ERIC

ADDITIONAL RECOMMENDATIONS
OF
THE ERISA INDUSTRY COMMITTEE
TO THE TREASURY DEPARTMENT
FOR GUIDANCE
UNDER INTERNAL REVENUE CODE § 409A
REGARDING
NONQUALIFIED DEFERRED COMPENSATION

November 23, 2004

Table of Contents

Page

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

On November 3, 2004, ERIC submitted its recommendations regarding a number of pressing issues under § 409A. This submission supplements ERIC's prior recommendations. ERIC anticipates submitting additional recommendations in the future.

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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.

A. Highlights

Among the recommendations made in this submission are recommendations regarding:

- Compensation paid promptly after it is earned;
- Severance and other employment-termination payments;
- Stock appreciation rights;
- Benefit restoration plans;
- Performance-based compensation;
- The 6-month delay rule for key employees;
- Deferrals governed by prior law; and
- Transition rules.

B. Discussion

1. Nonqualified Deferred Compensation Plans

a. Compensation Paid Promptly After It Is Earned

(1) *Recommendation:* The Treasury should make clear that a bonus that is paid promptly (for example, within 2-1/2 months) after the amount of the bonus is determined is not deferred compensation -- regardless of whether the bonus is paid within 2-1/2 months after the close of the taxable year (or years) in which the relevant services are performed.

Rationale: Compensation is not deferred if the compensation is paid as soon as reasonably possible after the amount of the bonus is determined. The Statement of Managers provides (at p. 525) that § 409A does not apply to annual bonuses or other annual compensation amounts paid within 2-1/2 months after the close of the taxable year in which the relevant services are performed. This statement does not purport to set forth the exclusive test for determining whether a payment constitutes deferred compensation. The Statement of Managers' 2-1/2 month rule addresses the case where the amount of the bonus is determined or determinable before the end of the taxable year, but where the employer does not pay the deferred compensation until the following year. In other cases, however, bonus amounts are not determined until after the end of the taxable year (for example, where bonuses are determined on a discretionary basis long after the close of the year or where bonus amounts hinge on external information regarding the performance of the company's competitors and where that information is not available until well after the close of the year); in such cases there is no deferral as long as the bonus is paid promptly after the amount of the bonus is determined. Likewise, a bonus paid promptly after the amount of a multi-year bonus is determined should not be treated as deferred compensation; in such circumstances -- where the bonus is paid promptly after it is determined -- the payment of compensation is not deferred.[2]

b. Sign-On Bonuses

(1) *Recommendation:* If an employer pays a sign-on bonus to a newly hired employee, contingent on the employee's completion of a specified period of service, the arrangement should not be treated as a deferred compensation plan as long as the bonus is paid promptly following completion of the specified service period.

Rationale: If the sign-on bonus is paid as soon as it has been earned, it is not deferred compensation. *See* ¶ 1.a(1), above.

c. The 2-1/2 Month Rule

(1) *Recommendation:* The Treasury should issue guidance stating that arrangements that provide for a lump-sum payout within 2-1/2 months after the end of the period (including a multi-year period) in which the compensation becomes vested (or, if later, within 2-1/2 months after the date when the compensation is otherwise no longer subject to a substantial risk of forfeiture) are not deferred compensation plans.

Rationale: If payment is made in a lump sum during the year of vesting (or, if later, the year in which there is otherwise no longer a substantial risk of forfeiture) or immediately thereafter, there is no significant deferral between the time when the compensation is earned and the time when the compensation is paid. *See* ¶ 1.a(1), above.

(2) *Recommendation:* The Treasury should issue guidance stating that the 2-1/2 month rule applies to fiscal-year plans.

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[2] The Statement of Managers' comment regarding payments within 2-1/2 months after the close of the year appears to relate to payments covered by the 2-1/2 month rule in Treas. Reg. § 1.404(b)-1T, Q&A-2, which allows an accrual-basis taxpayer to deduct compensation paid within the first 2-1/2 months of the following year (notwithstanding Code § 404(a)(5)) *if the compensation is otherwise deductible in the earlier year* (*e.g.*, "salary under an employment contract or a bonus under a year-end bonus declaration"). The 2-1/2 month rule under § 404 does not apply to discretionary bonuses that are determined and paid in the year following the year for which they are awarded: because such bonuses are not determined in the earlier year, such bonuses may not be deducted in that year regardless of whether they are paid within the first 2-1/2 months of the following year.

Rationale: According to the Statement of Managers (at p. 525), § 409A does not apply to annual bonuses or other annual compensation amounts paid within 2-1/2 months after the close of the *taxable year* in which the relevant services are performed. There is no principled reason for not applying this rule to fiscal-year plans on the basis of the plans' fiscal years.

d. Ongoing Severance Plans

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

Rationale: The Department of Labor safe harbor differentiates a severance plan from a pension or deferred compensation plan. Although it is often difficult to distinguish a severance plan from a pension or deferred compensation plan, there is no reason to draw the line at a point that differs from where Department of Labor has drawn it. Of course, if the plan gives the employee an election to defer receipt of his or her severance pay, the deferral arrangement would be subject to the provisions of § 409A.

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

Rationale: A plan that provides benefits only in the event of involuntary termination of employment, and that does not give employees an election to change the payment schedule, is not the kind of plan at which § 409A is directed. It is well established that, for federal tax purpose, such plans are *not* deferred compensation plans.[3]

e. Ad Hoc Severance Arrangements And Settlements

(1) Recommendation: An ad hoc severance arrangement that is negotiated with an employee in connection with the employee's termination of employment, and that prescribes the payment schedule (without giving the employee any deferral or acceleration elections), should not be treated as a deferred compensation plan.

Rationale: Ad hoc severance arrangements are often accompanied by a release that resolves pending disputes and eliminates the employer's potential liabilities. If these

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

ad hoc arrangements were covered by § 409A, it might be argued that, during the negotiations between the parties, the employee was presented with impermissible "elections" under § 409A(a) regarding the distribution schedule under the arrangement. In addition, if § 409A applied, the six-month delay required by § 409A(a)(2)(B)(i) for distributions to key employees would make it very difficult for public companies to enter into such arrangements with key employees. We are not aware of any evidence in the legislative history of the AJCA suggesting that, when Congress enacted § 409A, it intended to treat individually negotiated severance arrangements as nonqualified deferred compensation plans. *See* ¶ 1.d(2), above.

(2) *Recommendation:* The Treasury should make clear that a nonqualified deferred compensation plan does not include an ad hoc voluntary or involuntary severance plan or arrangement (including a voluntary window program) that requires an employee to terminate employment in the same taxable year in which the plan or arrangement is created and that provides that all benefits under the plan or arrangement (other than welfare benefits) will be paid in the year of termination.

Rationale: Because of the ad hoc nature of this arrangement, the severance pay relates only to services performed after the arrangement is created, and as long as payment is made in the same taxable year in which the arrangement is created, there is no deferral of compensation. If ad hoc bonus payments are not deferred compensation -- and clearly they are not -- then neither are ad hoc severance payments. *See* Treas. Reg. § 31.3121(v)(2)-1(b)(4)(v); *see also* ¶¶ 1.d(2) & 1.e(1), above.

(3) *Recommendation:* Payments made to settle an employment-related grievance or lawsuit (whether actual or threatened) should not be treated as deferred compensation for purposes of § 409A as long as the settlement agreement does not give the employee an election to defer or accelerate payment.

Rationale: Section 409A was not intended to restrict the terms on which bona fide employment disputes can be settled. Even though such disputes are often settled pursuant to an agreement that provides for payments over a period of years, these payments represent consideration for the release of a claim rather than deferred compensation within the meaning of § 409A. If the Treasury reaches a contrary conclusion, it should, at the very least, make clear that the advance election requirement in § 409A(a)(4) does not apply in these circumstances since the employee does not elect under such settlement agreements to defer the receipt of compensation that is otherwise payable to the employee.

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

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

f. Consideration For A Release

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

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

g. Stock Appreciation Rights

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

Rationale: Market-value SARs are economically and functionally equivalent to nonqualified stock options with an option price equal to the fair market value of the option shares on the date of grant. Since such undiscounted options are not treated as providing deferred compensation under § 409A, it makes no sense to treat market-value SARs differently.

(2) *Recommendation:* If the Treasury does not accept the recommendation in ¶ 1.g(1), above, the Treasury should at least make it clear that an SAR does not violate the requirements of § 409A if an employee elects the payment date under the SAR in advance in accordance with § 409A (by electing, for example, that payment will be made on the first day of the month following the expiration of the SAR), and the SAR allows the employee to exercise the SAR at any time (on or after the vesting date and on or before the expiration date) and credits interest (or hypothetical investment experience) on the gain on the SAR between the exercise date and the designated payment date.

Rationale: Under § 409A, an SAR could provide that payment will be made upon the expiration of the SAR (or upon a later date elected by the employee in accordance with § 409A), and the SAR could allow the participant to exercise the SAR at any time before the SAR's expiration date and provide that any gain realized by the employee upon the exercise of the SAR will be credited with interest (or hypothetical investment experience specified by the SAR or elected by the participant) between the exercise date and the payment date. An SAR designed in this way gives the employee control over the time and form of distribution only to the extent permitted by § 409A. By allowing the employee to decide when to exercise the SAR, the SAR gives the employee the ability to influence the arrangement's hypothetical investment experience. Since § 409A does not regulate the plan provisions governing an employee's hypothetical investment options, this design is entirely consistent with § 409A.

h. Nonqualified Employee Stock Purchase Plans

(1) *Recommendation:* A nonqualified employee stock purchase plan under which the option price is no less than the lowest option price allowed by IRC § 423 should not be treated as a nonqualified deferred compensation plan.

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

i. Post-Employment Perquisites

(1) *Recommendation:* Post-employment perquisites should be excluded from the definition of nonqualified deferred compensation, as long as the perquisites are (i) provided in kind (rather than by cash reimbursement), (ii) not cash equivalents, and (iii) not transferable.

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

j. Compensation For Post-Employment Service

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

Rationale: Compensation for bona fide current service as a director or consultant is compensation for current service, not deferred compensation for prior service as an employee.

2. Deferrals Governed By Prior Law

a. Vesting Of Prior Deferrals

(1) *Recommendation:* Compensation that is otherwise earned and vested before January 1, 2005, should not be treated as non-vested merely because it is subject to forfeiture pursuant to a "bad boy" clause under which the executive's rights can be forfeited if the executive engages in misconduct or violates non-competition or non-solicitation covenants.

Rationale: Deferred compensation should not be treated as non-vested merely because of the possibility that it might be forfeited due to conduct that is unlikely to occur. *See* Treas. Reg. § 1.83-3(c) (definition of "substantial risk of forfeiture").

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

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

b. Rabbi Trusts

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

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

c. Material Modifications

(1) Recommendation: A defined benefit restoration plan[4] should not be considered to be materially modified merely because the plan provides additional benefits as a result of an amendment that increases the benefits provided by the tax-qualified plan that the benefit restoration plan supplements. Likewise, a defined contribution spillover plan[5] should not be considered to be materially modified merely because the plan accepts additional deferrals as a result of an amendment to the tax-qualified plan that the spillover plan supplements.

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

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

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

(3) Recommendation: A defined contribution plan should not be considered to be materially modified merely because the plan adds a phantom investment fund that mirrors the performance of a publicly available investment or investment fund or that otherwise provides a market rate of return.

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[4] For this purpose, a "defined benefit restoration plan" refers to a nonqualified plan that provides benefits that a particular qualified defined benefit plan cannot provide because of certain limits or restrictions that the benefit restoration plan identifies (*e.g.*, the § 415 limits on benefits, the § 401(a)(17) limit on compensation, and the qualified plan's definition of compensation or service).

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

Rationale: In these circumstances, the plan's benefits are not materially increased. Participants' deferral and distribution rights -- the chief concerns of § 409A -- are not affected by the addition of a new phantom investment fund. Moreover, as long as the new phantom investment fund offers no better than a market rate of return, the addition of the fund does not increase the value of the benefits that the plan provides.

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

Rationale: If the material modification does not affect certain benefits under the plan (*e.g.*, the benefits earned by certain participants or the benefits earned before a specified date), the unaffected benefits should continue to be grandfathered just as if they had been provided under a separate plan.

(5) *Recommendation:* A nonqualified deferred compensation plan in existence on October 3, 2004, should not be considered to be materially modified merely because, after October 3, 2004, the sponsoring employer adopts a similar plan that applies to future deferrals and complies with § 409A.

Rationale: In enacting AJCA § 885 and Code § 409A, Congress intended to allow employers to do this very thing: to continue their existing plans for pre-2005 deferrals and to establish new § 409A-compliant plans for post-2004 deferrals. Congress did not intend to penalize the employees of employers that establish new § 409A-compliant plans.

(6) *Recommendation:* If a plan is amended to apply the § 409A rules to amounts deferred after December 31, 2004, the plan should not be considered materially modified.

Rationale: An employer should not be required to establish a separate plan for post-2004 deferrals. If an employer amends an existing plan to apply the § 409A rules to amounts deferred after 2004, and does not alter the provisions that apply to the pre-2005 deferrals, the pre-2005 deferrals have not been modified and should continue to be governed by prior law.

(7) *Recommendation:* A nonqualified plan should not be considered to be materially modified merely because, in accordance with the plan provisions in effect on October 3, 2004, the plan is terminated and benefits are distributed on an accelerated basis.

Rationale: The plan should not be considered to be materially modified for two reasons. First, because termination is an action taken pursuant to an existing plan provision, it is consistent with the terms of the plan rather than a modification of the plan. Second, because termination of the plan reduces participants' rights, it is not a material modification. Both of these points are supported by the Statement of Managers, which states (at p. 526), that "The addition of any benefit, right or feature is a material modification. The *exercise* or *reduction* of an existing benefit, right, or feature is not a material modification" (emphasis added).

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

Rationale: Because the rabbi trust does not give participants any additional benefits, rights, or features, the establishment of the trust is not a material modification. *See* Statement of Managers at p. 526 (quoted above).

(9) *Recommendation:* A nonqualified plan should not be considered to be materially modified merely because the plan is amended to remove a provision that allows benefit payments to be accelerated.

Rationale: Since the amendment reduces, rather than increases, participants' rights under the plan, it is not a material modification of the plan. *See* Statement of Managers at p. 526 (quoted above); *see also* ¶ 2.c(7), above.

(10) *Recommendation:* A deferred compensation plan should not be considered to be materially modified merely because an employer exercises discretion to vest benefits before the end of 2004 if the plan's terms in existence and in effect on October 3, 2003, allowed the exercise of discretion to grant or vest benefits, but did not specify *when or how* such discretion was to be exercised.

Rationale: The Statement of Managers provides (at p. 526) that the exercise of an existing benefit, right, or feature is not a material modification. Accordingly, the exercise of an existing right to grant or vest benefits is not a material modification.

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

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

3. Transition Rules

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

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

(2) *Recommendation:* Employees should be permitted, during 2005, to elect the time and schedule for future distributions of deferred compensation that is earned during 2005 (or that was earned before 2005, but was not vested at the end of 2004) even though the election is made after the beginning of the period during which the related services are performed.

Rationale: Because § 409A is much more restrictive than prior law, and because the AJCA was enacted so late in 2004, many employers will not be able, before 2005, to solicit and obtain employee elections regarding the time and schedule of distributions for deferred compensation that is earned in 2005. Similar relief is warranted for deferred compensation that was earned before 2005, but that is subject to § 409A because it was not vested at the end of 2004. These situations deserve the relief that Congress contemplated when it authorized the Treasury to provide transition relief pursuant to § 885(f). The need for relief is particularly acute under defined benefit restoration plans: in the absence of regulatory relief, additional benefits earned under these plans in 2005 (as well as benefits earned before 2005 that were not vested at the end of 2004) will be governed by rules that are far more restrictive than old law and that could not have been foreseen when employees began earning benefits years ago under these plans.

(3) *Recommendation:* The Treasury should exercise its authority under § 885(f) to allow taxpayers to revoke, reduce, or reform the deferral elections they have made with respect to both (i) compensation earned before 2005 (but not vested on December 31, 2004) and payable in 2005 or thereafter and (ii) compensation earned in 2005 and payable thereafter.

Rationale: Because of the many uncertainties regarding the rules that govern deferred compensation under § 409A, many individuals who have elected to defer compensation otherwise payable in 2005 or thereafter will want to revoke, reduce, or reform their elections once they learn what the new rules are. Moreover, some of the compensation that is earned in 2005 and that is otherwise payable in 2006 will likely, under the Treasury's forthcoming guidance, qualify as performance-based compensation for which a deferral election could be made as late as six months before the end of the applicable service period. In light of the uncertainties affecting such plans, the Treasury should allow individuals to revoke, reduce, or reform the deferral elections they have made with respect to compensation earned, in whole or in part, before 2006.

(4) *Recommendation:* The Treasury should exercise its authority under § 885(f) to give taxpayers until December 31, 2005, to revoke, reduce, or reform their prior deferral elections in accordance with ¶ 3(3), above.

Rationale: Even if the Treasury issues comprehensive guidance under § 409A in the first quarter of 2005, employers will need time to digest and implement the new requirements, and employees will need still more time to evaluate their options and to make elections under their employers' revised plans.

(5) *Recommendation:* The Treasury should exercise its authority under § 885(f) to allow an employer, during 2005, to amend an existing deferred compensation plan (which provides "grandfathered" pre-2005 benefits) to add one or more optional forms of distribution that are permitted by § 409A (thereby effecting a material modification of the pre-2005 benefits and subjecting the pre-2005 benefits to the requirements of § 409A) and to allow participants to elect, before the end of 2005, the distribution schedule that applies to their pre-2005 benefits (which were "grandfathered" prior to the material modification). Similarly, Treasury guidance should allow an employer to amend the plan provisions governing "grandfathered" pre-2005 benefits to mandate that, in the future, all such pre-2005 benefits will be paid in a specified form that complies with § 409A (*e.g.*, a lump sum paid 6 months after separation from service).

Rationale: This recommendation allows employers to elect to apply § 409A to the "grandfathered" pre-2005 benefits under their existing plans in exchange for the benefit of being able to offer (or mandate) one or more new distribution options that the plan had not offered (or mandated) in the past but that are consistent with the requirements of § 409A. Since the amended plan would comply with § 409A on a prospective basis, the Treasury's guidance should accommodate amendments of this kind.

(6) *Recommendation:* The Treasury should exercise its authority under § 885(f) to postpone the effective date of § 409A for a fiscal-year plan in existence on October 3, 2004, until the beginning of the first fiscal year that begins after January 1, 2005.

Rationale: Because January 1, 2005, occurs in the midst of a fiscal year, a January 1, 2005, effective date will create enormous practical problems for fiscal-year plans. The Treasury should put fiscal-year plans on a comparable footing with calendar-year plans.

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

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

(8) *Recommendation:* The Treasury should exercise its authority under § 885(f) to provide that no interest or penalties will be imposed under § 409A(a)(1)(B) before January 1, 2006, on a participant in a nonqualified deferred compensation plan if, before January 1, 2006, the plan makes an accelerated distribution of all or part of the participant's deferred compensation benefits under the plan.

Rationale: Some employers will wish to respond to § 409A by freezing deferrals and distributing in 2005 any deferrals that have accumulated previously during 2005. Some plans may be terminated altogether in 2005 and may distribute all of the deferred compensation benefits that have accrued under the plan. The Treasury should not penalize employees for being put in this position.

4. Deferral Election Rules

a. First-Year-Of-Eligibility Rule

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

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

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

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

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

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

b. Performance-Based Compensation

(1) *Recommendation:* If SARs and stock options with deferred payment features are treated as deferred compensation, each SAR and deferred-payment option should be treated as providing performance-based compensation for purposes of § 409A(a)(4)(B)(iii) as

long as the SAR and the option provide a benefit based solely on appreciation in the underlying shares after the date of grant of the SAR or option (in addition to the benefits flowing from the deferral feature under the option).

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

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

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

(3) *Recommendation:* The Treasury should permit performance criteria to be established within the first 90 days of the performance period (but not after the expiration of 25% of the relevant period of service), consistent with the regulations under IRC § 162(m). *See* Treas. Reg. § 1.162-27(e)(2)(i).

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

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

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

c. Fiscal-Year Plans

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

Rationale: Because many employers maintain bonus plans that are based on financial performance during a fiscal year, their bonus-deferral plans commonly operate on a fiscal-year basis. The Treasury should make clear that the election-timing rules in § 409A(a)(4) may be applied to a fiscal-year plan on the basis of the fiscal year rather than the calendar year. In these circumstances, efficient and effective plan administration will be facilitated if the employer's salary-deferral program also can be operated on a fiscal-year basis. It would be costly to the employer and confusing to employees if an employer that maintains a fiscal-year bonus-deferral plan were required to maintain a salary-deferral plan for the same group of employees on a calendar-year basis.

d. Deferral Of Commission Payments

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

Rationale: Because commission payments are subject to many contingencies, such as the customer's payment of the sales price from which the commission is derived, and are often paid over a period of many years, it is unrealistic to expect commission-earners to make deferral elections before the year in which he or she begins to perform the services that generate the commission. For one thing, it is frequently unclear when the commission-related services begin. Second, it is extremely difficult, if not impossible, to predict the commission-related services that will begin in the following year. Third, in a great many cases, the lengthy periods over which services are performed and commissions are paid make it impractical for commission-earners to make deferral elections in the year before his or her related services start. *See* IRC § 162(m)(4)(B) (recognizing the special nature of commission income).

e. Defined Contribution Spillover Plans

(1) *Recommendation:* The Treasury should clarify how § 409A applies to elections to defer compensation under defined contribution spillover plans (as defined in footnote 5, above). If the Treasury concludes that each participant's contribution rate or contribution amount must be fixed at the beginning of each taxable year (except as allowed by the exception for newly-eligible participants), the Treasury should provide transition relief for deferrals in 2005.

Rationale: Because of the prevalence of defined contribution spillover plans, it is important for the Treasury to clarify promptly how §409A applies to them. If deferrals under such plans must generally be fixed by each participant at the beginning of the year, this will require major revisions in how these plans operate, and it will be essential for the Treasury to grant transition relief for 2005.

5. Distribution Rules

a. Six-Month Delay For Key Employees

(1) *Recommendation:* The six-month delay rule in § 409A(a)(2)(B)(i) should not apply where monthly distributions are made in the form of a life annuity or in installments over a term of at least 10 years.

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

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

Rationale: When the payment of a bonus (*e.g.,* an annual bonus paid three months after the close of the year in which it is earned) is paid to all employees who are eligible for the bonus, the six-month delay rule should not be triggered just because some of the eligible employees have separated from service. Such payments do not represent deferred compensation (see ¶ 1.a(1), above) and, in any event, the payments are not made by reason of separation from service.

(3) *Recommendation:* Bonus payments that are not deferred can be paid at the employer's discretion even if payment is made more than 2-1/2 months after the year in which they are earned.

Rationale: Although the Statement of Managers indicates (at p. 525) that bonus payments made more than 2-1/2 months after the close of the year they are earned might be treated as deferred compensation, this does not mean that payments that are not deferred must be paid at a "specified time" or "pursuant to a fixed schedule" in accordance with § 409A(a)(2)(A)(iv). For example, some bonuses are paid only after the employer has collected and analyzed the information required to calculate the bonuses; others are paid only if and when the employer has accumulated the cash to fund the bonuses. The Treasury should confirm that, in these circumstances, bonuses are not deferred compensation and can be paid immediately even though they are not paid at a "specified time" or "pursuant to a fixed schedule." *See* ¶ 1.a(1), above.

(4) *Recommendation:* An employer should be permitted to identify its key employees once a year -- up to six months before the beginning of the taxable year.

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

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

Rationale: It is clear that the "controlled group" rules generally apply to determine key employee status under both § 409A and § 416(i)[6]. There is no exclusion for foreign members of the group or for their officers. However, because it is difficult for some U.S. companies to collect information from their foreign affiliates, U.S. employers should be given *the option* to disregard the employees of their foreign affiliates in identifying the employees who are key employees by reason of their officer status.

(6) *Recommendation:* The Treasury should prescribe a "safe harbor" that permits an employer to elect to treat more than 50 highly paid employees (*e.g.* 60 employees) as

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

its most highly paid officers in exchange for being relieved of the need to determine whether those employees qualify as "officers" for purposes of IRC § 416(i).

Rationale: The definition of "officer" for purposes of § 416 is so vague that many large employers will find it impossible to apply it in the context of § 409A. *See* Treas. Reg. § 1.416-1, *T-13*. The safe harbor that we recommend will make § 409A more administrable as long as the safe harbor can be applied on a once-a-year, look-back basis -- consistent with the recommendation in ¶ 5.a(4), above.

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

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

(8) *See ¶ 5.c(2), below.*

b. Defined Benefit Restoration Plans

(1) *Recommendation:* The Treasury should make clear that a defined benefit restoration plan (as defined in footnote 4, above) does not violate the requirements of § 409A merely because the employer amends its related qualified plan to accelerate the date on which benefits may be paid.

Rationale: If the benefit restoration plan otherwise meets the requirements of § 409A, the amendment to the qualified plan should not cause the benefit restoration plan to violate § 409A. For example, if the restoration plan provides that benefits will be paid in a specified form beginning on the earliest date following separation from service on which an employee can receive a distribution that is not reduced for early commencement, an amendment to the qualified plan to reduce the age at which unreduced benefits may be received does not cause the restoration plan to violate the requirement in § 409A(a)(2)(A) that distributions not begin earlier than separation from service. Nor does the plan impermissibly accelerate the payment of benefits in violation of § 409A(a)(3): both before and after the amendment, benefits start on the earliest date following separation from service on which an employee can receive a distribution that is not reduced for early commencement.

(2) *Recommendation:* The Treasury should provide flexible and practical rules governing employee elections regarding the distribution schedule under a defined benefit restoration plan and other nonelective, supplemental retirement plans.

Rationale: It is unrealistic to expect participants in a defined benefit restoration plan to be able to elect, many years (and even decades) before retirement, how they want their benefits under the plan to be distributed. The Statement of Managers authorizes (at p. 523) the Treasury to address this problem: "It is expected that in limited cases, the Secretary will issue guidance, consistent with the purposes of the provision, regarding to what extent elections to change a stream of payments are permissible. *The Secretary may issue regulations regarding elections with respect to payments under nonelective, supplemental retirement plans*" (emphasis added). For example, the Treasury might provide that a nonelective, supplemental retirement plan may honor elections made at least 12 months before they become effective if the plan does not offer a lump-sum option, but that the 12-month period must be extended to at least 24 months if the plan offers a lump-sum option.

c. Anti-Acceleration Rule

(1) *Recommendation:* A deferred compensation plan should be permitted to specify any amount that it chooses as the threshold for an automatic lump-sum distribution following separation from service.

Rationale: If the plan specifies in advance what the dollar threshold is (*e.g.*, a lump-sum amount of less than $50,000 or a single life annuity at age 65 of less than $1,000 per month), the plan should not be treated as violating the anti-acceleration rule in § 409A(a)(3). Because the automatic cashout provision does not give the employee greater control over the distribution of his or her deferred compensation, the Treasury should defer to the employer's judgment of what constitutes a "minimal" benefit for purposes of the plan's cashout provision as long as the cashout threshold is specified by the terms of the plan. *Cf.* Statement of Managers at p. 521.

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

Rationale: The Statement of Managers contemplates (at p. 521) such relief from the anti-acceleration rule. In order to be fully effective, however, such relief must also apply to the six-month delay rule for key employees in § 409A(a)(2)(B)(i).

d. Election To Delay Distributions

(1) Recommendation: The 12-month and 5-year rules in § 409A(a)(4)(C) should apply to an election to defer distribution of a restricted stock unit and any other time-vested deferred compensation.

Rationale: Because restricted stock units measure the employer's obligation to pay deferred compensation, an employee's election to delay distribution of the value of the units is subject to both the 12-month rules in § 409A(a)(4)(C)(i) and (iii) and -- except in the case of payments made on account of death, disability, or unforeseeable emergency -- the 5-year rule in § 409A(a)(4)(C)(ii). Suppose, for example, that under the terms of a restricted stock unit, an employee vests in (and becomes entitled to payment of) the unit after completing three years of service. In these circumstances, the terms of the grant could allow the employee, at least 12 months before the scheduled payment date, to defer payment until a date falling at least 5 years after the originally scheduled payment date (subject to the statutory exceptions for payments on account of death, disability, or unforeseeable emergency). The same conclusion should apply to any other time-vested deferred compensation arrangement (*e.g.,* a retention bonus that is payable if the employee works for 3 years).

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

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

e. Alternative Distribution Dates

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

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

f. Emergency Withdrawals

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

Rationale: If the employee meets the requirements for an emergency withdrawal, there is no purpose served by requiring the employee to continue to make deferrals at the rate he or she elected and then to make an emergency withdrawal from the plan. Plans and employees should be permitted to take the direct approach of curtailing future deferrals to the extent necessary to address the emergency.

g. Disability

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

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

h. Initial Election Regarding Time And Form Of Distribution

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

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

6. Foreign Rabbi Trusts

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

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

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

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

7. Foreign Deferred Compensation Plans

(1) *Recommendation:* The Treasury should make clear that § 409A does not apply to deferred compensation provided under pension, indemnity, and similar plans maintained outside the U.S. for persons who work primarily outside of the U.S.

Rationale: Most of the participants in such foreign plans are not U.S. taxpayers, and § 409A does not apply to individuals who are not U.S. taxpayers. However, some of the participants in such plans are U.S. citizens (for example, those who are hired abroad). Section 409A was not intended to impose U.S. standards on plans maintained outside the U.S. nor was it intended to penalize U.S. citizens who work abroad.[7]

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