March 28, 2005

The Honorable Mark W. Everson
Commissioner of Internal Revenue
Internal Revenue Service
Room 5226
1111 Constitution Avenue, NW
Washington, DC  20224

Re:  Comments on Code Section 409A Regarding the Definition of Nonqualified Deferred Compensation Focusing on Foreign Plan Issues

Dear Commissioner Everson:

Enclosed are comments on code section 409A regarding the definition of nonqualified deferred compensation focusing on foreign plan issues. These comments represent the individual views of those members who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

Sincerely,

Kenneth W. Gideon
Chair, Section of Taxation

Enclosure

cc:  Daniel Hogans, Attorney-Advisor, Office of the Benefits Tax Counsel, Treasury Department
The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments were prepared by individual members of the Employee Benefits Committee of the Section of Taxation. Principal responsibility was exercised by Susan P. Serota. Substantive contributions were made by Debra Davis, David Ellis, Russell Hall, James Klein, Mark Jones and Andrew Oringer. The comments were reviewed by Wayne R. Luepker, Chair of the Subcommittee on Executive Compensation, and Greta E. Cowart and Priscilla E. Ryan, Vice Chair and Chair respectively, of the Section’s Employee Benefits Committee; by the Quality Assurance Group of the Employee Benefits Committee, which is chaired by Thomas R. Hoecker and whose members are former chairs of the Committee; by T. David Cowart of the Section’s Committee on Government Submissions; and by Thomas A. Jorgensen, Council Director for the Employee Benefits Committee.

Although many of the members of the Section of Taxation who participated in preparing these comments have clients who would be affected by the federal tax principles addressed by these comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

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Date: March 28, 2005
I. EXECUTIVE SUMMARY

Because the definition of “nonqualified deferred compensation plan” in Section 409A\(^1\) is not limited to a plan maintained in the United States, Section 409A has the potential to apply to any nonqualified deferred compensation plan in which a U.S. taxpayer participates. Further, because the definition of “deferral of compensation” in Q&A-4 of I.R.S. Notice 2005-1 is not limited to compensation earned for services in the United States, Section 409A has the potential to apply to compensation earned for services rendered anywhere in the world.

Representatives of the U.S. Treasury Department (the “Treasury”) and the Internal Revenue Service (the “Service” or “IRS”) have stated in informal conversations that, in their view, Section 409A is not limited to a “water’s edge” theory of application, nor was it Congress’s intent to do so. Accordingly, just because a nonqualified deferred compensation plan is maintained by a non-U.S. employer outside of the United States, or defers compensation for services rendered outside of the United States, the plan will not necessarily be exempt from the application of Section 409A. We note that Section 409A generally does not have priority over the application of United States income tax treaties. See Sections 894(a) and 7852(d). However, the United States does not have tax treaties with all foreign countries. Moreover, existing treaties do not cover all jurisdictions and further do not cover all issues potentially raised by Section 409A in the international area.

There is very little in Section 409A itself which addresses non-U.S. deferred compensation. Subsection (b) addresses plans funded with assets set aside in a trust outside the United States, but, other than subsection (b), Section 409A does not expressly address nonqualified deferred compensation plans maintained outside of the United States or deferred compensation earned outside of the United States. Section 409A(e) authorizes the Secretary of the Treasury to prescribe regulations to carry out the purposes of Section 409A, including regulations exempting arrangements from the application of subsection (b) if such arrangements will not result in an improper deferral of U.S. tax and will not result in assets being effectively beyond the reach of creditors. However, we recommend that the Treasury issue regulations that go further than the issues specifically identified and address other international issues that will inevitably arise under Section 409A.

As described in more detail below, we recommend that the Service issue regulations exempting certain arrangements involving or potentially involving non-U.S. deferred compensation and non-U.S. deferred compensation plans from the application of Section 409A, such as (i) certain amounts related to expatriate allowances and similar items, even if received more than 2 ½ months after the close of the year in which earned; (ii) non-U.S. source income earned by a resident or non-resident alien; (iii) unfunded deferred compensation earned and vested prior to a foreign national’s becoming a resident alien; and (iv) non-U.S. funded retirement plans.

We also recommend that, pursuant to the authority granted in Section 409A(e), the Treasury clarify that the exception to the funding rules in Section 409A(b)(1) for assets located in foreign jurisdictions where substantially all services are rendered in that jurisdiction be

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\(^1\) All references are to the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.
expanded to take into account situations where the local law of the employer or service recipient provides favorable taxation for offshore funds, or where there is meaningful creditor access to such funds. We also recommend that the reference to “assets” in Section 409A(b)(1) be clarified to mean “indicia of ownership of assets” or legal ownership of such assets but should not include unallocated amounts contributed to trusts or funds set aside as reserves which are held for future accruals. Further, we recommend that employee benefit trusts and similar arrangements that are customarily maintained by non-U.S. companies for the benefit of their U.S. employees be exempt from the provisions of Section 409A(b) where certain requirements are met.

In addition, we recommend that the Service clarify that the definition of “established securities market” for purposes of the stock appreciation rights (SAR) exception described in Q&A-4(d)(iv) of Notice 2005-1 include foreign as well as U.S. public markets.

Further, we recommend that the Service clarify that compensation that is not U.S. source income and is earned by a nonresident alien may be excluded in determining the status as key employees of officers and one percent owners for purposes of the six-month delay in payment of deferred compensation upon separation from service under Section 409A(a)(2)(B)(i).

We also recommend that American depository receipts (“ADRs”) expressly be accorded the same treatment as actual shares of stock for purposes of the exceptions in Notice 2005-1 relating to stock options and SARs.

Finally, the term “fair market value” as used in Q&A 4(d)(i) of Notice 2005-1 regarding stock options should be clarified to take into account the rules and practices in non-U.S. jurisdictions setting option exercise prices as the average of prices over a period of time, rather than the price on a particular date.

II. BACKGROUND

Notice 2005-1 requested comments on funding arrangements for nonqualified deferred compensation that involve foreign trusts or similar arrangements, and identification of arrangements that will not result in an improper deferral of United States tax and will not result in assets being effectively beyond the reach of creditors for purposes of the potential exemption from the provisions of Section 409A(e)(3). These comments are submitted in response to that request.

III. COMMENTS

A. EXPATRIATE ALLOWANCES AND NONQUALIFIED DEFERRED COMPENSATION EARNED WHILE SERVICE PROVIDER IS NOT IN UNITED STATES

1. Summary.

Section 409A provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are satisfied. Notice 2005-1, Q&A-3, indicates that a nonqualified deferred
compensation plan means any plan, agreement, method or arrangement that provides for a
deferral of compensation. Under Notice 2005-1, Q&A-4, a plan provides for the deferral of
compensation if a service provider is entitled to receive compensation that has not been actually
or constructively received and included in gross income and is payable in a later year. The
Notice further provides that amounts will not be deemed deferred compensation if under the
terms of the plan the amounts will be actually or constructively received no later than 2 ½
months after the end of the service provider’s (or service recipient’s) first taxable year in which
the amount is no longer subject to a substantial risk of forfeiture. There are special situations in
which U.S. citizens or residents working abroad will be entitled to payment of certain amounts
related to their foreign assignment and thus will become subject to the rules of Section 409A. In
addition, Section 409A will by its terms apply to compensation earned by resident and
nonresident aliens for services performed outside the United States, even where such
compensation constitutes non-U.S. source income and is not includible in gross income for U.S.
federal income tax purposes.

2. **Recommendations.**

   a. **For U.S. residents and citizens working abroad (“expatriates”),** we recommend
      that the Treasury issue regulations or the Service publish a notice providing that
certain amounts related to expatriate allowances and similar items not be
considered deferred compensation for purposes of Section 409A, even if received
more than 2 ½ months after the close of the year in which earned, if normally paid
more than 2 ½ months after the end of the tax year of the service provider or
service recipient.

   b. **For resident aliens and nonresident aliens,** we recommend that Section 409A not
      apply to the extent (i) the compensation earned by such an individual would not
be U.S. source income or (ii) the compensation was earned and vested prior to
the individual becoming a U.S. resident alien.

   c. We recommend that plans providing deferred compensation that constitutes non-
U.S. source income not be aggregated with any other deferred compensation plans
that are subject to Section 409A for purposes of calculating the income tax and
interest payable in the event of a violation of Section 409A.

3. **Explanation.**

   a. **Expatriates**

   U.S. residents and citizens working outside the United States typically receive a variety
of allowances in order to place them on a similar economic footing to their position if they were
working in the United States. These allowances typically include some form of tax equalization
(resulting in after-tax income equal to what the employee’s after-tax income would have been
had it been subject only to U.S. tax), housing and education allowances, and certain travel

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3 “U.S. source income” as used in Section 864 means income derived from services performed in the U.S.

March 28, 2005
allowances, to name a few. These amounts, when paid, may be subject to U.S. income tax, to the extent not excluded under Section 911 or other Code sections. In many situations these amounts are earned in one year, and yet may not be paid until well into the next year, or even a subsequent year. In some jurisdictions, the local authorities will not assess a final tax until 1 or 1 ½ years after the services are rendered, or sometimes longer. In addition, expatriates often file applications to extend their filing deadlines. For example, the “true up” calculation for an expatriate under a tax equalization policy typically does not take place until the year following the year in which the U.S. and foreign taxes are paid. If the initial hypothetical tax calculated by the expatriate’s employer and withheld from his or her pay turns out to be higher than the expatriate’s final hypothetical tax, then the employer will pay to the expatriate an amount equal to the difference. The expatriate has a legally binding right to the “true up” payment, but whether the expatriate will receive such a payment or whether the expatriate is obligated to make a payment back to the employer (where the initial hypothetical tax is lower than the expatriate’s final hypothetical tax liability) is not known until the calculations are done. Similarly, take as an example an expatriate employee working in a low tax jurisdiction who may receive taxable family tuition benefits. While taxable at a low local rate, the benefits would be taxable in the United States at a higher rate. Theoretically, the employee could have a vested right to a tax gross up payment, which would not be calculated until the return was filed, after the 2 ½ month period. While these benefits are nonelective, such amounts might be seen as having some element of “event based” distribution (for example, if they could be accelerated if the employee were transferred early), and could cause extra tax to be imposed under Section 409A. Rather than force employers to estimate these allowances early, or require forfeiture if employment ends before the assignment is concluded, there should be an administrative exception for allowances and other amounts related to an expatriate’s foreign assignment which normally are paid more than 2 ½ months after the end of the tax year of the service provider or service recipient.

These allowances should be viewed in the same context as compensation-related loans under Section 7872. Congress has indicated its position in the context of Section 7872 that certain compensation-related loans should be exempt as long as the interest arrangements did not have a significant effect on the tax liability of the borrower and lender. Proposed Regulations Section 1.7872-2 provides that “an advance of money to an employee, salesman, or other similar person to defray anticipated expenditures is not treated as a loan for purposes of Section 7872 if the amount of money advanced is reasonably calculated not to exceed the anticipated expenditures and if the advance of money is made on a day within a reasonable period of time of the day that the anticipated expenditure will be incurred.” Similarly, the allowances received by expatriates who are under a tax equalization policy, while not loans, by analogy are reasonably calculated to place them on a similar economic footing to their position when working in the United States. As a result, these amounts should be excluded for purposes of Section 409A.

b. Aliens

In many cases, resident and nonresident aliens participate in unfunded deferred compensation plans maintained by employers or service recipients outside the United States. For example, a nonresident alien may defer compensation under a non-U.S. plan prior to his transfer to work in the United States. Alternatively, a nonresident alien may participate in a deferred compensation plan that covers services performed both inside and outside the United States. The alien may vest (in the U.S. sense of that term) in his deferred compensation either before or after March 28, 2005
arrival in the United States. Because the underlying compensation is earned for services performed outside the United States, the definition of “deferred compensation” should contain an exclusion for compensation that is not includible in U.S. gross income. With respect to a nonresident alien taxpayer, such compensation would not attract U.S. income tax, so it would be inappropriate to cover such compensation under the provisions of Section 409A. With respect to a resident alien taxpayer, deferred compensation is taxable, even if non-U.S. source, if distributed to the individual while he is a resident alien. However, where a foreign national who works in the United States and becomes a “resident alien” during his U.S. assignment (because he meets the “substantial presence” test of Section 7701(b)) had earned and vested in his deferred compensation prior to such change in status, Section 409A penalties should not apply even if the amounts are distributed and taxable while a resident alien. Furthermore, such a foreign national often returns to his home country and becomes a nonresident alien with respect to the United States before he requests or receives a distribution of his deferred compensation. If the deferred compensation is distributed after an alien’s departure from the United States, and he is a nonresident alien at the time of distribution, he will not be taxable in the United States if the distribution is not U.S. source. However, if Section 409A were to apply, then both nonresident aliens and resident aliens with non-U.S. source income might be exposed to potential taxation in the United States, particularly if with respect to a resident alien the deferred compensation vests when he is physically in the United States. We recommend that unfunded deferred compensation that is non-U.S. source income (e.g., deferrals earned outside the United States) with respect to an alien be excluded from Section 409A and that unfunded deferred compensation payable to a foreign national be subject to Section 409A only if earned and vested while a resident alien and only to the extent such amount would be U.S. source income.

As another example, an alien may take part in a plan that is funded and, by U.S. standards, vested prior to his arrival in the United States. For example, a resident of the United Kingdom who does not intend to stay in the United Kingdom may be a beneficiary of a deferred compensation plan funded through a trust outside the United Kingdom, with a beneficial interest that the United States would consider vested and funded. If such an alien were to become a U.S. resident, that resident alien would be taxable under Section 402(b) on any subsequent contributions or earnings in that trust. However, the vested, funded principal already in that trust would not be income. We recommend that the vested, funded principal in the trust in this situation not be considered deferred compensation for purposes of Section 409A.

The concept behind this approach is that amounts funded and vested (under U.S. principles) should be treated in a similar fashion to other types of investments held by aliens that are not subject to U.S. tax. Our proposals are consistent with the premise that Section 409A was enacted to address abusive deferred compensation situations, not to accidentally capture appropriate and reasonable compensation arrangements which were not motivated by tax-deferral concerns. For example, many aliens have bank accounts, mutual fund holdings and other types of investments that are treated as capital rather than income, and would not be taxable in the United States when liquidated and spent by the individual. Similarly, deferred compensation resulting from non-U.S. source income that is vested and funded before the individual becomes a U.S. taxpayer should arguably be treated as capital and should not be subject to Section 409A. For these reasons, deferred compensation that constitutes non-U.S. source income should not be aggregated with deferred compensation plans involving U.S. source income for purposes of determining any amount subject to taxes under Section 409A.
B. NON-U.S. FUNDED RETIREMENT PLANS

1. **Summary.**

Under Section 409A(d)(1) and Notice 2005-1, the rules of Section 409A do not apply to plans that do not permit the deferral the taxation of income to a point past vesting or shortly thereafter. Funded retirement plans maintained outside the United States generally are not “qualified” plans in the U.S. sense, and benefits under such plans will result in taxation when they become vested. Therefore, U.S. taxpayers who participate in such plans should not be subject to Section 409A. If there is a treaty override to the U.S. taxation at vesting, that should not change the result.

2. **Recommendation**

We recommend that by notice or regulation, it be made clear that foreign nonqualified retirement plans maintained outside the United States are exempt from Section 409A if they are funded (in the U.S. sense of segregation of assets from the claims of creditors), provided that the funding arrangements are effected for non-U.S. purposes and not to avoid U.S. income tax. This recommendation would not depend on whether the retirement plan in question is broad-based or whether it is locally tax-favored and would not depend on whether the United States has an income tax treaty with the particular foreign jurisdiction.

3. **Explanation**

U.S. taxpayers who participate in non-U.S. retirement programs historically have been taxed under the U.S. tax laws applicable to nonqualified deferred compensation plans. If the non-U.S. retirement plan is funded, the general rule of U.S. taxation would result in taxation when vesting occurs. In this context, “funded” means that the assets are segregated from the claims of creditors, which is the common approach for any non-U.S. plan that accumulates assets. “Rabbi trust” provisions are virtually unknown in non-U.S. tax-favored retirement systems. If the funding is in the form of a trust, then the United States would tax the vested interest under the rules of Section 402(b). If in some other form, such as a mutual fund, collective fund or provident fund, then the interest would be taxable under Section 83. Where a foreign trust or other funded vehicle funds a broad-based plan or an individual arrangement, a participant who is subject to U.S. income taxation will be taxed at the time he or she vests and since, under the reasoning in Notice 2005-1, there is no deferral of income to the extent taxed at vesting, Section 409A would not apply.

Where the United States has an income tax treaty with a foreign country, the treaty may, for example, exempt from taxation the vested interest in the foreign retirement fund. Under

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4 Similar issues arise with respect to unfunded and incentive plans maintained outside the United States.
5 Similarly, an unfunded foreign plan may result in constructive receipt at vesting. Again, Section 409A should not apply.

March 28, 2005
Sections 894(a) and 7852(d), such a treaty itself should override Section 409A. Hence in all situations a non-U.S. funded retirement plan should be outside the scope of Section 409A. We note that we are not suggesting any special rules under general tax principles; we are merely proposing that Section 409A would be inapplicable as described above and recommend that Treasury confirm these results.

C. ASSETS LOCATED WHERE SERVICES ARE RENDERED

1. Summary

A U.S. taxpayer who participates in a U.S. nonqualified funded retirement or deferred compensation plan is taxable on his interest in the trust when he becomes vested, measured by the amount contributed to the fund (or the annual accrual, in the case of Section 410(b) discriminatory plans). If the funding vehicle is other than a trust, such a participant would be taxed under Section 83 principles. Funding means that the assets of the plan are segregated from the claims of creditors. “Rabbi trusts,” which permit creditor access to trusteeed funds, are treated as unfunded plans. Under Section 409A(b)(1), assets set aside in a trust or similar arrangement outside the United States are not eligible for unfunded treatment under the rabbi trust rules, unless the assets are located in the same foreign jurisdiction where substantially all of the services for which the deferred compensation was earned were provided (the “Jurisdiction Where Services Performed Exception”). It is not unusual for companies to use a trust to reserve shares for future grants or to meet future obligations under stock options. In some countries (such as the U.K.) there have been limitations on a company holding stock in its treasury, and therefore holding the stock in a trust is quite common. These trusts are often used in conjunction with a plan covering employees in several countries.

2. Recommendations

a. We recommend that the Jurisdiction Where Services Performed Exception be extended to include a trust with a situs in a non U.S. jurisdiction other than the jurisdiction in which services are performed if either there is effective creditor access to the funds in the offshore trust or where corporate law applicable to the employer or service recipient provides significant benefits for establishing the trust favorable taxation for the funds in the offshore trust or where there is effective creditor access to the funds in the offshore trust.

b. We recommend that the reference to “assets” outside the United States be clarified to mean either (i) the “indicia of ownership” of such assets or (ii) the legal ownership of

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7 Although we recognize that one of the reasons underlying the enactment of Section 409A(b)(1) was the concern that employers would locate a “rabbi” trust in a jurisdiction where a creditor did not have effective access to the trust’s assets due to local law restrictions, we believe that the Treasury’s authority to issue regulations which will exempt “arrangements from the application of subsection (b) if such arrangements will not result in an improper deferral of United States tax and will not result in assets being effectively beyond the reach of creditors” [Section 409A(c)(3)] should include arrangements where there is effective access by creditors to such trust’s assets.
such assets, provided the manner of holding such assets does not in either case have
the principal purpose of avoidance of Section 409A and should not include
unallocated amounts contributed to trusts or funds set aside as reserves which are held
future accruals.

3. Explanation

The legislative history notes that “in the case of assets set aside (directly or indirectly) in
a trust (or other arrangement determined by the Secretary) for the purposes of paying
nonqualified deferred compensation, such assets are treated as property transferred in connection
with the performance of services under Section 83 (whether or not such assets are available to
satisfy the claims of general creditors) at the time set aside if such assets . . . are located outside
of the United States . . . .” Conference Agreement, p. 523. Treasury or the Service should
confirm that Section 402(b) of the Code, which section provides that contributions to a
nonqualified trust will be taxable “in accordance with section 83,” will apply equally to plans
funded by U.S., or non-U.S., nonqualified trusts. I.R.C. § 402(b)(1). In addition, it should be
clarified that the term “assets”, as used in Section 409A(b)(1) and the legislative history, does
not apply to unallocated amounts contributed to trusts or funds taxed under Section 402(b) as
reserves for future accruals, for example, a nonexempt trust funding a nonqualified defined
benefit plan where the trust assets exceed accrued liabilities or a stock employee compensation
trust (a “SECT”) holding stock and other assets for the purpose of funding future accruals and
obligations under several employer-sponsored compensation plans. These unallocated assets are
usually considered assets of the grantor-employer rather than trust assets taxable under Section
402(b), even if the assets are located outside the jurisdiction of the employer. See Treas. Reg. §
1.672(f)-3(C) and Prop. Treas. Reg. § 1.671-1(g). Accordingly, unallocated assets set aside to
pay future compensation obligations of the employer should not be subject to the rules of Section
409A(b)(1) where such assets are subject to the creditors of the employer, even if they are
located in a jurisdiction other than the jurisdiction of the employer or the jurisdiction where the
employee performs services.

The integrity of the Jurisdiction Where Services Performed Exception would be
preserved if it were extended to include jurisdictions other than the jurisdiction in which services
are performed if either there is effective creditor access to the funds in the offshore trust or if the
local tax or company law of the employer or service recipient provides significant benefits for
establishing the trust offshore. In light of the legislative history, such an extension would be
consistent with pre-AJCA treatment, which placed emphasis on creating creditor access under
the appropriate jurisdiction’s rules or where creditor access was not needed for local tax-favored
treatment.

In addition, there should be a clarification of what it means for the “assets” to be located
in a given jurisdiction. Virtually all major jurisdictions protect broad-based funded plan assets
from creditors. (For example, the United Kingdom, Canada and Australia are all countries with
broad-based funded retirement plans. Employers and employer creditors do not have access to
funds underlying accrued benefits in such plans.) A literal reading of the statute would seem to
permit U.S. taxpayers working, for example, in Hong Kong, to use a tax-haven rabbi trust, as
long as the “assets” were in Hong Kong (perhaps through holding the indicia of ownership in a
Hong Kong branch of the tax haven trustee or holding the assets in a Hong Kong trust with a

March 28, 2005
branch in the tax haven). It would appear that the policy behind this rule is the concern that the non-U.S. rabbi trusts are located in jurisdictions without creditor access and thus are an evasion of the rabbi trust rules. Section 409A(b) would treat such trusts as funded unless the local retirement plan rules of the jurisdiction where services were rendered would require, or it is the customary practice for, assets to be located in such jurisdiction. We recommend clarification that, by reference to “assets,” Congress meant the “indicia of ownership” or legal ownership of such assets, so that the jurisdiction being tested is the one in which the trust (or other arrangement) is located, provided in either case the trust was not established for the primary purpose of avoidance of U.S. taxation.

D. FOREIGN PARENT COMPANY BENEFIT PLANS FOR U.S. EMPLOYEES

1. Summary

Many non-U.S. parent companies fund their employee benefit plans, especially stock-based plans, by maintaining non-U.S. trusts (or similar vehicles) to accumulate the necessary assets (typically, company stock) to pay benefits. These trusts and similar arrangements are quite common in many countries. They are established for a variety of legitimate business reasons and are not intended for purposes of tax avoidance. In many cases, these trusts cover employees who are working overseas outside the non-U.S. parent’s country. Typically, a single trust is established to cover employees working in all countries, including the United States. However, in some cases companies establish separate trusts for different groups of employees, in which case a separate trust may be established to cover primarily employees working in the United States. Section 409A(b)(1) indicates that employees participating in a nonqualified plan with a related trust or underlying assets located outside the United States are deemed to have received a transfer of property under Section 83 if substantially all of the services are not rendered in such jurisdiction.

2. Recommendation

Employee benefit trusts (“EBTs”) and similar arrangements that are maintained outside the United States by non-U.S. companies and that benefit their (or their affiliates’) U.S. employees should be exempted from the offshore trust provisions of Section 409A where (1) the establishment and maintenance of the EBT or the holding of its assets in a foreign jurisdiction serves a legitimate business purpose or is driven by local, non-U.S. laws and regulations, and (2) the EBT does not otherwise result in tax avoidance or improper tax deferral. The exemption from Section 409A should also apply if the plan or arrangement to which the trust (or other funding arrangement) relates is maintained outside of the United States primarily for the benefit of persons who are non-resident aliens.8

3. Explanation

There are large numbers of U.S. employees who are covered under EBTs or similar arrangements and for reasons that do not involve tax avoidance. Many of them are employees who are U.S. taxpayers working for U.S. subsidiaries of non-U.S. companies. Others are U.S.

8 See Section 4(b) of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”).

March 28, 2005
expatriates working for non-U.S. companies in foreign countries or are foreign employees working temporarily in the United States. For reasons beyond their control, and in many cases without their knowledge, they are covered by compensatory arrangements that are funded through offshore trusts or similar vehicles that maintain assets outside the United States.

Utilizing trusts or other entities for funding employee benefit arrangements has become commonplace in many countries, particularly among those in western Europe. In some countries there is a legal prohibition on an issuer’s holding treasury stock. Other countries have institutional investor or stock exchange rules that limit the number of new shares a company may issue to satisfy stock option exercises and other employee compensation awards, but do not limit existing shares that may be used for these purposes. Moreover, there are some countries (e.g., the United Kingdom) that bar or effectively discourage (e.g., by requiring independent valuations, reports, etc.) companies from issuing free shares\(^9\) directly to their employees.\(^{10}\) Consequently, many companies use EBTs to purchase shares in the public markets in order to overcome these constraints, to help limit future dilution, or simply to hold shares earmarked for their stock-based programs.

EBT arrangements typically cover a broad-base group of employees, but usually are not tax-qualified under the local law of the employer or service recipient. While the U.S. practice is to use trusts primarily for qualified retirement plans, companies in other countries often maintain trusts for funding share-based programs (e.g., stock option plans) or other compensation arrangements (long-term incentive plans). Depending on the particular country, funding vehicles other than trusts may be used, although generally they serve the same purpose as EBTs.

An EBT is established by the company (usually with shareholder approval) and an independent trustee is appointed. The trustee typically has broad discretion over the shares and how they will be used to benefit employees. While the company can make its wishes known to the trustee, the trustee has total discretion over sale or distribution of the shares, subject to the terms of the trust instrument. Although covered employees do not have allocated accounts or direct vested interests in the EBT, under the terms of the trust employees as a class are the sole beneficiaries. These trusts are similar in concept to U.S. SECTs,\(^{11}\) except that the discretionary authority of a SECT is typically retained by the grantor-employer.

In some cases the trust is maintained in the country in which the employee is located, while other non-U.S. employers set up arrangements in different countries. For example, the U.K. practice is to establish an offshore trust, typically in Jersey or Guernsey,\(^{12}\) in order to avoid

\(^9\) “Free shares” means shares for which the employee pays no consideration other than personal services, e.g. bonus shares or restricted stock.
\(^{10}\) See, e.g., Companies Act, 1985, c.6, § 103 (Eng.).
\(^{11}\) See C.3, above.
\(^{12}\) While the recent change in U.K. corporate law allows public companies to use treasury shares to compensate employees (with the result that there may no longer be a need for a trust), there are significant new requirements for approvals and reporting obligations as well as a number of U.K. company law issues that arise if a U.K. company decides to use treasury shares for this purpose. Also, there are many companies that already have offshore trusts with significant numbers of shares that have yet to be utilized. Furthermore, treasury shares carry no voting or dividend rights for covered employees, thereby frustrating one of the advantages offered by EBTs.
U.K. company law restrictions. For legal and tax reasons, the class of beneficiaries is limited to employees and former employees (and their families). Some companies establish a single EBT trust for all employees, regardless of the country in which they work, while others maintain separate trusts for different employee groups, thereby resulting in a number of offshore trusts being maintained by non-U.S. companies, some of which primarily cover U.S. employees.

The company either funds the trust with company shares or provides a loan to the trustee to purchase shares in the public markets, from existing shareholders or by subscribing for new shares. When distributions are scheduled to be made to employees, the trustee will either distribute the shares or will sell the shares and distribute the proceeds to the employees.

In most cases the parent company charges its subsidiaries for the cost of shares delivered to the subsidiary employees. This cost ultimately is paid through direct payment by the subsidiary or the employee or both or an intercompany charge from the parent to the subsidiary.

U.S. employees participating in the benefit programs supported by an EBT receive payments, in cash or stock, from the trust when they are entitled to their benefits. Because these payments are compensatory, they are reported on employees’ Forms W-2 and are subject to income and payroll tax reporting. In most cases, U.S. employees are unaware that these amounts are being paid from a non-U.S. trust rather than from their employer directly.

For all the foregoing reasons, we recommend that EBTs established by a non-U.S. parent company for the benefit of U.S. employees, both citizens and residents aliens, be exempt from the provisions of Section 409A(b) even where the non-U.S. trust was not created in the jurisdiction where the non-U.S. parent company is organized or where its headquarters is located if the reason for using the trust relates to the tax or corporate law of the jurisdiction in which the non-U.S. parent company is organized or headquarterd.

EBTs that fund plans and arrangements primarily for the benefit of non-resident aliens should also be exempt from the offshore trust provisions of Section 409A. These plans are already exempt from ERISA pursuant to Section 4(b)(4), and transfers of securities under the plans are generally exempt from the registration requirements of the Securities Act of 1933 by virtue of Regulation S, 17 C.F.R. § 230.903(b)(1)(iv). In many cases, moreover, these plans may not be amended without running afoul of local legal restrictions, employment contracts or social contract rights protecting the benefits of covered employees. Thus, it may not be possible to amend such plans or trusts to comply with Section 409A requirements.

E. INCLUSION OF FOREIGN STOCK MARKET AS AN ESTABLISHED SECURITIES MARKET

1. Summary.

Notice 2005-1, Q&A-4(d), provides an exception from the restrictions of Section 409A for stock appreciation rights (SARs) that satisfy certain conditions. One of these is that the stock

Thus it is unlikely that the new rules permitting treasury shares will have any impact in reducing the number of offshore EBTs maintained by U.K. companies in the near future.
of the service recipient subject to the right is traded on an established securities market. The
Notice does not elaborate on the meaning of this term.

2. **Recommendation.**

We recommend that the Treasury expressly define this phrase to include non-U.S.
markets that meet certain criteria.

3. **Explanation.**

We presume that the requirement for the shares relating to an SAR to be traded on an
established securities market is being imposed to ensure that a market value for the shares can
clearly be established as a condition to exempt an SAR from the restrictions of Section 409A. In
turn, this result is needed to ensure compliance with the requirement that the value of the stock
the excess over which the right provides for payment upon exercise (the SAR exercise price)
may never be less than the *fair market value* of the underlying stock on the date the right is
granted. A reference to market-based prices is generally accepted as the best means to establish
the fair market value of stock.

Capital markets for the trading of shares have been established in many locations both
within and outside the United States. The precise means of effecting trades varies somewhat
among these markets, including markets here in the United States; e.g., between the New York
Stock Exchange and the NASDAQ market system. However, all such markets perform
essentially the same function. They facilitate the transfer of shares between sellers and buyers on
price terms that are reached on an arm’s length basis. Therefore, given our presumption
regarding the purpose of the requirement for shares to be traded on an “established securities
market,” we do not believe there is justification to exclude a market merely because of its
geographic location. Rather, we believe that non-U.S. markets should generally be accorded the
same status as comparable U.S. markets in this regard.

There is precedent treating foreign markets as established securities markets for other
purposes under the Code. Treasury Regulation Section 1.280G-1, Q&A-6(f), incorporates the
meaning of the term “established securities market” found in Treasury Regulation Section 1.897-
1(m). That definition includes a foreign national securities exchange that is officially
recognized, sanctioned or supervised by the governmental authority. Section 884(c) also uses
this phrase and Treasury Regulation Section 1.884-5(d)(2) provides some criteria that a market
needs to satisfy in order to qualify. Similarly, Treasury Regulation Section 1.367(a)-
1T(c)(3)(v)(D)(I) sets forth some criteria that must be satisfied in order for a non-U.S. market to
qualify as an established securities market. Neither set of criteria would exclude foreign markets
simply because of their location. We believe that criteria similar to those set forth in these two
regulations could be imposed for purposes of the SAR exception from Section 409A and these
should be adequate to ensure that only legitimate non-U.S. markets qualify.

While in our view, Notice 2005-1 should be read in good faith to provide the above
result, we recommend that Treasury provide certainty on this issue.
F. CALCULATION OF COMPENSATION FOR PURPOSES OF APPLYING KEY EMPLOYEE RESTRICTIONS

1. **Summary.**

Section 409A(a)(2)(B)(i) requires a six month delay in the payment of deferred compensation upon separation from service in respect of a key employee of a corporation any stock in which is publicly traded on an established securities market or otherwise. Key employees are determined under the rules of Section 416(i).

2. **Recommendation.**

For purposes of determining key employees under Section 409A, we recommend that the Treasury issue regulations or the Service issue a notice clarifying that it is acceptable to use any of the definitions of “compensation” set forth in Treasury Regulation Section 1.415-2(d), including the alternative definitions set forth in Treasury Regulation Section 1.415-2(d)(11). Providing this flexibility will be useful to taxpayers. For example, they can choose to include compensation paid to nonresident aliens in determining which persons are key employees, rather than limiting such calculations to “gross income,” which generally excludes compensation derived from sources outside the United States.

3. **Explanation.**

Under Section 416, compensation is relevant in determining the status as key employees of officers and one-percent owners. Treasury Regulation Section 1.416-1, T-21, incorporates the “compensation” definition in Section 1.415-2(d) for this purpose. It also provides, as an alternative definition of “compensation”, inclusion of all amounts that would be reported on a W-2. We recommend that the Treasury issue a clarification that the same definitions of “compensation” may be used to determine key employees for purposes of the payment restriction under Section 409A(a)(2)(B)(i).

The regulations under Section 415 contain four alternative definitions of compensation that can be used. See Treas. Reg. § 1.415-2(d)(2), (10) & (11). The first two definitions do not expressly address whether compensation derived by a nonresident alien from sources outside the United States is included. In contrast, the alternative definitions in Treasury Regulation Section 1.415-2(d)(11), which provides that the determination of what is “compensation” should be made without regard to rules that limit the remuneration taken into account based on the location of the employment or services performed, more clearly suggest that items that otherwise would be excluded from gross income as non-U.S. source should be included.

To help employers determine their key employees on the basis that is easiest for them to administer across national boundaries based on their administrative systems and capabilities, taxpayers should be permitted to use any of the four alternative definitions of “compensation” found in the regulations under Section 415 or the W-2 definition set forth under Section 416 for this purpose, provided they do so on a consistent basis for a given taxable year.
STATUS OF AMERICAN DEPOSITARY RECEIPTS AS STOCK

1. Summary.

Q&A-4 of Notice 2005-1 provides an exception from the restrictions of Section 409A for stock options that meet certain requirements. It appears to be implied that a stock option involves an option to purchase shares of stock. The same Q&A-4 provides an exception for stock appreciation rights provided certain conditions are met, including a condition that only stock of the service recipient can be delivered in settlement of the SAR upon exercise. Many non-U.S. companies with shares that are traded in the United States conduct such trading in American depositary receipts (ADRs) and often use these ADRs in connection with their equity compensation programs for U.S. service providers.

2. Recommendation.

We recommend that the Treasury issue regulations or the Service publish a notice clarifying that ADRs should be accorded the same treatment as actual shares of stock for purposes of the exceptions described above relating to stock options and SARs.

3. Explanation.

An ADR is a certificate issued by a depositary financial institution that represents actual shares of stock in a non-U.S. company that are deposited with that institution. This is done to facilitate trading in the United States. The ADRs are denominated in U.S. dollars and they are the intangible property that is actually traded in the United States. ADRs generally accord the owner the same beneficial ownership interest in the actual shares of stock held by the depositary as would direct ownership of the shares themselves.

For many compensation-related purposes under the Code, the Service has concluded that ADRs are the equivalent of shares of stock. For example, ADRs constitute employer securities for purposes of Section 409(l). PLRs 8546125 and 8645044. They also constitute stock for purposes of Section 422 relating to incentive stock options and Section 423 relating to employee stock purchase plans. PLRs 8537010, 8826049 and 199931005. See also Rev. Rul. 65-218, 1965-2 C.B. 556 and Rev. Rul. 72-271, 1972-1 C.B. 369, which reached the same conclusion respecting ADRs’ treatment as stock in a noncompensatory context. Similarly, we recommend that ADRs be treated as stock for purposes of Section 409A considering that holders of ADRs generally have full dividend and voting rights and that the ADRs can be freely exchanged for the underlying shares.

FAIR MARKET VALUE OF STOCK

1. Summary.

The exceptions for stock options and for stock appreciation rights under Q&A-4 of Notice 2005-1 depend in part on a determination of the fair market value of stock. The Notice
provides that any reasonable valuation method may be used. Such methods include, for example, the valuation method described in Treasury Regulation Section 20.2031-2.

In many countries outside the United States the exercise price of an option is based on a multi-day average price of the shares; e.g., 15 – 30 days leading up to the date of grant.

2. **Recommendation.**

We recommend that the Treasury issue regulations or the Service issue a notice clarifying that a multi-day average may be used to establish the fair market value of shares where the law of the issuer’s jurisdiction requires such averaging to obtain tax beneficial treatment or where the custom of such jurisdiction is to use such averaging.

3. **Explanation.**

In many countries the exercise price of an option is determined on the basis of a multi-day average, presumably in order to attempt to reach a fair value that ignores spikes and troughs on any given day. In fact, in a number of countries, tax and substantive laws require the use of a multi-day average for this purpose in order to receive favorable tax treatment. France is an example of such a country. It requires a 20-day average to be used for the exercise price. In other countries such an averaging approach is a typical practice, although not legally required.

A safe harbor used for many purposes under the Code to establish the fair market value of stock for which there is a market is the average between the high and low price, on the valuation date. Treas. Reg. §§ 1.421-1(e), 1.422-2(e)(1) and 20.2031-2(b)(1); see also Treas. Reg. § 1.424-1(a)(9). It is typical practice in the United States to use this or some other single-day basis (e.g., the closing price) to establish value for purposes of establishing the exercise price of stock options and stock appreciation rights.

However, concerns have sometimes been expressed that use of such a spot price approach to set an option exercise price may not be an optimal approach and may even provide opportunities for manipulation by management interested in depressing (or not boosting) the price on the valuation date. As indicated above, we suspect that the practice of using a multi-day average in many locations outside the United States was motivated, at least in part, by similar concerns.

Notice 2005-1 approves any reasonable valuation method. In other words it does not mandate the use of a single-day average for this purpose with respect to shares for which there is a market. Future guidance should make it clear that a multi-day average may be acceptable in appropriate circumstances. It should indicate that some of the factors to be taken into account to determine the reasonableness of a multi-day average are whether it is required or encouraged under the tax or other laws of a relevant jurisdiction or whether it is a customary practice in the relevant jurisdiction. Such deference to independently established foreign markets is particularly appropriate with respect to Section 409A. If the Service is unwilling to issue this clarification as a matter of general application, we recommend that it issue the clarification in connection with

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specific established foreign practices in the context of Section 409A, with a comment, if necessary, that no negative inference should be drawn regarding this aspect of the rules generally.