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Committe

May 10, 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:
Compliance With Conflict-of-Interest Requirements
(Prop. Treas. Reg. § 1.409A-3(h)(2)(ii))

Ladies and Gentlemen:

On behalf of The ERISA Industry Committee ("ERIC"),[1] I am pleased to submit this comment on the proposed regulations under Code § 409A regarding nonqualified deferred compensation. This comment supplements the comments that ERIC submitted on the proposed regulations on January 3, 2006.

Summary. ERIC recommends that the Treasury and the Service revise the conflict-of-interest exception in proposed § 1.409A-3(h)(2)(ii) –

(a) to make the exception applicable to individuals employed by any of the three branches of the Federal Government or by a State or local government or government agency,

(b) to make the exception applicable to employees who do not receive a § 1043 certificate of divestiture, and

[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 both the demands of their enterprise and the needs of their 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.

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(c) to clarify that the exception also applies to the six-month delay rule for payments due to specified employees upon separation from service.

Discussion. Government agencies commonly recruit experienced executives from the private sector to fill important agency positions. On occasion, a government official can be called upon to make, or to participate in making, a decision that affects, or that might affect, the official's former employer. Indeed, in some cases, the government official might be called upon to participate in decisions affecting the deferred compensation payments that the former employer is required to make to the official (for example, where the deferred compensation is credited with interest, and the government official is called upon to participate in a decision that affects the applicable interest rate).[2]

Conflict-of-interest rules are designed to prevent a government official from having interests that might influence, or be perceived to influence, the official's decisions. Because conflict-of-interest rules are designed to promote the integrity and quality of government decisions and to promote public confidence in those decisions, the conflict-of-interest rules advance fundamental, and extraordinarily important, public policy objectives.

Consider the following situation: (a) an employee is entitled to receive deferred compensation from his or her employer in the private sector; (b) the employee leaves his or her job in the private sector in order to accept a government position; (c) in the new position, the official is required to make regulatory decisions directly affecting the official's prior employer; and (d) the applicable conflict-of-interest rules require the official to take an immediate distribution of the present value of the deferred compensation that the official earned under the prior employer's plan.

In the past, an employee could address such conflict-of-interest concerns by persuading the private-sector employer to distribute the present value of the deferred compensation payments when the employee switched positions. Section 409A, however, makes it very difficult to address conflicts of interest in this way.

Under Code § 409A(a)(3) and Proposed Regulation § 1.409A-3(h)(1), deferred compensation payments may not be accelerated except as provided in the Treasury's regulations. The legislative history of § 409A reveals that Congress intended the Treasury to create an exception for employees who seek to comply with conflict-of-interest requirements:

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

> "It is intended that the Secretary will provide other, limited exceptions to the prohibition on accelerated distributions, such as when the accelerated distribution is required for reasons beyond the control of the participant and the distribution is not elective. For example, it is anticipated that an exception could be provided if a distribution is needed in order to comply with Federal conflict of interest requirements or a court-approved settlement incident to a divorce." H.R. (Conf.) Rep. 755, 108th Cong., 2d Sess. 731 (2004).

Proposed § 1.409A-3(h)(2)(ii) appears to be intended to provide the conflict-of-interest exception that Congress contemplated. The proposed regulation allows the time or schedule of a deferred compensation payment to be accelerated "as may be necessary to comply with a certificate of divestiture (as defined in Code § 1043(b)(2))."

However, as currently drafted, proposed § 1.409A-3(h)(2)(ii) fails to achieve Congress's objective – to allow employees to comply with government conflict-of-interest requirements without becoming subject to punitive tax consequences under § 409A:

1. The proposed regulation applies only to the conflict-of-interest requirements of the Executive Branch of the Federal Government. The regulation also should apply to the other branches of the Federal Government (the Congress and the Federal Judiciary) and to State and local governments.

2. The proposed regulation applies only to an employee who receives a certificate of divestiture under Code § 1043. Section 1043 applies only to an individual who wishes to sell *property* in order to comply with a federal conflict-of-interest rule and who would otherwise realize *capital gain income* from the sale (for example, by selling shares of common stock that the individual holds).[3] The right to receive deferred compensation is not treated as property under the Code, and deferred compensation payments are taxed as ordinary income, rather than as capital gain. Accordingly, the proposed regulation should be revised to allow an employee to accelerate receipt of deferred compensation payments without violating § 409A.

Unless these revisions are made, § 409A is likely to have unintended, adverse consequences. To the extent that responsible government officials retain their rights to receive deferred compensation from their former employers, government officials are likely to be required to recuse themselves from important matters more frequently. In addition, because of the increased frequency of recusal, government agencies are likely to have greater difficulty in identifying and hiring experienced people who are able and willing to fill

[3] *See* Code § 1043; 5 C.F.R. § 2634.1001(a).

important positions. It also is possible that the inconsistency between the conflict-of-interest rules and § 409A will result in more frequent violations of the conflict-of-interest rules and/or § 409A. The legislative history of § 409A, quoted earlier, makes it clear that this is the *opposite* of what Congress intended.

Recommendation. ERIC recommends that the conflict-of-interest exception be expanded so that the exception applies to the other two branches of the Federal Government (the Congress and the Federal Judiciary) and to State and local governments, and so that the availability of the exception does not depend on the receipt of a § 1043 certificate.

We understand that the drafters of the regulation believe that the conflict-of-interest exception should be circumscribed so that it cannot be exploited by someone who seeking to evade the requirements of § 409A.

In order to address this concern, we suggest that the exception should apply only if the employee furnishes to the administrator of the plan in question *either* (1) a written statement, signed by a responsible official at the government agency in question, affirming that accelerating the deferred compensation payment is reasonably necessary to comply with the conflict-of-interest rules that apply to the employee *or* (2) a written opinion from a lawyer engaged by the employee, stating that, in the lawyer's opinion, accelerating the employee's deferred compensation payment is reasonably necessary to assure that the employee complies with the applicable conflict-of-interest rules.

We think that the restrictions described in the preceding paragraph will prevent abuse. However, if the Treasury and the Service believe that additional measures are necessary, the regulation also could require the employee to submit, under penalties of perjury, copies of the written statement or opinion to (a) the IRS and (b) if the employee's lawyer furnishes an opinion in accordance with clause (2) in the preceding paragraph, the government agency's chief ethics or legal officer.

Proposed § 1.409A-3(g)(2) provides that the conflict-of-interest exception applies to the six-month delay rule in § 409A as well as to the anti-acceleration rule. We suggest clarifying this point (and making the regulation somewhat more user-friendly) by including a cross-reference to § 1.409A-3(g)(2) in § 1.409A-3(h)(2)(ii).

If the Treasury or the IRS has any questions about this comment, or if we can otherwise be of assistance, please let us know.

Respectfully submitted,

Mark J. Ugoretz
President

cc: Daniel Hogans
Stephen Tackney