New York State Bar Association

Tax Section

Employee Benefits Committee

Report on Section 409A

of the Internal Revenue Code and the

Proposed Regulations Thereunder

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Report No. 1104

New York State Bar Association
Tax Section

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of the Internal Revenue Code and the
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Background

In late 2004, the American Jobs Creation Act of 2004 fundamentally altered the federal income taxation of nonqualified deferred compensation by adding Section 409A to the Internal Revenue Code of 1986 (the "Code").[1] Previously, there had been no detailed statutory provisions in this area, but under Section 132 of the Revenue Act of 1978, the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "IRS") had generally been required to regulate nonqualified deferred compensation as set forth in regulations and rulings existing at the time that Section 132 was passed. In enacting Section 409A, Congress entered a highly complex and technical area with a relatively brief new statutory provision that nonetheless has broad implications for the compensation practices of businesses employing U.S. taxpayers.

Treasury and the IRS issued preliminary guidance and needed transition relief in Notice 2005-1. Among the critical issues addressed in Notice 2005-1 was the meaning of the term "deferred compensation," and thus the scope of the statute. On June 28, 2005, we filed a report[2] addressing various points in Notice 2005-1 (the "2005 NYSBA Report").

In September 2005, Treasury and the IRS issued the next major round of guidance under Section 409A, in the form of proposed regulations (the "Proposed Regulations"). With the Proposed Regulations, which are far more comprehensive in scope than Notice 2005-1, Treasury and the IRS continue to address the Congressional concerns that led to the enactment of Section 409A.

The Proposed Regulations and the expansive discussion in the preamble thereto (the "Preamble") reflect a careful consideration of many comments by Treasury and the IRS, and indeed they include a number of our suggestions specifically or conceptually. The Proposed Regulations are a positive step in providing understandable rules that service recipients and service providers can apply in practice. We appreciate the attention to our concerns and, more generally, the thoughtful and responsive approach that the Proposed Regulations take to this new and complex statute.

Against this backdrop, we offer comments to the Proposed Regulations, with a view to furthering the statute's purpose to curtail abusive deferral practices and manipulation of the timing of income

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1 All section references herein are to the Code, unless otherwise specified.

2 Report No. 1091 of the New York State Bar Association Tax Section, entitled "Employee Benefits Committee Report on Section 409A of the Internal Revenue Code and Internal Revenue Service Notice 2005-1."

recognition, while not unduly restricting legitimate and non-abusive compensatory practices.[3] We also suggest generally that Treasury and the IRS consider whether the next round of guidance should be in the form of temporary or reproposed regulations, in light of the number and complexity of the issues that continue to remain.

Executive Summary

Several of our recommendations can be briefly summarized as follows:

1. Initial Deferral Elections

(a) Deferral elections must generally be made before the beginning of the service provider's taxable year in which the deferred compensation will be earned. However, Section 1.409A-2(a)(6) permits a service provider who is newly eligible to participate in a plan to make an initial deferral election, as to compensation for service after the election, within 30 days after the first day of such eligibility. For this purpose, plans are aggregated. Under this exception, only compensation paid for services performed after the election may be deferred. *We suggest that only contributory arrangements should be aggregated for purposes of the 30-day initial eligibility requirement. We also urge Treasury and the IRS to consider not aggregating dissimilar plans (e.g., plans providing for deferrals of salary, as compared to bonus).*

(b) Section 1.409A-2(a)(7) of the Proposed Regulations permits an election to defer certain performance-based bonus compensation up to six months before the end of the bonus period. This is another exception to the requirement that deferral elections be made before the beginning of the calendar year. The Proposed Regulations provide that a service provider may use this exception only if he or she performs services continuously from the date the performance criteria are established through the date the deferral election is made. *We recommend that this requirement be relaxed.*

(c) Section 1.409A-2(a)(4) of the Proposed Regulations allows a service provider to make an election as to the time and manner of payment of a compensation award that does not vest for 12 months from the date of the election, even if the election is made after the services have started to be performed, so long as the election is made within 30 days of grant of the award. *We suggest allowing the 12-month vesting period to run concurrently with the 30-day election period.*

2. Acceleration of Payments; Certain Other Distribution Rules

(a) The Proposed Regulations generally permit a plan to be operated so as to satisfy a domestic relations order as to the making of payments, without the imposition of a Section 409A penalty. *We recommend that the final regulations clarify whether and the extent to which a plan document may expressly provide for distribution alternatives set forth in a domestic relations order.*

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[3] The principal authors of this report are Andrew L. Oringer and Max J. Schwartz. Significant contributions were made by Howard B. Adler, Carol I. Buckmann, Steven J. Friedman, Marjorie M. Glover, Mark T. Hamilton, Colleen M. Hart, George R. Ince, Jr., David E. Kahen, Amelia M. Klein, Karen G. Krueger, Jonathan Lewis, Michael J. Nassau, Martin Nissenbaum, Russell J. Pinilis, Kenneth A. Raskin, Laurence Reich, Brian D. Robbins, Laraine S. Rothenberg, Paul J. Wessel and Lawrence I. Witdorchic. Helpful comments were provided by Kimberly S. Blanchard, Andrew H. Braiterman, Kathleen L. Ferrell, Patrick C. Gallagher, Stuart J. Goldring, Elizabeth T. Kessenides, Janet B. Korins, David S. Miller, Charles Morgan and Michael L. Schler.

(b) Section 1.409A-3(h)(2)(ii) of the Proposed Regulations permits acceleration of the time or schedule of payments to "comply with a certificate of divestiture (as defined in [S]ection 1043(b)(2))." *We suggest that the final regulations should expand the conflict-of-interest exception to cover not only the conflict-of-interest rules applicable to federal government employees, but also to any pre-existing policy regarding ethical standards or conflicts of interest maintained in good faith by a service recipient or a professional group that is applicable to all similarly situated service providers.*

(c) The Proposed Regulations recognize that compliance with legal requirements may warrant either delays in payment (with specific reference to the securities laws, but also recognizing that other laws may have a similar effect), or acceleration of payments (e.g., in the cases of a conflict of interest, domestic relations orders or hardships). However, legal requirements may also (or instead) require curtailment of deferral elections. *We propose that similar allowance be made for cancellations or reductions of deferral elections as the service recipient may reasonably determine to be necessary (i) to limit deferrals to those in the "top hat" group, or (ii) to qualify for an otherwise applicable exemption from federal or state securities law or otherwise comply with such laws.*

(d) To implement the suggestion in the Conference Report that elections between actuarially equivalent annuity forms be permitted free of the usual constraints on elections to change the form of payment, the Proposed Regulations allow such elections where a life annuity or a joint and survivor annuity are allowed. *We suggest that the final regulations specifically state that the term "life annuity" for this purpose includes any of a straight life annuity, a life annuity guaranteed payable for a period certain, a life annuity with cash-refund feature, a life annuity with a cost-of-living adjustment, and a joint and survivor annuity with any of such period-certain or cash-refund features.*

3. Plan Aggregation

We believe that the plan aggregation rules can be refined without inviting abuse. *We propose that: (i) elective deferral plans be viewed as separate from nonelective plans; (ii) elective salary deferrals be treated as made under separate plans from elective bonus deferrals, even if made under one plan document; (iii) the variety of post-employment perquisites that may be provided in employment agreements represent a further distinct category; (iv) non-U.S. plans be treated separately from U.S. plans; and (v) other types of plans be treated separately, as may be set forth in notices or other authority from time to time.*

4. Stock Right Issues: Extensions of Stock Rights; Certain Other Modifications

(a) In the case of a modification in the form of the extension or renewal of the term of certain stock rights, the Proposed Regulations, contrary to the approach taken under the Section 424 regulations, treat the stock right as having had a deferral feature as of the time of its original grant, thus subjecting it to Section 409A ab initio. *We suggest that the final regulations state that (i) if a stock right that has been excluded from Section 409A since the time of grant is extended or renewed at a time when the exercise price is equal to or greater than the fair market value of the underlying stock, the stock right continues to remain outside the scope of Section 409A, and (ii) the extension or renewal of a stock right at a time when the exercise price is less than the fair market value of the underlying stock causes the stock right to be treated as having had an additional deferral feature from the date of modification, not from the date of grant.*

(b) Stock rights may well have been extended, renewed or modified before the enactment of Section 409A, and it presently is unclear whether such modifications would have an adverse effect under Section 409A. *We request clarification that any extension, renewal or modification of a stock right made before the end of 2004 will not cause the right to be subject to Section 409A.*

5. **Stock Right Issues: Definition of Service Recipient Stock**

(a) The Proposed Regulations provide that under no circumstances does stock of the service recipient include stock that is preferred as to liquidation or dividend rights. *We suggest that (i) the terms "preferred stock" and "common stock" be defined specifically for purposes of Section 409A and (ii) preferred stock could be permitted to qualify as service recipient stock in non-abusive circumstances.*

(b) For purposes of determining whether a given class of stock will qualify as "service recipient stock," the Proposed Regulations appear to limit each member of a controlled group of entities to using only (i) the publicly traded stock of a group member or (ii) if no member of the controlled group has publicly traded stock, the one class of stock within the controlled group having the "greatest aggregate value." *We recommend that the "service recipient stock" definition under the Proposed Regulations be expanded to permit the grant of stock rights not subject to Section 409A to all service providers working for a member of a controlled group of corporations based on the stock of any member of the controlled group regardless of whether another member of the controlled group has a publicly traded class of stock or stock with a greater aggregate value, so long as the issuer is in the same vertical chain as the actual service recipient or is in a different vertical chain and the use of the issuer's stock is based on legitimate business criteria. We also recommend that service recipient stock include any class of common stock of an acceptable entity (rather than merely the class of stock with the largest value), as well as any preferred stock thereof that meets whatever Section 409A requirements the final regulations impose.*

(c) The Proposed Regulations relating to the class of service recipient common stock that may be used for stock rights provide that the changes made by the regulations will not apply to stock rights granted on or before December 31, 2004. The Proposed Regulations provide no similar relief for the prohibition against the use of preferred stock. *The final regulations should provide that both the common stock and the preferred stock requirement should apply no earlier than the date the Proposed Regulations were released on September 29, 2005.*

(d) The Proposed Regulations permit a plan to specify that the controlled-group percentage to be used under certain circumstances can be 20% rather than 50%, but requires the use of the lower threshold to be effected consistently. *We propose that the final regulations provide that use of the 20% threshold is permitted in operation whenever the substantive rules of the regulations are satisfied, without requiring specification in the plan, and that the consistency requirement be explained or eliminated.*

(e) Provided that the use of the stock is based upon "legitimate business criteria," the Proposed Regulations permit a service recipient to elect to apply a 20% threshold for purposes of applying the controlled group rules in identifying service recipient stock. *We recommend that the final regulations provide more detailed guidance regarding what constitutes "legitimate business criteria" for this purpose.*

(f) The Proposed Regulations impose minimum ownership rules regarding the use of service recipient stock, even where the ultimate service providers are providing services indirectly for the benefit of an ultimate service recipient. *We recommend that the term "service provider" be amended to include persons who indirectly provide services to a designated service recipient, even if the entity for which the services are directly performed is not in the same controlled group as the ultimate service recipient.*

(g) Notice 2005-1 provided that "until additional guidance is issued, for purposes of Section 409A taxpayers may treat the issuance of a partnership interest (including a profits interest), or an option to purchase a partnership interest, granted in connection with the performance of services under the

same principles that govern the issuance of stock." *We recommend that the service recipient stock rules be extended to non-corporate service recipients such as partnerships and other similar entities.*

6. Stock Right Issues: Valuation of Private Corporation Stock

An option is not subject to Section 409A if the option exercise price is at least equal to the fair market value of the underlying stock on the date of grant. *We recommend that the final regulations permit stock to be valued in the same manner for all purposes of any nonlapse restriction applicable to the transfer of shares under the equity-based compensation plans of the service recipient, rather than limit the nonlapse restriction safe harbor to stock that is valued in the same manner for all purposes (both compensatory and noncompensatory).*

7. Fringe Benefits, Perquisites, Reimbursements, Etc.

The Proposed Regulations provide generally that an arrangement that otherwise provides for a deferral of compensation does not fail to provide a deferral of compensation merely because the right to payment of the compensation is conditioned upon a separation of service. *We believe that a service provider who terminates employment and receives certain of the same fringe benefits and perquisites that he or she enjoyed during employment should not be deemed to receive deferral of compensation.*

8. Separation Pay

Treasury and the IRS requested comments as to whether further guidance may be useful with respect to the application of the short-term deferral rule to arrangements containing constructive or "good reason" termination provisions. *We recommend that the final regulations continue the approach articulated in the Preamble, under which the determination of when a "good reason" or similar provision in a severance arrangement will cause a service provider to cease to have a substantial risk of forfeiture depends on the facts and circumstances of the particular case.*

9. Six-Month Payment Delay for Specified Employees

Section 409A provides that payments upon a separation from service to certain key employees must be delayed at least six months following separation from service. *We suggest that the final regulation not require the delay of payments to a specified employee to be incorporated in the applicable arrangement.*

10. Specified Employees

Section 409A provides that key employees as generally defined in Section 416(i) (without regard to Section 416(i)(5)) are subject to a six-month payment delay following separation from service. *We suggest that (i) employers be permitted to use a different method for determining Section 415 compensation for purposes of identifying key employees under Section 409A than they use in operating their tax-qualified plans, (ii) the number of individuals who can be "key employees" of a controlled group pursuant to the 1% and 5% owner provisions of Section 416 be limited to 50 (as is already the case for the number of officers who are required to be treated as key employees), (iii) employees of affiliates of a public company be excluded from the reach of Section 409A if those affiliates have no direct or indirect public shareholders, and (iv) the final regulations clarify that service providers who are independent contractors and not common-law employees with respect to the service recipient are not treated as key employees subject to the six-month delay.*

11. Grandfathered Supplemental Retirement Plans

The Proposed Regulations include rules regarding supplemental plans and the application of grandfather rules. *We suggest that (i) the regulations provide more guidance regarding (A) the use of reasonable actuarial assumptions when a plan supplements a qualified defined benefit plan, but uses different actuarial assumptions than the qualified plan, and (B) whether grandfathered amounts may be determined pursuant to a formula tied to the Treasury or another specified floating interest rate that changes over time, but using the rate determined under such formula as of the date of calculation, and (ii) consideration be given to modifying the general rule that only changes due to the passage of time and the participant's survival after December 31, 2004 are recognized in determining the grandfathered amount.*

12. Plans Linked to "401(k)" Plans

The Proposed Regulations are ambiguous as to the operation of a nonqualified account plan that supplements and is linked to a "401(k)" plan in the imposition of the limit with respect to elective deferrals under Section 402(g). *We recommend that the final regulations clarify that, at a minimum, a change in the deferral under the nonqualified deferred compensation plan resulting from a change to the Section 402(g) limitation applicable to the qualified plan should not be a Section 409A violation, so long as aggregate deferrals are unchanged.*

13. Transition Issues

The Proposed Regulations state that a cessation of deferrals under a plan, or the termination of a plan, pursuant to the provisions of such plan, is not a material modification. *We recommend that the final regulations provide that it is not a material modification of an otherwise grandfathered arrangement to terminate the arrangement and pay out amounts promptly upon the termination if the plan document provides that the arrangement may be terminated but does not specify the time or form of payment of amounts deferred under the arrangement upon the termination, as long as all amounts deferred under the arrangement are paid out within 12 months following the date of such termination.*

The recommendations summarized above, and a number of other technical issues, are discussed in more detail below.

Detailed Report

I. Initial Deferral Elections and Subsequent Changes

A. First Year of Eligibility

Deferral elections must generally be made before the beginning of the service provider's taxable year in which the deferred compensation will be earned. However, Section 1.409A-2(a)(6) permits a service provider who is newly eligible to participate in a plan to make an initial deferral election, as to compensation for service after the election, within 30 days after the first day of such eligibility. For this purpose, plans are aggregated in broad categories of account balance, nonaccount balance, separation pay and other (principally equity-based compensation). Under this exception, only compensation paid for services performed after the election may be deferred.

Proposal

Only contributory arrangements (i.e., those under which the service provider could under the plan receive the compensation in a manner under which it would not constitute deferred compensation) should be aggregated for purposes of the 30-day initial eligibility requirement. We suggest that Treasury and the IRS also consider not aggregating dissimilar plans (e.g., plans providing for deferral of salary, as compared to bonus).

Discussion

Most plans permitting initial deferral elections will be of the account-balance type. This category is very broad and the effect of the plan aggregation rule may effectively preclude many employees from ever even attempting to avail themselves of the 30-day initial-eligibility provision of the statute. The Preamble notes that commentators responding to Notice 2005-1 requested that the plan aggregation rules not apply at all to the rules on initial deferral elections, and that Treasury and the IRS rejected this approach as permitting abuse of the 30-day initial eligibility exception through serial annual arrangements.[4] Nevertheless, we believe that some level of disaggregation of plans that are fundamentally different would be appropriate, so as to allow the 30-day rule to be used in a broad range of appropriate cases. We note that the 30-day initial-election rule was well established before the enactment of Section 409A even under the IRS's official ruling position,[5] and that no abuse of this aspect of deferred compensation was cited in the legislative history (nor, to our knowledge, in previous hearings or studies of deferred compensation). We believe that if only all contributory arrangements are aggregated (so that previous participation in a non-contributory plan would not make a service provider ineligible to use the 30-day rule upon first becoming eligible for a contributory plan), the potential for abuse described in the Preamble would continue to be addressed adequately. For these purposes, a contributory arrangement would be one under which the service provider could under the plan receive the compensation in a manner under which it would not constitute deferred compensation (e.g., where there would be a short-term deferral under the regulations).

We also suggest that Treasury and the IRS consider whether even contributory plans could be distinguished and not aggregated, based on the type of underlying compensation in issue – that is, salary deferral arrangements would not be aggregated with bonus deferral arrangements. We believe that the aggregation of contributory plans into two types of plans – salary and bonus – fully addresses the "serial annual election" concern raised in the Preamble, as there would be only one opportunity for a service provider to avail himself or herself of the exception for each of the two types of compensation.

B. Six-Month Election for Performance-Based Compensation

Section 1.409A-2(a)(7) of the Proposed Regulations permits an election to defer certain performance-based bonus compensation up to six months before the end of the bonus period. This rule is another exception to the requirement that deferral elections be made before the beginning of the calendar

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4 The Preamble also comments that other initial deferral rules should adequately address any concerns regarding deferrals of bonus and equity grants. However, the Proposed Regulations still impose significant obstacles in practice to the use of the initial deferral rules (e.g., by requiring that the election apply only to compensation that has not yet begun to be earned, except in certain circumstances involving forfeitable rights or performance-based compensation).

5 Rev. Proc. 71-19, 1971-1 C.B. 698, amplified by Rev. Proc. 92-65, 1992-2 C.B. 428.

year. The Proposed Regulations provide that a service provider may use this exception only if he or she provides services continuously from the date the performance criteria are established through the date the deferral election is made.

Proposal

This special election should be available to service providers who are hired during a performance period and at least six months before the end of the period even if they do not perform services continuously from the date the performance criteria are established through the date the deferral election is made.

Discussion

The service requirement precludes any new employee who becomes eligible for a plan after the beginning of the service period from availing himself or herself of this special election, effectively limiting a newly hired employee to electing under the special 30-day rule discussed in Section I(A) above, even though other participants may have longer to make the election. For example, if, as is common, a service recipient establishes its annual bonus goals and targets before March 15 each year, its employees will generally be able to elect a deferral of their bonuses as late as June 30, but an employee hired on April 1 will only have until the beginning of May to make a deferral election. We do not understand what purpose this continuous-employment condition serves, and recommend its deletion.

C. Initial Deferral Elections With Respect to Certain Forfeitable Rights

Section 1.409A-2(a)(4) of the Proposed Regulations allows a service provider to make an election as to the time and manner of payment of a compensation award that does not vest for one year from the date of the election, even if the election is made after the services have started to be performed, so long as the election is made within 30 days of grant of the award. We recognize that this provision is an important and flexible departure from past practice, and may have derived at least in part from a comment we made in the 2005 NYSBA Report.

Proposal

We recommend relaxing the 12-month vesting prohibition to permit vesting 12 months after the date of grant.

Discussion

Measuring the requisite one-year period of risk of forfeiture from the date of the deferral election will effectively require a 13-month rather than a 12-month vesting period from date of grant of the award. Plans commonly provide for initial one-year vesting periods, and we question the utility of requiring a departure from this standard practice. If the one-year period were instead measured from the date of grant, the required post-election vesting period would be shortened by only a single month, and this common practice would not be required to change.

II. Acceleration of Payments; Certain Other Distribution Rules

In this section of our Report, we comment on the exceptions to the prohibition on accelerating payments set forth in Section 1.409A-3(h)(2) of the Proposed Regulations, and on the application of various exceptions to the prohibition on accelerating payments to different forms of life annuities.

A. Domestic Relations Orders

The Proposed Regulations generally permit a plan to make payments in compliance with a domestic relations order (a "DRO") as to the making of payments, without the imposition of a Section 409A penalty, even if the order provides for distributions that otherwise would not be permitted under Section 409A (whether as to payment terms or as to election timing). However, it is unclear whether and to what extent a plan may expressly provide for distribution in accordance with a DRO.

Proposal

The final regulations should clarify whether and to what extent a plan may expressly provide for distribution alternatives set forth in a DRO.

Discussion

We appreciate the recognition by Treasury and the IRS of the need on the part of service providers and service recipients alike to comply (as with any applicable legal requirement) with valid and binding DROs, as reflected both in Notice 2005-1 (Q&A 15) and Sections 1.409A-3(g)(2) and 1.409A-3(h)(2)(i) of the Proposed Regulations, and we believe the penalty relief set forth in the Proposed Regulations should generally be retained. In the absence of relief on this point, severe penalty taxes could be imposed merely because the parties are forced to comply with the demands of a state court. However, the extent to which a plan can by its terms defer to a DRO is presently unclear, and we would appreciate further clarification. For example, can a plan provide by its terms for special distribution criteria in the case of a DRO, or, more generally, expressly contain a general statement that any requirement in a valid and binding DRO can be satisfied? Can a service provider effectively alter the terms and method of payment of deferred compensation by voluntarily agreeing to the terms of a court-issued DRO? We note that Treasury and the IRS, in considering this point, may wish to coordinate any clarification with the unforeseeable-emergency rules of Section 1.409A-3(g)(3) of the Proposed Regulations.

B. Conflicts of Interest

Section 1.409A-3(h)(2)(ii) of the Proposed Regulations permits acceleration of the time or schedule of payments to "comply with a certificate of divestiture (as defined in [S]ection 1043(b)(2))."

Proposal

The final regulation should expand the conflict-of-interest exception to cover not only the conflict-of-interest rules applicable to federal government employees, but also to any pre-existing policy regarding ethical standards or conflicts of interest maintained in good faith by a service recipient or a professional group that is applicable to all similarly situated service providers.

Discussion

Many employers, including state and local governments, financial auditing firms and law firms, impose ethical standards and policies affecting the investment activities of employees and their employees' family members. As one of many possible examples, independent auditing firms have strict conflict-of-interest policies applicable not only to their employees but also to certain of their family members; accordingly, a change of employment by a service provider or service provider's family member may require a payment acceleration or other action. For example, it may become impermissible for a service provider to retain an equity interest in the service recipient; yet many deferred compensation programs provide that equity is the sole benchmark for measuring the value of the deferral (e.g., under

restricted stock units and phantom stock plans). While we recognize that the legislative history of Section 409A refers to "Federal" conflict-of-interest requirements, we do not interpret this reference as limiting or exclusive, and believe that the concept in the final regulations can be expanded. We believe that the existence of generally applicable governmental standards or other established ethical or conflict-of-interest guidelines provide a sufficient safeguard against early access to deferred amounts to warrant this extension.

C. De Minimis Exception – In General

Section 1.409A-3(h)(2)(iv)(A) of the Proposed Regulations permits arrangements to be amended to provide for the acceleration of distributions to terminate a service provider's interest in a plan if the required payment is not more than $10,000.

Proposals

Our proposals are:

- We suggest that the requirement set forth in Section 1.409A-3(h)(2)(iv)(A)(2), that any such cash-out be made in the year of the service provider's separation from service from the service recipient or within 2-1/2 months following such separation from service, be expanded by adding as an alternative that a cash-out may also be made in, or within 2-1/2 months after the end of, the year in which the balance in the relevant account first drops below the $10,000 amount.
- In Section 1.409A-3(h)(2)(iv)(B) of the Proposed Regulations, regarding the application of the de minimis concept with respect to amounts that have yet to be deferred, the meaning of the second sentence of the paragraph should be clarified. Specifically, it is not clear whether the determination of whether "a service provider's interest under the arrangement has a value below an amount specified by the plan" (and therefore may be paid as a lump sum) is to be made when amounts are first payable to a service provider under the plan, or at any time that amounts are payable to the service provider.
- We suggest that the manner in which plans are aggregated to determine whether the amount remaining to be paid falls below the dollar threshold be modified as discussed below in Section III(A).

Discussion

The de minimis exception is welcome relief that reduces the burden of administering deferred compensation plans. Because of the relatively low $10,000 threshold, we do not believe that this exception is likely to lead to abuse, and we believe that our proposals would further the purpose of easing plan administration without increasing the risk of abuse. At a minimum, if a service recipient chooses to amend an existing plan to add a threshold below which plan balances may be paid or to increase that threshold amount (subject to a ceiling of $10,000), we believe there is no significant potential for abuse in having such amendment apply to former service providers (with respect to whom no further deferrals are anticipated) as well as current employees. Further, we believe that a modified plan aggregation rule as we propose below would be appropriate to apply to determine whether the $10,000 threshold is exceeded.

D. De Minimis Exception – Minimum Installment Requirements

Elective plans commonly allow participants to make separate elections between a lump sum and installments for each year's separate deferral, and the practice remains permissible under Section 409A.

However, in our experience, installment payouts are usually conditioned on (i) a minimum total account balance, (ii) a minimum total of the account balances for plan year deferrals first becoming payable at a scheduled fixed time, (iii) a minimum annual installment amount, or (iv) some combination of the foregoing. If the minimum account balance amount is not met, the installment option is not available, and amounts that would otherwise begin in installments on the applicable date (had the minimum been met) are instead paid in a lump sum.

Alternatively, if the minimum annual installment amount is not met, the plan may shorten the installment period to bring the annual installment payout up to the plan minimum. For example, if installments are required to be at least $10,000 annually, and a participant elected a 10-year installment payout starting on a specific date but had only $90,000 in his account (or relevant portion thereof) on that date, he would receive $10,000 for the first year (and so on in each later year) even though the result would be to shorten the payout period to less than 10 years.

Proposal

As a matter of administrative convenience or for other plan design reasons, plans sometimes set minimum requirements for amounts payable in installments, without requiring a full cash-out. We suggest a broadening of the de minimis concept to permit such plan provisions.

Discussion

Provisions of this type are adopted to avoid the administrative inconvenience of many small benefit payments, as well as on the assumption that an installment payout is of practical benefit only if each payment at least equals some reasonable minimum amount. For example, if a participant, expecting a $100,000 bonus, elects to defer that bonus and elects to receive it in 10 annual installments, but then receives only a $5,000 bonus, it is inconvenient for the plan administrator, and serves no significant purpose of Section 409A, to have to make payments of $500 a year. As to what thresholds should be recognized as a reasonable benchmark for reasons of administrative convenience, we suggest, based on our understanding of the approaches taken by various consultants and administrators, that a requirement of $50,000 or less, applied to either the total plan balance or the balance becoming payable at a specified date (so long as only one such date serves as the specified payment date during the year) be authorized as consistent with the Section 409A requirements as to time and form of payment. We suggest further, again for administrative convenience, that plans be permitted to accelerate any particular installment payment to the extent necessary to meet a minimum requirement of $10,000 or less.

E. De Minimis Exception – Relationship to Pre-2005 Deferrals

The use of account-based minimums raises the question of whether pre-2005 grandfathered deferrals and deferrals in and after 2005, if payable as of the same date, can be combined in determining the minimum amount required for either to be payable in installments (or to make up a minimum installment requirement, such as $10,000 in the example above), without resulting in a material modification of the pre-2005 plan.

Proposal

It should be clarified that, so long as the dollar minimum applicable for the purpose under the old plan is unchanged from the minimum on October 3, 2004, the combining of the grandfathered deferral balances with new balances subject to additional requirements of Section 409A is not a material modification.

Discussion

The practical effect of combining balances of both plans is that post-2004 deferrals can permit an account balance from pre-2005, which alone would have to be paid in a lump sum, to be paid in installments, along with the 2005 (and later) account balances payable at the same time. So long as the dollar minimum applicable for the purpose under the old plan is unchanged from the minimum on October 3, 2004, the combining of the grandfathered deferral balances with new balances subject to additional requirements of Section 409A does not seem to be a material modification. However, we believe the question could be clarified by a provision to that effect in the final regulations.

F. Cancellation or Modification of Deferral Elections

The Proposed Regulations recognize that compliance with legal requirements may warrant either delays in payment (e.g., delays in the exercise of stock rights to comply with securities laws), or acceleration of payments (e.g., in the cases of a conflict of interest, domestic relations orders or hardships). However, legal requirements may also (or instead) require curtailment of deferral elections, and we propose that similar allowance be made in the cases outlined below.

1. Compliance with ERISA Requirement Limiting Plan to "Top Hat" Group

Proposal

To permit employers to safeguard the compliance of their top hat plans under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), we suggest that the regulations defer to applicable legal requirements by authorizing cancellation of deferral elections upon a participant's ceasing to be a member of the class of employees that the employer has reasonably determined constitutes a "select group of management or highly compensated employees" for purposes of plan eligibility.

Discussion

Many non-qualified deferred compensation plans are also "pension plans" within the meaning of ERISA (because, for example, deferrals may systematically extend to termination of employment or beyond). As deferral for income tax purposes is possible only if the plan can avoid the general ERISA funding requirements for "pension plans," it is generally necessary as a practical matter for such nonqualified plans to qualify for the so-called "top hat" exception to the funding and other (e.g., vesting) rules of ERISA. The top hat exception is available for "a plan which is unfunded and is maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees."[6] In Advisory Opinion 90-14A, the Department of Labor held that "primarily" in the language quoted above refers to the purpose to provide compensation rather than to the permitted membership of the group and stated:

> [A] plan which extends coverage beyond a "select group of management or highly compensated employees" would not constitute a "top hat" plan for purposes of Parts 2 [participation and vesting], 3 [funding] and 4 [fiduciary standards] of Title I of ERISA.

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6 ERISA § 201(2), § 301(a)(3), § 401(a).

Thus, nonqualified deferred compensation plans that are intended to qualify for the top hat exception need to ensure that all active participants are within a top hat group. As a result, they typically provide that a participant who ceases to be a member of such a top hat group is no longer permitted to defer any additional compensation under the plan. However, it is not necessary for the plan to require distribution of amounts previously credited to the participant's accounts. For example, if a participant were transferred out of the top hat group mid-year, the participant's prior election to defer salary for the year would terminate on transfer, and any election to defer bonus for the year (otherwise payable in the year or the following year) would also be cancelled, but compensation credited to his account in the first part of the year (or in prior years) would remain deferred. We submit that this approach to ERISA's requirements should not be deemed to run afoul of Section 409A.

2. Securities Laws

Proposal

We suggest that cancellation or reduction of deferral elections be permitted as the service recipient may reasonably determine to be necessary to qualify for an otherwise applicable exemption from federal or state securities law or otherwise to comply with such laws.

Discussion

There are many federal and state securities laws that impose limitations on (i) the number of plan participants, (ii) the qualifications of participants, or (iii) the aggregate amount of "sales" that may occur under deferred compensation arrangements. These restrictions apply not only to equity-based awards but also to voluntary, elective deferred compensation, and affect both service recipients whose shares are publicly traded and those whose are not. We think it appropriate to permit service recipients to curtail deferral elections in order to comply with these requirements, regardless of whether the specific legal requirement that needs to be satisfied is expressly set forth in the plan.[7] (We note that the remedy for a number of securities law violations is rescission, effectively resulting in a revocation in any event.)

G. Actuarially Equivalent Life Annuities with Period-Certain, Etc., Features

To implement the suggestion in the Conference Report that elections between actuarially equivalent annuity forms be permitted free of the usual constraints on elections to change the form of payment, the Proposed Regulations allow such elections between life annuities and joint and survivor annuities. However, the definition of "life annuity" in the Proposed Regulations does not make clear whether the term includes a life annuity with survivor features not based on the lifetime of a contingent annuitant, but rather comprising, for example, a five- or ten-year certain feature or cash-refund feature.

Proposal

We suggest that, for purposes of permitted elections among actuarially equivalent annuity forms, the final regulations specifically state that the term "life annuity" includes any of a straight life annuity; a life annuity guaranteed payable for a period certain, where the period certain is not greater than the lesser

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7 We interpret the Proposed Regulations as permitting a service recipient to condition a service provider's deferral election on satisfaction of objective criteria, such as the service provider's qualifying as an "accredited investor," or that aggregate deferral elections not exceed a specified amount (and, if over-subscription occurs, participant elections may be cut back pursuant to a pre-established method).

of 10 years and the annuitant's life expectancy; a life annuity with cash refund feature; a life annuity with a cost-of-living adjustment; and a joint and survivor annuity with any of such period-certain or cash-refund features.

Discussion

We believe that the considerations informing Section 409A are satisfied if the various alternative forms of annuity listed above have the same actuarial value.

H. Conforming to a Statutory Technical Correction

The Preamble states:

> The Treasury Department and the IRS recognize that most taxpayers view the ability to elect installment payments as a choice of a single form of payment. Accordingly, the entitlement to a series of installment payments under a particular arrangement generally is treated as a single payment for purposes of the subsequent deferral rules. However, taxpayers could also view each individual payment in the series of payments as a separate payment. Accordingly, these regulations provide that an arrangement may specify that a series of installment payments is to be treated as a series of separate payments.

Subsequent to the issuance of the Proposed Regulations, Section 409A(a)(4)(C) was amended to delete the word "first," thus clarifying that the application of the rule providing that certain additional deferrals must be for a period of not less than five years is not limited to the first payment for which deferral is made.

Proposal

We believe that the carefully considered and well-reasoned approach of the Proposed Regulations is not inconsistent with the statute as amended, and suggest that the language of the Proposed Regulations be modified to reflect the enactment of the technical correction, while retaining the same substantive approach.

Discussion

The recent technical correction was apparently aimed at preventing avoidance of the subsequent election rules by postponement of only one of a series of installment payments, while leaving open the possibility that all other payments other than the "first" payment would escape regulation. The Proposed Regulations, at Section 1.409A-2(b)(2)(iii), permit installments to be viewed as separate payments or as a single payment for purposes of the rules governing changes in elections. As the Proposed Regulations already avoid the technical infirmity addressed by the technical correction, we recommend that the substance of the Proposed Regulations as to these matters be retained, with appropriate technical adjustment to the language of the Proposed Regulations to reflect the language now used in the statute.

III. Certain Definitions

A. Definition of "Plan"

In the 2005 NYSBA Report, we urged that the language "under the plan" in the penalty provisions of Section 409A be given its plain English meaning except in cases of abuse, where traditional doctrines honoring substance rather than form warranted aggregation. The Proposed Regulations did not

adopt our proposal. We recognize that it is important to prevent the manipulation of plan documentation to create ostensibly separate plans that are in substance one plan, thus evading the force of the penalties for violation of Section 409A. However, we believe that the plan aggregation rules can be refined without inviting abuse. We therefore respectfully request that Treasury and the IRS reconsider this question.

Proposal

We propose that:

- Within the account balance plan and non-account balance categories, elective deferral plans be viewed as separate from nonelective plans (but treating matching credits contingent on elective contributions as made under the same plan as the underlying elective combinations);
- Within the account balance categories, elective salary deferrals be treated as made under separate plans from elective bonus deferrals, even if made under one plan document;
- The variety of post-employment perquisites that may be provided in employment agreements, such as expense reimbursements or provisions for the use of facilities and services, represent a further distinct category;
- Non-U.S. plans be treated separately from U.S. plans; and
- Other types of plans be treated separately, as may be set forth in notices or other authority of general application from time to time.

Discussion

We recognize that proper administration of Section 409A requires that service providers and recipients be prevented from manipulating the documentation of deferred compensation arrangements to avoid the statutory requirements and penalties, by creating many ostensibly separate plans that are in fact substantively one plan. The Proposed Regulations address this issue by aggregating, for most purposes, all plans in each of four broad categories: account balance, nonaccount balance, separation pay and other (largely equity-based arrangements). We concur with this general approach, focusing on identifying types of arrangements that are similar in design and purpose, and treating each such type as one "plan." We request, however, that Treasury and the IRS reconsider the recommendations made in our 2005 NYSBA Report on this point to further refine this categorization.

We believe that the four broad categories set forth in the Proposed Regulations aggregate plans that are dissimilar in meaningful and critical respects. As a result, plans that by their nature are administered separately and have widely differing terms and features are aggregated, with various incongruous results. For example, consider the case in which an employer maintains an elective deferral program for senior management's bonuses, and an excess plan in which a much larger group participates, under which bonuses may not be deferred, but contributions from salary are matched by the employer; these two account balance plans would be aggregated under the Proposed Regulations. As a result, an employee who has participated for years in the excess plan and then becomes eligible for the management bonus deferral plan will not be able to make an initial deferral election under the latter plan using the 30-day rule, because he is already participating in a plan of the same category. In addition, if the administrator of the bonus deferral plan allows "late" deferral elections, employees who are participants in both plans will be subject to penalties on their elective deferrals of salary and matching contributions

under the excess plan, even though the failure of administration pertained to a feature that is not even relevant to the excess plan.

Our reason for recommending that salary deferral and bonus deferral plans be disaggregated is based on the distinctly different impact of Section 409A on such plans. The Section 409A timing rules for salary deferrals do not require change from traditional practice prior to the enactment of Section 409A. However, deferrals of bonuses and incentive compensation involve more complex rules, with different rules for bonuses that are performance-based and those that are not. Accordingly, we submit that arrangements for salary deferrals which do not involve the possibility of such an election timing error, and arrangements for bonus deferrals which involve that possibility, should be considered separate plans (and possibly treated as separate even if not formally so structured) in order to avoid imposition of a penalty on salary deferrals for a violation of a rule not even applicable to such deferrals.

In addition, it does not appear that much attention has yet been given to the treatment of items such as car or plane allowances, financial counseling services, club dues and other taxable post-termination reimbursement arrangements that may now be considered to be deferred compensation under Section 409A. The manner of applying rules designed for conventional plans, such as requiring that the time and form of payment be fixed at the date of deferral, does not readily fit the universe of perquisites. Accordingly, we believe that such taxable perquisites should not be aggregated with traditional deferral arrangements. At a minimum, such perquisites collectively should be viewed as a separate plan. However, we do not wish to rule out the possibility that differences in the treatment ultimately to be accorded various perquisites under the regulations will warrant the division into subcategories, each of which would be regarded as a separate plan for penalty purposes.

Non-U.S. plans represent another category that we believe has not yet received enough attention in the context of Section 409A. Such plans may be locally qualified or nonqualified and subject to separate regulatory regimes that have little or no relationship to U.S. requirements, and may be adopted and administered without any connection to or knowledge of applicable U.S. laws (including Section 409A). While the full range of the possible impact of Section 409A on non-U.S. plans is unclear, at a minimum, as a result of the plan aggregation rules a U.S. taxpayer who participates in both U.S. and non-U.S. deferred compensation plans of a multinational company is at risk for having severe penalties applied because of non-compliance with Section 409A by the company's non-U.S. plans.[8] Accordingly, we recommend that non-U.S. plans not be aggregated with U.S. plans. For these purposes, the excluded "non-U.S. plans" could be defined as plans that are (i) excluded from ERISA coverage by reference to non-U.S. participation (i.e., plans maintained outside the United States primarily for the benefit of persons substantially all of whom are non-resident aliens,[9] or (ii) maintained outside the United States which for legitimate business reasons cover primarily non-resident aliens.

Finally, we believe that, over time, Treasury and the IRS may become aware of other types of distinctions that justify disaggregation, perhaps for different purposes under Section 409A (e.g., if not for

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[8] For example, assume that a U.S. taxpayer who works for a period in the U.S. and accrues a deferred compensation balance under a U.S. account-based nonqualified deferral plan is transferred to another country, where he is covered by a different account-based deferral plan designed for employees based in that country, which does not comply with Section 409A. In such a case, the U.S. taxpayer's balance under the U.S. plan as well as the non-U.S. plan would be subject to acceleration and a 20% penalty.

[9] ERISA § 4(b)(4).

penalty purposes then for other purposes, such as plan termination provisions), and we believe that the final regulations should expressly permit the issuance of notices or other authority permitting specified departures from the ordinarily applicable aggregate rules. This flexibility could provide Treasury and the IRS with a convenient tool to address developments and provide additional analysis and consideration in the future.

B. Grandfathering and Plan Aggregation

1. Certain Actuarial Issues

Section 1.409A-6(a)(3)(v) of the Proposed Regulations states that, for purposes of paragraph (a), "plan" has the same meaning as provided in Section 1.409A-1(c), except that the provisions treating all nonaccount balance plans under which compensation is deferred as a single plan do not apply for purposes of the actuarial assumptions used in paragraph (a)(3)(ii) of such section.

Proposal

We believe there may be a typographical error in Section 1.409A-6(a)(3)(v) of the Proposed Regulations. Although it is not entirely clear, we believe the reference in such section should be to "paragraph (a)(3)(i)," rather than to "paragraph (a)(3)(ii)."

Discussion

Section 1.409A-6(a)(1) of the Proposed Regulations states, among other things, that Section 409A applies to amounts deferred in taxable years beginning before January 1, 2005, if the plan under which the deferral is made is materially modified after October 3, 2004. Section 1.409A-6 of the Proposed Regulations provides two separate definitions of "plan" – one in Section 1.409A-6(a)(3)(v) and the other in Section 1.409A-6(a)(4)(vi). Section 1.409A-6(a)(3)(v) of the Proposed Regulations states that, for purposes of paragraph (a), "plan" has the same meaning as is provided in Section 1.409A-1(c), except that the provisions treating all nonaccount balance plans under which compensation is deferred as a single plan do not apply for purposes of the actuarial assumptions used in paragraph (a)(3)(ii). However, paragraph (a)(3)(ii) relates to account balance plans and makes no reference to actuarial assumptions. We believe that the correct cross-reference should be to paragraph (a)(3)(i), which does relate to nonaccount balance plans.

2. Material Modifications and Aggregation

Because there are two separate definitions of "plan" in Section 1.409A-6 of the Proposed Regulations relating to grandfathered arrangements, the final regulation should clarify how the different definitions are to be applied.

Proposal

We believe that Section 1.409A-6(a)(1) of the Proposed Regulations should be clarified to state that a material modification to an individual plan (without giving effect to plan aggregation rules) will not result in amounts deferred under all plans of the same type as the modified plan (giving effect to plan aggregation rules) being subject to Section 409A.

Discussion

Section 1.409A-6(a)(1) of the Proposed Regulations provides that Section 409A is effective with respect to amounts deferred in taxable years beginning before January 1, 2005, if the "plan" under which the deferral is made is materially modified after October 3, 2004. Section 1.409A-6 of the Proposed Regulations has two separate definitions of "plans" – one in Section 1.409A-6(a)(3)(v) and the other in Section 1.409A-6(a)(4)(vi). Each is discussed below.

Section 1.409A-6(a)(3)(v) of the Proposed Regulations provides that for purposes of paragraph (a), the term "plan" has the same meaning as provided in Section 1.409A-1(c), with certain exceptions as described above. This reference could be read to mean that plan aggregation rules are applicable to the definition of "plan" used in Section 1.409A-6(a)(1). Accordingly, one could read Section 1.409A-6(a)(1) as meaning that, if a single arrangement is materially modified after October 3, 2004, all amounts deferred under that arrangement, and all arrangements of the same type (i.e., account balance plans, nonaccount balance plans, separation pay arrangements or all other plans) as the modified plan, will be subject to 409A. We believe that the intent was to have the "-6(a)(3)(v)" definition apply for purposes of Section 1.409A-6(a)(3).

On the other hand, Section 1.409A-6(a)(4)(vi) of the Proposed Regulations provides that for purposes of paragraph (a)(4) (relating to the definition of material modification), the term "plan" has the same meaning as provided in Section 1.409A-1(c), except that the provision treating all account balance plans under which compensation is deferred as a single plan, all nonaccount balance plans under which compensation is deferred as a separate single plan, all separation pay arrangements as a single separate plan, and all other nonqualified compensation plans as a separate single plan, does not apply. This paragraph implies that a material modification to one arrangement will not necessarily be a material modification to all arrangements of the same type. We believe that the intent was to have the "-6(a)(4)(vi)" definition apply for purposes of Section 1.409A-6(a)(4) insofar as a plan is modified.

C. **Definition of "Service Provider"**

Notice 2005-1 recognized, in Q&A 8, that Section 409A is essentially directed at individual service providers, and thus generally defined "service provider" to include only individuals, personal service corporations and qualified personal service corporations. Section 1.409A-1(f)(1) of the Proposed Regulations, like Notice 2005-1, specifically states that personal service corporations and qualified personal service corporations (and noncorporate entities that would qualify as such, were they corporations) are "service providers," but also includes corporations and other entities in the definition of "service provider."

Proposal

We believe that, in accordance with the approach in Notice 2005-1 regarding the definition of "service provider," the scope of those non-natural persons that are subject to Section 409A should not be expanded as a general matter beyond personal service corporations and qualified personal service corporations (determined without regard to form of organization).

Discussion

Section 1.409A-1(f)(1) of the Proposed Regulations specifically provides that personal service corporations and qualified personal service corporations are "service providers," but also earlier includes corporations and other entities in the definition of "service provider," thus making the later references to the specific types of entities superfluous. This change from the approach in Notice 2005-1 is not

discussed in the Preamble. While we acknowledge that the impact of this approach is less onerous than it might be as a result of the provisions excluding accrual-basis taxpayers and in light of the relief offered for back-to-back deferral elections, we nonetheless believe that this expansion extends Section 409A beyond its intended application to deferral of compensation by natural persons and their surrogates.

In particular, the inclusion within the scope of Section 409A of independent contractors, as opposed to coverage limited exclusively to employees, can result in the expansion of the concept of "service provider" to non-natural persons in a manner that can be problematic. For example, we would not think that Treasury and the IRS intend for any service provider in an arm's length commercial relationship to be subject to Section 409A merely because the service provider is a cash-method taxpayer. Stated another way, consistent with Notice 2005-1, an entity that is not regarded for federal tax purposes as the alter ego of a natural person should not be subjected to Section 409A merely because it operates on the cash basis.

We suggest that if Treasury and the IRS have identified particular types of non-natural persons, the use of which could serve to frustrate the anti-abuse intent of Section 409A, those types could be added to the list of entities covered. However, the blanket inclusion of all entities as covered entities (which, as noted, renders clauses (ii) and (iii) of Section 1.409A-1(f)(1) of the Proposed Regulations virtually superfluous) may unduly expand the scope of Section 409A. Under our proposal, Section 409A would capture compensation that is in the nature of employee-type compensation, including compensation to independent contractors performing employment-type services, without unduly expanding the scope of Section 409A to commercial arrangements and other services not in the employment-type context.[10]

IV. Stock Right Issues: Extensions of Stock Rights; Certain Other Modifications

A. In General

The Proposed Regulations provide that stock options and stock appreciation rights ("SARs," and, together with stock options, "stock rights") are not subject to 409A if they meet certain requirements, including the requirement that the stock rights not have any deferral feature other than the deferral of recognition of income until the date of exercise (or, if applicable, the date of the vesting of the stock acquired on exercise). For these purposes, a stock right is considered to have such a deferral feature unless its exercise price can never be less than the fair market value of the underlying stock, measured on the date of grant.

Generally, if a stock right is "modified" after it is granted, the Proposed Regulations treat the modified stock right as being newly granted for purposes of determining whether it is subject to Section 409A; for example, if the exercise price of the stock right is less than the fair market value of the underlying stock on the date of the modification, the stock right will be subject to Section 409A as of the date of the modification. This approach is modeled on the Treasury Regulations under Section 424 of the Code, relating to statutory options, which are also required to have exercise prices not less than the fair market value of the underlying stock on the grant date.

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[10] It is noted that some members of the Executive Committee of the Tax Section feel that the approach in the Proposed Regulations excluding accrual-basis taxpayers sufficiently addresses the concern about potential undue coverage of Section 409A to non-natural persons. The recommendation in the text above reflects the view of certain other members of the Executive Committee and of the co-authors of this Report.

However, Section 1.409A-1(b)(5)(v) of the Proposed Regulations takes a different approach than the Section 424 regulations in the case of a modification in the form of the extension or renewal of the term of a stock right; in such a case, the stock right is treated as having had a deferral feature as of the time of its original grant, thus subjecting it to Section 409A ab initio.

Proposal

Section 1.409A-1(b)(5)(v)(C) of the Proposed Regulations, concerning the modification, extension and renewal of stock rights, should take the approach of the Treasury Regulations under Section 424, applicable to statutory options, so that:

- if a stock right that has been excluded from Section 409A since the time of grant is extended or renewed at a time when the exercise price is equal to or greater than the fair market value of the underlying stock, the stock right continues to remain outside the scope of Section 409A; and
- the extension or renewal of a stock right at a time when the exercise price is less than the fair market value of the underlying stock (i.e., an in-the-money stock right) causes the stock right to be treated as having had an additional deferral feature (and thus to be subject to Section 409A) from the date of modification, not from the date of grant, as provided in the Proposed Regulations.

Discussion

The extension/modification provisions of the Proposed Regulations are based on the current regulations under Section 1.424-1(e) of the Treasury Regulations. Under Section 1.424-1(e) of the Treasury Regulations, if a statutory option is modified at a time when the option is "out of the money," it is not disqualified because, when analyzed as a new grant, it satisfies the exercise price requirement. The Proposed Regulations, however, disqualify a stock right that is modified by extension or renewal from its exclusion from Section 409A (because a deferral feature is added) as of the date of grant (not as of the date of modification). We are puzzled by this relation back to the date of grant and note the absence of any explanation in the Preamble. We believe that retroactive disqualification of out-of-the-money stock rights (which could include stock rights that were never in the money) is inconsistent with the underlying purpose of Section 409A because there is no income deferral at the time of modification. It also elevates form over substance, because if the stock right were simply replaced with a new stock right on the same terms, the new stock right would be exempt from Section 409A.

Further, consistent with the framework of Section 1.424-1(e) of the Treasury Regulations, if a stock right that has been excluded from Section 409A since the time of grant is extended or renewed at a time when the stock right is "in the money," the stock right should become subject to Section 409A at that time and not retroactively to its grant date. A modification of an in-the-money stock right, other than an extension or renewal thereof, causes the stock right to be subject to Section 409A on the date of modification. This result is consistent with the modification rules under Section 422. We do not see the basis for altering this approach in respect of modifications that are extensions or renewals. The deferral of compensation that results from an extension/renewal occurs at the time of the extension/renewal, and we submit that the tax consequences of this action are properly measured at that time.

B. Pre-Act Modifications

Stock rights may well have been extended, renewed or modified before the enactment of Section 409A, and it presently is unclear whether such modifications would have an adverse effect under Section 409A.

Proposal

We request clarification that any extension, renewal or modification of a stock right made before the end of 2004 will not cause the right to be subject to Section 409A.

Discussion

Before the issuance of Notice 2005-1 on December 20, 2004, there was considerable uncertainty as to the extent to which stock rights were subject to Section 409A and about whether, and to what extent, a modification of a stock right might cause it to become subject to Section 409A. Many stock rights that were not vested on December 31, 2004 and were modified before January 1, 2005 will already have been exercised, and many actions (such as termination of employment) will have been taken in reliance on the modification. Other provisions of the Proposed Regulations recognize that many points relating to stock rights were unclear during the initial months after the enactment of Section 409A. For example, Section 1.409A-1(b)(5)(iii)(E) of the Proposed Regulations provides that the limitations on the classes of stock that will be considered "service recipient stock" under the regulations will not apply to stock rights granted on or before December 31, 2004. Similarly, we believe that a modification made before the end of 2004 should not subject a stock right to Section 409A and its related penalties.

V. Stock Right Issues: Definition of Service Recipient Stock

Under the Proposed Regulations, in order for stock rights to qualify for exemption from Section 409A, the right must be to acquire stock of the "service recipient." "Service recipient" is generally defined by reference to the controlled group rules of Section 414(b) and (c). Our comments below are intended to help refine these rules to better accomplish what we believe to be their purpose: to exclude from the reach of Section 409A traditional compensatory stock rights, even though they may incorporate elements of deferred compensation.

A. Preferred Stock

Section 1.409A-1(b)(5)(iii)(A) of the Proposed Regulations provides that "under no circumstances does stock of the service recipient include stock that is preferred as to liquidation or dividend rights . . . ." The Preamble explains that Treasury and the IRS believe that the exemption from Section 409A for certain stock rights is intended to cover stock "the fair market value of which meaningfully relates to the potential future appreciation in the enterprise value of the corporation." According to the Preamble, "[t]he use of preferred stock with substantial characteristics of debt . . . could create an arrangement that more closely resembles traditional nonqualified deferred compensation arrangements rather than an interest in appreciation of the value of the service recipient."

Proposal

We recommend that the final regulations narrow the definition of "preferred stock" so that service recipient stock includes certain participating preferred that would be treated as common stock for other tax purposes and that satisfies additional requirements, such as stock that (i) is preferred in liquidation but, after payment of the preference, shares pari passu with the common, but only if the option or other right to acquire the preferred is not substantially certain to later become "in the money" as the result of a

time-based accretion (e.g., fixed dividends);[11] (ii) is "tracking" stock that is tranched or otherwise designed to return value based on the performance of specific subsidiaries or business units of a holding company for which a service provider has provided substantial services; (iii) is issued as part of a capital structure in which the outstanding "common" stock does not enjoy significant economic growth or return (e.g., as might be created in restructuring a troubled company); or (iv) satisfies such other criteria as may be set forth in notices or other guidance. We also recommend that the final regulations include appropriate examples.[12]

Discussion

As noted in the Preamble, stock with an automatically accruing dividend or liquidation preference could have the effect of deferring compensation if the service provider were substantially certain to obtain the economic benefit of accruals, rather than actually participating in the economic performance of the service recipient. However, because it is not clear how "preferred stock" is defined for purposes of Section 409A, confusion may arise, and taxpayers may be prevented from granting stock rights with respect to classes of stock that in fact would be treated as common stock for income tax purposes generally. This result is particularly likely in the context of private equity investments with complex capital structures.

While we acknowledge that issues will arise regarding preferred stock, we think it is inappropriate to exclude from the definition of "service recipient stock" every class of stock that has any liquidation or dividend preference, regardless of the extent of that class's participation in corporate growth. Corporations, particularly private companies, are often capitalized with one or more classes of participating stock that may have some economic preferences but that have none of the debt-like features resembling traditional deferred compensation (e.g., fixed dividends or other coupon, mandatory payment or redemption date, and creditors' rights in a bankruptcy proceeding). Sections 305 and 1504 of the Code recognize this distinction by treating certain "participating" preferred stock as common stock.

In light of the foregoing, we recommend that the final regulations permit the use of "preferred stock" for Section 409A purposes in the cases described above in the "Proposal" portion of this Section V(A).

On the other hand, an option would not be excluded from the scope of Section 409A if it relates to stock (i) that has a preference with respect to liquidation or distribution (either under the terms of the stock or by reason of other arrangements, such as a right granted to the holder to put the stock to the issuer or a related person) and (ii) with respect to which, as a result of the preference or other rights, it is substantially certain that the value of the stock will exceed the exercise price of the option (i.e., the option would become an in-the-money option) solely by reason of the passage of time. The option in this case would be appropriately subject to Section 409A because, taking into account the terms of the stock to which it relates as well as any other rights to put the stock, it more resembles traditional nonqualified deferred compensation arrangements than an interest in appreciation of the value of the service recipient.

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11 For example, a start-up corporation might issue, in year 1, 10 shares of class A common, and, in year 2, 10 shares of class B common that is entitled to a liquidation preference of $100 per share, after which all A and B shares participate pari passu in profits. Under the rule in clause (i) of the text, both classes of shares would qualify as service recipient stock.

12 See also footnotes 15 and 17.

For example, if a service provider receives an option to purchase for $1005 preferred stock with a liquidation preference (and fair market value) of $1000, the preferred stock provides for a 10% pay-in-kind dividend, and it is substantially certain that the value of the preferred stock (taking into account the pay-in-kind dividend) will exceed the $1005 exercise price, the stock would be excluded from the definition of "service recipient stock" and the option would be subject to Section 409A. The result would be the same if the stock had no liquidation preference but was subject to a put to the issuer or a related party for $1005 plus accrued dividends. Conversely, if the payment of the liquidation value or the pay-in-kind dividend were not substantially certain, the option would not be excluded under this rule.

B. Controlled Group Members Should Not be Limited to One Class of Stock

For purposes of determining whether a given class of stock will qualify as "service recipient stock," Section 1.409A-1(b)(5)(iii)(A) of the Proposed Regulations appears to limit each member of a controlled group of entities to using (i) the publicly traded stock of a group member or (ii) if no member of the controlled group has publicly traded stock, the one class of stock within the controlled group having the "greatest aggregate value."

Proposal

We recommend that the "service recipient stock" definition under Section 1.409A-1(b)(5)(iii) of the Proposed Regulations be expanded to permit the grant of stock rights not subject to Section 409A to all service providers working for a member of a controlled group of corporations[13] based on the stock[14] of any member of the controlled group, regardless of whether a member of the controlled group has a publicly traded class of stock or stock with a greater aggregate value, provided that (i) the issuer is in the same vertical chain as the actual service recipient or (ii) the issuer is in a different vertical chain and the use of the issuer's stock is based on legitimate business criteria. We also recommend that service recipient stock include any class of common stock of an acceptable entity (rather than merely the class of stock with the largest value), as well as any preferred stock thereof that meets whatever Section 409A requirements the final regulations impose.

Discussion

Business circumstances frequently make it desirable for service recipients to grant stock rights based on the stock of different members of the controlled group to different groups of service providers, based on the particular businesses to which they render services. For example:

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[13] References herein to the "controlled group" are intended to include members of the expanded controlled group as defined under Section 1.409A-1(b)(5)(iii)(D)(1) of the Proposed Regulations. See also our comments in Sections V(D) and V(E) below regarding the application of the "at least 20%" rule for these purposes.

[14] References herein to "stock" are also intended to refer to partnership and similar interests of members of a controlled group. As noted in Section V(F) below, we believe that Treasury and the IRS should generally continue to permit partnership and similar interests to be treated like stock for purposes of Section 409A (thereby permanently extending the application of Notice 2005-1, Q&A 7). See also our discussion in Section V(A) above regarding the application of these rules to preferred stock.

- Controlled groups with multiple members engaged in multiple, distinct lines of business often wish to create distinct equity incentives for employees based on the line of business in which they are engaged.

- Similarly, if a non-U.S. business entity has a U.S. subsidiary, it will often be more appropriate that stock rights granted to the U.S. subsidiary's U.S.-based employees be based on the U.S. subsidiary's stock rather than the stock of the foreign parent.

- Often, in connection with a pending disposition of a subsidiary by its parent or a pending stock spin-off, split-off or an initial public offering of stock of a subsidiary, employees are granted stock rights based on the stock of the subsidiary, to provide them with an incentive to maximize the equity value of the subsidiary.

Such grants, which are made for good business reasons in order to provide incentive compensation, and not as a means of providing disguised deferred compensation, would nonetheless not come within the exception to Section 409A provided by the Proposed Regulations, because the stock to which the stock rights relate is not "service provider stock."

As noted in the 2005 NYSBA Report, we recognize that Congress may have intended to limit the stock option exception from Section 409A to options (or SARs) that are based on the stock of an entity having a nexus to the service relationship. Accordingly, we do not propose that stock rights based on securities of entities having no connection to the service relationship (such as third-party mutual fund shares) should be exempt from Section 409A. However, we believe that the narrow scope of the service recipient stock rule in the Proposed Regulations expands the application of Section 409A well beyond its intended scope.

We therefore propose that each member of a controlled group be permitted to grant stock options or SARs based on its own stock to the employees and other service providers who perform substantial services for the group, so long as the issuer is in the same vertical chain as the actual service recipient (including the service recipient itself), or the use of the stock of an issuer in a different vertical chain satisfies legitimate business criteria. This expanded rule would permit companies to continue incentive arrangements for its own service providers and other arrangements that have been regularly used before the enactment of Section 409A for good business reasons, without using those arrangements as a means to provide disguised deferred compensation.

In addition, we believe that, when a single private issuer has multiple classes of common stock, the rule limiting service recipient stock to the class of issuer stock having the greatest value is unduly restrictive. Private companies often issue multiple classes of common stock, which may differ in voting rights and economic rights (e.g., as a result of successive financing rounds of a start-up company). Employees often receive stock, or options on stock, of a class that is not of the most valuable class. We believe such common stock generally should qualify as service recipient stock so as not to discourage nonabusive commercial arrangements of this type. Therefore, we recommend that service recipient stock include any class of common stock of the acceptable entity (rather than merely the class of stock with the largest value), as well as any preferred stock thereof which meets whatever Section 409A requirements

the final regulations impose (see Section V(A)), because the use of such stock does not seem susceptible to manipulation and abuse.[15]

If this recommendation is not adopted in whole or in part, we request that the final regulations explain how to apply the "greatest aggregate value" test (and, particularly, how, in the case of non-corporate entities, different classes of interests are to be measured for this purpose) and address the situation in which a controlled group has more than one class of publicly traded common stock. Common examples would include a corporate structure under which a publicly traded parent owns 80% of a subsidiary, with the other 20% being publicly traded, and "tracking stock" issued by a public corporation and designed to track the value of one of its business units. In such cases, one purpose of the structure frequently is to allow the subsidiary or tracking stock to serve as the basis for stock rights granted to employees of the relevant business unit. The Proposed Regulations address the situation in which a controlled group has one class of publicly traded stock, or no such class, but they do not provide any guidance when there is more than one such class.

C. Effective Date of "Service Recipient Stock" Requirements.

Section 1.409A-1(b)(5)(iii)(E), relating to the class of service recipient common stock that may be used for stock rights, provides that the changes made by the regulations will not apply to stock rights granted on or before December 31, 2004. The Proposed Regulations provide no similar relief for the prohibition against the use of preferred stock.

Proposal

The final regulations should provide that the common stock and preferred stock requirement will not apply to stock rights granted before the Proposed Regulations were released on September 29, 2005.

Discussion

The rules governing the use of common stock have been the subject of continued development, and the new rules in the Proposed Regulations relating to preferred stock were not foreshadowed. Taxpayers should not be penalized for a failure to have complied with those rules before the issuance of the Proposed Regulations.

D. Use of Reduced-Percentage Test for Service Recipient Stock – In General

Section 1.409A-1(b)(5)(iii)(D)(1) of the Proposed Regulations permits a plan to specify that the ownership percentage for identifying controlled-group members under Section 414(b) and (c) can, under certain circumstances, be 20% rather than 50%, but requires the use of the lower threshold to be effected "consistently."

Proposal

We propose that the final regulations provide that use of the 20% threshold is permitted in operation whenever the substantive rules of the regulations are satisfied, without requiring specification in the plan, and that the consistency requirement be explained or eliminated.

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15 As indicated in footnote 17, valuation and buy-back provisions that have the effect of converting stock to debt-like interests could appropriately be prohibited for purposes of Section 409A.

Discussion

A service recipient should be permitted to use stock that is consistent with the requirements of Section 409A, whether or not the plan expressly states that a reduced ownership percentage is being used, so long as it is clear which stock is applicable. We note that, for incentive stock options, the parallel requirement is an operational (and not a form) requirement. While many plans already do or will comply in form, this step would not appear to be necessary to assure compliance with Section 409A. We see no potential for abuse that is addressed by requiring service recipients to make the election in every case in which the lower threshold is to be utilized. Further, if the "legitimate business interests" requirement is retained, we question whether and how that requirement should be addressed in the plan documents, as opposed to being simply an operational requirement.

Lastly, because grants of stock rights by their nature are discretionary in any event, we do not see what is accomplished by the requirement that the reduced threshold be applied "consistently to all compensatory stock rights," and we request that Treasury and the IRS articulate their concerns on this point. We believe that if all of the other requirements are satisfied in respect of the grant of stock rights, there should be no abusive compensation deferral that would occur, and do not understand how the consistency requirement is intended to foster compliance.

E. Definition of "Legitimate Business Criteria" for the Use of the Reduced Percentage Test

If the use of the stock is based upon "legitimate business criteria," Section 1.409A-1(b)(5)(iii)(D)(1) of the Proposed Regulations permits a service recipient to elect to apply a 20% threshold for purposes of applying the controlled group and common control rules of Section 414(b) and (c) in identifying service recipient stock.

Proposal

We recommend that Section 1.409A-1(b)(5)(iii)(D)(1) of the Proposed Regulations be amended to provide more detailed guidance regarding what constitutes "legitimate business criteria" for this purpose.

Discussion

By way of example, the Proposed Regulations indicate that where a corporation has at least a 20% interest in a joint venture, the corporation's stock will generally be considered service recipient stock with respect to stock rights issued to employees of the joint venture who were former employees of the corporation. Presumably, the example was intended to indicate that "legitimate business criteria" exists where a prior service provider/service recipient relationship existed between the service providers and the service recipient corporation in question. Numerous other situations, not otherwise described in the example, should be encompassed in the ambit of "legitimate business criteria" for purposes of the 20% subsidiary rule. However, the Proposed Regulations provide no additional specific guidance regarding what constitutes "legitimate business criteria" in this context.

We recommend that the final regulations include additional examples showing that "legitimate business criteria" exist in cases where (i) the parent corporation's stock has greater liquidity or a more readily ascertainable value than the stock of the 20%-50% subsidiary, or (ii) the parent corporation and the 20%-50% subsidiary have a continuing service provider relationship with each other on an entity level (i.e., the parent corporation provides substantial services to the 20%-50% subsidiary, or vice-versa).

F. Indirect Service Provider Relationships

The Proposed Regulations impose minimum ownership rules for the use of service recipient stock, even where the ultimate service providers are providing services indirectly for the benefit of an ultimate service recipient.

Proposal

For purposes of the service recipient stock rules, we recommend that the term "service provider" be amended to include persons who indirectly provide services to a designated service recipient (such as employees of a REIT management company who indirectly provide services to the REIT), even if the entity for which the services are directly performed (e.g., the REIT management company) is not in the same controlled group as the ultimate service recipient (e.g., the REIT).

Discussion

In the 2005 NYSBA Report, we requested that there be no requirement for an ownership relationship between a direct service recipient and an issuer of a stock right, so long as (i) there was a business relationship between the recipient and the issuer, and (ii) (A) the stock rights were on securities of bona fide operating companies (including a parent company) as defined for purposes of Section 1042 (or possibly some other reference point) or (B) the options were on securities in certain tax-preferred vehicles that have characteristics which are likely to cause the grants to have predominantly customary, rather than abusive, characteristics. For example, the REIT rules are intended to provide tax incentives for the establishment and operation of REITs. We think that a rule which would prevent options on REIT shares from being granted to employees of the REIT management company and other affiliate employees would place externally managed REITs at a significant competitive disadvantage to self-managed entities, as a result of legitimate choices regarding business structure not related to compensation decisions. We asked that Treasury and the IRS consider these matters carefully so as to avoid unnecessary market disruption in industries where the unfettered use of options and SARs to compensate indirect service providers is not inconsistent with the fundamental policies underlying Section 409A.

We restate our request for consideration of these points. It is becoming evident that the rules as proposed will make a broad range of commercially reasonable compensation arrangements impermissible, merely because the corporate structure being used to do business involves the indirect performance of services for an ultimate service recipient. The rules should permit stock rights to be exempt from Section 409A so long as the ultimate grantees are individuals performing services and the ultimate recipient of those services is the issuer. This approach would allow externally managed entities to use the same legitimate techniques that are already available to internally managed entities, without posing a threat of abuse.

G. Service Recipient Stock Rules Should be Extended to Non-Corporate Service Recipients

Notice 2005-1, Q&A 7, provided that "until additional guidance is issued, for purposes of Section 409A taxpayers may treat the issuance of a partnership interest (including a profits interest), or an option to purchase a partnership interest, granted in connection with the performance of services under the same principles that govern the issuance of stock." Section II(E) of the Preamble similarly provides that "[u]ntil further guidance is issued, taxpayers may continue to rely on Notice 2005-1, Q&A 7," for purposes of determining the application of Section 409A to partnership arrangements.

Proposal

We recommend that the final regulations continue to reflect the same approach until specific requirements applicable to non-corporate service recipients such as partnerships and limited liability companies ("LLCs") are set forth.

Discussion

While we recognize that partnership and LLC arrangements raise some unique issues, we believe that there is no tax policy reason or legislative intent to limit the definition of service recipient stock to stock of corporate entities. Companies organized as partnerships and LLCs should be permitted to establish option and SAR-type arrangements for their employees and other service providers on the same basis as corporate entities.

As noted in Section V(B) above, the application of the "highest aggregate value" test is particularly ill-suited to non-corporate entities. Frequently, companies organized as partnerships or LLCs will have multiple classes of units or interests with different rights. Further, it is unclear how the exclusion of "stock that is preferred as to liquidation or dividend rights" from the definition of service recipient stock would be applied in the context of partnerships or LLCs.[16] When more specific guidance on the application of the "service recipient stock" concept to partnership and LLCs is issued, these questions should be addressed.

VI. Stock Rights: Valuation of Private Corporation Stock

One requirement for an option not to be subject to Section 409A is that the option exercise price be at least equal to the fair market value of the underlying stock at the time of grant. Treasury and the IRS have provided very helpful guidance for valuing stock that is not readily tradable on an established securities market, including three safe harbor methods: independent appraisal; valuation based on a formula meeting certain requirements (the "Nonlapse Restriction Formula Safe-Harbor"); and valuation based on a written report (available only for illiquid stock of start-up corporations). Among the requirements for a valuation method to qualify for the Nonlapse Restriction Formula Safe-Harbor are that the formula must meet the requirements of Section 1.83-5 of the Treasury Regulations, and that it be used consistently for both compensatory and noncompensatory purposes.

Proposal

We recommend that Section 1.409A-1(b)(5)(iv)(B)(2)(ii) of the Proposed Regulations be amended to make the Nonlapse Restriction Formula Safe-Harbor available so long as the same formula is used consistently under the equity-based compensation arrangements of the service recipient, eliminating the requirement that the same formula be used for all (compensatory and noncompensatory) purposes.

Discussion

Limiting the scope of the Nonlapse Restriction Formula Safe-Harbor to valuations that are used consistently for all compensatory and noncompensatory purposes is unnecessarily restrictive and will impose undue hardship upon a significant number of privately-held corporations. A significant number of

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[16] See Section V(A) above.

privately-held corporations maintain equity-based compensation arrangements that rely on the use of a nonlapse restriction formula as a method of valuing the underlying stock. For a variety of legitimate business reasons, it is not feasible for many of these corporations to ensure that the method used to value stock for purposes of its equity-based compensation arrangements is the same for all noncompensatory purposes requiring the valuation of the stock. For example, private equity investors and lenders will often dictate that alternative valuation methods be used to value stock for noncompensatory purposes. Accordingly, many privately-held corporations with equity-based compensation arrangements that value stock using a nonlapse restriction formula will be unable to meet the requirements of the proposed Nonlapse Restriction Formula Safe-Harbor. Since many privately held corporations are not start-up corporations and will not have the financial resources to obtain annual independent appraisals, many will be left without any assurance that their equity-based compensation arrangements are considered fairly valued for purposes of Section 409A. This result could place a significant number of privately held corporations at a competitive disadvantage from public corporations, because, although in theory private companies' valuation methods are not required to fit within one of the safe harbors, in practice the consequences of stock rights' failing to meet the requirements for exemption from Section 409A are so severe that many private companies may well be unwilling to take such a risk.

We understand that the proposed Nonlapse Restriction Formula Safe-Harbor has been drafted narrowly to alleviate concerns that the use of a nonlapse restriction formula may be subject to manipulation. However, we believe that Section 1.83-5 of the Treasury Regulations and the interpretive guidance thereunder sets forth meaningful and well-reasoned standards and safe-guards for determining whether the price of stock valued under a nonlapse restriction formula will be considered to be valued at fair market value. Specifically, in the Preamble, Treasury and the IRS acknowledge that Section 1.83-5(a) of the Treasury Regulations provides that:

> [I]n the case of property subject to a nonlapse restriction (as defined in Treasury Regulation Section 1.83-3(h)), the price determined under the formula price is considered to be the fair market value of the property unless established to the contrary by the Commissioner, and the burden of proof is on the Commissioner with respect to such value. If stock in a corporation is subject to a nonlapse restriction that requires the transferee to sell such stock only at a formula price based on book value, a reasonable multiple of earnings or a reasonable combination thereof, the price so determined ordinarily is regarded as determinative of the fair market value of such property for purposes of Section 83.

This regulation also states, in pertinent part, that, "in certain circumstances, the formula price will not be considered to be the fair market value of property subject to such a formula price restriction, even though the formula price restriction is a substantial factor in determining such value." However, the regulation does not require that the stock be valued using the same formula price for all compensatory and noncompensatory purposes.

We believe that any concerns regarding manipulation of the stock price may be adequately addressed by applying the standards under Section 1.83-5 of the Treasury Regulations and the interpretive guidance thereunder.[17] Such concerns could be further alleviated by requiring that the same nonlapse

[17] On the other hand, valuation and buy-back provisions that have the effect of converting the economics of a common interest into a debt-like instrument could appropriately be excluded from "service recipient stock."

restriction formula be applied consistently for all purposes of the equity-based compensation arrangements of the service recipient.[18]

VII. Fringe Benefits, Perquisites, Reimbursements, Etc.

Section 1.409A-1(b)(9)(i) of the Proposed Regulations provides generally that an arrangement that otherwise provides for a deferral of compensation under Section 1.409A-1(b) of the Proposed Regulations does not fail to provide a deferral of compensation merely because the right to payment of the compensation is conditioned upon a separation of service. Section 1.409A-1(m) of the Proposed Regulations specifies that "separation pay" includes "reimbursement of expenses incurred, and the provision of other taxable benefits."

Section 1.409A-1(b)(9)(iv)(A) of the Proposed Regulations provides an exception under which a deferral of compensation is not considered to occur pursuant to separation pay arrangements entitling a service provider to receive, for a "limited period of time"[19] (i) reimbursements that are otherwise excludible from gross income, (ii) reimbursements for expenses that are deductible business expenses of the service provider under Section 162 or Section 167 (without regard to limitations based on adjusted gross income), (iii) reimbursement of reasonable outplacement expenses and reasonable moving expenses actually incurred by the service provider that are directly related to the termination of services for the service recipient, and (iv) reimbursement by the service recipient of medical expenses incurred and paid by the service provider but not reimbursed and allowable as a deduction under Section 213 (without regard to the limitation based on 7.5% of adjusted gross income). Section 1.409A-1(b)(9)(iv)(B) of the Proposed Regulations states that the same benefits provided in-kind, rather than via reimbursement, are similarly not considered deferred compensation, subject to the same requirements.[20]

Proposal

We request clarification that the provision of benefits that are not taxable to the service recipient, e.g., insured medical coverage, is not a "deferral of compensation" governed by Section 409A, since no deferral of tax or taxable compensation is involved.

In addition, we propose that the types of benefits that can qualify for the exception set forth in Section 1.409A-1(b)(9)(iv)(A) of the Proposed Regulations be expanded to include indemnification for liabilities incurred as a director or officer of a service recipient, reimbursement of legal expenses incurred

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[18] Our proposal could be adjusted, for purposes of applying it to non-corporate entities, so as to focus on the liquidation value of the non-corporate entity.

[19] Under Section 1.409A-(b)(iv)(D) of the Proposed Regulations, the "limited period of time" may not extend beyond the December 31 of the second calendar year following the calendar year in which the separation of service occurred.

[20] The Preamble acknowledges that reimbursement arrangements following a termination of service are common, and that requiring the service recipient to designate an amount at the time of termination conflicts with the service recipient's desire to pay only amounts that the former service provider has actually incurred as an expense. However, as indicated in the Preamble, there is apparently a concern that a categorical exclusion for reimbursement arrangements would be susceptible to abuse because it would permit a limitless amount of deferred compensation to be provided without regard to the rules of Section 409A (e.g., reimbursement for certain personal expenses, such as home mortgage payments).

in disputing the right to severance or other payments, reimbursement of medical expenses, financial and tax services, and the provision of office space and secretarial assistance; provided in each case that the reimbursement or in-kind benefit was provided during employment, is available post-employment only to the extent the service provider actually uses the benefit, and is not being provided in exchange for an agreement on the part of the service provider to accept a lesser amount of cash compensation that the service recipient would otherwise be willing to confer.

Discussion

The definition of "separation pay" quoted above expressly includes "taxable benefits," which suggests that nontaxable benefits provided after termination of employment are not considered "separation pay" and, by implication, are not "deferred compensation" subject to Section 409A. This approach is consistent with the legislative purpose of Section 409A to eliminate deferred compensation practices that were viewed as abusive manipulation of the timing of taxable income.

Some confusion is raised, however, by the exact context of the reference to taxable benefits in the phrase "payments in the form of reimbursement of expenses incurred, and other taxable benefits," which implies that all expense reimbursements are presumed to be taxable. However, many employment-related reimbursements are in fact excluded from gross income (for example, under Section 105, relating to amounts received under accident and health plans). Furthermore, the exception for certain reimbursements described above expressly covers reimbursements that are excluded from gross income; if nontaxable reimbursements were not included in "separation pay," there would be no need to extend the exception to them.

One consequence of this confusion is that it appears that the continuation of employer-provided insured medical benefits provided after termination of employment is not subject to Section 409A, regardless of how long the benefits continue, but a service recipient's reimbursement of a former employee for the costs of purchasing such coverage or for actual medical expenses (e.g., under a self-insured arrangement) might be considered "separation pay" that is subject to Section 409A unless it is provided only for a "limited period of time." It is not clear to us what policy this distinction – if it exists – would serve.

More broadly, we believe that the application of Section 409A to the full range of fringe benefits and perquisites that may be continued post-employment is problematic. By their nature, these arrangements, whether in-kind or in the form of reimbursements, are beneficial to the service providers who receive them only as and to the extent they actually use them. A service provider who is entitled to reimbursement for financial planning services, but does not actually use such services, has received no benefit. Moreover, we are unaware of any instance in which a company would permit such a service provider to choose to forego such services currently in exchange for receiving them after separation from service: perquisites are of a "use it or lose it" nature. Thus, the actual cost or value of fringe benefits and perquisites is often not readily projected in advance, and they are not normally a vehicle for the manipulation of the timing of taxable income, regardless of whether they are continued post-employment.

A principal consequence of subjecting such benefits to Section 409A is that the six-month delay of payment to "key employees" of public companies would apply. In the case of reimbursements, presumably that delay could be implemented by either providing reimbursement only for expenses incurred more than six months after separation from service, or by imposing a six-month delay on reimbursement for earlier-incurred expenses. For in-kind benefits, the only obvious way to comply with the requirement is to begin providing the benefit six months after separation from service.

Perhaps even more awkward is the question of how to make reimbursements and provide in-kind benefits in accordance with the generally applicable rules of Section 409A. We understand that the IRS has indicated informally that a service recipient would be required to determine in advance a specified amount of compensation that it would be obligated to provide a terminated service provider (e.g., $100,000 per year) and, to the extent the terminated service provider's usage was less than the applicable amount, the service recipient would be required to pay the service provider the value of the unused balance, in cash. This approach would not be practical, and would usually result in over-reimbursement (to the detriment of the service recipient) or under-reimbursement (to the detriment of the service provider). Nor does it appear to us that this result was intended by Congress in adopting Section 409A.

We believe that benefits provided through reimbursements and continuation of fringe benefits and perquisites following termination of employment are not the types of benefits that Congress was primarily concerned about regulating through Section 409A. As noted in the House Committee Report with respect to the adoption of Section 409A (which was generally followed by the Conference Report):

> The Committee is aware of the popular use of deferred compensation arrangements to defer current taxation of substantial amounts of income. The Committee believes that many nonqualified deferred compensation arrangements have developed which allow improper deferral of income. Executives often use arrangements that allow deferral of income, but also provide security of future payment and control over amounts deferred . . . . The Committee believes that certain arrangements that allow participants inappropriate levels of control or access to amounts deferred should not result in deferral of income inclusion.[21]

In addition, the House Ways and Means Committee also specifically noted that the staff of the Joint Committee on Taxation made similar recommendations with respect to their investigation of Enron Corporation, which detailed how executives deferred millions of dollars in federal income taxes through nonqualified deferred compensation arrangements.[22] By contrast, perquisites that are provided in-kind and those for which reimbursement is paid as and when they are enjoyed are not generally vehicles for deferrals of compensation of the types referred to by the Committee, whether provided during or after employment; rather, by their very nature, they are limited to actual usage over a period of time. Thus, these arrangements are typically understood as providing current compensation to the covered service providers for expenses incurred by service providers on a current basis.

While there are certainly situations that could result in the use of reimbursements as a method to avoid the restrictions of Section 409A, we believe that, if our proposal is adopted, the regulations could provide for a significant expansion of the types of post-termination reimbursements and in-kind benefits that would be excluded from "deferred compensation" without running counter to the policies underlying Section 409A.

In addition, as discussed above in Section III(A), Treasury and the IRS should consider placing in-kind benefits and reimbursements in its own category of "plan" for purposes of Section 409A. As written, and given the ambiguities about how to comply, the rules regarding in-kind benefits and reimbursements present a significant trap for the unwary. Although the amount at issue in respect of in-

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[21] Conference Committee Report to Section 885 of the Act (quoting language from H.R. Rep. No. 108-548, pt. 1).

[22] *Id.* at note 453.

kind benefits and reimbursements should, as a general matter, be fairly low, if in-kind benefits and reimbursements are viewed as a separation pay arrangement, then an inadvertent mistake with respect to these arrangements could result in separation pay being subject to the tax and interest penalty provisions of Section 409A. If in-kind benefits and reimbursements are not viewed as an "other" plan, then an inadvertent mistake with respect to these arrangements could result in unrelated equity arrangements being subject to the penalty provisions of Section 409A. More generally, a decision not to consider in-kind benefits, reimbursements and other separate miscellaneous payments as a separate category of plan could make it difficult if not impossible to apply the rules governing when payments are made under a separate plan.

VIII. Separation Pay

Treasury and the IRS have requested comments about the application of the short-term deferral rule to severance arrangements containing constructive or "good reason" termination provisions.

Proposal

We recommend that the final regulations provide that whether a "good reason" or similar provision in a severance arrangement causes a service provider not to have a substantial risk of forfeiture depends on the facts and circumstances.

Discussion

The Proposed Regulations presently limit the exclusion of separation pay from the definition of deferred compensation to amounts payable only upon "involuntary separations." It is common for plans and employment agreements to provide for separation pay upon certain constructive terminations, often referred to as terminations for "good reason."

We recognize that in some situations, a purported "good reason" provision could be used as a subterfuge for conferring deferred compensation. For example, an employer and employee acting in concert could agree to a "good reason" provision with a threshold so low that amounts to a vested right to future compensation. Presumably for this reason, the Preamble states "the Treasury Department and the IRS are not confident that amounts payable upon a voluntary separation from service, and amounts payable only upon a termination of services for good reason, always may be adequately distinguished. . . . Accordingly, 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." This wording implies that the converse is also true – i.e., that compensation payable in the event of "good reason" is also not categorically considered automatically free of a substantial risk of forfeiture.

The great diversity of "good reason" definitions and the fact that the same definition may have a dramatically different impact for different service providers persuade us that the position articulated by Treasury and the IRS in the Preamble is the correct one. To illustrate, a common "good reason" event is "any diminution in the title, duties, responsibilities or authority" of the service provider. For a chief executive officer (a "CEO") of a public company that is acquired by another larger public company and becomes the subsidiary of the acquirer, remaining in the same position – as the CEO of the now non-public subsidiary – after the acquisition is likely to constitute "good reason," triggering a right to terminate employment and obtain severance under this definition; however, the same would not likely be true of a division head of the acquired company. Thus, the occurrence of this change in control would cause the CEO's severance benefits to cease to be subject to a substantial risk of forfeiture, but the division head's rights would continue to be subject to a substantial risk of forfeiture. The impact of other provisions, such as a reduction in salary of more than a specific amount, the downgrading of an employee

by a specified number of employment levels or the relocation to another principal place of work, will be more easily and objectively ascertainable.

Accordingly, in our view, the final regulations should provide that the effect of a "good reason" provision depends on the particular facts and circumstances. We do not recommend that the final regulations set forth safe harbors or list specific provisions that would cause a "good reason" provision to be regarded as eliminating a substantial risk of forfeiture.

IX. Six-Month Payment Delay for Specified Employees

Section 409A(a)(2)(B) provides that payments upon a separation from service to a "specified employee" (a key employee of a corporation whose stock is publicly traded) must be delayed at least six months following separation from service. Proposed Regulation Section 1.409A-3(g)(2) states that "[t]he arrangement must provide the manner in which the six-month delay will be implemented" and permits "[a] service recipient [to] amend a plan at any time to change the method for applying the six-month delay, provided that the amendment may not be effective for a period of 12 months."

Proposal

The final regulations should not require the delay of payments to a specified employee for six months from separation from service to be incorporated in the arrangement, and service recipients should be permitted to amend a plan or agreement to permit or impose any required delay with immediate effect.

Discussion

The Proposed Regulations do not address the problem that will arise when a particular service provider who has deferred compensation becomes subject to the six-month delay rule (for example, as a result of a promotion or pay increase). In addition, in some cases it will be discovered too late that an arrangement technically is subject to the six-month delay, although the arrangement might otherwise comply with Section 409A. In such cases, it appears to be difficult or impossible to amend the arrangement to avoid the problem and the application of the resulting tax penalties, regardless of how willing the parties might be to comply. Accordingly, we recommend that the final regulations permit a plan to be amended at any time to impose a six-month delay rule with immediate effect, whether as a result of the service provider's becoming subject to the requirement for any reason or to address a good-faith omission.

We recognize that this proposal may appear at first to be contrary to the statute's general emphasis on advance documentary compliance with its rules. However, we believe that Congress's overriding concern in adopting the six-month delay rule was to ensure that key employees of public companies are unable to obtain immediate payments of deferred compensation upon termination of employment, to the detriment of shareholders and non-key employees. Our proposal would facilitate the imposition of the six-month delay, even if documentary compliance may be permitted to occur later than is necessary for other Section 409A purposes.

The delay involved in making a "late" election to comply with the rule involves only six months, with the resulting delay in payment thereby generally limited to only, at most, one taxable year. Further, any decision to accept an early payment would come at the steep price of a 20% penalty and an adverse effect on other aggregated arrangements. Thus, we do not believe our proposal will lead to abusive maneuverings.

X. Specified Employees

Section 409A(a)(2)(B)(i) provides that key employees, as defined in Section 416(i) (without regard to Section 416(i)(5)), are subject to a six-month payment delay following separation from service. Section 1.409A-1(i)(1) of the Proposed Regulations facilitates compliance by providing generally that key employee status is to be determined in accordance with the regulations under Section 416(i), which have an established set of rules at Section 1.416-1 of the Treasury Regulations in question and answer format. The Proposed Regulations also recognize that Section 1.416-1 of the Treasury Regulations need not be applied without any modification for purposes of Section 409A – for example, they permit establishing determination dates different from those established under Section 416, and they set forth special rules for corporate transactions.

A. Allow Different Section 416 Elections to be Made for Purposes of Section 409A

Proposal

The final regulations should permit service recipients to use a different method for determining Section 415 compensation for purposes of identifying officers and 1% owners treated as key employees under Section 409A than they use in operating their tax-qualified plans. For example, a service recipient should be permitted to use the de minimis rule of the Proposed Regulations issued under Section 415 in their qualified plans without having to do so for purposes of Section 409A.

Discussion

We appreciate the flexibility accorded by the Proposed Regulations to determine key employee status as of a prior date set by the service recipient, as this not only permits advance identification of those employees subject to the six-month payment delay, but prevents severance pay from distorting the results. We believe that the additional modifications that we propose are appropriate because, despite the cross reference to Section 416(i) in Section 409A(a)(B)(i), Section 1.416-1 of the Treasury Regulations was issued years ago under the qualified plan top heavy rules in order to prevent excessive concentration of benefits on behalf of key employees in smaller businesses; did not target public companies, which is not a relevant concept under Section 416; and has not been updated to reflect recent amendments to the Code.

B. Addition of a 50-Employee Limit on Key Employees

Proposal

The final regulations should provide that, just as no more than 50 employees of a group will be considered "key employees" for purposes of Section 409A by virtue of being higher-paid officers, no more than 50 employees will be considered "key employees" by virtue of falling within the 1% owner or the 5% owner provisions of Section 416.

Discussion

The top heavy rules were enacted to apply to smaller employers, which are more likely than larger employers to have qualified plans that concentrate benefits in favor of key employees, and more likely to have a limited number of affiliates and subsidiaries. Public companies, whose key employees are subject to the six-month delay rule of Section 409A, often have many subsidiaries and affiliates, including many that constitute an insignificant part of the group's overall business operations, the employees of which should not be subject to the six-month delay. Further, the Section 416 regulations provide that 1% and 5% owners are not determined on a controlled group basis, but by reference to each

separate entity in the controlled group.[23] In the case of large public companies with many affiliated businesses and joint ventures, mechanical application of this rule could result in (i) 1% owners of totally insignificant entities becoming key employees, even though they have no realistic control over the operations of the group businesses, and (ii) a number of 1% and 5% owners that far exceeds the 50-employee cap applicable to officers under Section 416.

Thus, there is a practical need for a limit on 1% and 5% owners incorporating, or analogous to, the 50-employee cap. One way to do this might be to determine 1% and 5% ownership for purposes of Section 409A on a controlled-group basis. Another way would be to apply a de minimis rule that would exclude owners of businesses that represent at most a de minimis percentage of the controlled-group's assets or gross revenues from the six-month delay. For this purpose, it might be appropriate to incorporate the de minimis 10% business segment concept used by the Pension Benefit Guaranty Corporation (the "PBGC") in its "reportable event" notice regulations.[24]

C. Exclusion of Employees of Nonpublic Parents and Brother-Sister Entities

Proposal

The final regulations should exclude employees of affiliates of a public company from the reach of Section 409A, if those affiliates have no direct or indirect public shareholders.

Discussion

While we see a clear need to apply controlled group rules vertically in a chain of businesses to provide that a direct subsidiary of a company with publicly-traded stock is also a public company, we propose that parent and brother-sister entities without publicly-traded stock be excluded. We can identify no policy consideration supporting the application of these rules to non-public companies that happen to be substantial owners of public companies, or to non-public companies that happen to be substantially owned by the same non-public entity that owns a public company. For example, assume a non-public company that owns 80% of a company, with the remaining 20% publicly traded. The shareholders of the public subsidiary have no interest in the compensation practices of the parent and the application of the six-month delay requirement to the parent's executives does not seem warranted.

D. Exclusion of Independent Contractors

Proposal

The final regulations should clarify that key employees subject to the six-month delay do not include service providers who are independent contractors but not common-law employees with respect to the service recipient.

Discussion

Both the introductory language in Section 416(i)(A) and the examples given in the Proposed Regulations suggest that a key employee must be a current or former employee, partner or sole proprietor

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[23] See Treas. Reg. § 1.416-1 (Q&A T-20).

[24] See PBGC Reg. § 4043.29(c).

of the relevant entity; the fact that Section 409A also applies to independent contractors makes it advisable to clarify that a service recipient's payments to an independent contractor are not subject to Section 409A. The purposes of Section 416 are not relevant to this aspect of the analysis, since qualified plans of a service recipient are not permitted to cover independent contractors (such as outside directors) of the service recipient (and would be disqualified for violating the "exclusive benefit" rule limiting plan participation to employees and their beneficiaries if they did so). Accordingly, to count such individuals as key employees for Section 409A purposes even though they may have no accrued benefits under the plans being tested fails to take into account that they would not be counted for purposes of the top heavy calculations required for purposes of Section 416 and Section 1.416-1 of the Treasury Regulations. At a minimum, the final regulations under Section 409A should clarify that outside directors of a service recipient who have never been common law employees of that service recipient are not subject to the six-month delay.

XI. Grandfathered Supplemental Retirement Plans ("SRPs")

A. Actuarial Assumption and Interest Rate

Non-qualified SRPs may simply make up for benefits not provided under the sponsor's tax-qualified plans due to Code limitations on maximum benefits and recognized compensation, or may provide for a richer target formula for the group of participants selected for participation. In either case, the actuarial value of any benefit actually provided by the qualified plan is typically offset against the SRP benefit. Treasury and the IRS are to be commended for issuing rules providing that, in general, routine changes to benefits under qualified plans, including changes to benefit levels and plan freezes, will not destroy grandfathered status or result in impermissible indirect deferrals or acceleration of payments even if they have the effect of increasing or decreasing the benefit payable under the linked non-qualified plan. Similar assurance is needed regarding actuarial issues and changes to actuarial factors under defined benefit SRPs where the changes may be independent of any qualified plan amendments.

Although the determination of grandfathered amounts is fairly straightforward for account balance plans under the Proposed Regulations, neither Notice 2005-1 nor the Proposed Regulations answer a number of basic questions about the calculation of grandfathered amounts under nonaccount balance plans. The Proposed Regulations state that the grandfathered amount is the present value of the vested accrued benefit with the maximum value under the Plan to which the Participant would be entitled if his or her service voluntarily terminated without cause on December 31, 2004, generally without regard to service completed or compensation or subsidies earned after December 31, 2004. There is one exception providing that the grandfathered amount may increase to reflect a subsidy payable under the terms of the SRP and any applicable Code limits effective on October 3, 2004 which is subsequently elected by the Participant. It would appear that the grandfathered amount is otherwise frozen.[25] Q&A 17 of Notice 2005-1 states that, for purposes of determining present value, "the actuarial assumptions contained in the plan are used provided such assumptions are reasonable; otherwise, reasonable actuarial assumptions must be used." The Proposed Regulations do not amplify this language.

Further guidance and certainty in this area would be helpful because of the potential consequences of overstating the grandfathered amount or inadvertently making a material modification to a grandfathered plan.

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[25] Prop. Treas. Reg. 1.409A-6(a)(3)(i).

Proposal

We suggest that the final regulations clarify the following points regarding the determination of grandfathered benefits under non-account balance plans:

- whether, when such a plan supplements a qualified defined benefit plan, assumptions different from those used under the qualified plan may be used, so long as they are reasonable; and

- whether, if a plan specifies, as of October 3, 2004, an interest rate determined by reference to an externally established floating rate, the grandfathered benefit is to be determined by reference to the actual rate in effect as of December 31, 2004, or by using the rate determined under such formula as of the date of calculation.

Discussion

SRPs may use lump sum discount rates different from those in qualified plans, even if the actuarial factors are otherwise the same as those in the qualified plans. Any possibility of having the grandfathered and non-grandfathered accrued benefits add up to a number that is different from the total accrued benefit payable to the participant could be avoided by providing that the benefit subject to Section 409A would be equal to the difference between the total accrued benefit and the grandfathered benefit. The regulations also should clarify the effect of overstating the value of the grandfathered amount by using unreasonable actuarial assumptions and whether there are parameters or ranges within which reasonable actuarial assumptions must fall or within which assumptions are presumptively reasonable, and should provide guidance in the correct method to determine interest rates when a floating formula is used in the plan.

B. Determination of Grandfathered Amount

Proposal

Consideration should be given to modifying the general rule that only changes due to the passage of time and the participant's survival after December 31, 2004 are recognized in determining the grandfathered amount.

Discussion

Section 1.409A-6(a)(3)(i) of the Proposed Regulations appears to permit a subsidy earned by surviving to a qualifying age after December 31, 2004 (but not by virtue of also completing additional service after December 31, 2004) to increase the grandfathered amount, which is a relaxation of the rule set forth in Q&A 17 of Notice 2005-1. It would be more equitable to permit any increased benefit resulting from the aggregation of pre-2005 and later service and compensation to be allocated between pre-2005 and later service periods. For example, if a participant in a plan with an early retirement subsidy available to participants who retire after 25 years of service had, before January 1, 2005, completed 20 years of service, fully vested in his or her accrued benefit on December 31, 2004, and retired immediately upon completing 25 years of service, it would be equitable to treat a portion of the resulting subsidy as having been earned and vested before January 1, 2005. We suggest that an appropriate allocation would be to treat 80% of that subsidy as earned prior to January 1, 2005 and 20% as earned thereafter. If a plan adopted a retroactive benefit increase or converted from career average to final average pay, a similar allocation over the period of service eligible for the increase would be appropriate.

XII. Plans Linked to "401(k)" Plans

Section 1.409A-2(a)(8) of the Proposed Regulations does not clearly address how a change in the limit on elective deferrals under Section 402(g) affects a nonqualified account balance plan that supplements and is linked to a "401(k)" plan.

Proposal

We recommend that the final regulations clarify that a change in the deferrals under the nonqualified deferred compensation plan resulting from a change to the Section 402(g) limitation applicable to the qualified plan should not be a Section 409A violation, so long as aggregate deferrals are unchanged.

Discussion

The Proposed Regulations can be read as requiring the application of plan limits separately to each plan, and possibly as requiring a reduction in the aggregate benefit as a result of the application of the Section 402(g) limit to the qualified plan. We think the matter should be clarified as indicated above.

XIII. Transition Issues

Section 1.409A-6(a)(4)(iii) of the Proposed Regulations states, in pertinent part, that "[a] cessation of deferrals under, or termination of, a plan, pursuant to the provisions of such plan, is not a material modification."

Proposal

We recommend that the final regulations provide that it is not a material modification of an otherwise grandfathered arrangement to terminate the arrangement and pay out amounts promptly upon the termination if the plan document provides that the arrangement may be terminated but does not specify the time or form of payment of amounts deferred under the arrangement upon the termination, as long as all amounts deferred under the arrangement are paid out within 12 months following the date of such termination.

Discussion

Many nonqualified deferred compensation arrangements contain a provision reserving the right to terminate the arrangement but do not specify the time or form of payment of amounts upon plan termination. However, in fact if the arrangement is terminated, amounts are typically paid out within a short period of time thereafter. We believe that such approach is not inconsistent with the intent of Section 409A and should not be deemed to result in a material modification of an otherwise grandfathered arrangement. This approach is consistent with the requirements for distributing amounts under terminated tax-qualified plans, which generally require prompt payment of amounts from the terminated plan. This approach is also consistent with the requirements for payment of amounts under arrangements that are terminated pursuant to the transitional relief provisions of Notice 2005-1 or pursuant to certain exceptions under Section 1.409A-3(h)(2)(viii) of the Proposed Regulations, which contemplate prompt payment of amounts under the terminated arrangement.