November 1, 2005

Hon. Mark W. Everson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments on Proposed Treasury Regulations Under Section 409A

Dear Commissioner Everson:

Enclosed are comments on proposed regulations under Internal Revenue Code Section 409A. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Dennis B. Drapkin
Chair, Section of Taxation

Enclosure

cc: Donald L. Korb, Chief Counsel, IRS
    Eric Solomon, Acting Deputy Assistant Secretary (Tax Policy), Treasury
    Michael J. Desmond, Tax Legislative Counsel, Treasury
    Nancy J. Marks, Division Counsel/Associate Chief Counsel, TE/GE, IRS
    Alan N. Tawshunsky, Assistant Chief Counsel (Employee Benefits), TE/GE, IRS
    W. Thomas Reeder, Acting Benefits Tax Counsel (Business and International Tax), Treasury
COMMENTS CONCERNING PROPOSED TREASURY REGULATIONS UNDER SECTION 409A

These comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these comments was exercised by Robert A. Miller. These comments were reviewed by Eleanor Banister and James R. Raborn, Vice-Chair and Chair (respectively) of the Section’s Employee Benefits Committee. 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 members of the Section of Taxation who participated in preparing these comments have clients who would be affected by the federal income tax rules applicable to the subject matter addressed by these comments, or have advised clients on the application of such rules, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

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Date: November 1, 2005
EXECUTIVE SUMMARY

The following comments are submitted in response to the request for comments made by the Internal Revenue Service ("Service") in Notice of Proposed Rulemaking dated September 29, 2005 regarding Prop. Treas. Reg. § 1.409A-1 et seq., 70 Fed. Reg. 57930 (2005) ("Proposed Regulations") issued under section 409A of the Internal Revenue Code of 1986, as amended ("Code"). The Service requested comments by January 3, 2006. The comments address the position of the Service in the Proposed Regulations declining to extend certain transitional relief provided in IRS Notice 2005-1 ("Notice") beyond December 31, 2005. We set out below three reasons for extending some of these transitional relief rules: (i) as the Proposed Regulations may be changed as a result of the comment process, complying with Section 409A now is speculative, (ii) decisions with respect to certain actions would be taken without full appreciation of the scope and implications of the rules and (iii) the value of transition relief is reduced if it is only available in a compressed timeframe.

We recommend that:

1. The Proposed Regulations be modified to provide that the period within which a plan subject to Section 409A of the Code (references to "Section" hereinafter are to sections of the Code) may be terminated or suspended as described in Q&A-18(c) of the Notice is extended to December 31, 2006.

2. The Proposed Regulations be modified to provide that the period within which certain rights may be exercised under Q&A-20(a) of the Notice to terminate participation or cancel outstanding deferral elections under a plan is extended to December 31, 2006, and the required time limit for the plan amendment for such cancellations is extended to December 31, 2006.

3. The Regulations be clarified to provide that the time for amending a plan to incorporate the extended deferral election period provided by Q&A-21 of the Notice is extended to December 31, 2006.

BACKGROUND

Section 409A was added by the American Jobs Creation Act of 2004 and, with some exceptions, was generally effective January 1, 2005. The changes to nonqualified deferred compensation practices wrought by Section 409A are far reaching and complex. Recognizing the difficulty taxpayers would have in complying with Section 409A so soon after enactment, the Service established a number of transitional provisions in the Notice which ameliorated some of the more difficult problems facing taxpayers, primarily by allowing great flexibility until the end of 2005. This flexibility, we believe, was initially granted just for 2005 largely because of the expectation that the Service would issue additional guidance earlier in 2005. For a variety of reasons, including natural disasters such as Hurricanes Katrina and Rita, the additional guidance
was not issued until September 29, 2005. While the guidance does extend many of the transitional rules first announced in the Notice, there are at least three important transitional rules that were not extended.

COMMENTS

409A Transitional Relief

1. Summary.

In the Notice, the Service provided several salutary transitional relief rules. The preamble to the Proposed Regulations extends some of the transition relief measures until December 31, 2006, including the general period for amending plans for Section 409A under Q&A-19(a), the good faith compliance period under Q&A-19(b), the period for making new payment elections under Q&A-19(c), and the period during which payments under a nonqualified plan may be permitted based upon elections under a qualified plan under Q&A-23. We very much appreciate the significant flexibility and practicality of the relief generally. However, three key pieces of the transitional relief in the Notice were not extended. These provisions are:

- The provisions of Q&A-18(c) which permit termination of an arrangement and distribution of the amounts of deferred compensation in order to avoid application of Section 409A to the plan, expire on December 31, 2005.

- The provisions of Q&A-20(a), which allow termination, including partial termination, of participation in a plan or cancellation of a deferral election on or before December 31, 2005, provided the plan is amended to provide for such relief on or before December 31, 2005.

- The provisions of Q&A-21 permitting certain 2005 deferral elections to be made as late as March 15, 2005. The extent to which plan documents must be amended by December 31, 2005 in order to satisfy the requirements of Q&A-21 is unclear.

As the Proposed Regulations were only recently issued and there are many questions to be resolved and many issues to be addressed, taxpayers may be unable to evaluate the issues and take advantage of the relief in Q&As-18(c), and 20(a) of the Notice by December 31, 2005, without undue haste. An extension would afford taxpayers the opportunity to exercise more considered judgment with respect to the implications of Section 409A, the Notice and the Proposed Regulations. Moreover, as the Proposed Regulations are not effective by their terms earlier than January 1, 2007, the failure to extend this transitional relief beyond the end of 2005 creates at least a partial void in the guidance with respect to certain actions taken in 2006. Further, such an extension would improve consistency and promote compliance because taxpayers will be focused on a single date for all transition relief.
2. **Recommendations.**

We recommend that:

1. The Proposed Regulations be modified to provide that the period within which a plan subject to Section 409A of the Code may be terminated or suspended as described in Q&A-18(c) of the Notice is extended to December 31, 2006.

2. The Proposed Regulations be modified to provide that the period within which certain rights may be exercised under Q&A-20(a) of the Notice to terminate participation or cancel outstanding deferral elections under a plan is extended to December 31, 2006, and the required time limit for the plan amendment for such cancellations is extended to December 31, 2006.

3. The Regulations be clarified to provide that the time for amending a plan to incorporate the extended deferral election period provided by Q&A-21 of the Notice is extended to December 31, 2006.

3. **Explanation.**

As noted in the Notice and preamble to the Proposed Regulations, there are a number of substantive issues to be resolved under Section 409A, some of which are addressed in the Notice, some of which are addressed in the Proposed Regulations and some of which are expected to be addressed in future guidance. In the interim, taxpayers are faced with difficult decisions on how to adapt to Section 409A while at the same time confronting the specter of draconian tax penalties for technical, nonsubstantive failures to meet the form requirements of Section 409A. As more fully discussed below, decisions on complying or terminating are particularly difficult in this environment. The preamble to the Proposed Regulations states that the reason for not extending the relief in Q&A-18(c) and Q&A-20 and the time within which to make amendments under Q&A-21 is that there has been sufficient guidance to determine by the end of 2005 whether to take advantage of these provisions. We believe that, in the case of each of these Q&As, there is yet insufficient guidance and understanding in order that taxpayers might timely amend and/or take advantage of the actions permitted by these provisions before the end of 2005. In the case of Q&A-21, which requires changes to form, it is, in our view, not clear which provisions of Section 409A and the Proposed Regulations must be incorporated in instruments that may provide for the deferral of compensation. Similarly, without a full appreciation of the implications of the Proposed Regulations, it is difficult to make informed judgments as to whether to take advantage of the provisions of Q&A-18(c) and Q&A-20.

Although the Proposed Regulations clearly represent substantial progress toward comprehensive guidance under Section 409A, they are incomplete and inherently preliminary. A partial listing of the significant issues which the Proposed Regulations did not address includes the reporting and withholding obligations under Section 409A, the determination of taxes due in
the event that the provisions of Section 409A are violated, the application of the funding restrictions and the application of Section 409A to partnerships and partnership interests. Furthermore, with respect to many key areas, including deferral elections, distribution events and accelerations, and the determination of key employees, the Proposed Regulations are only the initial attempt to address the requirements in a comprehensive manner. Even in areas previously addressed by Notice 2005-1, such as the scope of programs covered by Section 409A, the Proposed Regulations proposed extensive changes and new, more detailed requirements relating to various matters, including, without limitation, the exemptions for stock appreciation rights, stock options and separation pay arrangements, the application of the plan aggregation rules, the determination of grandfathered benefits and the application of Section 409A to foreign plans and non-US service providers. To this list, the preamble highlights additional areas of concern, such as with respect to the potential application of Section 409A to split-dollar arrangements.

Given the scope and impact of Section 409A, it is inevitable that significant revisions to the Proposed Regulations will be sought by the public during the comment process. As a result, while the Section applauds the substantial efforts by Treasury and the Service to provide comprehensive and workable rules with respect to the many issues addressed in the Proposed Regulations, plan sponsors and participants will remain uncertain about many applications of Section 409A until comprehensive final regulations are promulgated. As the changes wrought through Section 409A are some of the most complicated and far reaching since the enactment of the Employee Retirement Income Security Act of 1974 (“ERISA”), it seems that a lengthier transition period similar to that provided with respect to ERISA is appropriate.

In the absence of extended transitional relief, problems encountered with respect to arrangements that are subject to or might be subject to Section 409A will have to be addressed before the full implications of Section 409A can be digested and assimilated. Important decisions regarding whether to terminate or cancel a program or a deferral will necessarily have to be made by sponsors and participants without full information regarding the new rules. Forcing participants and sponsors to make such decisions based on incomplete and preliminary guidance seems fundamentally unfair and is particularly unfortunate, given the harsh penalties under Section 409A for minor errors and the fact that the Proposed Regulations aggregate like plans for purposes of applying the penalties.

Moreover, curtailing the transition relief provided in Q&As-18(c) and 20(a) significantly reduces the value of the transition relief measures which Treasury and IRS did extend into 2006. Most fundamentally, it will compress many plan design decisions into 2005, even though plan sponsors are supposed to have until December 31, 2006, to finalize plan design and documents. In order to permit participants to make informed elections in 2005 concerning the time and form of their benefit distributions or whether to cash out their deferrals, sponsors must be able to communicate the new plan designs, and specify which benefits, if any, will be grandfathered. As a result, most of the fundamental decisions concerning plan designs will have to be made in 2005, unless the full range of transition relief is extended into 2006.
A clarification would also be appropriate regarding how the extension of the general time for making plan amendments under Q&A-19(a) applies with respect to the relief in Q&A-21 for making deferral elections as late as March 15, 2005 for compensation earned in whole or in part during 2005. The Notice indicates that the relief in Q&A-21 is available only if “the plan is amended to comply with the requirements of § 409A in accordance with Q&A 19” and the deferral elections are “made in accordance with the terms of the plan in effect on or before December 31, 2005 (other than a requirement to make a deferral election after March 15, 2005).” The cancellation of deferral elections and termination of participation elections similarly are only available if such actions are taken by December 31, 2005, and, “...provided that (i) the amendment is enacted and effective on or before December 31, 2005...” The extension of the plan amendment period would appear to delay plan documentation requirements generally, including those with respect to Q&A-20 and 21. However, we understand that some practitioners have questioned this conclusion and are concerned that plan amendments documenting the deferral elections permitted under the Q&A-21 and the cancellation of deferrals under Q&A-20 relief must be in place by December 31, 2005, or else the relief will retroactively fail, and Section 409A will be violated. In order to avoid confusion among plan sponsors, and avoid setting a trap for the unwary, we recommend that the Service clarify that the time for amending a plan to incorporate the extended deferral election period provided by Q&A-21 and the time for amending to cancel a deferral or terminate participation provided by Q&A-20 of the Notice is extended to December 31, 2006.

The requested extension of the transitional relief would not seem to frustrate any significant tax policy nor lead to abuse as the extension period requested is modest. Rather, extension of the relief would permit additional time to either conform arrangements to Section 409A or terminate the arrangements. In the former case, the arrangements would be Section 409A compliant. In the latter case, the arrangements would be terminated, the previous deferrals included in income and future deferrals halted. This result seems consistent with the aims of Section 409A, which are to reduce or significantly constrain opportunities for abusive deferral of compensation.

CONCLUSIONS

Because of the complexity of Section 409A and the concepts addressed in both the Notice and the Proposed Regulations, and because there appears to be no significant tax policy frustrated by adopting the recommendations outlined above, the Service, by acting promptly, could relieve significant untoward pressure on plan sponsors and participants regarding decisions and documents with respect to arrangements subject to Section 409A by granting the extended relief outlined above.