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 the Transition Rule and Effective Date Under Section 409A

Dear Commissioner Everson:

Enclosed are comments on Section 409A regarding the transition rule and effective date. 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 ON THE TRANSITION RULE AND EFFECTIVE DATE UNDER SECTION 409A OF THE CODE

The following comments represent the individual views of the members of the Section of Taxation who prepared them. Accordingly, they should not be construed as representing the position of the American Bar Association or of 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 Robert A. Miller. Substantive contributions were made by Dennis B. Drapkin, Mary Flaherty, Richard M. Harter, George R. Ince, Fred C. Kneip, and Brigette H. Renaud. These comments were reviewed by Wayne R. Luepker, Chair of the Executive Compensation Subcommittee, and by Greta E. Cowart, a 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 the Quality Assurance Group of the Employee Benefits 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 members who participated in preparing these comment 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 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 effective date and transition provisions of Section 409A of the Internal Revenue Code of 1986, as amended (the “Code”) and Notice 2005-1, 2005-2 I.R.B. 274 (Jan. 10, 2005) (“Notice 2005-1” or the “Notice”), published on December 20, 2004 by the Internal Revenue Service (the “Service”).

Our recommendations:

1. We recommend that during 2005, sponsors be permitted to revise (either by amendment or replacement) not only stock options and stock appreciation rights so that they fit within an exemption from Section 409A, but also all other types of deferred compensation arrangements existing on December 31, 2004. We further recommend that such a revision not be treated as a material modification of the plan involved if the plan existed on October 3, 2004.

2. In addition to the relief already provided in the Notice, we recommend that the definition of material modification be simplified and clarified so that (1) generally, an exercise of discretion by the sponsor or administrator that is provided under plan terms that were in effect on October 3, 2004 shall not constitute a material modification of the plan (except for discretion exercised to grant or vest pre-2005 deferrals, to increase the crediting rate for earnings on pre-2005 deferrals or similarly to increase the grandfathered deferrals), and (2) an exercise by the sponsor or administrator of authority provided under the terms of the plan in effect on October 3, 2004 to terminate the plan (in full or in part) and to distribute benefits shall not constitute a material modification of the plan, regardless of whether the exercise of authority occurs during or after 2005.

3. We recommend that any written plan established on or before December 31, 2004 that provided that the sponsor or administrator had the discretion to permit elective deferrals of compensation be eligible for the relief provided under Q&A-21, as long as the sponsor or administrator exercised discretion before March 15, 2005.

4. We recommend that noncompetition, nonsolicitation and forfeitures for misconduct clauses (so-called “bad boy” clauses) be disregarded in determining whether amounts are earned and vested for purposes of the effective date provisions of the Notice in Q&As 16 through 21 and Section 409A (as well as sections 885(d) and (e) of the American Jobs Creation Act of 2004, P.L. 108-357), regardless of their treatment under Section 83.

5. We recommend, for purposes of the effective date provisions of Section 409A, that a “grandfathered” plan can increase the amount payable with respect to equity based deferred compensation to include, where applicable, (a) cumulative dividends on the underlying stock, (b) interest on those cumulative dividends, (c) stock splits, stock dividends and other capital changes affecting the underlying stock, (d) securities into which the underlying stock may be converted.

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1 All Section references herein are to the Internal Revenue Code of 1986, as amended (the “Code”), unless expressly stated otherwise.
2 All references herein to “Q&As” are references to the numbered questions and answers set forth in the Notice.
pursuant to a merger, consolidation or other reorganization, and (e) appreciation pursuant to a formula or other provision stated in the plan.

6. We recommend that providing a participant with an election during 2005 to: (a) have a pre-2005 grandfathered benefit continue to be governed by the prior plan provisions, (b) have a pre-2005 benefit eligible for grandfathering become subject to the plan provisions applicable to new deferrals under Section 409A, or (c) receive all of a pre-2005 benefit during 2005 and recognize it in income at that time, not constitute a material modification, violate Section 409A, or cause constructive receipt.

7. We recommend that regulations or a notice (“Regulations”) provide relief for 2005 operational failures. One appropriate approach would be to excuse operational failures under Section 409A that are corrected to the extent reasonably possible during or shortly after 2005, or, if later, within a specified period (e.g., 90 days) after the failure is discovered (including such relief from the constructive receipt doctrine as may be necessary to permit corrections to be made).

8. Certain 401(k) “wrap” plans are designed so that a participant elects to defer compensation pursuant to a nonqualified plan during a year, subject to having the deferred amounts transferred to the participant’s 401(k) plan account at or shortly after the close of the year, once the maximum contribution to the 401(k) plan for the participant has been determined under the applicable limits, including the actual deferral percentage test (“NQ/401(k) wrap arrangements”). Provided that the elections to make such deferrals and subsequent transfers with respect to 2005 were made by March 15, 2005 (or another reasonable time after Regulations are published), we recommend that such deferral and transfer elections, and the related transfers of such deferral amounts to a 401(k) plan, be exempt from any further requirements under section 409A for 2005.

9. We recommend that Regulations clarify that if a plan uses a stated interest rate as a notional investment measure, a change in that rate will not be a material modification of the plan if the resulting rate is not more than a reasonable rate and the rate is reset with reasonable frequency (not required to be more often than every 5 years). For this purpose, we recommend that a resulting rate be considered reasonable if it involves no more than the same margin over the prime rate or the mid-term applicable federal rate as of the time of the change than the plan’s rate in effect as of December 31, 2004 did as compared to the corresponding prime or federal rate as of December 31, 2004.

II. BACKGROUND

Section 409A imposes adverse tax consequences on participants of a nonqualified deferred compensation plan, unless the plan complies with the requirements of Section 409A(a) and (b), which relate to deferral elections, distribution events, distribution elections and funding. If the requirements are not satisfied, the deferral amounts are includible in income in the later of (i) the year they are deferred and (ii) the year they are no longer subject to a substantial risk of forfeiture, and are also subject to an additional 20 percent tax. A participant may also be
required to pay interest on deemed underpayments at the underpayment rate plus one percent from date of deferral (or, if later, the date the amount is no longer subject to a substantial risk of forfeiture).

Section 409A generally is effective for amounts deferred after December 31, 2004 (or, perhaps, to amounts deferred in taxable years beginning after December 31, 2004). 3 Amounts deferred in taxable years beginning before January 1, 2005, however, are treated as amounts deferred in a taxable year beginning on or after such date if the plan pursuant to which the deferral is materially modified after October 3, 2004. A plan will not be considered materially modified if it is amended in accordance with Regulations providing that a plan may be amended (i) to permit a participant to terminate plan participation or cancel a deferral election or (ii) to conform to the requirements of Section 409A.

The Notice provides initial guidance under Section 409A, including rules for determining which plans constitute nonqualified deferred compensation plans, which amounts are treated as having been deferred after December 31, 2004, and what constitutes a material modification of a plan. In addition, the Notice provides guidance regarding the timetable for transitioning to compliance with Section 409A and also contains numerous provisions granting transition relief.

III. COMMENTS

We appreciate the opportunity to comment on the effective date and transition provisions of the Notice. We would also like to commend the Department of Treasury and the Service for their substantial efforts to ease the transition to the new rules and to craft the many transition relief provisions contained in the Notice. Our comments below recommending further transition relief measures are merely intended to supplement those efforts.

A. AMENDING PLANS TO BE EXEMPT FROM SECTION 409A

1. Summary.

Q&A-4 of the Notice provides rules for determining whether a plan involves a deferral of compensation for purposes of Section 409A. Q&A-4 permanently or temporarily excludes a variety of plans from the scope of Section 409A, including, without limitation, plans involving short-term deferrals under Q&A-4(c) and certain stock options and stock appreciation rights under Q&A-4(d). In addition, Q&A-19(d) exempts certain severance arrangements (including those which cover no key employees) from the requirements of Section 409A during 2005.

During 2005, Q&A-18(d) of the Notice allows sponsors to replace or revise stock options or stock appreciation rights so that they do not involve a deferral of compensation and will therefore be exempt from Section 409A pursuant to Q&A-4(d). Furthermore, Q&A-18(d)

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3 Section 855(d)(1) of the American Jobs Creation Act of 2004 states that Section 409A applies to “amounts deferred after December 31, 2004.” Notice 2005-1, Q&A-16(a), in contrast, indicates that Section 409A applies to “amounts deferred in taxable years beginning after December 31, 2004,” although Q&A-16(b) states the standard for coverage by Section 409A in terms of whether an amount is “deferred before January 1, 2005.”
indicates that such an amendment or replacement will not be treated as a material modification of the stock option or stock appreciation right. Consequently, such an amendment or replacement will not adversely affect the “grandfathering” of such stock options and stock appreciation rights if they were vested prior to 2005, to the extent that “grandfathering” is still relevant.

2. **Recommendation.**

During 2005, we recommend that sponsors be permitted to revise (either by amendment or replacement) not only stock options and stock appreciation rights so that they fit within an exemption from Section 409A but also all other types of deferred compensation arrangements existing on December 31, 2004. We further recommend that, such a revision not be treated as a material modification of the plan involved if the plan existed on October 3, 2004.

3. **Explanation.**

Section 409A imposes significant new requirements on compensation arrangements that constitute nonqualified deferred compensation plans. Notice 2005-1 provides rules to determine the types of programs that are included within the definition of nonqualified deferred compensation plan and those that are not. These rules enable sponsors to design plans in the future either to satisfy the Section 409A requirements or to be exempt from them.

We recommend that transition relief afford plan sponsors a similar opportunity with respect to deferred compensation arrangements that were in existence on December 31, 2004. Q&A-18(d) of the Notice provides this type of transition relief with respect to stock options and stock appreciation rights. It would be appropriate to extend similar relief with respect to other types of arrangements that reasonably might be modified to come within an exemption from Section 409A provided under Notice 2005-1 or future Regulations so that sponsors of deferred compensation arrangements that were in existence on December 31, 2004 would not be in a worse position than they would be with respect to new arrangements. In our view, plan sponsors should not be penalized for being unable to foresee Section 409A and the scope of its exemptions, as further set forth in the Notice, when they originally designed their deferred compensation arrangements.

For example, where a severance plan in existence on December 31, 2004 covers all employees, we believe that the plan sponsor ought to have the opportunity to amend the plan during 2005, effective as of January 1, 2005, to exclude key employees (or to spin off the key employees into a separate plan that is subject to Section 409A). The result of such an amendment (or spinoff) would be to exclude the revised plan without key employees from Section 409A during 2005 under the exemption provided in Q&A-19(d).

Similarly, where a plan normally would be subject to Section 409A but is amended during 2005 so that it only involves short-term deferrals, we recommend that such amendment be effective to exclude the plan from Section 409A. For example, assume that a calendar-basis company sponsors a long-term incentive program with a performance period from 2003-2005, which is expected to pay out the incentive compensation during the first half of 2006. Assume further that the plan provides incentive compensation to all participants who either remain in
service until the end of the performance period or retire on and after age 55 during the performance period and provides no further deferral mechanism. If the company desires to amend the plan to satisfy the short-term deferral exemption by requiring that the incentive compensation be paid no later than March 15, 2006, we recommend that such an amendment be permissible and result in the plan being excluded from Section 409A. We further recommend that payments to an individual who attained age 55 and retired in a year ending prior to December 31, 2005 also be excluded from Section 409A if they are paid out no later than December 31, 2005, or, for administrative convenience, no later than March 15, 2006.

The requested relief is reasonable as a transition measure. Until the Notice was published, plan sponsors could not ascertain whether, or the extent to which, their plans would be covered by Section 409A. Furthermore, for plans that were effective before October 3, 2004, the scope and impact of Section 409A could not have been envisioned when the plans were adopted. It would not undermine the intent of Congress in enacting Section 409A to permit plan sponsors to redesign their plans to take advantage of any permanent or temporary exemptions provided in Notice 2005-1 or yet to be published Regulations. If a plan as amended can reasonably satisfy the requirements for an exemption starting in 2005, then it would appear that the appropriate result would be for the plan to be treated as exempt.

In addition, we recommend that an amendment to cause a plan to be exempt from Section 409A not constitute a material modification. Some of the provisions of Notice 2005-1 that grant exemptions from Section 409A do so only for a temporary period, or until further guidance is issued. This is so, for example, with respect to the short-term deferral and limited severance plan exemptions. If, in the future, such an exemption expires, or is eliminated or curtailed, then sponsors or participants may desire to rely on grandfather treatment with respect any benefits that have vested prior to 2005. We recommend that amending a plan so that it is completely outside the ambit of Section 409A not constitute a material modification, just as amending a plan to comply with Section 409A generally is not. Furthermore, as noted above, Notice 2005-1 granted the requested relief with respect to the exemptions provided for stock options and stock appreciation rights, so providing parallel treatment with respect to the other exemptions would appear appropriate.

B. MATERIAL MODIFICATIONS OF GRANDFATHERED PLANS

1. Summary.

Q&A-18 explains which types of modifications to a plan constitute material modifications for purposes of the effective date provisions of Section 409A. Q&A-18(a) states that a modification of a plan is a material modification if a benefit or right existing as of October 3, 2004 is enhanced or a new benefit or right is added. Q&A-18 also indicates that a benefit enhancement or addition is a material modification whether it occurs pursuant to an amendment or the service recipient’s exercise of discretion under the plan terms. On the other hand, Q&A-18(a) provides that (i) a service recipient’s exercise of discretion over the time and manner of benefit payments is not a material modification of a plan if such discretion is provided under the terms of the plan as of October 3, 2004, and (ii) if a participant exercises a right
permitted under the terms of the plan as of October 3, 2004, the exercise of such right is not a material modification. Q&A-18(c) provides that amending a deferred compensation plan to terminate the plan on or before December 31, 2005 and to distribute the deferred amounts is not a material modification of the plan, provided that the amounts are included in income in the taxable year in which the termination occurs.

2. **Recommendation.**

In addition to the relief already provided in the Notice, we recommend that the definition of material modification be simplified and clarified so that (1) generally, an exercise of discretion by the sponsor or administrator provided for under plan terms that were in effect on October 3, 2004 shall not constitute a material modification of the plan (except for discretion exercised to grant or vest pre-2005 deferrals, to increase the crediting rate for earnings on pre-2005 deferrals or similarly to increase the grandfathered deferrals), and (2) an exercise by the sponsor or administrator of authority provided under the terms of the plan in effect on October 3, 2004 to terminate the plan (in full or in part) and to distribute benefits shall not constitute a material modification of the plan, regardless of whether the exercise of authority occurs during or after 2005.

3. **Explanation.**

The Conference Report (H.R. Rep. No. 108-755, 108th Cong., 2d Sess. (2004), and hereinafter “Conf. Rep.” or “Conference Report”), at 737, states in connection with the effective date rules applicable to Section 409A that “the addition of any benefit, right or feature is a material modification,” but that “the exercise or reduction of an existing benefit, right, or feature is not a material modification.” Under this standard, exercises by a plan sponsor, an administrator or the participants of rights that they have under plan terms as of October 3, 2004 would not constitute a material modification of a plan. Instead, for a material modification to occur, there would have to be an amendment altering the terms of the plan, rather than the mere exercise of rights and discretions already existing under the plan’s terms.

At least in part, the Notice appears to accept this interpretation of the statute. As noted above, Q&A-18(a) indicates that it is not a material modification for a participant to exercise a right permitted under the plan as in effect on October 3, 2004, or for a service recipient to exercise discretion over the time and manner of payment of a benefit to the extent such discretion is provided under the terms of the plan as of October 3, 2004. However, the Notice also indicates that a benefit enhancement or addition is a material modification whether it occurs pursuant to an amendment or the service recipient’s exercise of discretion under the terms of the plan.

The reference in Q&A-18(a) to the possibility that an exercise of discretion could constitute a material modification is counter to the Conference Report at 737 and also is unclear and generally unnecessary.

First, the reference is unnecessary because, in general, the major types of issues over which discretion could be exercised (such as the amount of benefit, vesting of benefit, and time
and form of distributions) are already adequately addressed in the Notice. To the extent that an exercise of discretion relates to the time and form of distribution, Q&A-18(a) states that such an exercise will not constitute a material modification. To the extent that an exercise of discretion after 2004 generates a new accrual or vests a pre-2005 accrual, then it would seem that such newly accrued or newly vested benefit would constitute a post-2004 deferral for purposes of Section 409A pursuant to Q&A-16 (pre-2005 deferrals only include an amount that as of December 31, 2004 is earned and vested and constitutes a legally binding right). Consequently, such an amount would already be subject to Section 409A. In contrast, the pre-2005 deferrals would seem unaffected by such an exercise of discretion, and thus should remain grandfathered.

Notwithstanding the foregoing analysis, we are aware of two situations in which the impact of an exercise of discretion may not be adequately addressed under other provisions of the Notice. The first involves an exercise of discretion between October 3, 2004 and December 31, 2004 to add an accrual or vest a pre-2005 accrual. The second would be an exercise of discretion after 2004 to increase the earnings crediting rate applicable to the pre-2005 benefit. With respect to these items, we acknowledge that they might constitute a material modification of a plan in certain circumstances. Even though they only involve an exercise of discretion, they impact the actual amount of the pre-2005 benefit and could fundamentally undercut the effective date provision if they were not treated as material modifications.

Except for these two cases (and any other cases having a similar impact), we recommend that the rule in Q&A-18 be revised and clarified so that the only type of modification which would result in the loss of grandfather status would be at the level of an actual plan amendment which adds or enhances a benefit with respect to the pre-2005 deferrals after October 3, 2004.

In this regard, the terms of many plans as in effect on October 3, 2004 may have reserved for the sponsor or participants some discretion or authority that they have not yet utilized, but which are an integral part of the plan design. Under the Conference Report cited above, we recommend that exercise of such discretion not constitute a material modification, provided such discretion is not exercised to increase the vesting or the earnings accrual rate on pre-2005 deferrals.

The authority to terminate a plan and distribute benefits is an important example of such a retained right. Where the terms of a plan in effect on October 3, 2004 give the plan sponsor the authority to terminate the plan and distribute plan benefits, we recommend that such a termination not constitute a material modification.

Second, the Notice is somewhat unclear regarding how such a termination should be treated. Q&A-18(a) indicates that a material modification does not occur if a sponsor exercises discretion over the time and manner of payment of a benefit to the extent such discretion is provided under the terms of the plan as of October 3, 2004. The discretion to terminate a plan and distribute benefits would appear to come within this provision. However, Q&A-18(c) provides specific relief for terminating a plan and distributing benefits in 2005. Under that relief, such a termination will not constitute a material modification. It is possible that Q&A-18(c) merely provides additional relief for situations in which Q&A-18(a) might not apply (such as where the sponsor did not retain discretion to terminate a plan and make distributions, but during
2005 amends the plan to add such a power and then terminates the plan). However, Q&A-18(c) might be read as implying that terminating a plan and distributing benefits after 2005 would be a material modification, even if the termination was pursuant to authority contained in the plan terms as of October 3, 2004.

If such an implication was unintentional, then we recommend that the provision be clarified to state that terminating and distributing grandfathered benefits after 2005 will not be a material modification if the plan sponsor had reserved the right to terminate the plan. If such an implication was intended, then we recommend that Regulations provide a different rule consistent with the position explained herein. As discussed below, to limit the relief available to merely those plan terminations and resulting recognitions of income that occur in 2005 effectively eliminates the extended protection the statute offered to grandfathered plans.

In general, Congress chose not to make pre-2005 deferrals subject to the new provisions of Section 409A, including those provisions which might impact the ability to make distributions upon plan termination. If a plan termination post-2005 is treated as a material modification, then in effect a provision is being added to the statute to make plan terminations involving pre-2005 deferrals subject to the new rules and to eliminate the plan sponsor’s reserved right to terminate the plan.

We recognize that there are significant concerns regarding participant control over the timing of a plan termination and over acceleration of distributions. We further recognize that a plan termination is sometimes accomplished by plan amendment. Nevertheless, where the plan document as in existence as of October 3, 2004 contains a provision which reserves to the plan sponsor the power to terminate the plan and distribute plan benefits, exercising such a reserved right would not appear to be a modification of the plan under the standard set forth in the Conference Report at 737, provided, there is not a simultaneous amendment or termination agreement which materially changes the sponsor’s powers regarding the termination or modifies the plan provisions regarding the time and form of distributions upon plan termination.

Furthermore, an interpretation that a plan termination inherently is a material modification, regardless of any termination authority reserved under a plan’s terms, would upset the reasonable expectations of sponsors and participants with respect to pre-2005 deferrals. In adopting a plan, the sponsor may have relied on having the ability to terminate the plan at any time in the future, as business considerations might dictate. A wide variety of changes in a company’s business or economic position may cause it to consider terminating a grandfathered plan in situations that have no hint of abuse or tax avoidance or control by the participants over the funds.

A reserved power and discretionary authority to terminate a plan deserves to be protected with respect to the pre-2005 benefit in the same manner as any other distribution right which is set forth in a plan as of October 3, 2004. In addition, permitting distributions of pre-2005 deferrals upon plan termination would seem to provide no more opportunity for abuse than other rights to accelerate benefits from pre-2005 deferrals under pre-existing plan provisions.
C.  **2005 DEFERRAL ELECTIONS EXEMPT FROM SECTION 409A**

1.  **Summary.**

Q&A-21 provides relief for participant elections to defer compensation earned in respect of the participant’s services performed before January 1, 2006, provided that the elections are made before March 15, 2005, and provided that (i) the amounts to which the deferral election relate have not been paid or become payable at the time of election, (ii) the plan under which the deferral election is or was made was in existence on or before December 31, 2004, (iii) the elections to defer compensation are made in accordance with the terms of the plan in effect on or before December 31, 2005, (iv) the plan is otherwise operated in accordance with Section 409A with respect to deferrals subject to Section 409A, and (v) the plan is amended to comply with the requirements of Section 409A in accordance with Q&A-19. Pursuant to this relief, a nonqualified deferred compensation plan is treated as in existence before January 1, 2005 only if, among other things, the written plan document provides that a participant in the plan may elect to defer compensation beyond the taxable year in which it otherwise would have been payable.

2.  **Recommendation.**

We recommend that any written plan established on or before December 31, 2004 that provided that the plan sponsor or administrator had the discretion to permit elective deferrals of compensation be eligible for the relief provided under Q&A-21, as long as the sponsor or administrator exercised such discretion before March 15, 2005.

3.  **Explanation.**

For purposes of providing liberal transitional relief and consistent with statements made by Treasury representatives that administrators and employers would not be disadvantaged by not taking action in response to Section 409A before December 31, 2004, we believe that the relief provided under Q&A-21 should be available to written plans established on or before December 31, 2004 that provided that the plan sponsor or administrator had the discretion to permit deferrals, regardless of whether sponsor or administrator had exercised that authority before December 31, 2004. Prior to the issuance of Notice 2005-1 there was a great deal of uncertainty surrounding the interpretation and implementation of Section 409A, particularly regarding the scope of the transition and election rules. As a result of this uncertainty, many plan sponsors and administrators were reluctant to exercise their discretion after the enactment of Section 409A to permit deferrals of 2005 compensation for fear of the potential consequences of such action. We believe that the requested clarification would provide more effective transitional relief.

D.  **SUBSTANTIAL RISK OF FORFEITURE FOR GRANDFATHER TREATMENT**

1.  **Summary.**

Section 409A is generally effective with respect to amounts deferred after December 31, 2004 (or, perhaps, under Notice 2005-1, Q&A-16(a), to amounts deferred in taxable years
beginning after December 31, 2004). The Conference Report indicates, at 737, that an amount is “considered deferred before January 1, 2005, if the amount is earned and vested before such date,” but does not, in the discussion of the effective date provisions, make any reference to Section 83 as providing the standard for this purpose.

Under Notice 2005-1 Q&A-16(b), an amount is considered deferred before such effective date if (i) the service provider has a legally binding right to be paid the amount and (ii) the right to the amount is earned and vested. For this purpose, an amount is earned and vested if the amount is not subject to a substantial risk of forfeiture as defined in Treasury Regulation § 1.83-3(c).

Pursuant to Treasury Regulation § 1.83-3(c)(1) and (2), plan provisions under which benefits may be lost if an employee is discharged for cause or for committing a crime will not be considered to cause a substantial risk of forfeiture, but plan provisions providing for forfeiture on lesser grounds could do so. Similarly, provisions that eliminate benefits in the event of a violation of a noncompetition clause will not ordinarily be considered to constitute a substantial risk of forfeiture unless the particular facts and circumstances indicate to the contrary. For this purpose, relevant factors include the age of the employee, the availability of alternative employment opportunities, the likelihood of the employee's obtaining such other employment, the degree of skill possessed by the employee, the employee's health, and the practice (if any) of the employer to enforce such covenants.

2. Recommendation.

Noncompetition, nonsolicitation and forfeitures for misconduct clauses (so-called “bad boy” clauses) should be disregarded in determining whether amounts are earned and vested for purposes of the effective date provisions of the Notice in Q&As-16 through 21 and Section 409A (as well as section 885(d) and (e) of the American Jobs Creation Act of 2004, P.L. 108-357), regardless of their treatment under Section 83.

3. Explanation.

Noncompetition, nonsolicitation and forfeiture for misconduct clauses are common components of existing employment agreements and deferred compensation arrangements. We recommend that the inclusion of such provisions in plans be disregarded in determining whether deferral amounts are “earned and vested” by December 31, 2004, and thus eligible for grandfather treatment.

For purposes of determining grandfather treatment, Q&A-16 indicates that an amount is vested only if it is not subject to a substantial risk of forfeiture. Q&A-16 then defines substantial risk of forfeiture for this purpose by reference to Treasury Regulation § 1.83-3(c). While Treasury Regulation § 1.83-3(c) does indicate that noncompetition, nonsolicitation and forfeiture for misconduct clauses generally will not rise to the level of generating a substantial risk of forfeiture for purposes of Section 83, it also requires a facts and circumstances analysis for making that determination. Applying this facts and circumstances test to determinations of grandfather treatment under Section 409A raises significant fairness and administrative issues and runs counter to the apparent purpose of the grandfather rule.
In the context of Section 83, this facts and circumstances test essentially acts as a relief measure to participants, to avoid forcing them to recognize income in limited situations in which ultimately they might not receive payment due to a misconduct clause. In the context of the grandfather provisions of Section 409A, this facts and circumstances test would have a significantly different impact. Far from providing helpful relief to participants in limited cases, we believe it would unnecessarily complicate the determination of which set of dramatically different rules apply to the taxation of plan benefits. For such a purpose, a clear demarcation between the amounts subject to the old rules and the amounts subject to the new rules would be more appropriate than a facts and circumstances determination. It would appear that Congress intended such a demarcation by providing that amounts deferred prior to 2005 remain subject to existing law.

For determining the availability of grandfather treatment under Section 409A, a bright line test saying that noncompetition, nonsolicitation and forfeiture for misconduct clauses do not create substantial risks of forfeiture is inherently fairer than a facts and circumstances determination under Section 83. Consider the case of an employer with a deferred compensation plan that contains a noncompetition provision. If that plan had 20 participants with amounts deferred under the plan prior to December 31, 2004, the employer would have to perform a separate facts and circumstances analysis for each participant concerning whether the provision created a substantial risk of forfeiture, which would risk creating divergent and unfair results regarding grandfather treatment under Section 409A. Such divergent results could occur despite all of the participants having the same rights and obligations under the plan terms and being equally eligible for benefit payments if they terminated employment (and thus, having benefits which in a common-sense view would be equally “earned and vested” and thus equally entitled to grandfather treatment).

With respect to noncompetition clauses, importing the Section 83 test also runs counter to the terms of the statute. Section 409A(d)(4) provides a single definition of “substantial risk of forfeiture,” and indicates that the “rights of a person to compensation are subject to a substantial risk of forfeiture if such person’s rights to such compensation are conditioned upon the future performance of substantial services by an individual.” Q&A-10 provides that an amount is not subject to a substantial risk of forfeiture merely because the right to the amount is conditioned, directly or indirectly, upon the refraining from the performance of services. Consequently, a noncompetition clause will not generate a substantial risk of forfeiture for most purposes under Section 409A. In contrast, a noncompetition clause could be treated as a substantial risk of forfeiture under the rule used in Treasury Regulation § 1.83-3(c), and thus, the amount would not be earned and vested under Q&A-16, resulting in the denial of grandfather treatment.

As a result of these considerations, we recommend that noncompetition, nonsolicitation and misconduct forfeiture provisions be disregarded in determining what is earned and vested for purposes of receiving grandfather treatment under Section 409A. Doing so will not permit abuse, because it would not allow service providers to include “new money” into old arrangements.
E. **EARNINGS ON EQUITY-BASED AMOUNTS DEFERRED BEFORE JANUARY 2005**

1. **Summary.**

   Q&A-17 of the Notice addresses how the amount of compensation deferred under a plan before January 1, 2005 is determined for purposes of the effective date of Section 409A. In the case of equity-based compensation plans, Q&A-17(d) provides that an increase in the amount payable above the amount payable as of December 31, 2004 that is “due to appreciation in the underlying stock after December 31, 2004 is treated as earnings on the amount deferred.”

2. **Recommendation.**

   For purposes of the effective date provisions of Section 409A, we recommend that a “grandfathered” plan can increase the amount payable with respect to equity based deferred compensation to include, where applicable, (a) cumulative dividends on the underlying stock, (b) interest on those cumulative dividends, (c) stock splits, stock dividends and other capital changes affecting the underlying stock, (d) securities into which the underlying stock may be converted pursuant to a merger, consolidation or other reorganization, and (e) appreciation pursuant to a formula or other provision stated in the plan.

3. **Explanation.**

   The word “appreciation” as used in Q&A-17(d) probably means appreciation in fair market value of the underlying stock. Plans presently provide specific techniques for valuing equity-based compensation, and we think that many of these techniques are not abusive and should be honored. Stock can increase in value in a variety of ways. The Notice should support valuation techniques that seek to determine “appreciation in the underlying stock” in ways that are consistent with the appreciation realized by the actual holders of equivalent stock. Equivalence of treatment is fair and is, accordingly, good policy. Each of the following techniques would confer upon a participant rights generally available to the actual holders of equivalent stock at the relevant time.

   (a) If the issuer of the underlying stock pays cash dividends, a deferred compensation plan may add the cumulative notional dividends to the December 31, 2004 value. This addition should be permitted because dividends are paid on all outstanding similarly situated shares in an equal amount per share, and favoritism is not permitted other than by terms of the corporate articles or charter that might create different classes of shares with different dividend rights. Thus, corporate law fiduciary duties limit the ability to use dividends disproportionately to favor executives.

   (b) If cash dividends are to be credited, the plan may also credit interest on these dividends at a notional rate provided in the plan. The second sentence of Q&A-17(d) permits notional interest on amounts deferred before January 1, 2005. Interest on such dividends is consistent with the policy behind that sentence.
(c) The issuer may declare a stock dividend, split the underlying stock or engage in another form of capital change affecting the underlying stock. Stock option plans and most equity-based deferred compensation plans would reflect these changes. We recommend that valuations that reflect such changes be permitted. See, for analogy, the regulations relating to statutory options affected by capital changes. Treas. Reg. § 1.424-1(a).

(d) If the issuer of the underlying stock merges into another corporation, the underlying stock will be transformed into another security. Stock option plans and most equity-based deferred compensation plans would reflect this transformation. We recommend that regulations should clarify how valuations reflect reorganizations. See, for analogy, the regulations relating to statutory options affected by reorganizations. Treas. Reg. § 1.424-1(a).

(e) Deferred-compensation plans for a privately held company may contain a formula for reflecting appreciation year-by-year as long as the company remains private, but switch to a different formula if the company goes public or is sold to an unrelated purchaser. If the company goes public, then the public market price is substituted for the formula price. We recommend that regulations permit both formula pricing and such switches to market price. If a privately held company is sold to an unrelated purchaser, then the actual sale price per share is substituted for the formula price. We believe that Regulations should state that operation of such a valuation provision is an appropriate measure of appreciation of the underlying stock, provided the provision does not give any rights greater than those provided to other similar shareholders.

We recommend that regulations support valuation techniques that seek to determine “appreciation in the underlying stock” in ways that are consistent with the appreciation realized by the actual holders of equivalent stock. Because corporate changes such as stock splits, stock dividends, cash dividends, reorganization and mergers apply to all shareholders equally, measuring appreciation considering such changes does not present an opportunity for abuse, as long as the persons receiving the equity based compensation are not receiving any greater rights or amounts than the other similar shareholders.

F. PERMISSIBLE CHOICES FOR PARTICIPANTS REGARDING PRE-2005 DEFERRALS

1. Summary.

Q&A-18(a) of Notice 2005-1 indicates that a material modification of a plan occurs if a benefit or right existing as of October 3, 2004 is enhanced or a new benefit or right is added. Q&A-20 of the Notice permits plan sponsors to provide participants with an election in 2005 to terminate participation in the plan or cancel deferral elections without triggering taxation based on either constructive receipt a violation of Section 409A. It is not clear that the relief in Q&A-20 extends to pre-2005 deferrals. Furthermore, the Notice can be read to say that providing participants with an election to cancel their pre-2005 deferrals is a material modification, causing such amounts to become subject to Section 409A.

In order to clarify and potentially to expand the types of elections that plan sponsors may provide to participants, we recommend the following.
2. Recommendation.

We recommend that providing a participant with an election during 2005 to: (a) have a pre-2005 grandfathered benefit continue to be governed by the prior plan provisions, (b) have a pre-2005 benefit eligible for grandfathering become subject to the plan provisions applicable to new deferrals under Section 409A, or (c) receive all of a pre-2005 benefit during 2005 and recognize it in income at that time, not constitute a material modification, violate Section 409A, or cause constructive receipt.

3. Explanation.

This recommendation considers the range of transition preferences which plan sponsors and participants may reasonably have in light of the adoption of Section 409A. Some participants may strongly favor the existing plan terms regarding distributions and distribution elections, and might prefer for benefits that have vested prior to 2005 to remain subject to the old plan provisions and receive grandfather protection. On the other hand, other participants may be willing, or even prefer, to shift prior amounts to the new distribution provisions.

As a result of these types of considerations, a particular participant may prefer any of three basic alternatives: (a) retaining the prior plan provisions with respect to the pre-2005 benefit, (b) shifting the pre-2005 benefit to the new plan design, or (c) cashing out the pre-2005 benefit entirely, thus avoiding any possibility that a future failure could result in adverse tax consequences.

Although some plan sponsors may have both the authority under existing plan terms and the desire to make the determination as to how the pre-2005 deferrals will be treated, other plan sponsors may not have sufficient amendment authority or may conclude that given the range of reasonable participant transition preferences, it is more appropriate for each participant to make his or her own election. We recommend that transition relief be structured to permit participants to make a straightforward choice between these alternatives.

Moreover, the proposed relief does not entail any meaningful possibility for abuse. If a participant elects to receive a distribution of the pre-2005 benefit amounts, then the amount distributed will be subject to ordinary income taxes in 2005, the same as is the case for other distributions permitted under Q&A-20. If the participant elects to have the pre-2005 benefit amounts be subject to the provisions for new deferrals, then those amounts will lose grandfathered status and be subject to all the constraints in Section 409A. If, instead, the participant elects to have the pre-2005 benefit amounts remain subject to the prior plan provisions, then the participant will simply remain subject to the old rules. That status is by no means abusive, since it is one of the positions Congress clearly permitted with respect to pre-2005 deferrals. Thus, each choice leaves a participant in an appropriate position.

Treasury representatives have indicated a preference to make the transition to Section 409A easy for plan sponsors and participants to avoid the application of the Section 409A tax penalties with respect to actions taken in 2005. We believe that the goal of providing a reasonable and fair transition to the new rules during 2005 is advanced by this recommendation.
G. CORRECTION OF 2005 OPERATIONAL FAILURES

1. Summary.

Notice 2005-1 provides no relief from operational errors occurring in calendar year 2005.

2. Recommendation.

We recommend that Regulations provide relief for 2005 operational failures. One appropriate approach would be to excuse operational failures under Section 409A that are corrected to the extent reasonably possible during or shortly after 2005, or, if later, within a specified period (e.g., 90 days) after the failure is discovered (including such relief from the constructive receipt doctrine as may be necessary to permit corrections to be made).

3. Explanation.

We appreciate the flexibility afforded to employers through the transition approaches provided in Notice 2005-1 and the ability to defer documentary compliance until as late as December 31, 2005. However, we believe that the very limited time between the enactment of Section 409A and its effective date, the broad scope of the changes required by Section 409A and of the plans and other arrangements impacted by it, and the lack of complete regulatory guidance (such as the scope of deferred compensation, permissible distributions and distribution elections) prior to the effective date will inevitably result in a large number of operational errors during 2005.

Moreover, even the essential transition relief afforded by Notice 2005-1 will itself lead to some operational errors. By delaying until the end of 2005 the legal necessity to bring plans into documentary compliance, Notice 2005-1 makes operational failures more likely because administrators will not readily have available written rules for compliant conduct. The need for administrators to make a good faith effort to comply with new requirements immediately, while at the same time allowing documentary compliance to be deferred until December 31, 2005, will result in administrators acting without the benefit of finalized plan documents and related materials, raising the likelihood of inadvertent failures to comply with Section 409A. For example, in contrast to the typical, historical situation in which a plan administrator’s actions are guided by written plan documents that specify the parameters applicable to a particular grant of deferred compensation, in 2005 many administrators will need to act without the benefit of such written documentation and guidance.

Consequently, while the transition guidance in Notice 2005-1 generally provides employers with the opportunity to conform their programs to Section 409A by the end of 2005, there could be numerous operational failures occurring during 2005. We believe that it is appropriate for the Treasury and the Service to recognize the difficulties faced by employers, particularly during this transition year, and provide relief from operational failures that occur during 2005. This is a part of the transition to Section 409A full compliance, and the government has demonstrated both in Notice 2005-1 and informally its willingness to provide reasonable transition rules.
In this regard, one approach would be to excuse operational failures with respect to Section 409A that are corrected to the extent reasonably possible during or shortly after 2005, or, if later, within a specified period (e.g., 90 days) after the failure is discovered. Since such an approach would effectively require full correction to the extent reasonably possible in the circumstances, it should not open up an avenue for any meaningful abuse. Certain types of corrections (such as unwinding an inappropriate distribution or election) may also require relief from the constructive receipt doctrine and Section 451. In our view, it would be appropriate to permit such relief, similar to that which is afforded with respect to other transition provisions of the Notice, such as Q&As-20 and 21.

H. ELECTIONS FOR 2005 UNDER 401(k) WRAP PLANS

1. Summary. Comprehensive rules regarding deferral elections, distribution events and distributions elections have not yet been issued. However, we understand that the Treasury and the Service have concerns over whether it is possible for certain wrap plan designs to satisfy the requirements of Section 409A.

2. Recommendation. Certain 401(k) “wrap” plans are designed so that a participant elects to defer compensation pursuant to a nonqualified plan during a year, subject to having the deferred amounts transferred to the participant’s 40l(k) plan account at or shortly after the close of the year, once the maximum contribution to the 40l(k) plan for the participant has been determined under the applicable limits, including the actual deferral percentage test (“NQ/401(k) wrap arrangements”). Provided that the elections to make such deferrals and subsequent transfers with respect to 2005 were made by March 15, 2005 (or another reasonable time after Regulations are published), we recommend that such deferral and transfer elections, and the related transfers of such deferral amounts to a 401(k) plan, be exempt from any further requirements under Section 409A for 2005.

3. Explanation. The Service has previously approved the use of NQ/401(k) wrap arrangements. See Private Letter Rulings 95-30-038 and 97-52-018. However, such arrangements raise several concerns under Section 409A.

The amount initially deferred pursuant to the nonqualified plan in the NQ/401(k) wrap arrangement generally would be elected prior to the beginning of the plan year, but the amount ultimately to be deferred pursuant to the nonqualified plan would not be fully ascertainable until the end of the year, raising possible concerns regarding whether the initial deferral election fully satisfied the requirements of Section 409A.
Furthermore, the transfer of amounts deferred pursuant to the nonqualified plan to the 401(k) plan (or more precisely, the elimination of a credit under the nonqualified plan in exchange for the contribution by the employer of a like amount into the 401(k) plan) might be construed as a distribution from the nonqualified plan or a subsequent deferral election or a prohibited acceleration under Section 409A(a)(2), (a)(4) and (a)(3), respectively. However, we recommend that the transfer from the NQ/401(k) wrap plan not be treated as a distribution of any nature or a subsequent election because under the terms of such arrangements the employee does not have any right to receive the transferred amount. This is consistent with the way such transfers have been treated under the private letter rulings issued on such plans (see, e.g., Priv. Ltr. Rul. 95-30-038 (May 5, 1995)).

Although these concerns may not be insuperable, we recommend that transition relief be provided for such arrangements for 2005 regardless of whether such arrangements shall be considered to satisfy Section 409A for future years. We recommend that the relief permit deferrals pursuant to such arrangements for 2005 and any related transfers of such amounts into 401(k) plans. We further recommend that such deferrals and transfers not be treated as violating Section 409A, provided that the deferral and transfer elections shall have been made by the time otherwise generally required under Notice 2005-1 for deferral elections into a nonqualified plan (currently, March 15, 2005) or during the period between that date and a reasonable date after the recommended relief is granted.

Sponsors and participants have relied on the pre-existing guidance in structuring, implementing and participating in these NQ/401(k) wrap arrangements. If they were to be prohibited from operating such arrangements in accordance with their terms for 2005, then we believe notice ought to have been provided prior to the beginning of 2005. Treasury and the Service have gone to significant lengths in Notice 2005-1 to provide sufficient transition relief so that the adverse tax consequences of Section 409A would not be imposed simply as a result of deferral elections made at the end of 2004 or early in 2005. Providing the requested relief with respect to NQ/401(k) wrap arrangements would be fully in accord with that goal and would not raise any meaningful possibility of abuse.

I. REVISING FIXED INTEREST CREDITING RATES

1. Summary.

Q&A-18(a) states that it is not a material modification of a plan to change a notional investment measure to, or to add, an investment measure that qualifies as a predetermined actual investment within the meaning of Treasury Regulation § 31.3121(v)(2)-1(d)(2).

2. Recommendation.

We recommend that regulations clarify that if a plan uses a stated interest rate as a notional investment measure, a change in that rate will not be a material modification of the plan if the resulting rate is not more than a reasonable rate and the rate is reset with reasonable frequency (not required to be more often than every 5 years). For this purpose, we recommend...
that a resulting rate be considered reasonable if it involves no more than the same margin over the prime rate or the mid-term applicable federal rate as of the time of the change that the plan’s rate in effect as of December 31, 2004 bore to the corresponding prime or federal rate as of December 31, 2004.

3. **Explanation.**

The relief provided by Q&A-18(a) regarding the change or addition of an investment measure that qualifies as a predetermined actual investment within the meaning of Treasury Regulations § 31.3121(v)(2)-1(d)(2) is helpful, but is not broad enough to cover a fairly typical plan design, namely, a plan with a stated interest crediting rate. We recommend that guidance provide a method for resetting a stated interest crediting rate with respect to pre-2005 deferrals under such a plan without causing a material modification or requiring the basic design of the plan to be altered to one that uses predetermined actual investments. One such method could be based on the rules related to reasonable interest rates under Treasury Regulations § 31.3121(v)(2)-1(d)(2)(i)(C).

Under Treasury Regulations § 31.3121(v)(2)-1(d)(2)(i)(C), if a fixed crediting rate is reasonable in light of prevailing interest rates at the time it is reset, and it is reset at a specified date that occurs at least every 5 years, it will be deemed to be reasonable throughout the period.

A comparable rule could be used under Section 409A, so that resetting a fixed crediting rate for pre-2005 deferrals would not be considered to be a material modification of the plan in respect of the pre-2005 deferrals. This would promote consistency and simplification for the tax treatment of these amounts under Sections 409A and 3121(v).

It is also appropriate to note that the material modification standard focuses on changes that advantage participants in comparison to their position as of October 3, 2004. Thus, abuse would occur if the change in the crediting rate materially advantaged participants versus their prior position. To tailor the general approach in Treasury Regulations § 31.3121(v)(2)-1(d)(2)(i)(C) to the relevant concern under the Section 409A grandfather rules, we recommend that a resulting rate be considered reasonable if it involves no more than the same margin over the prevailing interest rates as of the time of the change that the plan’s fixed rate in effect as of October 3, 2004 (or, for convenience, December 31, 2004) bears to the corresponding rate as of that date. For this purpose, prevailing rates could reasonably be determined based on a variety of rates, including the prime rate or the mid-term applicable federal rate.

We submit that such a rule provides necessary guidance to allow fixed crediting rates to be reset, while protecting against the possibility of abuse, promoting consistency and simplification in the tax law, and we consequently urge its adoption.