ERIC

THE ERISA INDUSTRY COMMITTEE

TESTIMONY
OF
JOHN M. VINE

HEARING
ON
THE PROPOSED REGULATIONS
UNDER SECTION 409A
REGARDING
NONQUALIFIED DEFERRED COMPENSATION PLANS

JANUARY 25, 2006

Good morning.

I appear today on behalf of The ERISA Industry Committee, commonly known as ERIC.

ERIC very much appreciates the opportunity to testify at this hearing.

ERIC **also** appreciates the thoughtful attention that the Service and the Treasury gave to the recommendations ERIC submitted before the proposed regulations were issued.

The proposed regulations respond constructively to many of ERIC's concerns.

This morning I will focus on **four** of ERIC's remaining concerns.

First, the proposed regulations' treatment of non-cash fringe benefits as deferred compensation.

The regulations should make clear that 409A does **not** apply to **nontaxable** fringe benefits.

There is no evidence in the statute or its legislative history that Congress was concerned with anything other than **taxable** compensation.

If a benefit is not taxable, whether it is received sooner or later should be of no concern under 409A.

The regulations should make clear that nontaxable benefits are **not** deferred compensation.

The provisions in the proposed regulations that suggest otherwise should be revised.

In addition, the regulations should make clear that 409A does not apply to those taxable fringe benefits that an employee receives both while working and thereafter.

There is no deferral of compensation in these circumstances.

The employee would have received the same fringe benefits even if he continued working.

Fringe benefits are subject to an extensive body of tax rules—including rules governing the treatment of **former** employees.

We are not aware of any evidence that Congress intended to modify those rules when it enacted 409A.

The 409A regime – which generally requires payments to be made **when scheduled** – is simply not compatible with the provision of fringe benefits – which are generally provided **when needed**.

The second area of concern relates to the treatment of stock options.

A nonstatutory option should **not** be deemed to provide deferred compensation merely because the **employer waives its right to terminate the option** before the end of the full option term.

A typical case involves an employee who is granted an option with a 10-year term.

The employee is laid off before the end of the 10-year term, and while the option is still outstanding.

Even though the option might provide that it terminates immediately in these circumstances, the employer might wish to waive early termination and allow the option to remain outstanding for the remainder of the 10-year term.

The proposed regulations treat this as an extension.

They say that when an option is extended, the option is treated as having had an additional deferral feature **from the original date of grant**.

Although the proposed regulations exempt **very short extensions**, the **general rule** is that when an option is extended, it is tainted **retroactively** by the addition of a new deferral feature.

But the employer is not really adding a new deferral feature in these circumstances.

The employer merely allows the employee to hold the option until the end of the original 10-year term.

The only deferral is the deferral that was contemplated when the option was granted.

The regulations allow an employer to grant options that do not include automatic early termination provisions, but that give the employer discretion **– negative discretion –** to terminate the option early.

The objectives of 409A are not served by barring an employer from exercising **positive discretion** when the regulations permit the employer to achieve the same result with **negative discretion**.

ERIC urges the Treasury and the Service either to withdraw the proposed rule on extensions or to apply the rule only when the employer extends **the original full term of the option**.

The **third** area of concern relates to the **proposed restrictions on payment elections – elections regarding the time and form of payment.**

Many of the problems arise under defined benefit plans -- what the regulations call **nonaccount balance plans**.

These plans are typically **nonelective:**

they do not allow an employee to elect to defer current compensation.

But these plans generally allow the employee to make a payment election **–** an election regarding **the time and form of payment**.

Under the regulations, an initial payment election must be made before the start of the year in which the employee earns the deferred compensation to which the election applies.

As a practical matter, it can be **extremely difficult**, if not impossible, for an employee to meet the advance election requirement.

- New participants often receive **credit for their past service**. When they enter the plan, it might be too late for them to make initial payment elections regarding past service benefits.

- If a new participant had previously been eligible for another nonaccount balance plan maintained by one of the employer's affiliates, the regulations' proposed aggregation rule would prevent him from using the exception for newly eligible participants.

- Under a **benefit restoration plan** -- a plan that provides benefits that the employer's qualified plan cannot provide -- the employer and the employee often do not learn, **until after the fact**, that the employee has accrued benefits under the restoration plan:

By then, according to the proposed regulations, it is **too late** to make an initial payment election.

I would like to make five suggestions that would help to **alleviate problems like these** under nonaccount balance plans:

First, make the aggregation rules inapplicable to payment elections.

Second, allow a newly eligible participant's initial payment election to apply to benefits accrued before the election is made.

Third, give a participant more time to make an initial payment election -- for example, until the first anniversary of the date he began accruing benefits under the plan.

Fourth, allow a participant to shift from one type of life annuity to another without treating it as a change in the time or form of payment.

Allowing participants to shift freely from one type of life annuity to another will reduce the pressure on their initial payment elections.

As we explain in our written comments, the proposed life annuity rule is far too narrow and leaves out many annuities that it should cover.

Fifth, when a benefit restoration plan provides early retirement window benefits that parallel those offered by a qualified plan, the restoration plan should be permitted to distribute benefits **on the schedule that applies under the qualified plan.**

The proposed regulations offer **some relief** for window plans, but **only under very limited conditions**.

The fourth area of concern is the proposed regulations' treatment of separation from service as a payment event.

In ERIC's view, the proposed regulations' approach is too restrictive.

The statute says only that unless another exception applies, a plan may not distribute benefits **earlier than** separation from service.

A plan meets this requirement if its definition of separation from service is **at least as stringent as the regulations' definition and is sufficiently objective to prevent abuse**.

Some specific suggestions:

First, allow a plan to provide that an employee is not deemed to terminate employment until the employer stops compensating him as an active employee.

Second, allow a plan to follow the "elapsed time" rules.

Under the elapsed time rules, an employee is not deemed to terminate employment **before the first anniversary of the start of a period of absence**.

Third, allow a plan to provide that an employee is **not** deemed to terminate employment until he terminates employment with both the employer and **designated companies that are outside the employer's controlled group**.

Fourth, allow a plan to 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 the employee has no right to reemployment**.

ERIC would welcome the opportunity to discuss these suggestions with you in more detail and to assist you in assuring that the regulations are both practical and consistent with the objectives of 409A.

That completes my prepared statement. I will be happy to answer any questions.