transfer is consistent with the objective of deferring the receipt of compensation. It is not a distribution.

h. Deferral Of Dividend Equivalents

(1) *Recommendation:* The Treasury should make clear that where an employer allows an employee to elect to defer the receipt of dividend equivalents, the employee must make a deferral election before the deadline that applies to the dividend equivalents in question. For this purpose, the Treasury should distinguish (i) dividend equivalents that are contingent on the performance of substantial future services from (ii) dividend equivalents that are not subject to such a contingency. Likewise the Treasury should issue guidance providing that dividend equivalents on common stock qualify as performance-based compensation for purposes of § 409A(a)(4)(B)(iii).

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[10] Of course, an employee who does not contribute to the qualified contributory DB plan exhausts less of the limit that § 415(c) imposes on annual additions and might therefore be able to contribute more to the employer's qualified defined contribution plan. *See* Treas. Reg. § 1.415-6(b)(3). This is hardly the kind of benefit that implicates § 409A(a)(4).

Rationale: To the extent that an employee's right to future dividend equivalents is contingent on the employee's performance of substantial future services, the dividend equivalents are comparable to a series of annual bonuses. Just as § 409A(a)(4) permits an annual election to defer the receipt of a bonus that is earned in the following year, § 409A(a)(4) permits an employee to make an annual election to defer the receipt dividend equivalents that are earned in the following year.

On the other hand, to the extent that the right to future dividend equivalents is no longer contingent on the performance of substantial future services (for example, because the employee has completed a period of service and/or attained an age specified by the plan), the employee may have satisfied his or her part of the bargain, and any deferral election with respect to such dividend equivalents presumably would be subject to the same timing requirements that apply to comparable types of compensation (including performance-based compensation) earned during the period in which the dividend equivalents are earned. *See* ¶ 1.k(2), above.

Because dividend equivalents on common stock are contingent on corporate performance, the Treasury should make clear that they qualify as performance-based compensation for purposes of § 409A(a)(4)(B)(iii). In accordance with § 409A(a)(4)(B)(iii), an employee should be permitted to elect to defer receipt of a dividend equivalent as late as six months before the dividend declaration date.

i. Payroll Periods Spanning Two Taxable Years

(1) *Recommendation:* The Treasury should provide that where a payroll period spans two taxable years, so that an employee's compensation for the payroll period is attributable to services performed in two taxable years and is paid in the second of the two years, the employee may make a deferral election with respect to that payroll period at any time before the beginning of the second taxable year.

Rationale: Because the compensation is paid in the second year and is partly attributable to services performed in the second year, allowing employees to make deferral elections before the second year, rather than before the first year, is a practical and sensible solution. The rule that we propose is consistent with the payroll period rule in Q&A-4(b) and is authorized by § 409A(a)(4)(B)(i).

If the Treasury does not accept our recommendation, it should at least apply the rule that we propose to payroll periods that span the 2005-2006 tax years – since the deadline for making deferral elections for 2005 has already passed, and many employers and employees doubtless assume that new deferral elections for 2006 will apply to the first paychecks issued in 2006.

5. Distribution Rules

a. Six-Month Delay For Specified (Key) Employees

(1) *Recommendation:* The six-month delay rule in § 409A(a)(2)(B)(i) should not apply where monthly distributions are made in the form of a life annuity or in non-decreasing installments over a term of at least ten years.

Rationale: When a plan distributes benefits on a life annuity or installment schedule, only a small fraction of the benefit is paid during the first six months. The apparent objective of the six-month delay rule -- to prevent a miscreant executive from receiving funds that he or she is not entitled to or from receiving funds from a company that the executive has damaged -- is not significantly advanced in these circumstances. By contrast, the six-month delay rule will significantly interfere with supplemental DB plans that are designed to coordinate the distribution of benefits with distributions from the employer's tax-qualified plans. Of course, the six-month delay rule should apply to lump-sum distributions and to installment distributions over periods of less than 10 years. *Cf.* 4 U.S.C. § 114 (restrictions on state source-tax legislation).

(2) *Recommendation:* The six-month delay rule in § 409A(a)(2)(B)(i) should not apply to bonus payments that are paid to all eligible employees -- including those who have separated from service at the time the bonus is paid.

Rationale: When the payment of a bonus (*e.g.*, an annual bonus paid three months after the close of the year in which it is earned) is paid to all employees who are eligible for the bonus, the six-month delay rule should not be triggered just because some of the eligible employees have separated from service. Such payments do not represent deferred compensation (*see* Q&A-4(c)) and, in any event, the payments are not made by reason of separation from service.

(3) *Recommendation:* The Treasury should make it clear that a plan may provide that, after the six-month period ends, the plan may distribute to the specified employee the payments that would have been made to him or her during the six-month period if he or she had not been a specified employee, plus (if the plan so provides) interest, an adjustment to reflect phantom investment experience, or any other adjustment that the plan provides to reflect the time value of money.

Rationale: If the specified employee elected to receive the distribution from the plan in a lump sum, the six-month delay rule would not prevent the plan from distributing the lump-sum after the end of the six-month period, with interest, an adjustment for phantom investment performance, or any other adjustment that the plan provides to reflect the time value of money. Since that is so, it would be illogical to prevent the plan from making a *smaller* retroactive payment to a specified employee who had elected to receive annuity or installment payments rather than a lump sum.

Nothing in § 409A(a)(2)(B)(i) suggests that Congress intended to limit the *amount* of deferred compensation that is paid to a specified employee. Once the six-month delay period expires, § 409A(a)(2)(B)(i) does not prevent a plan from adjusting the specified employee's benefit to reflect the delay in payment. This happens automatically under an account balance plan, since the specified employee's account balance automatically reflects the account's investment experience, and it also happens automatically under equity plans for similar reasons. Likewise, the benefit formulas under many nonaccount balance plans automatically adjust the amount of each participant's benefit to reflect the participant's age when benefits start. There is simply no justification for using § 409A(a)(2)(B)(i) as a vehicle for restricting the *size* (as opposed to the timing) of deferred compensation payments to specified employees.

(4) *Recommendation:* An employer should be permitted to identify its key employees once a year -- up to six months before the beginning of the taxable year. As a result, once the employer's roster of key employees is determined for a given taxable year, the roster should be fixed for the entire year, regardless of hirings, departures, promotions, demotions, and changes in compensation during the year.

Rationale: Because key employee status depends on the pay levels of the employer's top officers and because those pay levels can change at any time, it is essential -- if the six-month delay rule is to be administrable -- that employers be permitted to establish the identity of their key employees in advance and once (and only once) for each taxable year. Employers must identify their key employees accurately: paying an employee either too late or too early could subject the employee to punitive tax consequences under § 409A. *See* Treas. Reg. § 1.416-1, *T-14*, *-21* (allowing a plan to use either the definition of compensation in § 1.415-2(d) or the amount stated on Form W-2 for the year).

(5) *Recommendation:* Key employee status is determined on a "controlled group" basis, taking into account any foreign members of the group and their officers, including nonresident aliens with no U.S.-source income. However, in identifying the employees who are key employees by reason of their officer status, an employer should have *the option* to disregard any nonresident aliens who are officers of its foreign affiliates.

Rationale: It is clear that the "controlled group" rules generally apply to determine key employee status under both § 409A and § 416(i)[11]. There is no exclusion for foreign members of the group or for their officers. However, because it is difficult for some U.S. companies to collect information from their foreign affiliates, U.S. employers should have *the option* to disregard nonresident aliens employed by their foreign affiliates in identifying the employees who are key employees by reason of having officer status.

(6) *Recommendation:* The Treasury should prescribe a "safe harbor" that permits an employer to elect to treat more than 50 highly paid employees (*e.g.* 60 employees) as its most highly paid officers in exchange for being relieved of the need to determine whether those employees qualify as "officers" for purposes of IRC § 416(i).

Rationale: The definition of "officer" for purposes of § 416 is so vague that many large employers will find it impossible to apply it in the context of § 409A. *See* Treas. Reg. § 1.416-1, *T-13*. The safe harbor that we recommend will make § 409A more administrable

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[11] *See* IRC §§ 409A(d)(6), 414(b), 414(c); *cf.* IRC § 416(i)(1)(C) (controlled group rules do not apply to determine ownership); Treas. Reg. § 1.416-1, *T-20*.

as long as the safe harbor can be applied on a once-a-year, look-back basis -- consistent with the recommendation in ¶ 5.a(4), above.

(7) *Recommendation:* An outside director who participates in a deferred compensation plan that provides for the deferral of directors' fees is not a key employee with respect to that plan.

Rationale: IRC § 416(i) makes it clear that a "key employee" must be an employee. Thus, an independent contractor may not be a key employee of the company to whom he or she provides services. *Cf.* Treas. Reg. § 1.416-1, *T-12* (key employee must be an employee).

(8) *See* ¶ 5.c(2), below.

b. Supplemental DB Plans

(1) *Recommendation:* The Treasury should provide flexible and practical rules, akin to the temporary rule in Q&A-23, governing employee elections regarding the distribution schedule under a supplemental DB plan.

Rationale: It is unrealistic to expect participants in a supplemental DB plan to be able to elect, many years (and even decades) before retirement, how they want their benefits under the plan to be distributed. The Statement of Managers authorizes (p. 523) the Treasury to address this problem: "It is expected that in limited cases, the Secretary will issue guidance, consistent with the purposes of the provision, regarding to what extent elections to change a stream of payments are permissible. *The Secretary may issue regulations regarding elections with respect to payments under nonelective, supplemental retirement plans*" (emphasis added).

Q&A-23 now provides a temporary rule that allows the timing and form of payment under a nonqualified plan to be controlled by the payment election made by the participant under a qualified plan. We applaud this sensible and practical rule, and we urge the Treasury to make the rule permanent insofar as it applies to nonelective, supplemental plans.

If the Treasury is unwilling to make Q&A-23 permanent, it should at least provide that a nonelective, supplemental retirement plan may honor --

- elections made at any time before the annuity starting date if the only options offered by the plan are actuarially equivalent annuities;
- elections made at least 12 months before the annuity starting date if the plan offers installment options but not a lump-sum option; and
- elections made at least 24 months before the annuity starting date if the plan offers a lump-sum option.

c. Anti-Acceleration Rule

(1) *Recommendation:* A deferred compensation plan should be permitted to specify any amount that it chooses as the threshold for an automatic lump-sum distribution following separation from service. This recommendation calls for a change in Q&A-15(e).

Rationale: If the plan specifies in advance what the dollar threshold is (*e.g.*, a lump-sum amount of less than $50,000 or a single life annuity at age 65 of less than $1,000 per month), the plan should not be treated as violating the anti-acceleration rule in § 409A(a)(3). Because the automatic cashout provision does not give the employee greater control over the distribution of his or her deferred compensation, the Treasury should defer to the employer's judgment of what constitutes a "minimal" benefit for purposes of the plan's cashout provision as long as the cashout threshold is specified by the terms of the plan.

Q&A-15(e) adopts the rule that we propose, but applies it only to *future* deferrals. Under Q&A-15(e), a plan amendment that applies to *existing* deferrals may not specify a de minimis threshold exceeding $10,000.

The regime prescribed by Q&A-15(e) is unnecessarily restrictive. The $10,000 limit appears to be designed to prevent an employer from accommodating an employee's request for a lump-sum distribution by setting the de minimis threshold at a level that is high enough to allow the plan to cash out the employee who requested the lump sum. While this is an understandable concern, less restrictive rules can address that concern; for example:

- Provide that the $10,000 limit does not apply if there is an interval of at least three years between the date the amendment is adopted and the date it becomes effective;

- Increase the $10,000 limit to $100,000; and/or

- Provide that the dollar limit on the de minimis rule for existing accruals (currently $10,000) does not apply to non-key employees.

(2) *Recommendation:* The Treasury should issue guidance providing that the anti-acceleration rule (*and the six-month delay rule for key employees)* do not bar (i) federal, state, and local tax withholding, (ii) distributions to comply with domestic relations orders, and (iii) distributions required to comply with federal, state, and local conflict-of-interest requirements.

Rationale: The relief provided by Q&A-15 applies only to the anti-acceleration rule. In order to be fully effective, however, the relief must also apply to the six-month delay rule for key employees in § 409A(a)(2)(B)(i).

Moreover, Q&A-15 provides relief for compliance with federal tax withholding and federal conflict of interest rules. In order to be fully effective, the relief must also take into account state and local tax withholding and state and local conflict-of-interest requirements.

The Treasury should use its existing statutory authority to provide the relief we request. *See* Code §§ 409A(a)(3) (anti-acceleration rule) ("except as provided in regulations by the Secretary"), 409A(a)(2)(A)(vi) (six-month delay rule) (exception for emergency distributions).

(3) *Recommendation:* The Treasury should issue guidance providing that a supplemental DB plan does not violate the anti-acceleration rule in § 409A(a)(3) merely because the tax-qualified defined benefit plan that is being supplemented is amended to allow an eligible participant to retire, and to begin receiving benefits, on a date that precedes the plan's previous earliest retirement date.

Rationale: Section 409A(a)(3) provides that a deferred compensation plan may not permit acceleration of the time or schedule of payments under the plan, *except as provided in regulations*. We are concerned that, in the absence of regulatory relief, an amendment to a tax-qualified defined benefit plan that accelerates the time when benefits (or unreduced benefits) are distributable under the qualified plan might be treated as accelerating the time or schedule of payments under a related supplemental DB plan -- for example, where a participant has already elected to start receiving benefits under the supplemental DB plan as soon as he or she terminates employment and is eligible to receive benefits under the related qualified plan that are not reduced for early commencement.

However, if the participant has elected (or if the supplemental DB plan provides) that benefits will be paid in a specified form beginning on the earliest date following separation from service on which an employee can receive benefits under the qualified plan that are not reduced for early commencement, an amendment to the qualified plan to reduce the age at which unreduced benefits may be received should not cause the supplemental DB plan to accelerate the payment of benefits in violation of § 409A(a)(3): both before and after the amendment, benefits start on the earliest date following separation from service on which an employee can receive benefits that are not reduced for early commencement. Moreover, as long as the tax-qualified plan covers a significant number of employees and meets, as it must, the Code's coverage and nondiscrimination requirements, the impact on an individual participant's rights under the supplemental DB plan are incidental, and the supplemental DB plan should not be deemed to violate § 409A(a)(3) in these circumstances.

(4) *Recommendation:* The Treasury should issue guidance providing that the anti-acceleration rule does not prevent a participant from changing the form of distribution from an annuity (or installment payments) to a lump sum as long as the lump-sum payment is made no sooner than five years after the first annuity (or installment) payment was scheduled to be made.

Rationale: Unless the Treasury permits plan participants to change the form of distribution from an annuity (or installment payments) to a lump sum, the anti-acceleration rule will "trap" many participants in annuity and installment elections that they made many years before a distribution event occurred and at a time when they could not possibly anticipate what their future retirement or other financial needs would be.

Our recommendation strikes an appropriate balance between the needs of plan participants for some flexibility regarding the form of distribution and the anti-acceleration rule's objective of assuring that participants do not have excessive control over the distribution of compensation that is receiving tax-deferred treatment. The 5-year rule that we propose is analogous to the 5-year rule in § 409A(a)(4)(C) and assures that plan participants do not have excessive access to their deferred compensation. The Treasury clearly has the authority to adopt this rule: § 409A(a)(3) provides that a deferred compensation plan may not permit acceleration of the time or schedule of payments under the plan, *except as provided in regulations*.

(5) *Recommendation:* The Treasury should issue guidance that makes it clear that the anti-acceleration rule in § 409A(a)(3) does not bar a plan from making a payment that is scheduled to be made on a future date as long as the actual payment date and the scheduled payment date occur in the same taxable year.

Rationale: If the payment is made in the taxable year that includes the scheduled payment date, the income tax consequences to the participant are unchanged and the acceleration is de minimis (less than 12 months). In such circumstances, there is no acceleration within the meaning of § 409A(a)(3). Moreover, even if there were deemed to be an acceleration in these circumstances, § 409A(a)(3) authorizes the Treasury to promulgate the rule we propose. *See* ¶¶ 5.d(3) & 5.i(1), below.

(6) *Recommendation:* The Treasury should issue guidance making it clear that the anti-acceleration rule does not prevent a plan from providing that it will distribute an annuity contract issued by an insurance company to a participant under objectively-determined circumstances (unrelated to the employer's financial health) specified by the plan.

Rationale: From an income tax perspective, the distribution of an annuity contract is equivalent to a lump-sum cash distribution: each provides an immediately taxable benefit to the recipient. Just as a plan may provide for a cash lump-sum distribution under specified circumstances, so should a plan be able to provide for an in-kind distribution of an annuity contract under the same circumstances. For example, a plan should be able to provide that it will distribute an annuity contract to a participant upon termination of employment if the participant has so elected when making his or her deferral election or that it will distribute an annuity contract to every participant who terminates employment after attaining specified age and service requirements (subject, in each case, to the six-month delay rule for key employees).

d. Election To Delay Distributions

(1) *Recommendation:* The Treasury should issue guidance providing that the 12-month and 5-year rules in § 409A(a)(4)(C) apply to an initial election to defer distribution of a restricted stock unit and any other time-vested deferred compensation that does not qualify as performance-based compensation.

Rationale: Suppose, for example, that under the terms of a restricted stock unit, an employee vests in (and becomes entitled to payment of) the unit after completing three years of service. If the plan provides for (and actually makes) payment within the 2-1/2 month period allowed by the short-term deferral rule, the plan is not considered to provide for the deferral of compensation. If the plan permits employees to make deferral elections with respect to the restricted stock units, however, the deferral elections should not be subject to conditions that are more restrictive than those that apply under § 409A(a)(4)(C) to subsequent elections to delay, or change the form of, payment. Thus, the Treasury's guidance should provide that, in the circumstances we have described, the terms of the grant could allow the employee, at least 12 months before the scheduled payment date, to defer payment until a date falling at least 5 years after the originally scheduled payment date (subject to the statutory exceptions for payments on account of death, disability, or unforeseeable emergency). The same conclusion should apply to any other time-vested deferred compensation arrangement (*e.g.*, a retention bonus that is payable if the employee works for three years). Of course, awards that are not treated as deferred compensation -- such as stock options and SARs with an option price or strike price that is not less than the fair market value of the underlying stock on the grant date and with no deferral feature-- would not be subject to the 12-month and 5-year rules in any event.

(2) *Recommendation:* The Treasury should make it clear that subsequent elections to delay the distribution of deferred compensation may be made on a "class year" basis, so that they apply to deferrals from one or more years but not from others. Likewise, the Treasury should make clear that a subsequent election to postpone a distribution may apply to all or any part of the scheduled distribution.

Rationale: Just as initial deferral elections may be made on a year-by-year basis, so should it be permissible to make subsequent elections to delay the distribution of deferred compensation on a "class year" basis. Similarly, just as initial deferral elections may apply to all or any part of an individual's compensation, so should it be permissible to make subsequent elections to delay the distribution of all or any part of the compensation that has been deferred.

(3) *Recommendation:* The Treasury should issue guidance that makes it clear that the restrictions in § 409A(a)(4)(C) on subsequent elections to delay, or change the form of, payment do not prevent a plan from delaying a scheduled payment if the actual payment date and the scheduled payment date occur in the same taxable year.

Rationale: If the payment is made in the taxable year that includes the scheduled payment date, the income tax consequences to the participant are unchanged and the delay in payment is de minimis (less than 12 months). In such circumstances, there is no delay in, or change in the form of, payment for purposes of § 409A(a)(4)(C). *See* ¶ 5.c(5), above, & ¶ 5.i(1), below.

e. Alternative Distribution Dates

(1) *Recommendation:* The Treasury should make it clear that distributions may be made (or may start) at the later (or the earlier) of two permissible payment starting dates.

Rationale: There is no technical or policy reason to bar a plan from providing, for example, that distributions will be made (or start) at the later of separation from service or age 65 or from providing that distributions will be made (or start) at the earlier of separation from service or January 1, 2020.

(2) *Recommendation:* The Treasury should make it clear that § 409A(a)(4) does not bar a plan from including a provision that delays the date when it makes distributions to "covered employees" within the meaning of § 162(m).

Rationale: If an employer is a publicly held corporation, the employer's ability to deduct compensation with respect to a "covered employee" is subject to the $1 million annual limit imposed by § 162(m). A "covered employee" is defined as any individual who, *on the last day of the taxable year*, is

> (a) the chief executive officer of the corporation (or acting in such capacity), or
>
> (b) among the four highest compensated officers (other than the chief executive officer).

Whether an individual falls in either of the two foregoing categories is determined pursuant to the executive compensation disclosure rules under the Securities Exchange Act of 1934. *See* Treas. Reg. § 1.162-27(c)(2).

In order to protect the employer's ability to deduct its payments, many deferred compensation plans restrict the time when payment will be made to employees who are reasonably anticipated to be "covered employees" when the deferred compensation payments would otherwise be made. Such plans provide that if the employee is a "covered employee" during the calendar year preceding the year in which payment is otherwise scheduled to be made,[12] payment will not be made before the employee separates from service (six months following separation from service if the individual is a "specified employee" as determined under Code § 409A(a)(2)(B)(i)). By delaying payment until after the employee separates from service, the plan assures that the employee will not be a "covered employee" at the time the payment is made and that, as a result, § 162(m) will not disallow the deductibility of the payment.

Section 409A(a)(4) does not prohibit a plan from restricting distributions to "covered employees" in the manner we have described. In general terms, § 409A(a)(4) provides that its requirements are met if the plan provides that compensation for services performed during a taxable year may be deferred at the employee's election only if the election to defer the compensation is made not later than the close of the preceding taxable year or at such other time as provided in regulations. Code § 409A(a)(4)(B)(i).

An employee should not be viewed as making a late election merely because of a restriction that the plan imposes on distributions to "covered employees." As long as the plan imposes the restriction on distributions to "covered employees" from the outset, the application of the restriction does not represent either a late deferral election or an impermissible change in a prior deferral election. Far from giving a "covered employee" impermissible deferral election rights, the restriction bars a "covered employee" from making deferral elections that other employees can make.

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[12] As a practical matter, the restriction cannot be linked to the employee's status as a covered employee in the year of vesting because a current-year test would make it impossible to determine whether the restriction applies until the last day of the year -- well after the vesting date (the presumptive payment date) in the vast majority of cases.

The plan's restriction on distributions to "covered employees" does not differ, in principle, from the six-month restriction on distributions to "specified employees" imposed by § 409A(a)(2)(B)(i). Neither the plan's restriction on distributions to "covered employees" nor the six-month restriction on distributions to "specified employees" allows an employee to make a late deferral election or to make an impermissible change in a prior deferral election. In each case, the applicable distribution provisions do not change; changes in the employee's status within the corporation affect the application of those provisions.

A restriction on distributions to "covered employees" does not present an opportunity to circumvent the requirements of § 409A(a)(4). No public company (and no board of directors of a public company) could responsibly manipulate the identity of the company's "covered employees" in order to delay the distribution of deferred compensation.

f. Emergency Withdrawals

(1) *Recommendation:* The Treasury should allow an employee who meets the standard for an emergency withdrawal under § 409A(a)(2)(B)(ii) to reduce his or her future deferrals during the year to the same extent that he or she could make an emergency withdrawal under § 409A(a)(2)(A)(vi).

Rationale: If the employee meets the requirements for an emergency withdrawal, there is no purpose served by requiring the employee to continue to make deferrals at the rate he or she elected and then to make an emergency withdrawal from the plan. Plans and employees should be permitted to take the direct approach of curtailing future deferrals to the extent necessary to address the emergency. The Treasury has the authority to implement our recommendation under § 409A(a)(4)(B)(i).

g. Disability

(1) *Recommendation:* The Treasury should make it clear that a deferred compensation plan may, in defining disability, refer to the determination made by the Social Security Administration or under the employer's long-term disability plan.

Rationale: Many plans do not wish to make an independent determination regarding disability; such determinations can be difficult and time-consuming and could subject the plan to the Labor Department rules regarding the handling of disability claims. *See* 29 C.F.R. § 2560.503-1(d). Moreover, reliance on a determination by a third party will advance the objective of § 409A to restrict the discretion that can be exercised in administering a deferred compensation plan. *See* § 409A(a)(2)(C).

h. Business Dispositions

(1) *Recommendation:* The Treasury should make it clear that a nonqualified deferred compensation plan may provide that if the employer maintaining the plan (the "old employer") sells or otherwise disposes of a business unit, so that some plan participants ("affected participants") are employed by an entity that is outside of the old employer's

controlled group (the “new employer”), and the new employer does not assume liability for the affected participants’ benefits under the old employer’s plan, the plan will treat the transaction as resulting in a separation from service by the affected participants, or as effecting a change in control, for purposes of a applying the plan’s distribution provisions to the affected participants.

Rationale: There is no evidence to suggest that Congress intended to apply the “same desk” rule to nonqualified deferred compensation plans when it enacted § 409A. To the contrary, the other payment triggers recognized by § 409A(a)(2)(A), such as the “specified time,” “change in control,” and “unforeseeable emergency” triggers, show that the concerns animating the “same desk” rule in the qualified plan context did not concern Congress with respect to nonqualified plans.

Thus, a plan should be permitted to provide that when (i) the old employer sells or otherwise disposes of a business unit (for example, through a spin-off), (ii) as a result of the transaction, affected participants become employed by a new employer, and (iii) the new employer does not assume liability for the affected participants’ benefits under the old employer’s plan, the affected participants shall be considered to have separated from service for purposes of the plan’s distribution provisions. A different rule (that there was *no* separation from service in these circumstances) would be extremely difficult to administer, since it would require the old employer’s plan to treat a separation from service with the *new employer* as a separation from service under the old employer’s plan.

The Treasury should also allow a plan to treat the disposition of a business unit as a “change in control” that is a permissible payment trigger under § 409A(a)(2)(A)(v). Q&A-11(b) allows a plan to treat a change in control of a subsidiary corporation as a change in control for purposes of the plan’s distribution provisions, and Q&A-14(a) provides that a change in the ownership of assets with a gross fair market value of at least 40% of the total gross fair market value of all of the assets of a corporation may be treated as a change in the ownership of a substantial portion of a corporation’s assets and, therefore, as a change in control. *See* Q&A-11(a).

Q&A-11(b) and -14(a) do not cover a disposition of assets with a gross fair market value of *less than 40%* of the total gross fair market value of the corporation’s assets. This gap should be filled -- either by expanding the definition of “change in control” or, as we have suggested, by providing that the “separation from service” payment trigger applies in these circumstances. Since it is permissible for a plan to make a distribution when a corporation disposes of 40% or more of its assets, it makes no sense to invoke the “same desk” rule to prevent a plan from making a distribution when the corporation dispose of a smaller percentage of its assets. If § 409A does not bar distributions when a very large portion of the corporation’s assets are disposed of, it should not bar distributions in connection with the disposition of a small percentage of the corporation’s assets.

i. Timeliness Of Distributions

(1) *Recommendation:* The Treasury should make it clear that when a participant in a deferred compensation plan elects to have distributions made as of a specified time or pursuant to a fixed schedule, § 409A(a) allows the plan to make the scheduled

distribution at any time during the taxable year in which the distribution is scheduled to be made and does not require the plan to make the distribution on the precise day that the participant elected.

Rationale: As a practical matter, plans cannot always make distributions on the exact dates that participants elect. Plans cannot achieve that level of precision on a consistent basis. In any event, there is no reason to require such precision: as long as each distribution is made during the taxable year in which the distribution was scheduled to be made, the plan will not alter the income tax consequences of the distribution schedule that the participant elected. *See* ¶¶ 5.c(5) & 5.d(3), above.

(2) *Recommendation:* The Treasury should make it clear that when a participant in a deferred compensation plan elects to have a distribution made upon the occurrence of a specified event (such as separation from service, disability, death, unforeseeable emergency, or a change in control), a plan distribution will be timely if it is made within 90 days after the occurrence of all of the events that entitle the participant (or beneficiary) to the distribution (for example, in the case of a distribution triggered by the participant's death, the plan's receipt of the participant's death certificate and, in the case of a distribution triggered by an unforeseeable emergency, the plan's determination that an unforeseeable emergency has occurred and its determination of the amount eligible for distribution under § 409A(a)(2)(B)(ii)).

Rationale: Deferred compensation plans cannot realistically be expected to make distributions immediately after a triggering event occurs. Plans need a reasonable amount of time to process requests for distributions and, in many cases, plans will need time to ascertain and evaluate the facts and to determine whether a distribution is permitted (and the maximum amount that may be distributed) under the circumstances. As long as the participant (or other distributee) and the plan administrator act with reasonable diligence, the plan should have at least 90 days to make the distribution after the participant's (or beneficiary's) right to the distribution has been established.

(3) *Recommendation:* The Treasury should make it clear that a deferred compensation plan may provide that (i) some or all of the payments due in a calendar year may be combined in a single payment at the end of that year and (ii) an employee's deferral election need not specify in advance the amount of any payment that is due in a year as long as the employee (or the plan) specifies in advance an objective method or standard to be used to calculate the amount of the payment.

Rationale: In many instances, employers and plan administrators may find it more efficient or convenient to make annual payments of deferred compensation in a single combined payment at year end, rather than to make more frequent payments in smaller amounts. There is no reason why § 409A should prohibit this approach as long as all of the payments due in a calendar year are made within that year.

In many cases, it is impossible to specify in advance the amount of a future payment of deferred compensation. For example, in the case of an account balance plan, the employee can elect to receive the value of all or part of his or her account on a specified future date, but the employee cannot know in advance what the value of his or her account will be on that future date. Likewise, if an employee elects to receive on a specified future date payment of all or part of any dividend equivalents that have been deferred under the plan, the employee cannot know in advance what the value of the dividend equivalents will be (or, indeed, whether the deferred dividend equivalents will have any value at all).

j. Performance Requirements

(1) *Recommendation:* The Treasury should issue guidance making it clear that § 409A permits deferred payments to be distributed on the basis of a predetermined schedule after the employee vests in the payments by meeting a specified performance requirement (such as the employee's successful completion of a specific assignment).

Rationale: Assume that, in 2006, an employer promises an employee that, if the employee is able to arrange for the sale of one of the employer's subsidiaries before 2009, the employer will pay the employee a bonus of $X in four equal annual installments beginning in the calendar year following the year of the sale. This arrangement is permitted by § 409A(a)(2) because the performance requirement establishes a vesting condition, not the payment date. In this situation, the employer has promised the employee that if the employee vests in the bonus in 2006, the bonus will be paid in four annual installments in 2007-2010; that if the employee vests in 2007, the bonus will be paid in four annual installments in 2008-2011; and that if the employee vests in 2008, the bonus will be paid in four annual installments in 2009-2012. The four-year payment schedule is a fixed schedule that is permitted by § 409A(a)(2)(A)(iv). The performance requirement is a vesting condition that is comparable to a provision in an annual bonus plan that states that if the employer's annual earnings reach a specified level, the employee will be paid a bonus of $X over a specified four-year period.

k. Initial Election Regarding Time And Form Of Distribution

(1) *Recommendation:* If the general rule is that a participant must elect the time and form of distribution before the start of the applicable service period, the Treasury should make clear that this is so -- unless, of course, an exception applies (*e.g.,* the exceptions for newly eligible participants and for performance-based compensation).

Rationale: Although the text of § 409A does not make this clear, the Statement of Managers indicates (p. 522) that this is what Congress intended: "The time and form of distributions must be specified at the time of initial deferral."

6. Foreign Rabbi Trusts

(1) *Recommendation:* The Treasury should make clear that the restrictions on foreign trusts in § 409A(b) do not apply to trusts that apply solely to nonresident alien employees with respect to their services outside the U.S.

Rationale: Section 409A does not apply to individuals who are not U.S. taxpayers.

(2) Recommendation: The Treasury should issue guidance allowing an employer to establish a single rabbi trust abroad for employees who work outside the U.S.

Rationale: It is costly and inefficient for an employer to establish a rabbi trust in each foreign jurisdiction in which the employer has employees. Under the law of some jurisdictions, it might not even be possible to establish a rabbi trust.

7. Foreign Deferred Compensation Plans

(1) Recommendation: The Treasury should make it clear that § 409A does not apply to deferred compensation provided under pension, indemnity, and similar plans maintained outside the U.S. for persons who work primarily outside of the U.S., including (i) deferred compensation earned by non-U.S. citizens who work outside the U.S., (ii) increases in such non-U.S. deferred compensation, based on compensation increases received the non-U.S. citizen while working in the U.S., (iii) additional deferred compensation earned by a non-U.S. citizen while working temporarily in the U.S., and (iv) deferred compensation earned abroad by a U.S. citizen.

Rationale: Most of the participants in such foreign plans are not U.S. taxpayers, and § 409A does not apply to individuals who are not U.S. taxpayers. However, some of the participants in such plans reside temporarily in the U.S., while others are U.S. citizens working abroad (for example, those who are hired abroad). Section 409A was not intended to export U.S. standards outside the U.S. nor was it intended to penalize U.S. citizens who work abroad.[13]

Section 409A cannot be applied to non-U.S. citizens who work outside the U.S. These people are not U.S. taxpayers, and the Treasury should confirm that it has no interest in applying § 409A to them.

The Treasury should also exercise its administrative discretion to refrain from applying § 409A where it would be largely pointless or disruptive to do so: with respect to the benefits earned under foreign plans by non-citizens who work temporarily in the U.S. and U.S. citizens who are employed abroad. It would be pointless to insist that foreign plans be amended to conform to § 409A, and it would be disruptive to require those who temporarily employ or engage U.S. citizens outside the U.S. to provide them with deferred compensation that complies with U.S. income tax standards.

(2) Recommendation: The Treasury should make it clear that § 409A does not apply to deferred compensation provided to nonresident aliens who work in the U.S. but who earn deferred compensation under pension, indemnity, and similar "home country" plans maintained outside the U.S. primarily for persons who work in the home country.

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[13] *Cf.* Rev. Proc. 89-45, 1989-2 C.B. 596 (indicating that a similar issue might arise under § 402(b)); TAM 8911001 (Sept. 27, 1988) (same).

Rationale: Most of the participants in such "home country" plans are not U.S. taxpayers, and § 409A does not apply to individuals who are not U.S. taxpayers. However, some of the participants in "home country" plans are nonresident aliens on temporary assignment to the U.S. Section 409A was not intended to impose U.S. standards on plans maintained outside the U.S.

(3) *Recommendation:* If the Treasury is not willing to implement the two preceding recommendations regarding foreign plans, the Treasury should, at the very least, provide extended transition relief for the participants in such plans pursuant to AJCA § 885(f).

Rationale: Even if the Treasury concludes that its hands are tied because § 409A literally applies to participants in foreign plans, it is unreasonable to expect the sponsors and administrators of foreign plans to bring their plans into formal and operational compliance with § 409A on the same accelerated schedule that applies to U.S. plans. Congress did not focus on foreign plans when it enacted § 409A, and Notice 2005-1 does not address the problems that § 409A poses for foreign plans. The Treasury should use its authority under AJCA § 885(f) to provide foreign plans with a reasonable and appropriate way to transition into the § 409A regime.

8. Reporting Requirements

(1) *Recommendation:* The Treasury should allow an employer to report deferred compensation on an employee's Form W-2 in accordance with the same rules that apply to the calculation of "wages" for FICA purposes under Code § 3121(v)(2).

Rationale: This approach will reduce the burden on the employer since employers are already measuring and reporting wages for FICA purposes in accordance with the rules under § 3121(v)(2). This approach also will reduce the confusion that both employers and employees would experience if the Treasury imposed a reporting regime that differed from that prescribed by the § 3121(v)(2) regulations.

Our recommendation also is consistent with a suggestion made in the Statement of Managers (p. 526):

> "The provision also requires annual reporting to the Internal Revenue Service of amounts deferred. Such amounts are required to be reported on an individual's Form W-2 (or Form 1099) for the year deferred even if the amount is not currently includible in income for that taxable year. . . . . The Secretary may . . . provide that the reporting requirement does not apply with respect to amounts of deferrals that are not reasonably ascertainable. It is intended that the exception for amounts not reasonably ascertainable only apply to nonaccount balance plans and that amounts be required to be reported when they first become reasonably ascertainable.[815]"

"[815] It is intended that the exception be similar to that under Treas. Reg. sec. 31.3121(v)(2)-1(c)(4)."

We very much appreciate the opportunity to make this submission. If you have any comments or questions about this submission, please feel free to contact either ERIC or HR Policy.