April 15, 2005

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

Re: Comments Regarding Distribution Restrictions of Section 409A of the Internal Revenue Code

Dear Commissioner Everson:

Enclosed are comments on distribution restrictions of code section 409A. 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: Carol Gold, Director – TEGE Employee Plans, IRS
Nancy Marks, Division Counsel/Associate Chief Counsel – TEGE, IRS
Stephen Tackney, Attorney, Office of Division Counsel/Associate Chief Counsel – TEGE, IRS
William Bortz, Associate Benefits Tax Counsel, Treasury
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COMMENTS REGARDING DISTRIBUTION RESTRICTIONS OF SECTION 409A OF THE INTERNAL REVENUE CODE

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 Elizabeth Drigotas. Substantive contributions were made by David Doyle, Dennis Drapkin, Laura Edwards, Rick Ehrhart, Robert Miller, Helen Morrison, Gloria Nusbacher, Ed Razim, John Ronan, and Steven H. Sholk. The comments were reviewed by Wayne R. Luepker, Chair of the Executive Compensation Subcommittee, Greta E. Cowart, Vice Chair, and Priscilla E. Ryan, Chair of the Section’s Employee Benefits Committee; by the Quality Assurance Group of the Employee Benefits Committee, which is chaired by Tom 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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I. EXECUTIVE SUMMARY

The following comments relate to the provisions of Section 409A of the Internal Revenue Code of 1986, as amended,\(^1\) regarding distributions from nonqualified deferred compensation plans.

Our recommendations are as follow:

1. **Timing of Distributions.**
   - We recommend that, with respect to distributions that are to occur at a specified time or pursuant to a fixed schedule, regulations or a notice (“Regulations”) provide that it is sufficient for either a plan or a participant to specify that the distribution is to be made in the taxable year of the service provider.
   - We recommend that for all other distributions permitted under Section 409A Regulations provide that it is sufficient for the distributions to be made as soon as administratively practicable after the plan administrator is notified of the event.
   - We recommend that Regulations provide that distributions may be made on the first to occur of two or more permissible distribution events.
   - We recommend that Regulations provide that distributions may be made on the second, or last, to occur of two or more distribution events.
   - We recommend that Regulations provide that distributions may be made pursuant to a set schedule linked to a permissible distribution event (e.g., distributions will commence on the first anniversary of a permissible distribution event).

2. **Key Employees.**
   - We recommend that Regulations provide that “key employees” of a corporation, the stock of which is “publicly traded on an established securities market or otherwise,” be determined in accordance with the regulations under § 1.416-1, to the extent such regulations remain consistent with section 416(i), as amended by the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”).\(^2\)
   - We recommend that Regulations provide that the identification of “key employees” be determined as of December 31 of each year, and that the key

\(^1\) All section references herein are to the Internal Revenue Code of 1986, as amended (the “Code”), unless expressly stated otherwise.

\(^2\) P.L. 107-16. As discussed more fully in the explanation, infra, the regulations under section 416(i) have not been updated to reflect amendments to section 416(i) made by EGTRRA.
employees so identified are an employer’s key employees for purposes of section 409A for the 12-month period beginning on the next April 1.

- We recommend that Regulations provide that “publicly traded on an established securities market” be defined in a manner consistent with the application of similar terms for other purposes under the Code. Although there are some variations among similar terms under the Code, in each case, a market is broadly defined, including a traditional exchange, an over-the-counter market for which a quotation medium exists or, in the broadest sense of public trading, a single dealer making a market in the stock.

3. We recommend that Regulations permit participants in a nonqualified deferred compensation plan (i) to elect an annuity distribution form within the time frames prescribed in Section 409A and (ii) later, some time before the distribution commences, to elect the annuity form to be distributed from among actuarially equivalent life annuity forms. We recommend further that Regulations clarify that such an election would not cause the participant to be in constructive receipt of any amount that might have been paid earlier if the participant elected a different annuity option.

4. We recommend that Regulations permit nonqualified deferred compensation plans to provide for distributions on a change in ownership or control of a noncorporate service recipient.

5. We recommend that Regulations permit plans to provide for the acceleration of distributions upon termination of a nonqualified deferred compensation plan in the following circumstances:

- when an excess plan is being terminated in connection with the termination of the underlying qualified plan; and
- when the plan sponsor satisfies certain safeguards designed to ensure the accelerated distributions are related to independent business reasons.

6. We recommend that Regulations permit nonqualified deferred compensation plans or sponsors thereof to provide for distributions from such plans as follows:

- to accelerate or delay distributions as necessary to comply with legal obligations;
- to delay distributions as necessary to comply with third-party contractual obligations; and
- to delay distributions as necessary to satisfy objectively-determinable business needs related to cash flow and liquidity.

7. We recommend that Regulations permit plans to disallow disability distributions to an individual who is able to work with reasonable accommodations. In addition, we
recommend that Regulations clarify that payments can commence upon cessation of long-term disability ("LTD") payments, including in those situations where the service provider has some choice as to when this occurs. This result can be grounded either by treating the cessation of LTD benefits as a “separation from service” or by treating payments following the cessation of LTD benefits as covered by the disability trigger. Finally, we recommend that the Regulations address coordination of distributions related to disability and distributions related to separation from service.

8. We recommend that Regulations permit a service recipient to determine, on a transaction by transaction basis, whether (i) a sale of a business constitutes a separation from service for the employees who become employed by the buyer or who remain employed by the entity sold or (ii) a separation from service does not occur until such an employee terminates employment with the buyer or such entity. The determination should be required to be made before the closing of the transaction and to apply uniformly to all employees who become employed by the buyer or who remain employed by the entity sold.
II. BACKGROUND

Section 409A provides that amounts under a nonqualified deferred compensation plan are includible in income, to the extent not already included, in the year in which deferred or, if later, the year in which the amounts are no longer subject to a substantial risk of forfeiture, unless the nonqualified deferred compensation plan complies with the provisions of Section 409A with respect to the timing of elections and distributions, and funding. In addition, amounts included in income pursuant to Section 409A are subject to an additional tax equal to 20 percent, plus interest at the underpayment rate plus one percent for the period from the date of the initial deferral or, if later, when the amount is no longer subject to a substantial risk of forfeiture to the date of the inclusion in income.

Section 409A(a)(2) and (3) set forth requirements related to distributions. Section 409A(a)(2) provides that a nonqualified deferred compensation plan must provide that the amounts deferred “may not be distributed earlier than” any of the following:

(i) separation from service as determined by the Secretary of the U.S. Treasury Department (the “Treasury”) (except as provided in subparagraph (B)(i)),

(ii) the date the participant becomes disabled (within the meaning of subparagraph (C)),

(iii) death,

(iv) a specified time (or pursuant to a fixed schedule) specified under the plan at the date of the deferral of such compensation,

(v) to the extent provided by the Treasury, a change in the ownership or effective control of the corporation, or in the ownership of a substantial portion of the assets of the corporation, or

(vi) the occurrence of an unforeseeable emergency.

With respect to separation from service, distributions to a key employee of a publicly traded company must be delayed six months (or date of death, if earlier).


Section 409A(a)(3) provides that a nonqualified deferred compensation plan may not permit accelerations of the time or schedule of payments under the plan, except as provided by regulations promulgated by the Treasury.

On December 20, 2004, the Internal Revenue Service (the “Service”) issued Notice 2005-1, 2005-2 I.R.B. 274 (Jan. 10, 2005), interpreting Section 409A. The Notice did not
provide comprehensive rules on the timing of distributions, although the Notice did address specific distribution topics, such as the definition of “change in control” and circumstances in which accelerated distributions are permissible.
III. COMMENTS

We appreciate the opportunity to comment on the distribution provisions of Section 409A.

A. TIMING OF DISTRIBUTIONS IN GENERAL

1. **Summary.** Section 409A restricts the ability of a service provider to control the timing of income from a nonqualified deferred compensation plan. With respect to distributions to be made at a specified time or pursuant to a fixed schedule, it should be sufficient for a nonqualified deferred compensation plan to set times or schedules based on a service provider’s taxable year in which the distribution will be made. The other distribution events enumerated in Section 409A(a)(2) are either clearly beyond the control of the service provider or involve separation from service. Accordingly, for these other events, it should be permissible for a plan to require distributions to be made, or commence, as soon as administratively practicable after the plan administrator is notified of the event.

2. **Recommendations.**
   - We recommend that, with respect to distributions that are to occur at a specified time or pursuant to a fixed schedule, Regulations provide that it is sufficient for either the plan or a participant to specify that the distribution is to be made in the taxable year of the service provider.
   - We recommend that for all other distributions permitted under Section 409A Regulations provide that it is sufficient for the distributions to be made as soon as administratively practicable after the plan administrator is notified of the event.

3. **Explanation.** Section 409A(a)(2) requires that distributions cannot be made earlier than one of the specified, permissible distribution events. The legislative history cited above, however, suggests that distributions must occur closely in time to the enumerated events.

   Section 409A(a)(3) and (a)(4) govern changes in the timing of distributions, by precluding accelerations, except as permitted by the Treasury, and by restricting a participant’s ability to elect to delay a distribution. In light of the importance of a plan’s both setting and complying with provisions regarding the timing of distributions, Regulations should address the time within which a plan must make a distribution after the occurrence of one of the enumerated events. Moreover, given the severe consequences of failure to comply with Section 409A, Regulations should require no more specificity than is necessary to achieve the goals of Section 409A. For example, if a service provider were to die in December, it should not be required that the plan make a distribution by the end of December. Instead, Regulations should adopt a more pragmatic approach that is more precise than that suggested by the statutory language, but not as limited as a literal reading of the legislative history might indicate. As noted above, the legislative history provides that distributions are permissible only “upon” the

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occurrence of a permissible distribution event. A distribution that is made as soon as administratively practicable is fairly considered one made upon the applicable event.

With respect to distributions based upon a specific time or fixed schedule, distributions within the same taxable year of the participant as the specified time or schedule have the same general tax effect. For example, a plan could provide that a distribution must be made in 2007 (or during the taxable year beginning after December 31, 2006), or could say that distributions will be made in substantially equal installments over a five-year period beginning with a distribution in 2007. Requiring that a set schedule specify the year of distribution minimizes the risk that administrative or other delays by the service recipient would expose a participant to the additional tax penalties. In addition, as long as the distribution falls within the scheduled taxable year, there is no tax effect to the delay on the part of the service recipient.

With respect to distributions other than those set to occur at a specified time or pursuant to a fixed schedule, administrative precision in the timing of a distribution is unrealistic and not necessary to achieve the purposes of the statute. Some events, such as death or disability, are unpredictable and may occur when a participant is no longer actively providing services to the service recipient. Other events, such as separation from service or a change in control, may be easier to anticipate, but nevertheless require a reasonable time frame for the plan administrator to respond. Given the range of the predictability of these events by which a distribution is to be made, it is reasonable to allow a plan to provide that distributions will be made as soon as administratively practicable after the plan administrator is notified of the event, and to operate in accordance with this standard.

**B. EARLIER OF AND LATER OF DISTRIBUTIONS**

1. **Summary.** In designing a plan, a plan sponsor may wish to take into account the likelihood that more than one of the enumerated distribution events may occur. As long as a distribution is made only with respect to an event that is otherwise permissible under Section 409A, it should be permissible for a plan to provide that a distribution will be made at the earliest or latest of two or more permissible distribution events. In addition, it should be permissible for a plan to set a scheduled time of distribution using a permissible event as a starting point.

2. **Recommendations.**

   - We recommend that Regulations provide that distributions may be made on the first of two or more permissible distribution events.
   - We recommend that Regulations provide that distributions may be made on the second, or last, to occur of two or more distribution events.
   - We recommend that Regulations provide that distributions may be made pursuant to a set schedule linked to a permissible distribution event (e.g., distributions will commence on the first anniversary of a permissible
distribution event or the end of the calendar year in which the distributable event occurs).

3. **Explanation.** As noted above, Section 409A is structured to limit the ability of a service provider to control the timing of distributions under a nonqualified deferred compensation plan by requiring that the timing of distributions be set at the time of deferral, and providing only limited ability to later adjust this timing.

If distributions are made only with respect to an otherwise permissible distribution event and the timing of a distribution is established under the plan at the time of deferral, then it should not matter that the actual distribution occurs as a result of any one of the permissible events. For example, a plan that allows for distributions on the earlier of separation from service and age 55 should be allowed. Both events are permissible distribution events, and the combination of the two does not give the service provider any greater control over distribution timing. The same is true of a provision that provides for distributions on the later of separation from service and age 55.

Also, it should be permissible for a plan to provide for a distribution based on a schedule, the commencement of which is based on a permissible event. For example, a plan that provides for a distribution one year after separation from service should be permissible. The statute itself contemplates that distributions could be based on a schedule determined by reference to a permissible event in the context of the six-month delay in distributions after separation from service for key employees of publicly traded companies. As a way to avoid an inadvertent violation of this requirement (or to provide consistency among a group of otherwise similarly situated employees), a plan might provide for a delay in distributions for a group that included individuals who might not in fact be key employees at the time of distributions. More generally, it should similarly be permissible for a plan to impose, or allow a service provider to elect at the time of deferral, a delay after an otherwise permissible distribution event, as long as the schedule is fixed at the time of initial deferral.

The following examples illustrate these provisions:

**Example 1:** Assume that a participant makes a timely election to defer $120,000 otherwise payable during calendar year 2006. Assume further that the election specifies that the benefits from such deferral are payable in 5 installments over 5 consecutive calendar years beginning in 2016 (with the amount of each installment determined under a method specified in the plan at the time of deferral).

This plan should be considered to comply with the Section 409A distribution rules because benefits are to be paid at the times specified, regardless of whether the exact dates of the distributions are specified by the participant through an election or whether they are made in accordance with plan terms and administrative procedures.

**Example 2:** Assume that a participant instead specifies that the deferred amount is payable in 5 installments over 5 consecutive calendar years beginning with the

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earlier of 2016 and as soon as administratively practicable following the participant’s separation from service.

The plan should be considered to comply with the Section 409A distribution rules because benefits are to be paid after separation of service or at a time or times specified.

Example 3: Assume that a participant instead specifies that the deferred amount is payable in 5 installments over 5 consecutive calendar years beginning with the later of 2016 and as soon as administratively practicable following separation from service.

This plan should be considered to comply with the Section 409A distribution rules because benefits are to be paid after separation of service or at a time or times specified.

Example 4: Assume that a participant instead specifies that the deferred amount is payable in 5 installments over 5 consecutive calendar years beginning in the second calendar year after the calendar year in which the participant separates from service.

This plan should be considered to comply with the Section 409A distribution rules because benefits are to be paid after separation of service at the times specified.

C. IDENTIFICATION OF KEY EMPLOYEES AND PUBLICLY TRADED SERVICE RECIPIENTS

1. Summary. Section 409A(a)(2)(A)(i) provides an exception to the provision permitting distributions to a participant in the event of the participant’s separation from service by requiring at least a six-month delay after separation from service where the distribution is made to an employee described in Section 409A(a)(2)(B)(i) as a “key employee (as defined in Section 416(i) . . .) of a corporation any stock in which is publicly traded on an established securities market or otherwise.”

2. Recommendations.

- We recommend that Regulations provide that “key employees” of a corporation, the stock of which is “publicly traded on an established securities market or otherwise,” be determined in accordance with the Treasury Regulation under § 1.416-1, to the extent such regulations remain consistent with section 416(i), as amended by the EGTRRA.

- We recommend that Regulations provide that the identification of “key employees” be determined as of December 31 of each year, and that the key employees so identified are an employer’s key employees for purposes of section 409A for the 12-month period beginning on the next April 1.

- We recommend that Regulations provide that “publicly traded on an established securities market” be defined in a manner consistent with the application of similar terms for other purposes under the Code. Although
there are some variations among similar terms under the Code, in each case, a market is broadly defined, including a traditional exchange, an over-the-counter market for which a quotation medium exists or, in the broadest sense of public trading, a single dealer making a market in the stock.

3. Explanation.

(a) Key Employee.

The definition of key employee in Section 416(i) was developed for purposes of the top heavy rules, which for the most part are not applicable to the public companies to whom Section 409A(a)(2)(B)(i) is addressed. For most of these companies, the determination of their key employees is not one they would make but for Section 409A. Since these companies are generally larger and more complex than the typical sponsor of top heavy plans, the determination of key employees by these companies may be administratively difficult. Moreover, while the top heavy determination can be made on a retroactive basis (since the consequences of top heavy status are to provide minimum benefits and faster vesting, which can be corrected retroactively), for purposes of Section 409A, the determination must be made before a distribution can be made.

The regulations promulgated under section 416(i) provide useful guidance for purposes of section 409A. The basic test set forth in section 416(i) provides that a “key employee” is an employee who, at any time during the plan year, is --

(i) an officer of the employer having an annual compensation greater than $130,000 [as adjusted pursuant to section 416(i)]

(ii) a 5-percent owner of the employer, or

(iii) a 1-percent owner of the employer having an annual compensation from the employer of more than $150,000 [as adjusted pursuant to section 416(i)]

The current regulations under section 416(i) have not been updated to reflect the amendments to section 416(i) made by EGTRRA. However, the regulations continue to apply to the extent consistent with section 416(i) as amended, and address issues that remain important to the application of section 416(i), such as determination of compensation, (see Q&A T-21), identification of officers (see Q&A T-13), and identification of 5-percent and 1-percent owners (see Q&A T-16 and T-17).

Given the administrative complexity of the determination, and the importance of certainty, we recommend that, for purposes of Section 409A, an employer be permitted to determine its key employees by reference to its employees who were employed on the preceding December 31. The key employees so identified would be those for whom distributions would be delayed if they were to be made during the 12-month period beginning on the next April 1. The three-month delay between the date as of which the key employees are identified and the period during which such determinations apply to
distributions allows the employer time to complete the determination process. We note
that large public companies may use several different payroll systems in different
locations. The determination of key employees would involve not only combining the
information from the various payroll systems and ranking the employees in order of their
compensation, but also determining which of the employees qualified as “officers.”

With respect to compensation, regardless of whether an employer chooses the definition
of compensation in Treasury Regulation § 1.415-2(d) or Form W-2 compensation (an
employer may choose either definition under Treasury Regulation § 1.416-1 T-21 Q&A),
an employer will need some time after year end to process its payroll data and determine
its key employees for such year. We therefore recommend that employers be given until
April 1 to make the determination, and that they be permitted to rely on the list of key
employees as so determined until the following April 1. For example, key employees
determined as of December 31, 2005 would be considered key employees for separations
from service during the period commencing April 1, 2006 through March 31, 2007.
Thus, in a situation in which a corporation has more than 50 officers having an annual
compensation greater than $135,000, the termination of employment of one of those
officers during the 12-month period should not cause the 51st highest-paid officer to
become a key employee mid-year. We believe that a requirement to coordinate
information regarding employee terminations, which would frequently involve different
geographic locations and decentralized administrative and payroll systems, would create
an administrative burden that far outweighs the benefit of any such requirement.

The issue of identifying key employees will also come up in the context of corporate
transactions involving companies that continue to be publicly traded after the transaction.
In the case of a spin-off occurring mid-year, we recommend that the employees who are
key employees of a corporation prior to the spin-off be considered key employees of the
corporation that is their employer after the spin-off. In addition, a key employee who is
employed by the spun-off corporation would continue to be considered a key employee
of his or her former employer for purposes of determining the timing of distributions
from the nonqualified deferred compensation plans of the former employer. We also
recommend that neither of the two companies would be required to identify additional
key employees until the April 1 after the spin-off.

In the context of a merger or other combination, it should be permissible for the newly
merged company to combine the key employees identified at the two predecessor
companies and re-rank the employees, generally limiting the group to 50 as permitted
under Section 416(i). This ordering can be based on the information used at each
company to determine key employee status. More importantly, we believe there is no
policy reason for ruling that a merger or other transaction should result in a public
company having 100 key employees (or more, in the event of multiple mergers).

(b) “Publicly Traded on an Established Securities Market.”

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3 The $130,000 compensation requirement in 416(i)(A)(i) is currently $135,000.
Section 409A(a)(2) applies to each corporation that has a class of stock that is “publicly traded on a recognized securities exchange or otherwise.” Section 409A gives no indication as to what constitutes public trading on a recognized securities exchange. The term "publicly traded" and like concepts "actively traded" and "readily tradable" are used in several sections of the Code. The precise wording and definitions vary under each section, but similar concepts are used. The terms “publicly traded on an established securities market” should be defined for purposes of Section 409A in a manner consistent with the application of similar terms for other purposes under the Code.

The following definitions are illustrative:

- **Section 280G.** The golden parachute rules generally do not apply to a shareholder-approved payment by a corporation no stock in which is “readily tradable on an established securities market or otherwise.” Stock is treated as readily tradable if it is “regularly quoted by brokers or dealers making market in such stock.” Treas. Reg. § 1.280G-1, A-6(e). Q&A-6 defines “established securities market” by reference to Treasury Regulation § 1.897-1(m), which defines the term for purposes of Sections 897, 1445 and 6039C as

  1. a national securities exchange which is registered under Section 6 of the Exchange Act,
  2. a foreign national securities exchange which is officially recognized, sanctioned or supervised by governmental authority, and
  3. any over-the-counter market which uses an interdealer quotation system.

- **Section 453.** The installment sales rules of Section 453 do not apply if the debt obligation is issued by a corporation and is “readily tradable in an established securities market.” The definition of an “established securities market” includes a national securities exchange which is registered under Section 6 of the Exchange Act, an exchange which is exempted from registration under Section 5 of the Exchange Act because of its limited volume of transactions, and any over-the-counter market, which uses an interdealer quotation system. See Treas. Reg. § 15A.453-1(e)(4)(iv).

- **Section 7704.** Section 7704 treats certain partnerships as corporations if interests in such partnership are “traded on an established securities market” or are “readily tradable on a secondary market or the substantial equivalent thereof.” Established securities market includes a national securities exchange registered under Section 6 of the Exchange Act, a national securities exchange exempt from registration under Section 6 of the Exchange Act because of the limited volume of transactions, certain foreign exchanges, regional or local exchanges, and any interdealer quotation system that regularly disseminates firm buy or sell quotations by identified brokers or dealers by electronic means or otherwise. Treas. Reg. § 1.7704-1(b). On the other hand, a “secondary market or substantial equivalent thereof” generally exists if the interests are regularly quoted by any person, such as a broker or dealer, making a market in the interests, firm bid or
offer quotes are regularly made by any person to the public, holders of such
interest have a readily available, regular, and ongoing opportunity to sell or
exchange the interest through a public means of obtaining information of offers to
buy, sell, or exchange such interests in a similar time frame and with similar
regularity and continuity as any of the foregoing. Treas. Reg. § 1.7704-1(c).

- **Section 1092.** The straddle rules of Section 1092 define “actively traded”
property as property for which there is an established financial market, including:
(i) a national securities exchange registered under Section 6 of the Exchange Act;
(ii) an interdealer quotation system sponsored by a national securities association;
(iii) a domestic board of trade designated as a contract market by the
Commodities Futures Trading Commission; (iv) certain foreign exchanges and
boards of trade qualifying under local law; (v) an interbank market; (vi) an
interdealer market; and (vi) with respect to a debt instrument, a debt market.
Treas. Reg. § 1.1092(d)-1(b)(1).

As shown above, the term “publicly traded” has been the subject of varying
interpretations. To generalize, however, they all establish a degree of liquidity, whether
on a traditional exchange, an over-the-counter market for which a quotation medium
exists or, in the broadest sense of public trading, a single dealer making a market in the
stock.

In addition, we recommend that a similar standard apply to stock appreciation rights with
respect to stock that is traded on an established securities market. Notice 2005-1, Q&A-
4(d)(iv).

**D. ELECTION OF ALTERNATIVE ANNUITY BENEFIT FORMS**

1. **Summary.** When a service provider timely makes his or her distribution election, it
should be sufficient if the service provider simply elects to receive a life annuity
distribution. There is no underlying policy reason to require that the service provider
elect at that time the form of annuity, as long as all annuity distribution forms are
actuarially equivalent.

2. **Recommendation.** We recommend that Regulations issued under Section 409A
permit participants in a nonqualified deferred compensation plan (i) to elect an annuity
distribution form within the time frames prescribed in Section 409A and (ii) later, some
time before the distribution commences, to elect the annuity form to be distributed from
among actuarially equivalent life annuity forms. We recommend further that Regulations
clarify that such an election would not cause the participant to be in constructive receipt
of any amount that might have been paid earlier if the participant elected a different
annuity option.

The Conference Report states in its discussion of various benefit choices that do not
offend the principles behind the prohibition on the acceleration of distributions that: “It is
also intended that the Secretary provide rules under which the choice between different
forms of actuarially equivalent life annuity payments is permitted.” Conf. Rep. at 731.
We believe that our recommendation, when administered in accordance with the terms and reasonable actuarial assumptions contained in the plan, does not raise any material opportunity for abuse, and would facilitate the administration of non-qualified deferred compensation plans that have limited distribution options.

E. CHANGE IN CONTROL FOR NONCORPORATE ENTITIES

1. Summary. One of the permissible distribution events under Section 409A(a)(2) is a change in control of a corporation. Notice 2005-1 provides that a change in control occurs only with respect to a corporation. Regulations should permit distributions in comparable situations involving a change in control of a noncorporate entity. From the perspective of the service provider, the effect of a change in control is the same whether the service recipient is taxed as a corporation, partnership or trust.

2. Recommendation. We recommend that Regulations permit nonqualified deferred compensation plans to provide for distributions on a change in control of a noncorporate service recipient.

3. Explanation. One of the main thrusts of Section 409A is to restrict the ability of a service provider to control the timing of distributions from a nonqualified deferred compensation plan. With this in mind, there does not appear to be a policy reason to treat a change in control of corporation different from a change in control of another type entity. Although Section 409A(a)(2) references a change in ownership or control of a corporation, the legislative history does not provide a reason why only corporate entities should be permitted to make distributions on a change in control. See Conf. Rep. at 730. In fact, the legislative history contemplates that Regulations will provide other limited exemptions to the rule against acceleration of distributions (“it is intended that the Secretary will provide . . . limited exceptions to the prohibition on accelerated distributions.” Conf. Rep. at 731.) A change in control, whether of a corporate or noncorporate entity, should equally be considered beyond the control of a service provider. Use of this regulatory authority to provide for comparable provisions related to changes in control of noncorporate entities would not give service providers greater control over distributions relative to service providers to corporations. Rather, it would mean that nonqualified deferred compensation plans, and the related income consequence for a service provider, would not be affected by the form in which the service recipient chooses to operate its business.

We recognize that under this approach, what constitutes a “change in control” will need to be determined in manner consistent with a noncorporate context. With respect to a sale of substantially all assets, there is no reason to distinguish between a service recipient that operates as a corporation versus a service recipient that is a noncorporate entity. In the context of sale of a controlling interest, it should be possible to develop a test that looks to whether there has been a sufficient change in ownership interests, or in control of, the noncorporate entity. Pending further review of these issues, noncorporate entities should be allowed to provide for distributions on changes in control applying the same principles applicable to corporations.
F. DISTRIBUTIONS UPON PLAN TERMINATIONS

1. Summary. Neither the statutory provisions dealing with distributions in Section 409A(a)(2) nor the Conference Report address distributions upon the termination of a nonqualified deferred compensation plan. Under Section 409A(a)(3), a plan cannot permit acceleration of the time or schedule of any payment except as provided in regulations by the Treasury. Thus, under the statute, the Treasury has the authority to issue regulations for distributions on plan termination that accelerate the timing of distributions.

2. Recommendations. We recommend that Regulations permit plans to provide for the acceleration of distributions upon the termination of a nonqualified deferred compensation plan without subjecting recipients to the adverse tax consequences of Section 409A in the following circumstances:

- When a plan sponsor terminates a qualified plan and there is a related excess benefit plan, the plan sponsor may terminate the nonqualified plan at the same time as the termination of the qualified plan and make distributions from the nonqualified plan at the same time distributions are made from the qualified plan.

- The plan sponsor may terminate a nonqualified plan and distribute benefits as soon as practicable after termination of the plan, as long as all four of the following requirements are satisfied:
  
  (a) The plan provides for distribution of benefits upon its termination, and the plan contained this provision for at least 12 months prior to the date of the plan sponsor’s decision to terminate the plan;

  (b) The decision to terminate the plan is pursuant to a process intended to ensure independence. This decision could be made by a committee of at least two outside directors as defined in Treasury Regulation § 1.162-27(e)(3), but without the reference to “publicly held” in describing the corporation. For an entity that does not have two or more outside directors, the decision could be made by an outside director or, if there are no outside directors, by shareholders (or other owners) who do not participate in the plan. In the context of a noncorporate entity, through a process similarly designed to protect against the ability of participants to control the termination decision;

  (c) Distributions are made as soon as practicable after termination of the plan (taking into account the financial health of the sponsor, including the need to address issues such as fraudulent transfer claims, and other cash flow needs of the business); and

  (d) The plan sponsor does not adopt a substantially similar plan within three years after the date lump sum distributions are made and installment payment distributions commence from the terminated plan.
3. **Explanation.** It is a common business practice for plan sponsors to terminate a deferred compensation plan when the plan no longer serves its purpose, such as aligning the interests of executives with shareholders, or retaining executives, or the plan becomes too costly. Neither the statute nor the Conference Report indicates any Congressional intent to interfere with this common business practice. Thus, as long as a termination is not inconsistent with the purposes of Section 409A, Regulations should allow acceleration of distribution of benefits on plan termination.

Section 409A is intended to prevent executives from controlling the timing of payments. Section 409A(a)(3) provides for accelerated distributions only as provided by regulations. As noted above, the Conference Report indicates that this authority should be used to allow for accelerated distributions in situations outside of the control of the service provider. Conf. Rep. at 731. The proposed safeguards are consistent with this intent. When the decision to terminate a plan is approved by a corporation’s outside directors, the executive does not exercise control over the decision. Not all corporations have two outside directors. For those corporations, a single outside director or, if there are no outside directors, the shareholders could make the decision to terminate. In either case, the ability to make the decision could further be limited so that only individuals who do not participate in the plan are part of the decision making process. A similar procedure could be required in the case of plans sponsored by entities that are not corporations having the power to terminate a plan.

Another purpose of Section 409A is to limit the ability of executives to take undue advantage of their positions and bargaining power. Our recommendation furthers this purpose in two ways. First, the plan document must contain a provision that permits distributions upon termination of the plan for at least 12 months before the plan termination. This is similar to the presumption under Section 280G(b)(2)(C) that an agreement entered into within one year before a change in control is presumed to be contingent on the change in control unless the contrary is established by clear and convincing evidence. The presumption is reversed for an agreement entered into more than one year prior to a change in control.

Second, the plan sponsor must wait three years after distributions before adopting a substantially similar plan. It would avoid plan terminations solely entered into to give executives distributions with an immediate creation of a similar deferred compensation plan. This provision would limit plan terminations to only those plans that no longer serve its purpose or becomes too costly.

The ability to the plan sponsor to reserve the right to terminate the plan is an important one. It is true that a plan sponsor could freeze a plan and reduce future liabilities. However, a freeze would still leave the plan sponsor with the obligation to continue to administer, and bear the cost, of the plan for years into the future. With the ability to terminate a plan and distribute as soon as practicable, the plan sponsor is able to respond more directly to concerns about cost or governance. We suggest that the proposal outlined above allows plan sponsors the ability they need to terminate a plan completely,
G. PERMISSIBLE CHANGES TO DISTRIBUTION TIMING

1. **Summary**. In some cases, a service recipient may need to change the timing of a distribution to address circumstances beyond its control. It is essential that Regulations provide guidance so that plan sponsors are not forced to choose between documentary or operational violations of Section 409A on the one hand, and potential or actual violations of law, breaches of contract or essential business needs on the other hand. The need to manage these issues on the part of the service recipient does not affect the service provider’s ability to control timing of distributions and should continue to be permissible.

2. **Recommendation**. We recommend that Regulations permit nonqualified deferred compensation plans or sponsors thereof to provide for distributions from such plans as follows:

   - to accelerate or delay distributions as necessary to comply with legal obligations;
   - to delay distributions as necessary to comply with third-party contractual obligations; and
   - to delay distributions as necessary to satisfy objectively determinable business needs related to cash flow and liquidity.

3. **Explanation**. In certain circumstances, a service recipient will need to change the timing of distributions from a nonqualified deferred compensation plan in order to comply with legal, contractual obligations, or other objective business situations.

   (a) **Legal Obligations**.

   **Securities Laws**. In connection with securities laws, it should be permissible for a plan to provide that no shares of common stock will be issued or transferred pursuant to an award unless and until all then applicable requirements imposed by federal and state securities and other laws, rules and regulations by any regulatory agencies having jurisdiction, and by any exchanges upon which the shares of common stock may be listed, have been fully met.

   **WARN Act Payments**. In the context of severance benefits, many employers in the course of reductions in force that trigger the Worker Adjustment and Retraining Notification Act (“WARN Act”) requirements (generally plant closures or mass layoffs of 50 or more employees in one location) offer a large group of employees the option of receiving 60 days pay in lieu of notice under the WARN Act and then a set number of weeks of pay for each year of service. Many employers cannot practically give the WARN Act notice due to constraints of transactions or the employer’s particular business circumstances, thus instead the employer provides pay for the 60 day period in lieu of the notice without requiring the employees to work during the 60 day period. Since the pay in lieu of the
notice required by the WARN Act (whether it is paid in a lump sum or on an accelerated basis or paid with the employer’s normal payroll cycle during the 60 day period) is not received as the result of negotiations for additional compensation and there is no election to defer, there should be no reason why these amounts paid in the nature of severance should be considered deferred compensation subject to Section 409A, even if paid as part of a severance plan’s benefits.

While the WARN Act notice was enacted to protect employees who lose their jobs when a plant closes, in some cases an executive may be located at the facility as well. If the executive is a key employee of a publicly traded corporation, the employer must consider whether providing the executive the 60 day pay in lieu of notice might violate the Section 409A requirement that such persons not receive any payment of nonqualified deferred compensation for 6 months following separation from service. However, there are also concerns that some employers may try to use the pay in lieu of notice as an alternative basis to circumvent the 6 month prohibition on payments following separation from service for key employees of a publicly traded company in situations when there is no event triggering the WARN Act notice, by paying key employees upon separation from service an amount as pay in lieu of notice, even if no notice would have been required under the WARN Act related to the separation from service.

In order to avoid the conflict an employer faces when confronted with Section 409A and a layoff subject to the WARN Act requirements, we recommend that Regulations specifically exclude severance payments, assuming the severance plan is determined to be covered by Section 409A, paid in lieu of notice to satisfy the WARN Act required 60 day notice. The pay in lieu of notice exception should only apply if there was a plant shutdown or similar event triggering the application of the WARN Act. The exception for pay in lieu of notice for WARN Act compliance should not apply to any key employee unless there truly is a layoff giving rise to WARN Act notice rights for that key employee.

**Permitted Distributions under 409(p).** A specific example of the need to accelerate a payment arises in the case of an ESOP that owns stock of an S corporation and must comply with the Section 409(p) requirements. The preamble to the Temporary Regulations under Section 409(p) issued on December 16, 2004 states that a permissible step to avoid a violation of Section 409(p) includes the “reduction of synthetic equity, e.g., by cancellation or distribution of the synthetic equity” held by a “disqualified person,” as defined in Section 409(p). In most cases, “synthetic equity,” as defined in Section 409(p), is considered nonqualified deferred compensation under Section 409A. Consequently, without regulatory relief, a cancellation or distribution of the synthetic equity held by a “disqualified person” would be an impermissible acceleration of the payment of the deferred compensation. The elimination of the synthetic equity in order to comply with Section 409(p) does not violate the intent of the Section 409A to limit the control that a service recipient has over the timing of the payment of the deferred compensation. Distribution of synthetic equity to comply with Section 409(p) should be a permissible acceleration of the payment in the same manner as those exceptions set forth in Q&A-15 of Notice 2005-1.
General Legal Obligations. There are likely other legal obligations that could arise and that could require the service recipient either to accelerate or to delay distributions. It is essential to allow the service recipient to comply with such other legal requirements. In so doing, the service recipient should be permitted to make a reasonable interpretation of the other legal requirements, which necessarily implies some degree of discretion.

(b) Contractual Obligations. Under certain contracts, there are covenants that, if certain conditions occur, might require a delay in a distribution under a nonqualified deferred contract. For example, a plan might provide that distributions must be delayed if under the terms of (i) debt covenants negotiated with a lender, or (ii) restrictive covenants required by a shareholder or other investor, a distribution would violate liquidity, cash reserve, or other restrictions. The distribution would normally be made as soon as practicable once compliance with the restrictive covenants is possible.

As with legal obligations, Regulations should permit a service recipient to change distributions as necessary to comply with contractual commitments imposed pursuant to arms’ length negotiations with a party having adverse interests. It should make no difference whether the contractual restrictions predate or post-date either the establishment of the nonqualified deferral plan or the effectiveness of the deferral. As with compliance with legal requirements, Regulations should allow for reasonable interpretations of the contractual restrictions, which necessarily would include some element of discretion.

(c) Objectively Determinable Cash Flow and Liquidity Needs. Finally, a service recipient should be permitted to retain the ability to delay a distribution in order to satisfy essential business requirements related to cash flow and liquidity. For example, a plan should be permitted to provide the service recipient with the right to defer payments in order to meet cash flow, liquidity or other business constraints; the constraints may or may not be prescribed pursuant to an objective formula, with any payment so deferred to be made at the earliest possible time consistent with the business constraints.

Although these concerns are less objective than legal or contractual obligations, they are just as significant. The constraints are objective and meaningful. Imposition of the deferral would clearly be adverse to the interests of the service providers. In the case of a need to meet liquidity or cash flow requirements, delay is related to a need to retain cash within the business, not to advantage the service providers. Indeed, given the circumstances in which these kinds of covenants or cash flow restrictions would be applicable, it is more likely that the service providers would prefer to take the cash, rather than delay the distributions.

(d) General Discussion. In each case, the issue is whether the service recipient is permitted to satisfy the needs and obligations of the business as a whole. It would be unfortunate if a deferral made for the necessity of the business and that was a part of the deferral agreement from the beginning could result, either in operation or due to the presence of the provision in the plan, in the imposition of Section 409A penalties on service providers. Allowing the service recipient to change the timing of distributions as
necessary to meet legal, contractual, or essential business needs is consistent with Section 409A.

In the case of a need to accelerate a payment to satisfy a legal obligation, such as in order to comply with section 409(p), the Treasury is provided with explicit regulatory authority to allow accelerations, under Section 409A(a)(3). Such legal obligations of the service recipient are reasonably considered a condition outside the control of the service provider, and therefore present a reasonable basis as an exception to the acceleration restrictions.

In the case of a need for the service recipient to delay a distribution, such a provision would also be consistent with the purposes of Section 409A. First, the distribution provisions of Section 409A require that a distribution be made no earlier than one of the permissible distribution events. Assuming such an event has occurred, a distribution that is delayed because of the operation of an objective requirement, as outlined above, is still a distribution made no earlier than a specified distribution event. Also, since there is no election on the part of the service provider regarding the operation of this sort of objective requirement, Section 409A(a)(4) and the specific provisions related to elective redemptions are not implicated.

Finally, allowing a nonqualified deferred compensation plan to delay distributions for objective legal, contractual, or essential business reasons does not provide service providers with additional control over distributions. To the contrary, allowing the service recipient to change the timing of distributions in these circumstances would allow the service recipient to put the timing of distributions to service providers behind other needs of the business.

An obvious concern with allowing changes in the timing of distributions in these circumstances is whether a service provider would be able to conspire with a service recipient to change the timing of distributions to the advantage of the service provider. In the case of the types of legal obligations discussed above, such collusion would be difficult to achieve. The proposed rules set forth above would require that the contractual obligation be one reached through arms’ length negotiations with a party with adverse interests. Such a standard is intended to protect against situations in which a service provider could somehow create such a contractual obligation. Changes in timing to meet essential business needs, while in some ways the most general, also involves circumstances in which the service provider and service recipient’s goals are most adverse. As noted above, to the extent that the service recipient does not have sufficient cash or liquidity to meet both business needs and make distributions, the interests of the service provider are for distribution, not delay. Indeed, it would seem a curious result if the service provider could use Section 409A and the contract rights under a nonqualified deferred compensation plan to force the service recipient to make distributions to executives ahead of other needs of the business.
H. DISTRIBUTIONS UPON DISABILITY

1. **Summary.** Section 409A(a)(2) permits a plan to provide for distributions on disability. This is an important protection for participants. At the same time, these distributions should be coordinated with other applicable law regarding disabilities and with the expectation that these distributions will be provided to individuals no longer in a position to actively perform services.

2. **Recommendation.** We recommend that Regulations permit plans to disallow disability distributions to an individual who is able to work with reasonable accommodations. In addition, Regulations should clarify that payments can commence upon cessation of LTD payments, including in those situations where the service provider has some choice as to when this occurs. This result can be grounded either by treating the cessation of LTD benefits as a “separation from service” or by treating payments following the cessation of LTD benefits as covered by the disability trigger. Finally, we recommend that the Regulations address coordination of distributions related to disability and distributions related to separation from service.

3. **Explanation.**

   (a) **Coordination with reasonable accommodations.** Section 409A provides for payment when an individual is disabled. An individual is disabled under Section 409A if the individual either:

   (i) is unable to engage in an substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, or

   (ii) is, by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than 3 months under an accident and health plan covering employees of the participant’s employer.

The Americans with Disabilities Act requires employers to provide reasonable accommodations to a disabled employee to permit the employee to return to work or to be employed. Such an employee must be provided the opportunity to return to employment if the employee can perform the essential functions of his or her job with or without reasonable accommodations. An example would be an executive fighting cancer who is able to work with the reasonable accommodation of a reduced schedule during chemotherapy.

The disability definition in Section 409A does not consider the fact that an employer could be required to provide reasonable accommodations to an employee to enable the employee to work, yet the employee could still be disabled within (ii) above. This means that an individual who may be working with reasonable accommodations could be
disabled under Section 409A and receive nonqualified deferred compensation benefits, unless the definition of disability under the nonqualified deferred compensation plan can be modified to permit distributions only if the individual is disabled as defined above and cannot perform the essential functions of his or her position, with or without reasonable accommodations. Incorporating the caveat that the individual must be unable to perform the essential functions of the job, with or without reasonable accommodations, should be permitted to be added to the disability definition to ensure the employee is truly disabled and not double-dipping from the employer.

(b) Coordination between disability and separation from service. An employee’s commencement of supplemental retirement benefits upon the cessation of LTD payments should be treated as a permissible distribution event under Section 409A. The employee must forego the receipt of a stream of current income (salary or LTD payments) in order to receive the supplemental retirement benefits. However, in many cases, even if the plan documents literally provide for employee choice as to timing, a comparison of the amount of LTD payments versus retirement payments is likely to dictate the employee’s choice.

As an alternative to treating cessation of LTD payments as a “separation from service,” Regulations could provide that a distribution upon the cessation of LTD payments satisfies the statutory requirement that a distribution occur no earlier than the occurrence of disability.

Whichever approach is taken, Regulations need to take into account that employers have contractual obligations to employees who are currently receiving LTD payments. The general Section 409A grandfather provision is insufficient to take care of some of these situations, particularly those where the supplemental retirement benefits continue to accrue during the period of disability. Thus, we recommend that Regulations expressly provide grandfather protection on this issue for employees who become disabled prior to the issuance of the regulations.

1. SEPARATION FROM SERVICE FOLLOWING SALE OF A BUSINESS

1. Summary. Regulations should address the definition of “separation from service” in the context of the sale of a business unit.

2. Recommendation. We recommend that Regulations permit a service recipient to determine, on a transaction by transaction basis, whether (i) a sale of a business constitutes a separation from service for the employees who become employed by the buyer or who remained employed by the entity sold or (ii) separation from service does not occur until such an employee terminates employment with the buyer or such entity. The determination should be required to be made before the closing of the transaction and to apply uniformly to all employees who become employed by the buyer or who remain employed by the entity sold in that transaction.

3. Explanation. The treatment of supplemental pension benefits in a sale of a business unit can vary from transaction to transaction. Sometimes the parties choose to treat an
asset sale as a separation from service which entitles employees to receive a distribution of their retirement benefits. In other cases, the parties agree to apply a “same desk rule” under which the employee is not entitled to a distribution until he or she separates from the service of the buyer. In many of these cases, service with the buyer is applied to satisfy the plan’s vesting requirements. Often the treatment of a supplemental employee retirement plan which provides benefits in excess of the limitations imposed on qualified plans parallels the treatment of the related qualified plan.

Because the treatment of supplemental benefits has historically been negotiated between buyers and sellers to address the needs and interests of the parties, Regulations should not mandate one of these types of treatment as opposed to another. While the sale of a business unit may in many cases be a permissible distribution event under the change in control provisions of the Regulations, there may be transactions where the sale of a business does not satisfy the change in control definition (for example, a sale of assets which constitutes only a small percentage of a company’s business).

In any case, any definition of separation from service that is more limiting than the one described above should be made to apply prospectively, and should be applied only to transactions entered into after the effective date of final Regulations. The general grandfather protection under Section 409A is inadequate to deal with the situation where contractual commitments were made prior to 2005 covering benefits that were accrued but unvested as of January 1, 2005. Similarly, contractual commitments made as part of transactions entered into before the issuance of guidance on this issue should also be protected.

Providing this type of flexibility to employers does not create a potential for abuse. As contemplated, the decision regarding whether to apply the “same desk rule” will be negotiated between the employer and a third party, and will apply to all employees in the transaction. Moreover, regardless of whether the parties apply the same desk rule, if the distribution is on account of separation from service, key employees will be required to wait until six months after their separation from service before getting their distributions.