May 20, 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 Deferral Elections Under Section 409A

Dear Commissioner Everson:

Enclosed are comments on deferral elections under 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
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COMMENTS REGARDING DEFERRAL ELECTIONS
UNDER 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 members of the Employee Benefit Committee of the Section of Taxation. Principal responsibility was exercised by Linda Wilkins. Substantive contributions were made by Andrea Dudek, Linda Thomas, Ian Lofwall, Marvin Swift, Susan Wetzel, Kurt Lawson, Wayne Luepker, Jeremy Goldstein and Richard A. Grimm. 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 Employee Benefits Committee of the Tax Section of the American Bar Association. The comments were further reviewed 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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May 20, 2005
I. EXECUTIVE SUMMARY

The following comments relate to the provisions of Section 409A of the Internal Revenue Code of 1986, as amended,\(^1\) regarding deferral elections in nonqualified deferred compensation plans, subsequent elections, the definition of “performance-based compensation,” and the definition of a “substantial risk of forfeiture.”

Our recommendations are as follows:

1. We recommend that regulations or a notice (“Regulations”) provide that elections to defer compensation under a nonqualified deferred compensation plan with a plan year that is the employer’s fiscal year may be made prior to the first day of such fiscal year, even if the fiscal year commences during the calendar year in which participants will earn a portion of the compensation being deferred and the elections are made after that calendar year ends, but before the fiscal year begins.

2. We recommend that Regulations permit an individual to reduce or revoke deferral elections prospectively upon the occurrence of one of the following events:

   - the individual becomes disabled (as defined in Section 409A);
   - a change in control; or
   - upon the occurrence of an unforeseeable emergency.

We further recommend that Regulations provide that neither the availability of such an election to reduce or revoke an existing election, nor the making of such a modification or revocation election by the individual, will result in a violation of the requirements of Section 409A or cause amounts previously deferred to be includible in income under Section 451 or the doctrine of constructive receipt.

We also recommend that Regulations provide a nonqualified deferred compensation plan can provide that deferral elections are deemed to be prospectively revoked or terminated upon the occurrence of any of the following events:

   - the individual experiences a change in employment status (e.g., a demotion or decrease in compensation) that results in the individual no longer satisfying the eligibility requirements of the nonqualified deferred compensation plan;
   - the plan ceases to constitute a “top hat” plan; or
   - the individual receives a hardship distribution under a 401(k) plan in which the individual participates.

\(^1\) All references to “Sections” refer to the Internal Revenue Code of 1986, as amended, unless otherwise noted.
3. We recommend that Regulations provide, with regard to “performance-based compensation,” that

- “qualified performance-based compensation” that satisfies the requirements of Treasury Regulation § 1.162-27(e) be deemed “performance-based compensation” under Section 409A; and

- performance criteria may be established no later than within the 90 day period following the commencement of the service period.

4. We recommend that, with regard to “subsequent elections,” Regulations provide that:

- the ability to choose an actuarially equivalent but different form of life annuity paid at the same time or on the occurrence of the same event is not a change in the form of distribution requiring compliance with Section 409A(a)(4)(C) nor is it a violation of the prohibition against acceleration of payments under Section 409A(a)(3).

- an individual cannot change a life annuity form of payment to a single sum payment, unless the single sum payment date is payable upon (i) the individual’s Disability; or (ii) a change of control.

- in the event of death or Disability or an “unforeseen emergency” (as defined in Section 409A(a)(2)(B)(ii)), any election to change the form or time of a distribution can take effect immediately, and is not required to be effective only on the date twelve months after the date on which the election is made.

- if an individual elects a form or time of distribution some time after the plan’s “default” time or form of distribution has taken effect, then such an election will be treated as a change in time or form of distribution, and will be governed by the rules of Section 409A(a)(4)(C).

- where a plan provides that participants can make a separate election as to time and form of distribution for each year’s deferral (“class year elections”), then each class year election is a separate deferral election and a participant may make a subsequent election separately for each class year election.

- for purposes of Section 409A(a)(4)(C), the term “plan” has the same meaning as provided in Q&A 9 of Notice 2005-1, except that the provisions treating (i) all account balance plans under which compensation is deferred as a separate single plan, (ii) all nonaccount balance plans under which compensation is deferred as a separate single plan, and (iii) all other nonqualified deferred compensation plans (which are neither account balance plans nor nonaccount balance plans) as a separate single plan, do not apply.

5. We recommend that Regulations provide that Section 457(f) salary deferral plans not be subject to the rule which provides that a substantial risk of forfeiture will not exist unless “the
amount subject to a substantial risk of forfeiture (ignoring earnings) is materially greater” than the amount that otherwise could have been received.

6. We recommend that Regulations clarify that an irrevocable election to contribution to a 401(k) excess benefit-type plan for a year for amounts that cannot be contributed to the 401(k) plan because of Sections 402(g), 401(a)(17) and 415, or plan limits that are intended to prevent violations of those Sections, which is made by the applicable deadline in Section 409A(4)(B), will not violate the advance election requirement merely because by their nature the contributions made pursuant to the election will vary depending on the participant’s deferral election under the 401(k) plan.

We also recommend that Regulations provide that the event that triggers a pour-over into a 401(k) wrap plan—completion of the ADP and other tests for the year—is not a distribution event under Section 409A, or alternatively, that amounts poured over to a 401(k) plan do not involve a “deferral of compensation” for purposes of Section 409A.

7. We recommend that Regulations lengthen the short-term deferral rule of Notice 2005-1, Q&A-4 in the case of calendar year bonus plans where the service recipient is unable to determine or calculate the objective factors for awarding bonuses until after March 15, to a period that ends shortly after such determination is made.

8. We recommend that Regulations provide that lump sum severance benefits paid by reason of a “good reason” termination of employment no later than two and one-half (2 ½) months after the end of the employee’s or employer’s tax year during which the termination of employment occurs not be subject to Section 409A, regardless of when “good reason” occurs.
II. BACKGROUND

We want to thank the Internal Revenue Service (the “Service”) and the Department of Treasury (the “Treasury”) for their prompt guidance and transition relief in Notice 2005-1, 2005-2 I.R.B. 274 (Jan. 10, 2005). Notice 2005-1 provided guidance on a number of difficult issues under Section 409A and requested comments. However, it did not address some of the issues that arise under the Section 409A rules regarding elections and subsequent elections. This comment addresses some of those issues.

III. COMMENTS

A. Interaction of Election Rules and Fiscal Year Plans and Employers with Calendar Year Employees

1. Summary

Section 409A(a)(4)(i) requires nonqualified deferred compensation plans to provide that compensation for services performed during a taxable year may be deferred at the participant’s election only if the election to defer such compensation (other than the initial deferral election and an election to defer performance-based compensation) is made not later than the close of the preceding taxable year or at such other time as provided in the regulations. If regulatory relief is not provided for calendar year service providers working for service recipients with fiscal year plans, then such service providers would be required to make their deferral election before the beginning of the calendar year in which the beginning of the fiscal year occurred in order for the deferral election to be made no later than the close of the preceding taxable year. The Committee Report for Section 409A provides that “[i]t is expected that the Secretary will issue guidance providing coordination rules, as appropriate, regarding the timing of elections in the case when the fiscal year of the employer and the taxable year of the individual are different.” H.R. CONF. REP. NO. 108-755, 108th Cong., 2d Sess. at 732 (2004) (the “Conference Report” or “Conf. Rep.”).

2. Recommendation

We recommend that Regulations provide that elections to defer compensation under a nonqualified deferred compensation plan with a plan year that is the employer’s fiscal year may be made anytime prior to the first day of such fiscal year, even if the fiscal year commences during the calendar year in which the service providers will earn a portion of the compensation being deferred and the elections are made after that calendar year ends but before the fiscal year begins.

3. Explanation

For deferral elections other than the initial deferral election and elections related to performance-based compensation, the service provider’s deferral election for services performed during the taxable year is required to be made not later than the close of the preceding taxable year or at such other time as provided in the regulations. While an individual service provider making the deferral election is on a calendar tax year, many corporations and their bonus plans are on fiscal
years, which means the amounts deferred for the plan year are earned by the service provider in
two different tax years. Thus, a strict application of the requirement that the deferral election be
made no “later than the close of the preceding taxable year” to a calendar year service provider
participating in a fiscal year plan would require the service provider to make his or her deferral
election in the calendar year that ends prior to the calendar year in which the beginning of the
plan’s fiscal year occurred.

For example, a bonus plan with a fiscal year from October 1, 2006 to September 30, 2007 with a
payment date between December 17, 2007 and December 31, 2007 will provide compensation
for services individuals performed in both 2006 and 2007. If a deferral election is to be made in
accordance with an individual’s taxable year, then the individual must make a deferral election
prior to December 31, 2005, because the bonus to be deferred in part relates to services
performed in October through December 2006.

Absent guidance on how Section 409A(a)(4)(i) applies to fiscal year plans, service providers
participating in fiscal year plans will be required to make their deferral elections far earlier than
those participating in calendar year plans, resulting in disparate treatment without any good
policy reason for treating such service providers differently.

Section 409A(a)(4)(i) clearly provides authority for Regulations to permit deferral elections to be
made at a time other than prior to the close of the service provider’s preceding taxable year by
the inclusion of the phrase “at such other time as provided in the regulations”. Section
409A(a)(4)(i). If Regulations permit calendar year service providers who participate in a fiscal
year plan to make a deferral election prior to the beginning of a plan’s fiscal year, this would be
consistent with the application of Section 409A to service providers who participate in calendar
year plans. Further, this treatment is consistent with the doctrine of constructive receipt since the
service provider will be making his or her deferral election prior to the date he or she would be
actually or constructively entitled to receive the compensation being deferred. Such a rule will
prevent service providers who participate in fiscal year plans from being unfairly disadvantaged
and will permit them to receive treatment under Section 409A that is consistent with the
treatment afforded to service providers who participate in calendar year plans. We do not
believe the ability to make the deferral election prior to the fiscal year of the plan for these
service providers would present an opportunity for abuse or tax avoidance.
B. Revocations of Deferral Elections upon Certain Permissible Distribution Events or to Comply with Applicable Laws

1. Summary

Under the constructive receipt doctrine, amounts deferred under a nonqualified deferred compensation plan are generally not included in an individual’s income unless the compensation is available to the individual, the individual’s right to receive the compensation is not restricted, and the individual’s failure to receive such amounts resulted from the exercise of the individual’s own discretion. To avoid constructive receipt and immediate taxation of deferred income, nonqualified deferred compensation plans typically required that an individual’s election to defer compensation for a taxable year be made prior to the beginning of the taxable year in which the income was to be earned and that the deferral election be irrevocable. Section 409A codifies part of this practice, but is silent as to whether an individual may modify or revoke his or her deferral election during the taxable year.

2. Recommendation

Permitted Revocation Events. We recommend that Regulations permit individuals to reduce or revoke deferral elections prospectively upon the occurrence of one of the following events:

- the individual becomes disabled (as defined in Section 409A(a)(2)(C));
- upon a change in the ownership or effective control of the corporation (trade or business), or in the ownership of a substantial portion of the assets of the corporation (trade or business) (as defined in Section 409A(a)(2)(A)(v) and Notice 2005-1, 2005-2 I.R.B. 274, Q&A-11 through14); or
- upon the occurrence of an unforeseeable emergency (as defined in Section 409A(a)(2)(B)(ii)).

Other Revocation Events. We recommend that Regulations provide that a nonqualified deferred compensation plan can be written to provide that deferral elections are deemed to be automatically and prospectively revoked or terminated upon the occurrence of any of the following events:

- the individual experiences a change in employment status (e.g., a demotion or decrease in compensation) that results in the individual no longer satisfying the eligibility requirements of the nonqualified deferred compensation plan;
- the plan ceases to constitute an unfunded plan maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees within the meaning of Sections 201, 301 or 401 of the Employee Retirement Income Security Act of 1974, as amended (i.e., a “top hat” plan); or
• the individual receives a hardship distribution under a 401(k) plan in which the individual participates.

3. Explanation

Under Section 409A, deferred amounts may not be distributed earlier than: (i) an individual’s separation from service; (ii) the occurrence of the individual’s Disability; (iii) the death of the individual; (iv) a specified time; (v) upon 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) upon the occurrence of an unforeseeable emergency. The application of these rules, without providing the individual an opportunity to reduce or revoke an existing deferral election, may result in a circumstance where an individual is permitted to take a complete or partial distribution of previously deferred amounts, but must continue to defer amounts earned prospectively for the remainder of the deferral period.

Example. An individual elects in December 2005 to defer 20% of his or her salary for 2006 under the employer’s nonqualified deferred compensation plan. During 2006, the individual’s home and contents are completely destroyed by a tornado. The resulting catastrophic losses (even after considering the insurance available to the individual) cause a severe financial hardship to the individual that cannot be satisfied through other means. Section 409A permits the individual to receive a distribution of amounts deferred under the nonqualified deferred compensation plan in an amount necessary to satisfy the unforeseeable emergency. Section 409A is silent, however, as to whether the individual could reduce or revoke his or her election to defer 20% of his or her salary for the remainder of 2006. Absent such a revocation, each new deferral would potentially be subject to immediate distribution if the financial hardship is continuing.

Therefore, we recommend that Regulations provide that employers may, but are not required to, amend their deferred compensation plans to allow an individual to terminate participation in the plan or to cancel or reduce a deferral election mid-year, upon the occurrence of one of the following permissible distribution events under Section 409A: (i) the occurrence of the individual’s Disability; (ii) upon 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 (iii) upon the occurrence of an unforeseeable emergency. Because each of these events is an event that would permit an accelerated distribution from the plan, it would not lead to tax avoidance similarly to permit a service provider to cancel or reduce a deferral election upon the occurrence of these events. None of these events is within the control of the individual.

We recommend that Regulations also provide that deferred compensation plans can provide that deferral elections are deemed to be prospectively revoked or terminated if the individual experiences a change in employment status (e.g., a demotion or decrease in compensation) that results in the individual no longer satisfying the eligibility requirements of the nonqualified deferred compensation plan.
If for any reason a nonqualified deferred compensation plan that is intended to qualify as a top hat plan ceases to so qualify, then the plan can provide that the deferral elections also automatically cease even if this occurs mid-year. From a policy perspective, it is important that an individual who is no longer a “top hat group” member not continue to participate in such a plan. Once the plan no longer qualifies as a top hat plan, all amounts are subject to the ERISA trust requirements, which means that vested accounts will then be immediately taxable to the participants. There is no reason from a policy perspective to require further deferrals when the individual would be immediately taxed on them as soon as they are vested.

Finally, we recommend that Regulations provide that an individual’s deferral election under a non-qualified deferred compensation plan be deemed to be revoked or otherwise terminated upon the individual receiving a hardship distribution under the employer’s 401(k) plan. This provision is necessary to support the policies established under the 401(k) regulations regarding “safe harbor” hardship withdrawals. Under the terms of a 401(k) plan that utilizes the safe harbor definition of financial hardship, the individual may not take such distribution unless, in accordance with Treasury Regulation § 1.401(k)-1(d)(3)(iv)(E)(2), the individual is prohibited from making elective contributions to all plans maintained by the individual’s employer, including the nonqualified deferred compensation plan, for at least six months following the distribution. See Treas. Reg. § 1.401(k)-1(d)(3)(iv)(E)(2). Consequently, absent an ability to revoke the deferral election under the nonqualified deferred compensation plan, the individual would be restricted from taking a hardship distribution from the 401(k) plan. We recommend that an individual’s ability to avail himself of permissible distribution rights under a 401(k) plan not be restricted by his or her participation in a nonqualified deferred compensation plan. Therefore, it is necessary that the rules under Section 409A be coordinated with Section 401(k) to ensure that a participant is allowed to exercise his or her rights under the 401(k) plan.

If receiving a hardship distribution under a 401(k) plan does not automatically result in revocation of a deferral election, highly compensated employees could access their 401(k) accounts through hardship withdrawals while still benefiting from the tax deferral benefits of a “top hat” plan. As a policy matter, highly compensated employees should not have the ability to exercise this type of discretion in attaining tax deferral benefits. As an example, it would allow a highly compensated individual to access his or her 401(k) deferrals to pay tuition for his or her children’s college education (a permitted safe harbor hardship distribution event), with the ability to continue to have tax deferral benefits under a nonqualified plan during the same year.
C. Deferral Elections Related to Performance-based Compensation

1. Summary.

Section 409A(a)(4)(B)(iii) provides an exception to the general rule that compensation for services performed during a taxable year may be deferred at a service provider’s election only if the election to defer such compensation is made not later than the close of the preceding taxable year. Section 409A(a)(4)(B)(iii) states the following:

“In the case of any performance-based compensation based on services performed over a period of at least 12 months, such election may be made no later than 6 months before the end of the period.”

Q&A 22 of the Notice 2005-1 provides interim guidance for permissible elections related to performance-based compensation.

2. Recommendations.

• We recommend that Regulations provide that “qualified performance-based compensation” that satisfies the requirements of Treasury Regulations § 1.162-27(e) be deemed “performance-based compensation” under Section 409A.

• We recommend that Regulations permit performance criteria to be established in connection with “performance-based compensation” under Section 409A no later than within the 90 day period following the first day of the service period.

3. Explanation.

Most well advised service providers that are subject to Section 162(m) have already adopted a compensation plan that complies with the requirements of Treasury Regulation § 1.162-27(e), relating to the 162(m) exception for qualified performance-based compensation. These service providers would find compliance with Section 409A substantially less difficult if they were assured that compensation structured under such plans would be deemed performance-based compensation under Section 409A. As indicated above, the legislative history at H.R. CONF. REP. NO. 108-755, at 732 (2004) related to Section 409A reflects the congressional intent that performance-based compensation may be required to satisfy certain requirements similar to those under Section 162(m), but would not be required to meet all requirements under that section. We recommend that compensation paid under a plan, which exceeds the expectations outlined in the legislative history by satisfying all of the requirements applicable under Section 162(m), be deemed to satisfy the performance-based compensation requirements of Section 409A. If the requested guidance is provided, many service recipients subject to Section 162(m) will find compliance with Section 409A less onerous. It also promotes policy goals of consistency and tax simplification.

The Conference Report cited above at 732 states that “. . . it is expected that the Secretary will provide that performance criteria would be considered preestablished if it is established in writing no later than 90 days after the commencement of the service period, but the requirement
of determination by the compensation committee of the board of directors would not be required”. H.R. Conf. Rep. No. 108-755, at 732 (2004). This is consistent with the requirement for performance goals under Treasury Regulations § 1.162-27(e)(2) The above quoted provision from the Conference Report reflects the congressional intent that service recipients be permitted to establish performance-based compensation goals for a period of up to 90 days following the commencement of the applicable service period. We recommend that future guidance make it explicit that performance goals may be established for a period of up to 90 days following the commencement of the applicable service period, just as Q&A 22 of Notice 2005-1 expressly states that the compensation committee of the board of directors would not be required to approve performance criteria. This would carry out the intent of Congress and would promote consistency in the application of requirements under Sections 409A and 162(m).
D. Subsequent Deferral Elections and Changes in Time and Form of Distribution

1. Summary

Section 409A(a)(4)(C) provides the rules under which an individual may change either (i) his or her initial election regarding the time or form (or both) of the distribution of deferred compensation or (ii) the time or form of distribution specified by the Plan. Conf. Rep. At 732-733. Such a subsequent election will comply with Section 409(a)(4)(C) provided that

(i) the plan requires that such election may not take effect until at least 12 months after the date on which the election is made,

(ii) in the case of a payment to be distributed on events other than death, Disability, or unforeseeable emergency, the plan requires that the first payment with respect to which such election is made be deferred for a period of not less than five years from the date such payment would otherwise have been made, and

(iii) the plan requires that any election related to a payment to be made at a specified time or pursuant to a fixed schedule may not be made less than 12 months prior to the date of the first scheduled payment.

Additionally, Section 409A(a)(3) prohibits the acceleration of the time or schedule of any payment except as provided by the Secretary in regulations.

2. Recommendation 1

We recommend that Regulations provide that, if an individual has elected a distribution in the form of a life annuity beginning on a stated date or after a permissible event, then the individual’s ability to choose an actuarially equivalent but different form of life annuity, including changing between a single life and a joint and survivor annuity that is actuarially equivalent, paid at the same time or on the occurrence of the same event is not a change in the form of distribution requiring compliance with Section 409A(a)(4)(C) nor is it a violation of the prohibition against acceleration of payments under Section 409A(a)(3).

3. Explanation

By enacting Section 409A(a)(4)(C), Congress intended to give an individual the ability to change his or her form of distribution under a nonqualified deferred compensation plan only if certain requirements were satisfied. However, the House Committee and the Conference Committee anticipated the need for relief from these requirements for stream of payment distributions. Both reports provide that “it is expected that in limited cases, the Secretary will issue guidance, consistent with the purposes of the provision, regarding to what extent elections to change a stream of payments are permissible.” H.R. Rep. No. 108-548, “REPORT OF THE COMMITTEE ON WAYS AND MEANS HOUSE OF REPRESENTATIVES TO ACCOMPANY H.R. 4520 TOGETHER WITH DISSenting AND ADDITIONAL VIEWS,” 108th Cong. 2d Sess. at 346 (2004) (the “WAYS AND MEANS REPORT”). H.R. Conf. Rep. No. 108-755, at 724 (2004). In addition, the Conference
Committee report provides at H.R. CONF. REP. NO. 108-755, at 731 (2004): "It is also intended that the Secretary provide rules under which the choice between different forms of actuarially equivalent life annuity payments is permitted."

An individual who desires to change the form of life annuity previously elected generally does so because of a change in personal circumstances, such as a marriage or a divorce. We recommend that this flexibility be extended to installment payments paid out over the life expectancy of one or two individuals, as well as all annuity forms.

If the Treasury is concerned about abuse – for example, an individual switching between a single life annuity and a joint and survivor life annuity in which the second life is a young child – the Treasury could limit the relief with respect to the change from a single life to a joint and survivor annuity (or vice versa) only in the situations in which the survivor is the individual’s spouse or, if the survivor is not the individual’s spouse, the life expectancy of the individual and the survivor are no more than 10 years apart. This is the approach taken in the 1987 proposed regulations under Section 401(a)(9), for purposes of the minimum distribution incidental benefit (“MDIB”) requirement. See the discussion of the MDIB rule in the Notice of Proposed Regulations published in the *Federal Register* on January 17, 2001 (66 FR 928). The 1987 proposed regulation provided that an individual could determine the minimum required distributions commencing at age 70 ½ by reference to a joint life expectancy, either with the individual’s spouse or with another family member, but only if the age of the other family member was not more than 10 years less than the individual’s age. The Uniform Lifetime Table set forth in the current regulations under Section 401(a)(9) preserves the ten-year maximum age difference. Treas. Reg. § 1.401(a)(9)-9, Q&A-2.

4. Recommendation 2

We recommend that Regulations provide that an individual cannot change a life annuity form of payment to a single sum payment unless the single sum payment is made upon (i) the individual’s Disability; or (ii) a change of control.

5. Explanation

Section 409A(a)(4)(C) provides the rules under which an individual may change his or her initial deferral regarding the time or form of the distribution of deferred compensation. In addition, Section 409A(a)(3) prohibits the acceleration of the time or schedule of any payment except as provided by the Treasury (the “nonacceleration provision”). The Ways and Means Report at 343 (2004) makes clear that the nonacceleration provision was designed to prohibit “haircut” elections, which provided “deferral of income, but also provided security of future payments and control over amounts deferred.” The Ways and Means Report at 343 also indicates these deferred compensation arrangements were available to the executives of Enron, were described in the Joint Committee’s Report of Investigation of Enron Corporation (February 2003) (cited in the Ways and Means Report at 343, footnote 453 (2004)), and should be limited by specific rules. The statute contemplates that the Treasury may permit limited elections to accelerate the time or schedule of payments. Absent specific relief, it would be impossible for a participant who has elected a life annuity form of payment to ever change such an election to a single sum
payment election. Allowing this change to a single sum election, but requiring that it be only upon the occurrence of events beyond the participant’s control, such as Disability or a change of control, would prevent any abuse and should not be a violation of the prohibition on acceleration under Section 409A(a)(3).

The Ways and Means Report at 345 (2004) specifically authorizes the Treasury to provide in regulations that certain accelerated distributions may be allowed:

“As previously discussed, except as provided in regulations by the Secretary, no accelerations of distributions may be allowed. For example, changes in the form of a distribution from an annuity to a lump sum are not permitted. The provision provides the Secretary authority to provide, through regulations, limited exceptions to the general rule that no accelerations can be permitted. It is intended that exceptions be provided for reasons beyond the control of the participant.”

6. Recommendation 3

We recommend that Regulations provide that, in the event of an individual’s death or Disability or in the event of an “unforeseen emergency” (as defined in Section 409A(a)(2)(B)(ii)), any election to change the form or time of a distribution can take effect immediately, and is not required to be effective only on the date twelve months after the date on which the election is made.

7. Explanation

Section 409A(a)(4)(C) clearly provides that the five-year additional deferral requirement of Section 409A(4)(C)(ii) does not apply to any change in the time or form of distribution upon death, Disability or unforeseen emergency. However, this section does not exempt a change in time or form of distribution upon death, Disability or unforeseen emergency from the requirement of Section 409A(4)(C)(i) that the election not take effect until 12 months from the date that the election is made.

Accordingly, if an individual elects to change the form of payment upon his or her Disability from a five-year installment payment to a lump sum payment, such election could not take effect until the date that is 12 months following the date of the election change, even if the individual was disabled (and would otherwise be entitled to a distribution but for the election to change the form of the distribution) prior to the expiration of this 12-month period.

The incidence of a Disability is certainly an event outside of the individual’s control, and from a policy perspective, such an exception would be consistent with the statutory language and would not permit access to deferred amounts in any way that would be abusive or cause constructive receipt.

8. Recommendation 4
We recommend that Regulations provide that if an individual elects a form or time of
distribution some time after the plan’s default time or form of distribution has taken effect, then
such an election will be treated as a change in time or form of distribution and will be governed
by the rules of Section 409A(a)(4)(C).

9. **Explanation**

Section 409A provides the time at which an individual may make an initial deferral election and
the requirements for making subsequent elections regarding the time and form of distributions.
Some deferred compensation plans provide for a default time and form of distribution and then
allow an individual subsequently to elect a different time or form of distribution. For example,
the plan may provide that all deferrals will be paid out in a single sum at a specified time if an
individual does not make an election. We recommend that the plan’s default time and form of
distribution be treated as an individual’s initial election if the individual did not make an election
to the time of deferral, and any election made by the individual thereafter must satisfy the
requirements of Section 409A(a)(4)(C). This recommendation is consistent with the following
statement in the Ways and Means Report: "The time and form of distributions must be specified
at the time of initial deferral. A plan could specify the time and form of payments that are to be
made as a result of a distribution event (e.g., a plan could specify that payments upon separation
of service will be paid in a lump sum within 30 days of separation from service) or could allow
participants to elect the time and form of payment at the time of the initial deferral election."

Thus, permitting a default provision regarding the time and form of payment to be changed is, in
effect, a “second election.” To avoid potential abuse, we recommend that the default provision
be treated as the initial election, and that any changes be subject to the rules of Section
409A(a)(4)(C).

10. **Recommendation 5**

We recommend that Regulations clarify that if a plan provides that participants can make a
separate election as to time and form of distribution for each year’s deferral (“class year
elections”), then each class year election is a separate deferral election, and a participant can
make a subsequent election separately for each class year election.

11. **Explanation**

Some deferred compensation plans provide for class year elections, thereby permitting
participants to choose the time and form of distribution for each year’s deferral. We recommend
that each class year deferral be treated as a separate deferral, and that participants be permitted to
make subsequent elections separately for each class year election.

Requiring that any change in the time and form of distribution would have to apply to all deferral
elections would be inconsistent with the statute.
12. **Recommendation 6**

We recommend that Regulations provide that, for purposes of Section 409A(a)(4)(C), the term “plan” has the same meaning as provided in Q&A 9 of Notice 2005-1, except that the provision treating all account balance plans under which compensation is deferred as a separate single plan, all nonaccount balance plans under which compensation is deferred as a separate single plan, and all other nonqualified deferred compensation plans as a separate single plan, does not apply.

13. **Explanation**

If a service provider participates in multiple plans of a single type (i.e., account balance plans or non-account balance plans), it is appropriate to allow the service provider to change his or her election regarding the time and form of payments under one plan without requiring the service provider to satisfy the “five-year deferral rule” and the “non-acceleration provision” with respect to all of the account balance plans in which he or she has a balance. We do not think that employers will design multiple plans in an effort to avoid these restrictions on subsequent elections.

Example: Non-qualified Plan A provides for a 5-year installment payment commencing at retirement or upon the attainment of age 50 after termination of employment. Non-qualified Plan B provides for a single sum at age 52. Under our recommendation a participant in both plans will be able to elect, prior to attaining 49, to defer the commencement of his or her 5-year installments under Plan A until age 55, will not be required to satisfy the “five-year deferral rule” with regard to his or her benefits under Plan B so that those benefits will still remain payable at age 52.
E. Deferring Salary Under Section 457(f) Plans

1. Summary

Non-qualified deferred compensation plans maintained by tax-exempt organizations (other than churches) are subject to Section 457. They come in two varieties: Section 457(a) plans—so-called because they satisfy a long list of requirements set forth in Section 457(b) and therefore their tax treatment is determined under Section 457(a)—and Section 457(f) plans—so-called because they fail to satisfy one or more of those requirements and therefore their tax treatment is determined under Section 457(f).

Benefits under a Section 457(a) plan generally are not subject to income tax until they are paid or made available to the participant. By contrast, benefits under a Section 457(f) plan are subject to income tax as soon as the participant’s right to the benefits is no longer subject to a substantial risk of forfeiture. Therefore, in order to defer income tax under such a plan, vesting must be delayed. A substantial risk of forfeiture generally means the same thing under Section 457(f) as it does under Section 83. See Section 457(f)(3). Thus, vesting generally can be delayed for this purpose by conditioning the participant’s right to benefits on the performance of substantial future services or the occurrence of a condition related to a purpose of the compensation, e.g., a performance requirement or a requirement to comply with a noncompete agreement, and the possibility of forfeiture is substantial.

Section 409A does not apply to Section 457(a) plans. However, it does apply to Section 457(f) plans unless an exception is available. Notice 2005-1 provides an exception from Section 409A if the amount deferred is “actually or constructively received” by the participant (i.e., actually paid out or made available without restrictions to the participant, not just subject to tax) by the later of (i) 2½ months from the end of the participant’s first taxable year in which the amount is no longer subject to a substantial risk of forfeiture or (ii) 2½ months from the end of the eligible employer’s first taxable year in which the amount is no longer subject to a substantial risk of forfeiture.

Notice 2005-1 generally defines a “substantial risk of forfeiture” for purposes of Section 409A in the same way as the regulations under Section 83 do. Q&A-10(a). Since, as noted above, a substantial risk of forfeiture for purposes of Section 457(f) also generally means the same thing as it does under Section 83, and Section 457(f) plans generally distribute benefits as soon as that risk is eliminated, many Section 457(f) plans will be able to rely on this exception. However, not all Section 457(f) plans will be able to do so. That is because Notice 2005-1 modifies the definition of a substantial risk of forfeiture for this and most other purposes under Section 409A in several significant ways.

One such modification provides that an amount that a recipient could have elected to receive cannot be made subject to a substantial risk of forfeiture unless “the amount subject to a substantial risk of forfeiture (ignoring earnings) is materially greater than the amount the recipient otherwise could have elected to receive.” Notice 2005-1, Q&A-10(a). This means that
Section 457(f) plans that permit participants to defer salary or bonuses that they could have elected to receive currently will be subject to Section 409A, unless the effective rate of return is increased by providing some kind of bonus.

2. Recommendations

We recommend that Regulations provide that Section 457(f) salary deferral plans not be subject to the rule that provides that a substantial risk of forfeiture will not exist unless “the amount subject to a substantial risk of forfeiture (ignoring earnings) is materially greater” than the amount a participant otherwise could have received. If the special rule is to apply to Section 457(f) plans, then we recommend that it be limited to situations where an individual truly had a right to receive the compensation. We also recommend that the meaning of important terms such as “materially greater” be clarified as explained in more detail below.

3. Explanation

The burden of complying with Section 409A is significantly greater in the case of a Section 457(f) plan, compared to a nonqualified deferred compensation plan, because deferring distributions until one of the permitted distribution events under Section 409A is not, in itself, effective to defer taxes under such a plan. Therefore, Section 457(f) plans that are subject to Section 409A not only must defer distributions until one of the permitted distribution events, but also must provide for interim distributions to pay taxes due on the benefits when they vest.

We presume the premise for the rule for salary deferrals is that a rational participant would never agree to give up current compensation in exchange for future compensation that is worth the same, on a present value basis, but the receipt of which is subject to a substantial risk of forfeiture. Cf. Richardson v. Commissioner, 64 T.C. 621 (1975) (“the moneys paid into the trust were actually derived from compensation otherwise receivable by Dr. Richardson, and he has shown no reason for subjecting them to a risk of forfeiture”). However, there are several reasons why a rational participant might be a party to such an exchange. First, the participant’s apparent freedom of choice in such a situation often is illusory. In the tax-exempt sector many Section 457(f) plans are negotiated when the participant is hired, as part of the terms of employment. Some are structured as elective arrangements to give the participant some flexibility, but with the understanding that the participant will defer all or most of what he or she is allowed to defer, subject to a risk of forfeiture. (Neither Section 457 nor Section 3121(v)(2) distinguishes between elective and nonelective arrangements, so there has not been any tax reason to use one form or the other.) If the employer had to pay the participant his or her entire compensation in cash, without any risk of forfeiture, it would not be willing to pay as much. Second, a rational participant might agree to such an exchange if the tax deferral benefit compensated for the risk of forfeiture. (Such a transaction would not be undertaken solely for tax reasons, since the employer would obtain a clear business benefit from the arrangement.) Finally, the rule does not really take a present-value approach, but instead requires taxpayers to disregard “earnings.” If the earnings promised under the plan are larger or safer than those available to the participant in the marketplace, that alone could compensate for the risk of forfeiture.

If this rule is retained, we recommend that Regulations provide that it applies to nonqualified deferred compensation plans under Section 457(f) only in situations when a participant has a true
right either to receive an amount currently or to defer it, and not in every situation where a participant could, in theory, through more astute bargaining or otherwise, have received an amount currently rather than on a deferred basis.

We also recommend that Regulations modify the approach taken in Notice 2005-1, Q&A-10(a) that a salary deferral will not be considered subject to a substantial risk of forfeiture unless the amount, ignoring earnings, that is subject to such forfeiture is “materially greater” than the salary deferral amount. We recommend that Regulations provide that the amount that is required to be “materially greater” is the benefit that the participant will be eligible to receive when he or she terminates employment etc., and that whether that amount is “materially greater” than the amount the participant could have received currently is determined using a discount rate that is appropriate for the degree of risk involved, so that increases that are contingent on individual or employer performance, for example, are taken into account even if they do not occur. Finally, we recommend that materiality be determined on a facts and circumstances basis, but that the Regulations provide a safe harbor.
F. Section 401(k) Tandem Plans

1. Summary

Some non-qualified deferred compensation plans are designed to work in tandem with Section 401(k) plans. Two kinds are common. One is an excess benefit-type plan that accepts contributions and makes allocations that the Section 401(k) plan cannot because of statutory limits imposed by Sections 402(g), 401(a)(17), and 415, and plan limits intended to prevent violations of those limits. Typically, a participant in the 401(k) plan must elect to contribute the maximum amount permitted under Section 402(g) before he or she is entitled to contribute anything to or receive any allocations under the excess benefit-type plan. Such arrangements are expressly permitted by the Section 401(k) regulations. See Treas. Reg. § 1.401(k)-1(e)(6)(iii) (2004).

Another is a so-called “wrap” plan, similar to the one approved by the Service in PLR 9530038 (May 5, 1995). A participant in a wrap plan elects before the beginning of the year in which services are performed to contribute a portion of his or her compensation for those services to the wrap plan. Once the average deferral percentage test (“ADP”) and other tests have been performed for the 401(k) plan for a year, the maximum amount that the participant can contribute to the 401(k) plan for the year is calculated, and the wrap plan “pours over” that amount to the 401(k) plan pursuant to a cash-or-deferred election made at the same time as the initial deferral election under the wrap plan. The pour-over must occur no more than 2½ months after the end of the plan year being tested in order for it to be treated as an elective contribution for that year under the ADP test. See Treas. Reg. § 1.401(k)-2(a)(4)(B)(2) (2004).

Section 409A requires deferral elections to be made “not later than the close of the preceding taxable year or at such other time as provided in regulations.” It does not expressly require deferral elections to remain the same throughout the year to which they apply, but there is a concern that any changes during that year would violate the requirement that elections be made before the beginning of the year.

Section 409A prohibits compensation deferred under a nonqualified deferred compensation plan from being distributed any earlier than the occurrence of certain distribution events, including “a specified time (or pursuant to a fixed schedule) specified under the plan at the date of the deferral of such compensation.” A question has arisen whether the event that triggers the pour-over—completion of the ADP and other tests for the year—qualifies as a “specified time” or “fixed schedule” under this rule. We believe that because a participant does not have the current right to receive the compensation, there is no distribution event and that the participant’s deferral election in the prior year to participate in the wrap plan arrangement satisfied the requirement that the deferral election be made before the beginning of the year. Alternatively, if the Service’s position is that there is a distribution event at the time of the pour-over, there is no “deferral of compensation” at that time under the short-term deferral rule in Notice 2005-1, Q&A-4(c), because the pour-over must occur within 2½ months after the end of the plan year.
2. Recommendations

We recommend that Regulations clarify that an irrevocable election to contribute to a 401(k) excess benefit-type plan for a year, for amounts that cannot be contributed to the 401(k) plan because of Sections 402(g), 401(a)(17), and Section 415, or plan limits that are intended to prevent violations of those Sections, which is made by the applicable deadline in Section 409A(a)(4)(B), will not violate the advance election requirement merely because by their nature the contributions made pursuant to the election will vary depending on the participant’s deferral election under the 401(k) plan.

We also recommend that Regulations provide that the event that triggers a pour-over in a 401(k) wrap plan—completion of the ADP and other tests for the year—is not a distribution event under Section 409A or alternatively that amounts poured over to a 401(k) plan do not involve a “deferral of compensation” for purposes of Section 409A.

3. Explanation

Nothing in the legislative history of Section 409A suggests the Congress intended to eliminate or even curtail the common practice of providing retirement benefits that cannot be provided under a tax-qualified plan because of various statutory limits to “top hat” employees under a non-qualified plan. Indeed, the legislative history specifically authorizes the Treasury to make special accommodations under the election rules of that section for “payments under nonelective, supplemental retirement plans.” H.R. Conf. Rep. No. 108-755, at 718 (2004). Section 401(k) excess benefit and wrap plans differ very little in design or intent from other supplemental retirement plans, except that contributions to such plans are elective.

Nothing in Section 409A prohibits the Regulations from providing that the “pour-over” from a 401(k) excess plan to a 401(k) plan is not a distribution event. No tax is recognized at the time of the “pour-over.” Alternatively, Regulations could provide that the “pour-over” qualifies as a specified time or occurs pursuant to a fixed schedule. The pour-over must occur within 2½ months after the end of the relevant plan year and must be elected in advance.
G. What Constitutes a Legally Binding Right in the Context of Bonus Payments?
Objective Bonus Factors Not Determinable Before March 15

1. Summary

In the context of a calendar year bonus plan, where bonuses are calculated using objective factors for services performed during the calendar year, the initial guidance issued under Section 409A is unclear whether the legally binding right arises as of December 31 or the date the bonus amount is determined.

2. Recommendation

We recommend that Regulations provide that with respect to a calendar year bonus plan, if the service recipient is unable to determine the objective factors for awarding bonuses under the plan until after March 15 of the following year, then for purposes of determining whether there is a deferral of income that is subject to Section 409A, the legally binding right be considered to arise only after the objective factors are determined, because it is not possible until then to determine what a participant has a legally binding right to receive as of December 31.

3. Explanation

The interplay between when a legally binding right arises and the measurement of the 2 ½ month period for the short-term deferral rule is not clear under Notice 2005-1 in situations where a calendar year bonus plan provides that bonuses are earned for services provided through December 31 and are measured using objective factors, but such factors are not determinable by the service recipient until after December 31. If the service recipient is unable to determine the objective factors for awarding or calculating bonuses until after March 15, then for purposes of determining whether there is a deferral of income that is subject to Section 409A, we recommend that the legally binding right be considered to arise only after the objective factors are determined, because it is not possible to determine what a participant has a legally binding right to receive as of December 31.

If Regulations provide that under such circumstances a legally binding right with respect to the bonus payment arises as of December 31, we suggest that the short-term deferral rule set forth in Notice 2005-1 be expanded to provide that if a bonus is paid shortly after the determination of the objective factors used to calculate such bonus, then no deferral of compensation occurs where a service provider has a legally binding right to a bonus as of December 31, but the amount cannot be determined by the service recipient within 2 ½ months from the date on which the legally binding right arises. We recommend that whether a bonus can be determined within 2 ½ months be subject to a facts and circumstances test to prevent abuse.
H. Lump Sum Severance Payments Payable Upon Constructive Termination

1. **Summary.**

A severance benefit arrangement will often provide for payment of benefits if either (i) the employer (or other service recipient) terminates the employee (or other service provider) for reasons other than cause or (ii) the employee resigns following action by the employer that constitutes “good reason” (typically, a breach by the employer of agreed-upon terms of employment). Resignation under the latter circumstances is sometimes referred to as "constructive discharge."

2. **Recommendation.**

We recommend that Regulations provide that lump sum severance benefits paid by reason of constructive discharge no later than two and a half (2 ½) months from the end of the employee's or employer's tax year during which the employee's termination of employment occurs not be subject to Section 409A, regardless of when “good reason” occurs.

3. **Explanation.**

Q&A-4(a) under Notice 2005-1 generally states that a plan provides for the deferral of compensation only if the employee has a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in gross income in that year, and the compensation is payable to, or on behalf of, the employee in a later year. Q&A-4(c) generally provides that a deferral of compensation does not occur if the terms of the plan require payment by the employer by the date that is two and a half months after the end of the employee's first taxable year (or, if later, employer's first taxable year) in which the amount is no longer subject to a substantial risk of forfeiture.

We recommend that if a severance arrangement provides for the payment of benefits upon the occurrence of good reason (typically, a breach by the employer of agreed-upon terms of employment), the employee not be treated as having a legally binding right to the benefit upon the occurrence of good reason, because the benefits in fact are not payable unless the employee resigns from employment, which ordinarily would result in the employee being required to forego other rights and benefits appurtenant to continued employment and the employer to agree that “good reason” exists. Under those circumstances, we believe that the legally binding right does not arise until resignation occurs with the employer’s agreement that “good reason” exists under the employment agreement’s terms. Unlike compensation with respect to which the legally binding right arises in a year prior to the year in which the compensation is payable, severance pay pursuant to an employment agreement is compensation for the early termination of the agreement and is not vested until such resignation and agreement as to whether good reason has occurred is reached. As such, it is not properly viewed as earned during the prior years, but rather should be viewed as earned upon termination of employment. We also believe that there is not a rational basis to distinguish between severance payable upon employment being terminated by the employer and a termination initiated by the employee arising from a

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failure of the employer to satisfy all agreed-upon terms of employment – both are in the control of the employer.

To the extent that it is determined that an employee has a legally binding right to severance upon the occurrence of good reason, rather than at the time that the employee in fact terminates employment, we recommend that Regulations provide that severance be deemed to be subject to a substantial risk of forfeiture until such time as the employee actually resigns by reason of the constructive termination. In order for an employee to receive severance, an employee is required to relinquish the benefits of remaining in the employ of the employer. Moreover, an employee generally forfeits an entitlement to severance if the employee dies, becomes disabled, is terminated by the company for cause and, in certain circumstances, if the employee does not resign during a period specified in the governing arrangement (e.g., within two years following a change of control or within 90 days of the event or circumstances giving rise to the right to terminate). These conditions to receipt of the severance constitute a risk of forfeiture substantial enough to constitute a “substantial risk of forfeiture” for purposes of the rules.

To the extent that the Service and Treasury disagree with the foregoing and conclude that such severance pay is not subject to a substantial risk of forfeiture once the events or circumstances giving rise to a right to resign and receive severance pay have occurred, we recommend that, to address administrative and policy considerations, Regulations provide an exclusion for lump sum severance benefits paid within two and a half (2 ½) months of the termination of employment. Although the circumstances giving rise to an employee’s right to resign and receive severance pay pursuant to a constructive termination provision may vary from agreement to agreement, the enumerated circumstances and events are often subject to multiple interpretations and frequently lead to disputes between the parties. Indeed, litigation over constructive termination is commonplace. A rule providing that a lump sum severance benefit payable within two and a half months of a termination of employment is not deferred compensation would avoid the need to determine, within an arbitrarily short period of time, whether the occurrence of certain circumstances constitute good reason.

In addition, a rule providing that the employee is vested in severance benefits upon the occurrence of good reason (rather than at resignation for good reason) would create an incentive for companies to design compensatory arrangements pursuant to which an employee would be required to resign within two and a half (2 ½) months after the end of the year during which the events constituting good reason occur. This could artificially accelerate the time during which an employee would need to resign to receive severance benefits without triggering penalties under Section 409A, and so would frustrate the interests of many companies who rely on the continued services of the employee after the change in control. We believe that other unintended consequences would result if the severance benefit is deemed to be vested upon the occurrence of good reason (rather than at the time of resignation for good reason). For example, such arrangements are likely to be redesigned to shorten the period after the occurrence of good reason during which an employee must resign to receive severance, and may also encourage greater use of change in control payments that are triggered by the change itself (i.e., a single trigger arrangement) rather than being triggered by a termination of employment for good reason or without cause after the change in control (i.e., double trigger arrangement).