The ERISA Industry Committee

January 3, 2006

By Hand

Internal Revenue Service
CC:PA:LPD:PR (REG-158080-04)
Courier's Desk
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Proposed Regulations Under Code Section 409A

Ladies and Gentlemen:

We are pleased to submit the enclosed comments of The ERISA Industry Committee ("ERIC")[1] on the proposed regulations regarding the application of section 409A to nonqualified deferred compensation plans. We have previously submitted a request to testify at the January 25th hearing on the proposed regulations.

If the Service or the Treasury has any questions about our comments, or if we can otherwise be of assistance, please let us know.

Respectfully submitted,

Mark J. Ugoretz
President

cc: Daniel Hogans
Stephen Tackney

[1] ERIC is a nonprofit association committed to the advancement of the employee retirement, health, incentive, and compensation plans of America's largest 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.

1400 L Street, N.W.
Suite 350
Washington, DC 20005
TEL: (202) 789-1400
FAX: (202) 789-1120
www.eric.org

COMMENTS
OF
THE ERISA INDUSTRY COMMITTEE

ON

THE PROPOSED REGULATIONS

REGARDING

THE APPLICATION OF SECTION 409A
TO
NONQUALIFIED DEFERRED COMPENSATION PLANS

January 3, 2006

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A. Introduction

The ERISA Industry Committee ("ERIC")[1] is pleased to submit the following comments on the proposed regulations under Internal Revenue Code § 409A. The proposed regulations were published in the October 4, 2005, issue of the Federal Register. The preamble to the notice of proposed rulemaking (the "Preamble") states that comments on the proposed regulations must be received by January 3, 2006. 70 Fed. Reg. 57,930. Technical corrections to the proposed regulations were published in the December 19, 2005, issue of the Federal Register. 70 Fed. Reg. 75,090.

On November 3, and 23, 2004, and April 19, 2005, well before the proposed regulations were published, ERIC made three detailed submissions to the

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[1] ERIC is a nonprofit association committed to the advancement of the employee retirement, health, incentive, and welfare benefit plans of America's largest employers. ERIC's members provide comprehensive retirement, health care coverage, incentive, and other economic security benefits directly to some 25 million active and retired workers and their families. ERIC has a strong interest in proposals affecting its members' ability to deliver those benefits, their costs and effectiveness, and the role of those benefits in the American economy.

Treasury Department and the Internal Revenue Service presenting specific recommendations on an array of critical issues under § 409A.

ERIC very much appreciates the thoughtful attention that the Treasury and the Service have given to ERIC's prior recommendations. ERIC is gratified that the proposed regulations respond constructively to many of ERIC's recommendations.

However, the proposed regulations do not resolve all of ERIC's concerns, and they raise new concerns as well. In this submission, ERIC recommends specific changes in the proposed regulations to resolve ERIC's concerns. ERIC looks forward to working with the Treasury and the Service on these recommendations.

ERIC reserves the right to supplement this submission to make additional recommendations.

B. Background

Section 409A covers a wide variety of nonqualified deferred compensation plans. Because deferred compensation plans are designed to achieve important business objectives, ERIC's members 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, including both employment agreements and severance agreements, supplemental retirement plans, severance plans, window 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 also 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).

All of these 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 that § 409A raises 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.

C. Highlights

We highlight below a number of the topics that we address in this submission, together with the pages on which each topic is addressed. We emphasize, however, that ERIC considers *all* of its recommendations to be important and to merit serious attention from the Treasury and the Service.

- **Plans Covered By § 409A**
  - Stock Options (pp. 4-9)
  - Fringe Benefits (pp. 9-10, 31-32)
  - Foreign Plans (pp. 10-12)
- **Deferral and Distribution Elections**
  - Benefit Restoration Plans (pp. 17-19, 32-33)
  - Involuntary and "Good Reason" Terminations (pp. 19-21)
  - First Year of Eligibility Rule (pp.13-15)
  - Performance-Based Compensation (p. 15)
  - Annuity Options (pp. 28-29)
  - Fixed Schedule (pp. 29-31)
- **Distribution Events**
  - Termination of Employment (pp. 22-25)
  - Six-Month Rule (pp. 25-26)
  - Change in Control (pp. 26-27)
  - Plan Termination (p. 27)

D. Detailed Comments

1. Deferred Compensation

    a. Stock Options

The proposed regulations state that a nonstatutory stock option does not provide for the deferral of compensation if, among other things, the option does not include any feature for the deferral of compensation other than the deferral of recognition of income until the later of the exercise (or disposition) of the option or the time when the option shares become substantially vested. The proposed regulations also provide that any modification of the terms of an option, other than an "extension" or renewal of the option, is considered as the grant of a new option, but that when a stock option is "extended" or renewed, the option is treated as having had an additional deferral feature from the date of grant.

According to the proposed regulations, an "extension" of a stock option refers to the grant to the optionee of an additional period of time within which to exercise the option beyond the originally prescribed exercise period, except that it is not an extension if the additional exercise period does not extend beyond the later of (i) the 15th day of the third month following the date on which the option otherwise would have expired or (ii) December 31st of the calendar year in which the option otherwise would have expired. *See* Prop. Reg. § 1.409A-1(b)(5)(i)(A) & (v)(A), (C).

(1) *Recommendation:* A nonstatutory stock option should not be deemed to have an additional deferral feature merely because the employer waives (or does not invoke) its right to terminate the option before the end of the basic term of the option.

Rationale: Although the proposed regulations' reference to the "extension" of an option is consistent with common usage, "extension" is somewhat of a misnomer in this context. In reality, the basic term of the option (*e.g.*, ten years) is rarely extended.

A typical situation involves an employee[2] who has been granted an option by his employer; the option has a "term" (or exercise period) of 10 years, and the employee is laid off before the end of the 10-year period and while the option is still outstanding. Although the terms of the option might provide that in these circumstances the option terminates early (*e.g.*, immediately or within a few months or years after termination of employment), the employer sometimes elects to waive (or not to invoke) the option's early termination provision and to

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[2] Although the proposed regulations generally refer to "service recipients" and "service providers," we generally refer to "employers" and "employees" in this submission because employer-sponsored benefit plans for employees are ERIC's principal concern. ERIC recognizes that § 409A does not apply only to employers and employees.

allow the option to remain outstanding for all or part of the remainder of its basic 10-year term.

In such circumstances, the employer's action does not add a new deferral feature to the option. The employer's action merely allows the employee to hold the option until the end of the term that was authorized when the option was granted. There is no deferral of compensation apart from the deferral that was contemplated when the option was granted and that occurs under all options (typically, deferral from the date the option is granted to the date the option is exercised). It is a mistake to treat the employer's action as adding a new deferral feature to the option – as of the date of grant or as of any other date.

An employer can avoid being deemed to add a deferral feature to an option in these circumstances by relying on the exercise of "negative discretion" to terminate the option early, *i.e.,* by granting options that do not automatically terminate early, but that give the employer the discretion to terminate the option early – either in specified circumstances (*e.g.*, if the employee quits before reaching retirement age) or under any circumstances that the employer chooses. Although the use of negative discretion has employee relations drawbacks, the proposed regulations allow an employer to use it.

But if negative discretion is the solution, what is the problem that the proposed regulations solve? What purpose is achieved by allowing employers to exercise negative discretion, while forbidding them to exercise positive discretion, when both approaches produce the same result? We recommend that the Treasury and the Service either withdraw the proposed rule on extensions or apply the rule only to an increase in the basic term of the option (the 10-year period in our example).

(2) *Recommendation:* If, contrary to ERIC's recommendation, the final regulations treat an employer's waiver of (or failure to invoke) a stock option's early termination provisions as a "modification" of the option, the regulations should treat the "modification" as the grant of a new option and should not treat the option as having had an additional deferral feature from the date of grant.

Rationale: We cannot think of any justification for (i) retroactively treating an option granted in Year 1 as having had an impermissible deferral feature when granted and (ii) subjecting the employee who received the option to harsh retroactive income tax consequences – not because of any action taken in *Year 1*, nor because of any action that *the employee* took at any time, but because of an action that *his employer* in Year 1 (or a successor employer) takes *many years later* – in Year 8, for example.

The proposed rule is both impractical and inequitable. It subjects an employee to harsh retroactive income tax consequences because of actions taken by someone else (the employer) many years later – at a time when it is too late for the employee to do anything to solve the problem.

The employer's action should have consequences to the employee that are no more severe than those that result from a modification of the option, such as a reduction in the option price. Under the proposed regulations, if an option is modified as result of a reduction in the option price, the modification is treated as the grant of a new option – which might not be subject to § 409A if the reduced option price per share is no less than the value of an option share on the date of the modification.

If, contrary to ERIC's recommendation, the final regulations treat an employer's waiver of (or failure to invoke) a stock option's early termination provisions as a "modification" of the option, the regulations should not treat the "modification" differently from the way they treat other modifications: as the grant of a new option.

(3) *Recommendation:* If, contrary to ERIC's recommendation, the final regulations treat an employer's waiver of (or failure to invoke) a stock option's early termination provisions as a "modification" of the option, the regulations should make it clear that a nongrandfathered nonstatutory option will not become subject to § 409A – either before 2007 or after 2006 – merely because the early terminations provisions of the option were waived (or not invoked), or the option was extended, before January 1, 2007.

Rationale: In accordance with the Preamble, a plan will not be treated as violating § 409A during 2005 and 2006 if, during 2005 and 2006, the plan is operated in good faith compliance with § 409A or in accordance with a good faith belief that the plan is not subject to § 409A. The regulations are not proposed to become effective before January 1, 2007, and a plan is not required to comply with either the proposed regulations or the final regulations before that date. 70 Fed. Reg. at 57,954.

During 2005, many employers have waived (or have not invoked) the early termination provisions of stock options, and others have extended the terms of stock options, based on the good faith belief that such actions did not cause the options to be treated as deferred compensation plans for purposes of § 409A. This practice is likely to continue in 2006.

The proposed rules regarding modifications of stock options appeared for the first time in the proposed regulations. They are not in the text of the statute, and they were not included in Notice 2005-1. In fact, Notice 2005-1 referred to certain provisions of Code § 424, relating to statutory stock options, for purposes of determining whether the substitution of one option for another (or the assumption of an option) in connection with certain corporate transactions will be treated as the grant of a new option. The Notice did not incorporate other aspects of § 424, including the rules in § 424 pertaining to the modification of a statutory option. Thus, if Notice 2005-1 suggests anything about modifications, the Notice suggests that the § 424 rules regarding modifications do *not* apply in determining whether an option is covered by § 409A. *See* Notice 2005-1, Q&A-4(d)(ii).

Under the circumstances, employers clearly act in good faith in 2005 and 2006 when they act on the basis of the belief that the waiver of an early termination provision, the extension of the term of an option, or *any* modification of an option (other than to add a disqualifying feature, such as a discounted option price or an option gain deferral feature) does not cause the option to become subject to § 409A. There is nothing in the statute or Notice 2005-1 that requires, or even suggests, a contrary view.

Employees have relied on the effectiveness of such waivers, extensions, and modifications in deciding whether to exercise their options. Many have chosen *not* to exercise their options and, in some cases, to allow otherwise-applicable early termination dates or expiration dates to pass, in reliance on their right to exercise their options during the exercise periods that their employers had made available to them in good faith.

If options must be modified by the end of 2006 – presumably by rescinding actions that, with the benefit of hindsight, caused the options to become subject to § 409A – in order for the options to conform to rules that did not previously exist, employees will be irreparably and unnecessarily harmed merely because their employers acted on the basis of good faith views that differed from those that the Treasury and Service ultimately adopted. The purpose of the good faith compliance period will be subverted if employees are penalized in these circumstances.

The regulations also should provide that § 409A does not apply to a nonstatutory stock option that was not vested on December 31, 2004, and which therefore was not grandfathered, merely because the option was extended before the AJCA was enacted. Employers have commonly granted employees whose employment was being terminated – especially those whose employment was terminated involuntarily without cause – additional time to exercise their outstanding options. This was a common practice before § 409A was enacted, just as it was a common practice during 2005. The Treasury and the Service have appropriately recognized that employees should not be penalized because of good faith efforts to comply with § 409A during 2005 and 2006. *A fortiori*, employees should not be penalized under § 409A on the basis of lawful actions taken by their employers before § 409A was even enacted.

(4) *Recommendation:* If, contrary to ERIC's recommendation, the final regulations treat an extension of a nonstatutory stock option as a "modification," the regulations should make it clear that any of the following measures may be used to prevent § 409A from applying to an outstanding nongrandfathered option whose original terms gave the employer the discretion to waive, in whole or in part, the option's early termination provision:

i. Amend the option to make it exercisable for a specified fixed term, with no employer discretion to increase or reduce that term;

ii. Amend the option to provide that it will remain outstanding for its full term unless the employer elects to terminate the option early in specified circumstances; or

iii. Make no change in the terms of the option, but refrain from waiving the early termination provision.

Rationale: Measures i. and ii. would be effective because each eliminates the feature that could otherwise cause § 409A to apply to the option. Measure iii. would be effective because it involves neither the *exercise* of discretion to provide an additional benefit nor a *grant of discretion* to provide an additional benefit. *See* Prop. Reg. 1.409A-1(b)(5)(v)(A) (stock right is deemed to have an additional deferral feature from date of grant if stock right is extended) & (F) (addition of discretion to provide an additional benefit is a modification); 70 Fed. Reg. 57,954 ("a plan adopted before December 31, 2006, must be amended on or before December 31, 2006, either to conform to the provisions of section 409A with respect to amounts subject to section 409A, or to provide a compensation arrangement that does not provide for a deferral of compensation for purposes of section 409A").

(5) *Recommendation:* The regulations should clarify that a grandfathered stock option (an option that was exercisable on December 31, 2004) is not materially modified where, pursuant to the terms of the option in effect on October 3, 2004, the employer exercises its discretion to waive the option terms that would otherwise cause the early termination of the option following certain events, such as the optionee's termination of employment.

Rationale: Both Notice 2005-1 and the proposed regulations provide that it is not a material modification for an employer to exercise discretion over the time and manner of payment of a benefit to the extent such discretion is provided under the terms of the plan as of October 3, 2004. *See* Notice 2005-1, Q&A-18(a); Prop. Reg. § 1.409A-6(a)(4)(i).

(6) *Recommendation:* The last sentence of Prop. Reg. § 1.409A-1(b)(5)(iv)(B)(3) should be revised to make clear that it governs the method used to establish (i) the value of the stock from which the exercise price is subtracted to determine the amount of a payment under a stock appreciation right or (ii) the amount paid, pursuant to a put or call right or other obligation, for stock acquired under a stock option or stock appreciation right, and that the sentence does *not* require the exercise price under a stock option or stock appreciation right to be reset when the stock subject to the option or right becomes publicly traded.

Rationale: The last sentence of Prop. Reg. § 1.409A-1(b)(5)(iv)(B)(3) states that "where after the date of grant, but before the date of exercise, of the stock right, the service recipient stock to which the stock right relates becomes readily tradable on an established securities market, the service recipient must use the valuation method set forth in paragraph (b)(5)(iv)(A) of this section for purposes

of determining the payment at the date of exercise or the purchase of the stock, as applicable." It is evident that this sentence does not require the exercise price to be reset when the stock becomes publicly traded, and it would make no sense to impose such a requirement. Some readers, however, have misinterpreted the sentence to require the exercise price to be reset. Because the sentence is not as clear as it should be and because it has confused some readers, the sentence should be revised to make its meaning clear.

b. Nontaxable and taxable fringe benefits

(1) *Recommendation:* The regulations should state that § 409A does not apply to an employer's provision to retirees of fringe benefits that the employer provides or has provided to active employees.

Rationale: It has been clear for many years that deferred compensation does not include an employer's provision to retirees of benefits that it provides or has provided to active employees:

> "Of course, if a plan maintained for retirees is merely a continuation of a plan maintained currently or in the past for active employees, then the retiree plan would not be considered a plan of deferred compensation because medical benefits would have been provided without the necessity of retirement or other separation from service. For example, if an employer provides post-retirement medical benefits under a plan for employees who separate by reason of a plant shutdown, and the plan merely continues the benefits provided to those employees (or their dependents) before the shutdown, then the plan would not be regarded as a deferred compensation plan even though its coverage is limited to retirees." General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 at 784-85 (Staff, Joint Comm. on Taxation 1984); *see also* PLR 9834037 (May 28, 1998) (same).

We are not aware of any evidence that Congress intended to change this well-established rule when it enacted § 409A. In the absence of any such expression of Congressional intent, the Treasury and the Service are not free to change the rule administratively.

Thus, § 409A should not apply to a fringe benefit (including an insured or uninsured death benefit or medical benefit) that an employer provides to a former employee, either in kind or by reimbursement, and that is comparable to a fringe benefit that the employer would have provided if the former employee's employment had continued. Of course, in accordance with existing IRS policy regarding fringe benefits, this rule would not apply to real property and property of a kind normally held for investment. *See* Ann. 85-113, 1985-31 I.R.B. 31.

(2) *Recommendation:* The regulations should make it clear that § 409A does not apply to nontaxable benefits.

Rationale: Congress enacted § 409A in order to impose conditions that must be met when income tax on compensation is deferred. The concerns that prompted Congress to enact § 409A do not apply to nontaxable benefits, since those benefits are not subject to income tax. *See also* Recommendation (1), above.

(3) *Recommendation:* The regulations should make it clear that § 409A does not apply to medical expense reimbursements that are included in an employee's gross income pursuant to § 105(a) or (h).

Rationale: Prop. Reg. § 1.409A-1 states that the term "nonqualified deferred compensation plan" does not include, among other things, any medical reimbursement arrangement, including a health reimbursement arrangement, that satisfies the requirements of §§ 105 and 106. Section 105 provides that, in general, amounts received by an employee through accident or health insurance for personal injuries or sickness are includible in gross income to the extent that such amounts are provided by the employer. *See* Code § 105(a). Although § 105(b) and (h) provide exceptions to this general rule, under which certain employer-provided medical reimbursements are excluded from gross income, § 105 applies to taxable and nontaxable health reimbursements alike. *See also* Recommendation (1), above.

(4) *Recommendation:* The regulations should provide that, except in cases of gross abuse, § 409A does not apply to in-kind fringe benefits that employers provide to retirees.

Rationale: The taxation of in-kind fringe benefits is subject to an extensive body of legislative and regulatory rules – a number of which expressly address the treatment of retirees. *See, e.g.,* Code §§ 61, 79, 105, 132; *see* also Code § 132(h)(1) (retirees); TRA '86 § 1853(d) (specifically referring to retirees); Treas. Reg. § 1.61-21. We are not aware of any evidence that § 409A was intended to supplant, modify, or complicate those rules. Although we understand why the drafters might wish to prevent in-kind fringe benefits from being used to evade the requirements of § 409A, the proposed regulations go far beyond what is necessary to achieve the objective of combating abuse by transforming what should have been a narrow, anti-abuse rule into an intricate regime that needlessly complicates the provision of fringe benefits to retirees. We are not aware of any evidence that this is what Congress intended when it enacted § 409A.

c. Foreign plans

The proposed regulations state that the term nonqualified deferred compensation plan does not include a "broad-based foreign retirement plan" maintained by a non-U.S. employer if the plan does not provide for elective deferrals and the deferred amounts do not exceed the § 415 limits that would apply if the plan were a qualified plan and the employee's foreign earned income were treated as compensation for purposes of § 415.

According to the proposed regulations, in order for a plan to qualify as a broad-based foreign retirement plan, the plan must (i) be written; (ii) meet a nondiscrimination requirement that assures that benefits are provided to a wide range of employees, including rank and file employees; (iii) limit pre-retirement distributions to hardship or unforeseeable emergency situations and be subject to plan provisions or tax rules that discourage such distributions; (iv) provide reasonable benefits at a stated age, termination of employment or death; and (v) provide no more than incidental survivor benefits. *See* Prop. Reg. § 1.409A-1(a)(3)(iii) & (v). Although proposed regulations have not yet been issued regarding nonqualified plans funded by foreign trusts, it is reasonable to anticipate that funded foreign plans that do not qualify as broad-based foreign retirement plans will be subject to the foreign trust rules.

(1) *Recommendation:* A foreign plan should not be required to meet U.S. standards regarding benefit amounts and benefit distributions in order to be exempt from § 409A. A written plan that is maintained outside the U.S. for the benefit of a broad range of local employees should not be subject to § 409A. The final regulations should not include the restrictions on benefit amounts and benefit distributions in proposed subparagraphs (a)(3)(v)(C) and (D).

Rationale: Plans established by the foreign subsidiaries of U.S. companies for local employees are designed to meet the requirements of local law and to reflect prevailing competitive practices. Except in a very few countries which have tax or other laws that discourage or prevent funding, these plans are funded by trusts, insurance contracts, or local legal equivalents. In some countries, these plans provide for in-service distributions as a result of events (*e.g.*, the marriage of a child) that do not qualify as hardships or as unforeseeable emergencies under U.S. law. Likewise, it is unrealistic to expect foreign plans to meet U.S. legal requirements governing incidental death benefits.

Applying U.S. legal requirements rules to foreign plans will unjustifiably penalize U.S. taxpayers who accept employment outside the U.S. with a foreign employer that maintains a deferred compensation plan. A typical situation involves early- or mid-career employees who take jobs at foreign subsidiaries for career enhancement or family reasons. These employees are not covered by an expatriate program that keeps them in the U.S. benefit plans, nor are they covered by a tax equalization program. The jobs are on the local country payroll, and the employees are enrolled in the local country benefit plans that provide for non-elective participation, frequently because of local legal requirements. Plan provisions that exclude employees who are U.S. taxpayers may not be permitted under local law, and special plan provisions that apply only to U.S. citizens may be unacceptable as a matter of local employee relations. Moreover, the local payroll system may not be able to identify those employees who are U.S. taxpayers, and the local payroll administrators are unlikely to be able to alert employees who are U.S. taxpayers to the U.S. tax consequences of participating in a local deferred compensation plan that is subject to § 409A.

As a result, the proposed rules will create a trap for a significant number of employees who do not seek to avoid § 409A, but who cannot avoid its penalties other than by not taking a foreign job. Section 409A was not intended to discourage U.S. citizens from taking jobs outside the U.S.

Applying U.S. legal requirements rules to broad-based foreign plans is not necessary to prevent avoidance of § 409A. It is not reasonable to believe that employees who wish to defer income tax on their compensation will seek to achieve that objective by taking jobs outside the U.S. and participating in bona fide broad-based foreign retirement plans.

d. Short-term deferral rule

In general, under the proposed regulations, a deferral of compensation does not occur if an employee actually or constructively receives compensation by the later of (i) the 15th day of the third month following the employee's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture or (ii) the 15th day of the third month following the employer's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture. *See* Prop. Reg. § 1.409A-1(b)(4).

(1) *Recommendation:* The regulations should explain how the short-term deferral rule applies where an employee's right to compensation ceases to be subject to a substantial risk of forfeiture on the last day of the applicable taxable year.

Rationale: If both the employee and the employer are calendar-year taxpayers, and the employee's right to compensation ceases to be subject to a substantial risk of forfeiture on December 31st of Year 1, the generally applicable deadline under the short-term deferral rule is March 15th of Year 2; on the other hand, if the substantial risk of forfeiture lapses on January 1st or 2nd of Year 2, the generally applicable deadline is March 15th of Year 3. The regulations should make this distinction clear.

(2) *Recommendation:* The regulations should make clear that an employee's right to be reimbursed by an employer for certain expenses (such as relocation expenses) is subject to a substantial risk of forfeiture until the employee receives a bill for those expenses and that, as a result, the reimbursement payments are covered by the short-term deferral rule if the reimbursement payment is made by the end of the short-term deferral period that is triggered by the employee's receipt of the bill.

Rationale: The employee's right to reimbursement is subject to a substantial risk of forfeiture because his right to be reimbursed is contingent on the occurrence of a condition (incurring an expense) related to the purpose of the compensation (to reimburse him for the expense) and the possibility of forfeiture is substantial: he will not be reimbursed unless he incurs the expense. *See* Prop. Reg. § 1.409A-1(d)(1).

e. Split-dollar insurance

The Preamble states that § 409A may apply to certain types of split-dollar life insurance arrangements, but indicates that if the only benefit that an employee receives under the arrangement is a death benefit (as defined in the regulations), the arrangement may be excluded from § 409A coverage. *See* 70 Fed. Reg. 57,941; *see* Prop. Reg. § 1.409A-1(a)(5) (referring to Treas. Reg. § 31.3131(v)(2)-1(b)(4)(iv)(C)).

(1) *Recommendation:* The regulations should make clear that § 409A does not apply to a split-dollar life insurance arrangement under which the employee obtains no interest in the insurance policy's cash surrender value.

Rationale: The Preamble reflects what we think is the correct analysis: if a split-dollar arrangement provides only death benefits to or for the benefit of the employee, the arrangement is excluded from the definition of deferred compensation plan on the ground that it is a death benefit plan.

2. Deferral Elections

a. First year of eligibility rule

Under the proposed regulations, an employee may make an initial deferral election within 30 days after the date the employee first becomes eligible to participate in a plan with respect to compensation paid for services after the election is made. For compensation that is earned on the basis of a performance period, where an election to defer compensation is made after the performance period starts, the election is deemed to apply to compensation for services performed after the election is made if the election applies to a fraction of the compensation, based on the ratio of the number of days in the performance period after the election is made to the total number of days in the performance period.

For purposes of the first year of eligibility rule, the "plan" is determined after applying an aggregation rule that treats two or more plans involving the employer and the employee as a single plan if the plans fall in the same category. In general terms, the regulations recognize four plan categories: (i) nonaccount balance plans, (ii) account balance plans, (iii) separation pay arrangements due to involuntary termination or participation in a window program, and (iv) all other plans (such as discounted stock options). *See* Prop. Reg. §§ 1.409A-1(c), -2(a)(6).

(1) *Recommendation:* The regulations should provide that the plan aggregation rule will be applied only in abusive cases to bar a participant from making a deferral election within 30 days after the employee first becomes eligible to participate in a plan.

Rationale: If the plan aggregation rule is incorporated into the first year of eligibility rule, the first year of eligibility rule could become almost meaningless for many large employers. For example, if an employee is promoted to a position in which the employee is eligible to defer compensation under a typical

salary deferral plan, the first year of eligibility rule will not apply unless the employer determines that the employee has never been granted a restricted stock unit or otherwise been eligible to participate in an account balance plan. It will be extremely difficult, if not impossible, for a major employer with operations throughout the world to make such determinations. It is no small task for a major employer to compile a complete and reliable record of all of the nonqualified deferred compensation plans for which every employee in its controlled group has ever been eligible.

The first year of eligibility rule should be applied principally on a plan-by-plan basis. To prevent abuse, the regulations could apply the plan aggregation rule, but limit its application to the current and immediately preceding years. For example, under this approach, the first year of eligibility rule would not apply if the employee were eligible, during the current or immediately preceding year, for another plan of the same type maintained by the same employer.

(2) *Recommendation:* The regulations should provide that in determining whether an employee is covered by the first year of eligibility rule, a plan may disregard any period of participation in the plan before the employee's most recent date of hire.

Rationale: Under the proposed regulations, if a newly-hired employee is assigned to a position in which the employee is eligible to elect to defer compensation under a nonqualified deferred compensation plan, the first year of eligibility rule will not apply unless the employer can determine whether, at some time in the past, the individual worked for the company (or a member of its controlled group) and was eligible to participate in the same deferred compensation plan or a plan that must be aggregated with that plan. This will be extraordinary difficult, if not impossible, for major employers to determine, and the penalty for being wrong will be severe. Accordingly, the final regulations should provide that prior periods of service are disregarded in applying the first year of eligibility rule.[3]

(3) *Recommendation:* The regulations should provide either (i) that the service ratio for performance compensation does not apply to an award to a newly hired employee or (ii) that the period included in the denominator of the service ratio does not start before an employee's date of hire.

Rationale: Although it might be appropriate to reduce the portion of a performance award that is eligible for deferral by an employee who is transferred to a position in which the employee is eligible for a performance award that

[3] The regulations might reasonably make an exception if the newly hired employee (i) has a vested benefit under the plan in question or (ii) is rehired within one year after having separated from service.

might reflect his service before the transfer, it does not seem appropriate to reduce the portion of an award that is eligible for deferral by a new hire. The regulations should recognize that the size of a new hire's award will necessarily be based solely on his services after his date of hire.

b. Performance-based compensation

Under the proposed regulations, an employee may make an initial deferral election with respect to performance-based compensation up to six months before the end of the performance period if (i) the employee performed services continuously from the date the performance criteria were established through the date he makes the initial deferral election and (ii) the election is made before the performance-based compensation has become both substantially certain to be paid and reasonably ascertainable. "Performance-based compensation" is defined as compensation where the amount of, or entitlement to, the compensation is contingent on the satisfaction of preestablished organizational or individual performance criteria for a performance period of at least 12 consecutive months in which the employee performs services. *See* Prop. Reg. §§ 1.409A-1(e)(1), -2(a)(7).

(1) *Recommendation:* The regulations should be revised to eliminate the requirement that an employee perform services continuously from the date the performance criteria are established through the date on which the employee makes an initial deferral election and the requirement that the election be made before the performance-based compensation is reasonably ascertainable.

Rationale: These restrictions are unnecessary. It should be sufficient that the election is made at least six months before the end of the performance period and before the performance-based compensation has become substantially certain to be paid.

(2) *Recommendation:* The regulations should make clear it that the crediting or payment of dividend equivalents with respect to a performance-based award does not prevent the performance-based award from qualifying as performance-based compensation.

Rationale: Even if the payment of dividends is substantially certain, the dividend equivalents should not prevent the remainder of the award from qualifying as performance-based compensation. This conclusion is consistent with Prop. Reg. § 1.409A-1(e)(1), which provides in part that performance-based compensation does not include "any amount or portion of any amount" that is not contingent on performance.

c. Forfeitable awards

Under the proposed regulations, an employee may make an initial deferral election with respect to compensation up to the 30th day after the employee obtains a legally binding right to the compensation if (i) the legally binding right relates to a payment in a subsequent year and is subject to a forfeiture condition requiring the employee's continued

services for a period of at least 12 months from the date the employee obtains the legally binding right and (ii) the election is made at least 12 months before the earliest date on which the forfeiture condition could lapse. *See* Prop. Reg. § 1.409A-2(a)(4).

(1) *Recommendation:* The regulations should be revised to make the forfeitable award rule available even if the award can vest before the end of the 12-month period in the event of a contingency such as the employee's death or disability.

Rationale: Death and disability benefits are not even subject to § 409A. *See* Prop. Reg. § 1.409A-1(a)(5) (referring to the definitions of disability pay and death benefit plan in the FICA regulations); Treas. Reg. § 31.3121(v)(2)-1(b)(4)(iv)(C) (for FICA purposes, benefits that vest early due to death or disability without any associated deferral opportunity are not deferred compensation).

(2) *Recommendation:* The regulations should be revised to make the forfeitable award rule available even if the award can vest before the end of the 12-month period *if* the employee is not permitted to elect to defer payment of any award that vests before the 12-month period ends.

Rationale: The forfeitable award rule should apply even if the award can vest early as long as the payment under any award that vests early cannot be deferred. For example, if an award can vest early due to a change in control of the employer or the employee's retirement, the forfeitable award rule should still apply to an employee who does not vest early under these provisions as long as any award that vests early cannot be deferred. In these circumstances, only those awards that have been subject to forfeiture for the required 12-month period will be eligible for deferral.

(3) *Recommendation:* The regulations should be revised to make the forfeitable award rule available for an entire award where a significant portion of the award is subject to a substantial risk of forfeiture for at least 12 months and the employee is not entitled to receive the portion of the award that is not subject to a substantial risk of forfeiture for at least 12 months until at least 24 month after that portion of the award vests.

Rationale: Many employers make multi-year awards that vest on a pro-rata basis on each anniversary of the grant date (*e.g.*, 25% per year over a four-year period). Where a grant is made after the beginning of the multi-year award period and before the first anniversary date, for example, it would be administratively cumbersome to allow the second, third, and fourth quarters of the award to be deferred but to forbid deferral of the first quarter (because it will not be subject to a substantial risk of forfeiture for at least 12 months).

d. Benefit restoration and wrap-around plans

The proposed regulations state that if a nonqualified deferred compensation plan provides benefits that are determined by reference to the formula under a qualified plan, or are offset by benefits provided by a qualified plan, and if the nonqualified plan meets certain requirements, none of the following will be treated as deferral elections or accelerated payments:

i. The way that the qualified plan responds to changes in statutory benefit limits;

ii. An employee's election to receive (or to forgo) a subsidized or ancillary benefit under the qualified plan;

iii. An amendment to the qualified plan that adds or removes a subsidized benefit or ancillary benefit, or that reduces or increases future benefit accruals;

iv. An employee's exercise of rights under a § 401(k) or similar plan, including a change in the employee's deferral election under that plan – but only to the extent that the deferrals under the nonqualified plan do not increase or decrease by more than the dollar limit on elective deferrals ($14,000 in 2005); and

v. An employee's exercise of rights under a qualified plan with respect to before-tax or after-tax contributions that affects the amounts credited under the nonqualified plan as matching contributions or other contingent contributions – but only to the extent that the contingent contributions under the nonqualified plan do not increase or decrease by more than the dollar limit on elective deferrals. *See* Prop. Reg. §§ 1.409A-2(a)(8), -2(b)(6), *Examples 12 & 13*, -3(h)(3).

(1) *Recommendation:* The regulations should be revised to eliminate the dollar limits (referred to in paragraphs iv. and v., above) on increases and decreases in the deferrals and contingent contributions under the nonqualified plan.

Rationale: The dollar limits are unnecessarily restrictive. As long as the underlying plan is tax-qualified, the appropriate limits apply to that plan. There is no need to subject nonqualified plans to dollar limits that were designed solely for qualified plans.

(2) *Recommendation:* The regulations should be revised to state that where a nonaccount balance plan provides benefits that are offset by an amount that is actuarially equivalent to the balance in the employee's matching contribution account under the employer's qualified defined contribution plan, neither a change in the matching rate under the qualified defined contribution plan (whether by plan amendment or otherwise) nor the employee's exercise of rights

under the qualified plan with respect to before-tax or after-tax contributions that affects the matching contributions under the qualified plan will be treated as deferral elections or as accelerated payments.

Rationale: The regulations should allow an employer to maintain a nonaccount balance plan that provides benefits which are reduced (or offset) by a variety of amounts, including the actuarial equivalent of the balance in the employee's matching contribution account under the employer's qualified defined contribution plan. The regulations should not discourage this sound benefit design.

(3) *Recommendation:* The regulations should allow an employee to make an initial benefit distribution election under his employer's nonaccount balance benefit restoration or wrap-around plan at any time before the first anniversary of the date when the employer initially determines, based on objective criteria, that the employee has accrued a benefit that plan. Alternatively, and at the very least, an employee should be permitted to make an initial benefit distribution election under such a plan at any time before the earlier of (i) the date on which the employee terminates employment or (ii) the date on which the employer initially determines, based on objective criteria, that the employee has accrued a benefit under the plan.

Rationale: In many instances, the employer does not know, until close to the date when an employee retires, that the employee has accrued a benefit under the employer's nonaccount balance benefit restoration or wrap-around plan. In view of this reality, the regulations should permit an employee to make an initial benefit distribution election during the first year following the employer's determination that the employee has accrued a benefit under the plan. *See* ¶ D.4.d, *infra.*

(4) *Recommendation:* If the Treasury and the Service are unwilling to adopt Recommendation (3), above, the regulations should at least allow an employee to make an initial benefit distribution election under a benefit restoration or wrap-around plan at any time before the first anniversary of the employee's initial participation in the plan.

Rationale: Because an employee often does not learn until after the fact that he has accrued a benefit under a benefit restoration or wrap-around plan, the regulations should at least allow an employee to make an initial benefit distribution election during the first year of participation in such a plan. *See* ¶ D.4.d, *infra.*

(5) *Recommendation:* The regulations should provide that the benefits distributed under a benefit restoration or wrap around plan that provides early retirement window benefits that parallel those offered by a qualified plan can be distributed either (i) at the same time and on the same schedule that applies to the

employee's benefits under the qualified plan or (ii) in accordance with an election that the employee makes at any time during the window period.

Rationale: Because an early retirement window that is offered under a qualified plan must satisfy the nondiscrimination requirements imposed by Code § 401(a)(4), employers often exclude some or all their highly compensated employees ("HCEs") from eligibility for the qualified plan window benefits and offer the excluded eligible HCEs the same window benefits under a nonqualified plan that they would have received under the qualified plan window (without regard to the compensation and benefit limits and nondiscrimination requirements that apply to qualified plans).

Because it makes little sense to distribute window benefits on one schedule and basic retirement benefits on another, the regulations should accommodate the special needs of early retirement windows. If the Treasury and the Service are unwilling to allow distributions under the two plans to be linked (as we recommend in clause (i), above), the regulations should at least allow a distribution election to be made during the window period on the ground that until the employee terminates employment and meets such other requirements as are imposed by the terms of the window (*e.g.*, execution of a release), he has only a contingent right to a future early retirement window benefit. *Cf.* Prop. Reg. §§ 1.409A-1(b)(1), -2(a)(12).

e. Involuntary and "good reason" terminations

The proposed regulations state that a separation pay plan that provides for separation pay upon an actual involuntary separation from service (or pursuant to a window plan) is not considered to provide deferred compensation if the plan meets certain requirements.

The regulations also provide that where, in connection with an actual involuntary separation from service, separation pay is the subject of bona fide, arm's length negotiations, the employee may make an initial deferral election at any time until he obtains a legally binding right to the payment. On the other hand, the proposed regulations' rule for nonelective deferred compensation arrangements states that where the employee has no right to elect the time (or form) of payment, the time (or form) of payment must be specified by the time the employee first has a legally binding right to the compensation.

Separation pay is defined by the proposed regulations as any compensation where one of the conditions to the right to the payment is voluntary or involuntary separation from service. The proposed regulations also provide that any payment that is a substitute for amounts deferred by an employee under a separate deferred compensation plan constitutes a payment or a deferral of compensation under the separate deferred compensation plan rather than a payment or deferral of compensation under a separation pay plan. *See* Prop. Reg. §§ 1.409A-1(b)(9)(i) & (iii), -1(m), -2(a)(9) & (12).

(1) *Recommendation:* The regulations should provide that the rule regarding bona fide, arm's length negotiations applies regardless of whether the employee's termination of employment is involuntary.

Rationale: There is no reason to limit the rule for arm's length negotiations to involuntary terminations of employment. In many cases, it is not clear whether an employee is departing voluntarily or involuntarily. If the terms of an employee's departure are negotiated at arm's length and the employer gives the employee an election regarding the time or schedule of a potential severance payment before the employee has a legally binding right to any payment at all, the consequences under § 409A should not depend on whether the employee's departure is "involuntary."

(2) *Recommendation:* The regulations should make it clear that the rule for nonelective arrangements can apply to the negotiations regarding a deferred compensation arrangement in connection with a voluntary termination of employment.

Rationale: We can think of no reason why the rule for nonelective arrangements would not apply in the context of a voluntary termination of employment, but it would be very helpful if the regulations said so explicitly.

(3) *Recommendation:* The regulations should make clear that an employee's termination of employment will be treated as involuntary if the employee "resigns" after the employer notifies him that his employment will be terminated.

Rationale: In such circumstances, the employee's "resignation" is cosmetic; in fact, his termination of employment is involuntary.

(4) *Recommendation:* The regulations should make it clear that if an employee is entitled to one set of benefits following an involuntary termination of employment ("IT Benefits") and to another set of benefits following a termination of employment for "good reason" ("GR Benefits"), (i) the IT Benefits are subject to a substantial risk of forfeiture and can be structured to qualify for the short-term deferral rule to the extent that they do not consist of GR Benefits and (ii) whether the GR Benefits are subject to a substantial risk of forfeiture depends on the facts and circumstances.

Rationale: An employee's entitlement to GR Benefits or deferred compensation benefits should not preclude the possibility that he might become entitled to *additional* benefits as a result of involuntary termination of employment and that those additional benefits could be structured to qualify for the short-term deferral rule. *See* 70 Fed Reg. at 57,940. If an employee is entitled to certain benefits in the event of a termination for good reason, the regulations should state explicitly that whether those benefits are subject to a substantial risk of forfeiture depends on the facts and circumstances. *See* Recommendation (5), below.

(5) *Recommendation:* The regulations should provide that an employee's right under a plan to receive payments following his termination of employment for "good reason" may be subject to a substantial risk of forfeiture, depending on the facts and circumstances.

Rationale: This recommendation is consistent with statement in the Preamble that "the regulations do not treat the right to a payment upon a separation from service for good reason *categorically* as a right subject to a substantial risk of forfeiture." *See* 70 Fed. Reg. at 57,941 (emphasis added). We are concerned that this statement might be misinterpreted to mean that a "good reason" provision *never* creates a substantial risk of forfeiture or does so only in unusual circumstances. The regulations should make clear that this is a misinterpretation.

(6) *Recommendation:* The regulations should provide that where an employee is entitled to benefits both in the event of an involuntary termination and in the event of a good reason termination, the employee's contingent right to the good reason benefits does not prevent the short-term deferral rule from applying to the involuntary termination benefits.

Rationale: Some have interpreted the Preamble to say that if an employee is entitled to benefits in the event of either an involuntary termination or a good reason termination, and the good reason termination benefits are not always payable within the short-term deferral period, the *entire arrangement* fails to qualify for the short-term deferral rule because the arrangement otherwise provides for the deferral of compensation. *See* 70 Fed. Reg. at 57,940-41. We do not believe that it is appropriate to deny the benefit of the short-term deferral rule to an employee who is involuntarily terminated, and who receives involuntary termination benefits within the short-term deferral period, merely because the employee would also have been entitled to benefits in the event of a good reason termination.

(7) *Recommendation:* If Recommendation (6), above, is not adopted, the Treasury and the Service should grant transition relief for benefits paid as a result of involuntary terminations occurring before January 1, 2007, pursuant to arrangements in effect before that date.

Rationale: The Treasury and the Service did not raise the issue of "good reason" terminations until October of 2005 and, even then, they raised the issue only in the Preamble to *proposed* regulations and invited comment on the issue. *See* 70 Fed. Reg. at 57,940-41. Because of the uncertainty regarding this issue, transition relief is both appropriate and necessary.

f. Commissions

The proposed regulations provide that where a service provider earns commission compensation based on payments that the service recipient receives from customers, the service provider is deemed to provide the services to which the commissions

relate solely in the year that the customer pays the service recipient and that, as a result, the service provider may make an initial deferral election with respect to commission compensation in the year preceding the year in which the customer pays the service recipient. *See* Prop. Reg. § 1.409A-2(a)(10), -2(b)(6), *Examples 7 & 8*; 70 Fed. Reg. at 57,945-46.

(1) *Recommendation:* The rule for commissions should be revised to treat a commission as earned in the year in which, in the absence of a deferral election, the commission would be paid by the service recipient, provided that (i) the customer pays the service recipient within the last 90 days of the year, and (ii) the service recipient processes the customer payment and the commission in accordance with its customary procedures.

Rationale: Service providers are accustomed to making (and service recipients are accustomed to processing) deferral elections with respect to commission payments in the year before the commissions are paid, rather than in the year before the customer pays the service recipient. Although the two payments (the payment by the customer to the service recipient and the payment by the service recipient to the service provider) often occur in the same year, this is not always so, since the service recipient needs time to process customer payments and to calculate and pay commissions. The regulations should accommodate the inevitable lag between the two payments and allow service providers to make deferral elections based on the service recipient's payment schedule rather than based on the customer's payment schedule.

3. Distribution Triggers.

a. Termination of employment

The proposed regulations state that whether a termination of employment has occurred is determined on the basis of the facts and circumstances. According to the proposed regulations, an employee is treated as having separated from service where he enters into an employment agreement with his employer, but the facts and circumstances indicate that the employer and the employee do not intend the employee to provide more than insignificant services for the employer. For this purpose, an employer and an employee are not treated as intending the employee to provide insignificant services where the employee continues to provide services for the employer as an employee at an annual rate that is at least equal to 20% of the services he rendered, on average, during his three most recent years of employment and his annual remuneration for those services is at least 20% of his average annual remuneration during his three most recent years of employment.

In addition, under the proposed regulations, an employee who is on a bona fide leave of absence (for any reason, such as to engage in government, charitable, or religious activity, to obtain additional education or training, or to address a health or family emergency) is treated as having terminated employment immediately after six months of leave unless the employee's right to reemployment is provided by statute or contract. *See* Prop. Reg. § 1.409A-1(h)(1)(i).

(1) *Recommendation:* The regulations should provide that an employee will not be considered to terminate employment merely because his duties are diminished as long as his employer continues to pay him his regular salary and to treat him as an active employee for purposes of the employer's benefit plans.

Rationale: If § 409A permitted deferred compensation plans to make distributions *only* after termination of employment, it might be appropriate to take an approach similar to that taken in the proposed regulations: to require all deferred compensation plans to adhere to a single, very specific definition of termination of employment. But since § 409A permits a plan to make distributions *before* termination of employment – for example, after a fixed number of years – it is far more important that the plan's definition of termination of employment be objective rather than it is for every plan to adopt the same definition of termination of employment.

The regulations should impose a consistency requirement rather than a uniform definition of termination of employment. An employee should not be considered to terminate employment for purposes of § 409A if his employer consistently treats him as its employee. On the other hand, if the employer treats the employee as a former employee for purposes of eligibility to receive distributions from its pension plan, the employee should be considered to have terminated employment.

A consistency requirement will also be easy to administer since it will be based on the employer's treatment of similarly situated employees whose employment has not terminated. By contrast, the proposed regulations' working time test will be difficult to administer, since few employers keep records of the working time of employees who participate in deferred compensation plans.

(2) *Recommendation:* The regulations should provide that an employee is not deemed to have terminated employment while he is on a bona fide leave of absence, even if the leave lasts longer than six months and he has no right to reemployment.

Rationale: A bona fide leave of absence has a legitimate purpose independent of any deferral that occurs while the employee is on leave. A bona fide leave of absence is not a device to defer compensation.

A requirement that the employee have a right to reemployment is unnecessary and inconsistent with common business practice. An employer does not typically alter the at-will employment relationship with an employee merely because the employee takes a leave for a bona fide purpose, such as to pursue additional training or education.

A reemployment right requirement would raise a host of questions that the regulations would have to resolve in order to provide meaningful guidance. For example, what restrictions could an employer impose on the employee's right to

reemployment? What if the employee's position has been filled or no longer exists? What if the employee's business unit no longer exists? What kind of position must be offered? On what terms must reemployment be offered? For what period must reemployment be continued? These questions are merely illustrative; the list of questions is virtually endless.

In addition, because the proposed reemployment right/six-month rule would require case-by-case determinations, this rule would be extremely difficult to administer and could curtail many existing leave policies that are highly beneficial to employees.

(3) *Recommendation:* The regulations should provide that an employee is not deemed to have terminated employment while he is on a bridge leave of absence if the leave (i) is taken by an employee who is within two years of qualifying for early retirement and (ii) lasts no longer than the period that the employee needs to qualify for early retirement benefits.

Rationale: Many employers offer "bridge leaves" to employees who are involuntarily terminated, or encouraged to terminate in a window program, at a time when they are approaching retirement eligibility. By allowing an employee to continue employment for purposes of becoming eligible for early retirement, a bridge leave ameliorates the impact of a reduction in force and makes it more attractive for employees to accept an offer of an early retirement window.

(4) *Recommendation:* The regulations should incorporate the rule in the "elapsed time" regulations under which an employee is not deemed to terminate employment before the first anniversary of the first day of *any* absence from service for a reason other than quit, retirement, discharge, or death. *See* Treas. Reg. § 1.410(a)-7(b)(2).

Rationale: Many nonqualified deferred compensation plans supplement or otherwise operate in tandem with qualified plans that use the elapsed time method. Other nonqualified plans independently use the elapsed time method. Because of the widespread use of the elapsed time method, it is inappropriate to require deferred compensation plans to adopt a rule that differs from the elapsed time rule.

(5) *Recommendation:* The regulations should permit a plan to provide that an employee is not deemed to terminate employment until the employee terminates employment with both the employer and entities with a specified affiliation with the employer (*e.g.*, entities in which the employer holds at least a specified ownership interest) regardless of whether those entities are part of the employer's controlled group.

Rationale: The regulations should allow a plan to incorporate an objective definition of "termination of employment" that imposes a *higher* standard than the regulatory definition of "termination of employment." For example, some

employers would wish to bar an employee from receiving a plan distribution until the employee has terminated employment with any joint venture in which the employer holds an ownership interest of 20% or more. There is no reason for prohibiting a plan from including an objective distribution provision that is more restrictive than what the regulations require.

b. Six-month rule

The proposed regulations provide that a payment due to a specified employee upon separation from service "may not be made before the date that is six months after the date of separation from service (or, if earlier, the date of death of the specified employee)."

The regulations further provide that, in general, specified employees are those employees determined to be key employees as of an identification date designated by the employer and that the employees determined to be key employees as of an identification date must be treated as specified employees for the 12-month period beginning on the first day of the fourth month following the identification date.

The regulations also state that where two corporations merge (or become members of the same controlled group), any employee of the merged corporation who was a key employee of either of the merging corporations immediately before the merger is a key employee of the merged corporation until the first day of the fourth month after the identification date of the merged corporation next following the merger.

In addition, the regulations state that a plan may provide that payment will be delayed where the employer reasonably anticipates that its deduction for the payment otherwise will be limited or eliminated by Code § 162(m), *provided* that the plan requires the payment to be made either (i) at the earliest date on which the employer reasonably anticipates that § 162(m) will not limit or eliminate the deduction or (ii) in the calendar year in which the employee separates from service. *See* Prop. Reg. §§ 1.409A-1(i), -2(b)(5)(i), -3(g)(2).

(1) *Recommendation:* The regulations should allow an employer to designate any date after the identification date and on or before the first day of the fourth month following the identification date as the date on which the key employee census for that identification date becomes effective.

Rationale: If an employer can assemble and act upon its key employee census before the fourth month following the identification date, the employer should be permitted to do so.

(2) *Recommendation:* The proposed rule to accommodate § 162(m) compliance should be modified to allow payment to be further delayed, if necessary, in order to comply with the six-month rule.

Rationale: This change is necessary to avoid a conflict between the § 162(m) rule and the six-month rule.

(3) *Recommendation*: The regulations' merger provision should be revised to state that if a nonpublic company (a corporation whose stock is *not* publicly traded on an established securities market or otherwise) is acquired by a public company (*e.g.*, by merging into the public company or into a member of the public company's controlled group), the employees of the acquired nonpublic company are not taken into account in determining the specified employees of the public company's controlled group until the effective date following the first identification date that occurs after the acquisition.

Rationale: The merger provision in the proposed regulations unnecessarily expands the number of specified employees by treating an acquired *nonpublic company*'s key employees as specified employees immediately after a merger into a public company's controlled group. The merger provision should apply only to the extent that the merging companies were covered by the six-month rule (*i.e.,* only to the extent their stock was publicly traded on an established securities market or otherwise) immediately before the merger.

(4) *Recommendation*: The merger provision should be revised to make clear whether it applies to transactions other than mergers.

Rationale: The merger provision makes one reference to transactions other than mergers ("or become part of the same controlled group of corporations so as to be treated as a single service recipient"), but otherwise refers exclusively to mergers. The scope of this provision should be clarified.

(5) *Recommendation:* The six-month rule should be clarified to state that a distribution to a specified employee upon separation from service "may not be made before the earlier of (i) the date that is six months after the date of the specified employee's separation from service or (ii) the date of death of the specified employee."

Rationale: This change eliminates an ambiguity that appears in both the statute and the proposed regulations.

c. Change in control

In general, according to the proposed regulations, a change in the ownership of a corporation occurs when one person (or a group) acquires stock of the corporation that (together with any stock that the person or group already holds) represents more than 50% of the total value or voting power of the stock of the corporation. In addition, the regulations provide that a change in the effective control of a corporation occurs when one person (or a group) acquires (or has acquired during a 12-month period) stock possessing 35% or more of the voting power of the stock of the corporation. *See* Prop. Reg. § 1.409A-3(g)(5)(v) & (vi).

(1) *Recommendation:* The 35% standard for a change in effective control should be reduced to 20% in the case of a corporation whose securities are readily tradable on an established securities market.

Rationale: Although the 35% standard might be appropriate for a closely-held corporation, a 20% standard is commonly and appropriately used to determine whether there has been a change in control of a major public corporation. We recognize that the appropriate standard is ultimately a matter of judgment and that the right standard might vary from company to company. That said, the 35% standard is far too high for the vast majority, if not all, of major public corporations. *See* Treas. Reg. § 1.280G-1, Q&A-28.

d. Plan termination

The proposed regulations provide that if certain conditions are met, a plan may permit payments to be accelerated due to the termination of the plan in connection with: (i) a corporate dissolution or bankruptcy, (ii) a change in control *if* all similar arrangements sponsored by the employer are also terminated, (iii) the termination of all plans that would be aggregated with the plan if the same employee participated in all of the plans, or (iv) other events and conditions that the Service may specify in the future. *See* Prop. Reg. § 1.409A-3(h)(2)(viii).

(1) *Recommendation:* The regulations should allow an employer that acquires a business to terminate any or all of the deferred compensation plans that are transferred to the buyer's controlled group as a result of the acquisition, as long as the termination occurs by the end of the first plan year that begins after the effective date of the acquisition.

Rationale: Section 409A should not require one company that acquires another company to preserve the acquired company's nonqualified deferred compensation plans. In some cases, it will be possible for the acquired company to terminate its plans before the acquisition occurs. In other cases, however, this will not be possible either because the buyer is acquiring only one subsidiary or division from the seller or because the acquisition occurs on such a fast schedule that the acquired company does not have sufficient time to address the issue. Congress, the Treasury, and the Service have long recognized that special rules are often required to apply the Code's benefit and compensation rules in the context of mergers and acquisitions. A special merger and acquisition rule is exactly what is required here. *See, e.g.*, Code § 410(b)(6)(C); Prop. Reg. § 1.409A-1(b)(5)(v)(D).

e. Disability

The proposed regulations state that an employee is considered disabled if (i) he is unable to engage in any substantial gainful activity due to a medically determinable physical or mental impairment that can be expected to result in death or to last for at least 12 months or (ii) he is receiving, by reason of such impairment, income replacement benefits for a period of at least three months under an accident and health plan covering the employer's employees. The regulations also state that a plan may provide that an employee will be deemed disabled if the Social Security Administration deems him to be disabled or if he is

determined to be disabled in accordance with a disability *insurance* program that uses the regulations' definition of disability. *See* Prop. Reg. § 1.409A-3(g)(4).

(1) *Recommendation:* The regulations should state that although a plan is *permitted* to provide that disability determinations will be governed by the Social Security Administration's determination or by the determination under a disability insurance program, a plan is not *required* to so provide. In particular, the regulations should state that the disability determinations also may be made by the Railroad Retirement Board, under the deferred compensation plan, or under an *uninsured* disability program that uses the regulations' definition of disability.

Rationale: The sole concern of the regulations should be whether the plan's disability distribution provisions are articulated and administered in accordance with § 409A and the regulations. The identity of the party who decides whether an employee is disabled is irrelevant -- just as the identity of the party who authorizes other distributions (*e.g.,* emergency distributions) under a deferred compensation plan is irrelevant.

4. Distribution Elections

a. Annuity options

The proposed regulations provide that a change in the form of a payment from one type of life annuity to another type of life annuity, before any annuity payment has been made, is not considered a change in the time and form of payment *if* the annuities are actuarially equivalent applying reasonable actuarial assumptions. The regulations define "life annuity" as a series of substantially equal periodic payments, payable not less frequently than annually, for the life (or life expectancy) of the employee or the joint lives (or life expectancies) of the employee and his beneficiary. *See* Prop. Reg. § 1.409A-2(b)(2)(ii).

(1) *Recommendation:* The annuity rule should not impose an actuarial equivalence requirement if (i) one of the annuity options is a single life annuity, (ii) the amount of the periodic payment under each life annuity option does not exceed the amount of the periodic payment under the single life annuity, and (iii) the annuity starts at age 50 or later.

Rationale: If a plan's annuity options meet the requirements specified by our recommendation, the differences in the annuity payments available under each option will not be large enough to justify requiring an election to be made long before the annuity starting date.

(2) *Recommendation:* The annuity rule should apply to a change in the *time* of payment as well as to a change in the *form* of payment if (i) one of the annuity options is a single life annuity, (ii) the amount of the periodic payment under each life annuity option does not exceed the amount of the periodic payment under the single life annuity, and (iii) the annuity starts at age 50 or later.

Rationale: The rationale for restricting the timing of distribution elections does not apply to an employee whose ability to elect his annuity starting date is narrowly circumscribed as we suggest.

(3) *Recommendation:* The annuity rule should provide that a life annuity does not fail to meet the "substantially equal" requirement merely because the amount of the annuity payment *increases* upon the death of the survivor annuitant (*e.g.,* under a "pop-up" annuity) or to reflect increases in the cost of living (*e.g.,* under an indexed annuity benefit) or merely because the amount of the payment *decreases* upon (i) the death of the employee (*e.g.,* under a 50% or 75% joint and survivor annuity), (ii) the death of the survivor annuitant (*e.g.,* under a joint annuity), (iii) the cessation or reduction of Social Security (or Railroad Retirement) supplements or disability benefits (*e.g.,* under an annuity that is paid with a Social Security (or Railroad Retirement) supplement), (iv) the attainment of Social Security (or Railroad Retirement) retirement age (or upon the commencement of Social Security (or Railroad Retirement) early retirement, survivor, or disability benefits) if the reduction in the payments is level and no greater than the applicable Social Security (or Railroad Retirement) benefit (*e.g.,* under a Social Security (or Railroad Retirement) level income option), or (v) recovery from disability (*e.g.,* under a disability benefit).

Rationale: If applied woodenly, the "substantially equal" requirement will exclude many conventional forms of annuity distribution that have been regarded as providing "substantially equal" payments for other purposes. The regulations under § 409A should, like the regulations that apply to qualified plans, accommodate these well-established and benign forms of annuity distribution. *See* Treas. Reg. §§ 1.402(c)-2, Q&A-5(b), 1.417(e)-1(d)(6).

(4) *Recommendation:* The annuity rule should be revised to make clear that a life annuity includes a life annuity with a term certain feature (such as a life annuity with a 10 years' certain feature, *i.e.,* an annuity that continues until the *later of* (i) the annuitant's death or (ii) the 120th monthly payment).

Rationale: A life and term certain annuity *is* a form of life annuity. The term certain feature simply assures that payments will continue for the remainder of the designated term if the annuitant dies before the end of that term. The Treasury and the Service have long recognized that a life and term certain annuity *is* a life annuity *See, e.g.,* Treas. Reg. § 1.401(a)(9)-6, Q&A-1(b).

b. Fixed schedule

The proposed regulations state that, in general, a plan may provide for payment on an objectively determinable date (or in an objectively determinable year) based on the occurrence of a permissible payment event or in accordance with a "fixed schedule" that is objectively determinable based on the date of the payment event. According to the regulations, amounts are payable at a specified time or pursuant to a fixed schedule if objectively determinable amounts are payable at a date or dates that are objectively

determinable at the time the amount is deferred. The regulations provide that a plan may allow for payment upon the earliest or the latest of more than one permissible payment events and that payment upon any such event must be made in accordance with a fixed schedule that is objectively determinable based on the date of the event. *See* Prop. Reg. § 1.409A-3(b), (c), (g).

(1) *Recommendation:* The regulations should make clear that a plan may provide for different payment schedules for different payment events, including events falling in the same general category (*e.g.*, separation from service), but that differ based on objectively determinable criteria (*e.g.*, voluntary quit vs. involuntary separation or involuntary separation due to a plant closing vs. involuntary separation for other reasons).

Rationale: Many plans provide for different payment schedules for different payment events. The applicable payment schedule frequently depends on the manner in which the employee's employment terminates (*e.g.*, voluntary quit vs. involuntary separation). The regulations should permit plans to continue to take this approach as long as the rules that determine the applicable payment schedule are based on objective criteria.

(2) *Recommendation:* The regulations should allow a plan to provide that the applicable payment schedule is determined by the employee's marital status on the payment or payment starting date.

Rationale: Because a participant's marital status can be objectively determined, the participant's marital status should be a permissible criterion for determining the applicable payment schedule. For example, a plan should not be deemed to violate the "fixed schedule" requirement if the plan provides that benefits will be paid as a single life annuity if the participant is unmarried on his annuity commencement date and, if the participant is married on that date, as an actuarially equivalent 50% joint and survivor annuity for the benefit of the participant and his spouse.

(3) *Recommendation:* The regulations should make it clear that a plan may provide that the date when an employee has completed a specified period of service, or has both attained a specified age and completed a specified period of service, will determine the distribution date and/or the distribution schedule (*e.g.,* a rule that distributions will be made in installments only if the employee separates from service after having attained at least age 55 and after having completed at least 10 years of service).

Rationale: Service criteria are commonly used to determine eligibility for various forms of distributions. Because service criteria are objectively determinable, they are just as acceptable as age criteria.

(4) *Recommendation:* The regulations should allow a plan to provide that the applicable payment schedule is determined by size of the employee's account

balance or the present value of the employee's benefit (provided that the plan specifies the assumptions to be used to determine present value, if applicable).

Rationale: Many plans provide that certain forms of distribution are available only if the employee's benefit is at least a certain size. Because the size of an employee's account balance or the present value of the employee's benefit can be determined objectively, a plan should be allowed to use such criteria to determine how benefits will be paid.

c. Taxable fringe benefits

The proposed regulations provide that a payment includes the provision of any taxable benefit in cash or in kind and also includes the cancellation or reduction of any amount of deferred compensation in exchange for any benefit that is excluded from gross income. *See* Prop. Reg. § 1.409A-2(b)(2)(i).

As explained earlier, we do not think that § 409A was intended to regulate employers' provision of noncash fringe benefits to retirees, and certainly not to the vast extent that has been proposed. However, because it is possible that the drafters will disagree with our views, we submit the following recommendations:

(1) *Recommendation:* The regulations should explain how an employer can provide taxable in-kind benefits to retirees without violating § 409A. In the following paragraphs, we describe three examples of approaches that the regulations should explicitly permit:

- *Example 1:* The employer allows a retiree to use the employer's aircraft for personal trips, but only if the retiree's use of the aircraft does not interfere with the employer's use of the aircraft, as determined by the employer in its sole discretion.

- *Example 2:* The employer allows a retiree to use the employer's aircraft for personal trips with an aggregate value of up to $X per year, subject to a "use it or lose it" rule: if the retiree does not make sufficient use of the aircraft to exhaust the $X limit in a year, the retiree will forfeit the unused portion of the $X limit.

- *Example 3:* The employer allows a retiree to use the employer's aircraft for personal trips with an aggregate value of up to $X per year, subject to a "cash-out" rule: if the retiree does not make sufficient use of the aircraft to exhaust the $X limit in a year, the employer will pay the unused portion of the $X limit in cash to the retiree by the last day of that year or as soon as administratively practical thereafter.

Rationale: Section 409A was not intended to prohibit an employer from providing noncash fringe benefits to retirees. If the regulations restrict an employer's freedom to provide noncash fringe benefits to retirees, it is

imperative that the regulations explain how an employer can do so without violating § 409A.

Each of the approaches identified in the foregoing examples should be permitted. Because the approach in *Example 1* does not give the retiree a legally binding right to the aircraft until he actually uses it, there is no deferral of compensation for purposes of § 409A. In both *Examples 2* and *3*, because the employer designates the maximum value that a retiree can access in any year, the approaches used in those examples meet the fixed schedule requirement of § 409A. The only difference between the approach in *Example 2* and the approach in *Example 3* is that in *Example 2* the employee forfeits the unused portion of the annual allowance. There is nothing in § 409A that indicates that the presence of a forfeiture condition prevents a plan from meeting the fixed schedule requirement.

d. Timing of participant's distribution election

The proposed regulations state that, subject to a number of exceptions, a plan meets the requirements of § 409A(a)(4)(B) only if the plan provides that compensation for services performed during a year may be deferred at the employee's election only if the election is made and becomes irrevocable before the beginning of that year. For the first year in which an employee is eligible to participate in a plan, the employee may make a deferral election within the first 30 days of initial eligibility, but only with respect to compensation for services to be performed after the election. According to the proposed regulations, an election to defer includes an election as to the time and/or form of payment. *See* Prop. Reg. § 1.409A-2(a).

(1) *Recommendation:* The regulations should give employees more time to make initial benefit distribution elections under benefit restoration and wrap-around plans, since both the employer and the employee are frequently unaware that the employee has accrued benefits under such a plan until well after the benefits have accrued. For example, the regulations might allow an employee to make an initial benefit distribution election under his employer's nonaccount balance benefit restoration or wrap-around plan at any time before the first anniversary of the date on which the employer initially determines, based on objective criteria, that the employee has accrued a benefit that plan. Alternatively, the regulations might allow an employee to make an initial benefit distribution election under such a plan at any time before the earlier of (i) the date on which the employee terminates employment or (ii) the date when the employer initially determines, based on objective criteria, that the employee has accrued a benefit under the plan. Another alternative would be to provide that an employee's initial benefit distribution election under such a plan will be timely if the election (I) is made before the first anniversary of the participant's accrual of a benefit under the plan and (II) does not become effective before the first anniversary of the date the election is made.

Rationale: Employees are often not aware they have accrued benefits under benefit restoration and wrap-around plans until after the fact. The regulations should give employees more time to make their initial distribution elections under such plans. *See* ¶ D.2.d, *supra.*

5. Anti-Acceleration Rule

Subject to a number of exceptions, the proposed regulations forbid a plan from permitting the acceleration of the time or schedule of any payment under the plan. Among the exceptions to this general rule are those for: (i) withholding of FICA tax and any required federal, state, local, or foreign income tax withholding due to the payment of FICA tax and (ii) income inclusion under § 409A itself. *See* Prop. Reg. §§ 1.409A-3(h)(1), -3(h)(2)(v), (vi).

a. RRTA tax

(1) *Recommendation:* The proposed exception to the anti-acceleration rule to permit the payment of FICA tax on compensation deferred under the plan should be expanded to cover any Railroad Retirement Tax Act ("RRTA") tax imposed on compensation deferred under the plan.

Rationale: We assume that the proposed regulations' failure to refer to the RRTA tax was simply an oversight.

b. State, local and foreign taxes

(1) *Recommendation:* The proposed exceptions to the anti-acceleration rule to permit the withholding of income taxes due to the payment of FICA tax on compensation deferred under the plan and for income inclusion under § 409A should be expanded to refer to the RRTA tax as well as to the FICA tax and to cover *all* federal, state, local, and foreign taxes that are required to be withheld from compensation deferred under the plan.

Rationale: The proposed exception for tax withholding is too narrow. An employer should be able to comply with all federal, state, local, and foreign tax withholding requirements without subjecting its employees to harsh consequences under § 409A.

c. De minimis rule

Under the proposed regulations, a plan may be amended to provide for the mandatory cash-out of benefits of $10,000 or less (including amounts deferred in the past as well as amounts to be deferred in the future) *if* the employee's interest in the arrangement and "all similar arrangements" is cashed out by the end of the calendar year in which the employee separates from service (or, if later, by the 15th day of the third month following the employee's separation from service). The proposed regulations also allow a plan to provide, or to be amended to provide, for the mandatory cash-out of *future* deferrals at the time

amounts are payable under the plan, but only if the employee's "entire interest under the plan" is distributed in a lump sum. *See* Prop. Reg. § 1.409A-3(h)(2)(iv).

(1) *Recommendation:* The regulations should be revised by increasing the $10,000 limit to $25,000.

The $10,000 limit is much too low. It will saddle deferred compensation plans and/or sponsoring employers with administrative costs that are disproportionate to the size of the benefits being administered. Amounts far exceeding $10,000 (certainly including $25,000) are small in the context of a great many nonqualified deferred compensation plans – most of which are restricted to (i) a select group of management or highly compensated employees (in accordance with ERISA's top-hat exemptions) or (ii) employees with qualified plan benefits exceeding the Code § 415 limits (in accordance with ERISA's "excess plan" exemption).

Section 409A is not an "anti-cutback rule" that protects participants in deferred compensation plans from having optional forms of distribution removed from their plans. Section 409A should not prevent employers from simplifying plan administration and reducing plan costs by cashing out deferrals of $25,000 or less in a lump sum.

(2) *Recommendation:* The regulations should provide that the plan aggregation rules are not required to be used to determine whether the de minimis rule applies.

Rationale: The plan aggregation rules would be extremely difficult to administer - for example, the present *value* of a benefit under a non-account balance plan might not be ascertainable at a time when the cash-out rules would require a payment from another non-account balance plan.

(3) *Recommendation:* The regulations should clarify that a cash-out of the participant's entire "interest under the arrangement" refers only to compensation subject to § 409A and excludes, for example, grandfathered amounts and other amounts that are not governed by § 409A.

Rationale: We assume that this is what the drafters intended. The "entire interest" requirement should take into account only amounts that are governed by § 409A; it should disregard benefits that are not governed by § 409A for *any* reason, *e.g.*, because the benefits are grandfathered, because the benefits represent current (rather than deferred) compensation, or because the benefits are excluded by § 409A itself or the regulations thereunder.

(4) *Recommendation:* The regulations should provide that if a plan is amended to provide for a mandatory cash-out with respect to future deferrals, the only amounts that are required to be cashed out are amounts deferred after the effective date of the amendment.

Rationale: One might think that this clarification would be unnecessary, since the proposed rule in question applies only to cash-outs of future deferrals. However, the proposed rule requires the employee's "entire interest under the plan" to be distributed in a lump sum.

We trust that the drafters intended the "entire interest" requirement to apply only to future deferrals. For example, if a plan is amended on December 31, 2007, to provide for the mandatory cash-out of post-2007 deferrals with a value of $50,000 or less, the plan should be permitted to cash out post-2007 deferrals that do not exceed the $50,000 limit, even though the amendment does not provide for the cash-out of pre-2008 deferrals.

(5) *Recommendation:* The regulations should permit a plan to be amended before January 1, 2007, to provide for the mandatory cash-out of all benefits under the plan that are subject to § 409A, at the time amounts are payable under the plan, provided that the payment is not made before January 1, 2007.

Rationale: The rule that we recommend is consistent with transition rule that now allows a plan to be amended to provide for new payment elections during 2006 as long as the amendment and the election apply to amounts that would not otherwise be payable in 2006 and do not cause an amount to be paid in 2006 that would not otherwise be payable in that year. *See* Notice 2005-1, Q&A-19(c), *as modified by* 70 Fed. Reg. 57,954-55.

6. Changes in Deferral Elections

The proposed regulations state that, subject to a number of exceptions, a plan that permits a subsequent election to delay payment or to change the form of payment meets the requirements of § 409A(a)(4)(C) if the plan satisfies certain conditions. Because the regulations do not identify or limit the parties who might make the subsequent elections that must meet these conditions, we are concerned that the conditions apply to elections by alternate payees and beneficiaries as well as to subsequent elections by participants.

In general, if a plan allows a subsequent election to delay a payment or to change the form of payment, (i) the subsequent election may not take effect for 12 months; (ii) a subsequent election that is related to a payment that is not triggered by disability, death, or emergency must defer payment (or the payment starting date) for at least five years; and (iii) a subsequent election that is related to a payment that is scheduled to be made at a specified time or under a fixed schedule may not be made less than 12 months before the scheduled payment date or payment starting date.

The proposed regulations also allow a plan to permit any acceleration of the time or schedule of payment to a person other than the employee that may be necessary to fulfill a domestic relations order. *See* Prop. Reg. §§ 1.409A-2(b)(1), -3(h)(2)(i).

a. Election by alternate payee or beneficiary

(1) *Recommendation:* The regulations should allow an alternate payee or beneficiary to make a distribution election at any time before he or she acquires a legally binding right to the payment.

Rationale: The generally applicable deferral election rules should, at the very least, permit an alternate payee or beneficiary to make a distribution election before he acquires a legally binding right to the distribution. *See* Prop. Reg. § 1.409A-2(a)(12).

(2) *Recommendation:* The regulations should expand the exception to the anti-acceleration rule for domestic relations orders to allow a plan to comply with an order that requires or permits an alternate payee to receive, or to elect to receive, a deferred payment or payments as well as an accelerated payment or payments.

Rationale: If a domestic relations order allows the alternate payee to elect alternate forms of distribution, the plan should not be deemed to have violated § 409A merely because it complies with the order.

(3) *Recommendation:* The regulations should allow a beneficiary to make a distribution election that (i) is made before the first anniversary of the participant's death and (ii) does not become effective before the first anniversary of the date the participant's death.

Rationale: Because beneficiaries often do not know that they are beneficiaries until after the employee's death, the regulation should allow beneficiaries to make a distribution election for a limited period of time after the employee's death.

b. 5-year delay

(1) *Recommendation:* The regulations should provide that if an employee elects initially to defer payment until the *earlier* of a designated date or the occurrence of a permissible payment event (such as separation from service), but subsequently wishes to postpone the designated date, the five-year delay rule requires the new date to occur at least five years after the previously designated date, but it does not require payment to be deferred for at least five years after the designated payment event.

Rationale: *See* the Rationale following Recommendation (3), below.

(2) *Recommendation:* The regulations should provide that if an employee elects initially to defer payment until the *later* of a designated date or the occurrence of a permissible payment event (such as separation from service), but subsequently wishes to postpone the designated date, the five-year delay rule requires the new date to occur at least five years after the previously designated date, but it does

not require payment to be deferred for at least five years after the designated payment event.

Rationale: See the Rationale following Recommendation (3), below.

(3) *Recommendation:* The regulations should provide that if an employee elects initially to defer payment until a permissible payment event occurs, but subsequently wishes to change the payment date until the *later* of a designated date or the occurrence of the previously-designated payment event, the five-year delay rule requires the new date to occur at least five years after the occurrence of the previously designated payment event.

Rationale: The first two recommendations recognize that when an employee wishes to change a designated payment date that is one of two designated alternative payment events or dates, the five-year delay should apply only to the payment date that is changed, and not to the payment event or date that is preserved. The third recommendation recognizes that when an employee wishes to change from one designated payment event to the later of that event or a designated date, the five-year delay rule requires the new payment date to occur at least five years after the payment event that the employee elected initially. The third recommendation is consistent with Prop. Reg. § 1.409A-2(b)(6), *Example 20,* which involves an employee who elects initially to defer compensation until he attains age 65, but subsequently wishes to change the payment date until the *later* of a predetermined age or separation from service. *Example 20* provides that the five-year rule is satisfied if the employee designates the later of age 70 (five years after the originally designated payment date) or separation from service.

7. Transition Provisions

a. New payment elections

Notice 2005-1, Q&A-19(c), allows a plan to be amended to provide for new payment elections without violating the restrictions that § 409A imposes on subsequent deferrals and accelerations, provided that the plan is amended and the participant makes the election by December 31, 2005. The Preamble extends this period through December 31, 2006, but provides that during 2006 an employee may not change payment elections for payments that he would otherwise receive in 2006 or cause payments to be made in 2006 if those payments would not otherwise be paid in 2006. *See* 70 Fed. Reg. at 57,954-55.

(1) *Recommendation:* The regulations should modify the election period originally made available in 2005 by Notice 2005-1, Q&A-19(c), and later extended by the Preamble until December 31, 2006, to permit changes in payment elections during 2006 where the change (i) relates to payments that would otherwise be made during 2006 or (ii) causes payments to be made in 2006 even though the payments are not otherwise scheduled to be made in that year.

Rationale: Because the proposed regulations were issued late in 2005, the restrictions that the Preamble imposes on payment elections that are made in 2006 will reduce significantly the value of extending the transition period beyond the end of 2005. Many employers and employees did not have sufficient time to review and analyze the proposed regulations and to provide for (and to make) payment elections during the last few months of 2005. As a result, the restrictions on payment elections that are made in 2006 will make the extended transition period unavailable to many of the people who are in greatest need of transition relief: those who retire in 2006.

b. Grandfathered benefits

The proposed regulations provide that the amount of compensation deferred before January 1, 2005, under a nonaccount balance plan is the present value (the "PV") as of December 31, 2004, of the amount that the employee would be entitled to under the plan if the employee voluntarily terminated employment on December 31, 2004, without cause and received a payment of benefits with the maximum value available from the plan on the earliest possible date that the plan allows the employee to receive a payment of benefits following termination of employment. For any subsequent year, the grandfathered amount may increase to equal the PV of the benefit that the employee actually becomes entitled to, determined under the terms of the plan as in effect on October 3, 2004, without regard to any additional services by the employee after December 31, 2004, or any other events affecting his benefits. *See* Prop. Reg. § 1.409A-6(a)(3)(i); 70 Fed. Reg. at 57,953.

(1) *Recommendation:* The regulations should make clear that, for purposes of determining the amount includible in income, and the related additional tax and interest, due to a violation of § 409A, the grandfathered amount is calculated on the basis of the PV of the benefit that the employee *is entitled (or becomes entitled) to receive,* rather than the PV of the benefit he *actually receives,* and that, as a result, an employee's grandfathered amount is not reduced merely because the PV of the pre-2005 benefit that the employee actually receives under the plan is less than the grandfathered amount. *See also* Recommendation (2), below.

Rationale: The statute and the regulations grandfather a benefit amount. Once that amount has been determined, it is grandfathered from the taxes and interest imposed by § 409A, regardless of whether the employee elects to receive his benefits under the plan on a schedule that maximizes the value of the employee's pre-2005 benefit.

(2) *Recommendation:* The regulations should make clear that the annuity benefits that were earned and vested under a nonaccount balance plan as of December 31, 2004 (and not the PV of those benefits) are grandfathered from the § 409A rules.

Rationale: The PV calculation called for by Recommendation (1) is relevant in determining the consequences of violating § 409A, but it should have no bearing on the operation of the plan.

8. Other Issues

a. Definition of account balance plan

(1) *Recommendation:* The regulations should state explicitly that an award of stock units (such as shadow stock, phantom stock, and restricted stock units) is treated as an account balance plan rather than as an equity plan for purposes of § 409A. This can be clarified by referring to "stock units" in the definition of account balance plan in Prop. Reg. § 1.409A-1(c)(2)(i)(A) and by using a term in Prop. Reg. § 1.409A-1(c)(2)(i)(D) other than "equity-based compensation" (such as "other stock value rights described in § 31.3121(v)(2)-1(b)(4)(ii)").

Rationale: A careful reading of the proposed regulations and the provisions of the FICA regulations to which the proposed regulations refer reveals that a stock unit award is treated as an account balance plan, rather than as an equity plan. *See* Prop. Reg. § 1.409A-1(c)(2); Treas. Reg. §§ 31.3121(v)(2)-1(c)(1)(ii)(A), -1(b)(4)(ii). We are concerned, however, that some might mistakenly assume that because stock units have some of the characteristics of equity awards, they are treated as equity plans for purposes of § 409A. Such an assumption would be reinforced by Prop. Reg. § 1.409A-1(e)(3), which appears to treat stock units as a form of "equity-based compensation."

b. List of required plan provisions

(1) *Recommendation:* The regulations should include a list of the provisions that a deferred compensation plan must include in order to satisfy the "form" requirements of § 409A.

Rationale: Because it is not clear which requirements of § 409A (and how much detail) must be set forth in the plan document and because the penalties for violating § 409A are so severe, it is essential that the Treasury and the Service publish a list of the issues that a deferred compensation plan must address (and the appropriate level of detail) in order for the plan to comply with § 409A in form. Although the Treasury and the Service might conclude that they do not wish to publish model plans or model plan provisions, a checklist of the kind we suggest would be extremely useful to employers and employees and will promote compliance with § 409A.

c. Reporting

(1) *Recommendation:* When the Treasury and the Service issue guidance on tax reporting issues relating to amounts deferred under non-account balance plans, the guidance should provide that where the employer uses the lag method to

report the related FICA wages in the first quarter of the calendar year following the calendar year in which the FICA wage amount becomes reasonably ascertainable, the employer may also delay reporting the deferred amount until the calendar year following the calendar year in which the amount is reasonably ascertainable. *See* Treas. Reg. § 31.3121(v)(2)-1(f)(3).

Rationale: The considerations that made it appropriate to allow the lag method to be used for FICA reporting also apply here.

d. Technical correction

(1) *Recommendation:* Prop. Reg. § 1.409A-1(b)(3) should be revised to change the mistaken reference to "service provider" to "service recipient" in the following phrase: "the normal timing arrangement under which the service **[recipient]** normally compensates non-employee service providers . . .."

We appreciate the opportunity to present these comments. If the Treasury or the Service has any questions about our comments, or if we can be of further assistance to the Treasury or the Service, please let us know.

THE ERISA INDUSTRY COMMITTEE