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

February 16, 2006

Re: Separation from Service Issues under IRC Section 409A Proposed Regulations

Dear Commissioner Everson:

Enclosed are comments concerning Separation from Service Issues under Internal Revenue Code Section 409A Proposed Regulations. 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, Internal Revenue Service  
    Eric Solomon, Acting Deputy Assistant Secretary (Tax Policy), Treasury  
    Michael J. Desmond, Tax Legislative Counsel, Treasury  
    Carol Gold, Internal Revenue Service, TEGE Employee Plans  
    Nancy Marks, IRS Chief Counsel, CC: TEGE  
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    Bill Bortz, Office of Benefits Tax Counsel, Department of Treasury  
    Daniel Hogans, Attorney Advisor Office of Benefits Tax Counsel, Department of Treasury
COMMENTS ON SEPARATION FROM SERVICE ISSUES UNDER INTERNAL REVENUE CODE SECTION 409A PROPOSED REGULATIONS

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 Adam B. Cohen of the Employee Benefits Committee of the Section of Taxation. Substantial contributions were made by Mark Wincek and Andrew Liazos. These comments were reviewed by Greta E. Cowart, Chair-Elect and James R. Raborn, Chair of the Section’s Employee Benefits Committee. The comments were further reviewed by the Quality Assurance Group, a committee comprised of past chairs of the Employee Benefits Committee that is chaired by Thomas R. Hoecker. 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 Committee on Employee Benefits.

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 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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January 31, 2006
EXECUTIVE SUMMARY

The following comments are submitted in response to the request for comments made by the Internal Revenue Service ("Service") in the Notice of Proposed Rulemaking, 70 Federal Register 57930 (October 4, 2005), published with Proposed Treasury Regulations issued under section 409A of the Internal Revenue Code of 1986, as amended ("Code").

These comments address issues arising under Proposed Regulations §§ 1.409A-1 through 6 in connection with a service provider’s separation from service. Our recommendations are as follows:

1. We recommend that Regulations provide that for purposes of determining whether a service provider has a “separation from service”, a “service recipient” include all entities in the controlled group with the members of the controlled group determined by applying the same standard as that which applies in determining a “service recipient” for purposes of stock rights under Proposed Regulation §1.409A-1(b)(5)(iii)(D), provided that the ownership percentage threshold to be used is specified by the service recipient when the time and form of payment is specified.

2. We recommend that the Regulations provide a safe harbor list of good reason termination events and that an actual termination of employment by an employee following the occurrence of one of the listed safe harbor good reason termination events be treated the same as an involuntary termination as long as the employer is not controlled by the employee. This recommendation is made for purposes of both the short-term deferral exception (the “Short-term Deferral Exception”) and the separation pay exception (the “Separation Pay Exception”). We further recommend that the Regulations provide a rule that treats other good reason terminations the same as an involuntary termination if, based on an analysis of the facts and circumstances, it appears that the separation pay is not a mere substitute for deferred compensation that is available at the option of the employee. If the determination of whether a good reason event has occurred is made by a person who is not controlled by the service provider (using the definition in Prop. Reg. § 1.409A-1(d)(3)), we recommend that the Regulations provide a presumption that the determination is correct.

3. We recommend that the Separation Pay Exception provide that, in applying the dollar limits of the Separation Pay Exception, the amount of a service provider’s separation pay be compared only to twice the Section 401(a)(17) limit in the

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1 All references herein to “Section” shall be to sections of the Internal Revenue Code of 1986, as amended, unless otherwise explicitly stated.
2 All references herein to the “Proposed Regulations” shall be to the respective sections in Proposed Treasury Regulation §§ 1.409A-1 through and including 6, or to such Proposed Regulations as a whole.
3 Proposed Regulation §1.409A-1(b)(4).
calendar year in which the payments commence and not to twice the service provider’s prior year compensation.

BACKGROUND

We commend the Service for directly addressing many of the difficult issues arising with payments occurring upon a separation from service in the Proposed Regulations under Section 409A of the Code. Our comments are primarily focused on the exceptions from Section 409A coverage for certain separation pay arrangements. Typical separation pay arrangements are not in our experience thought of or used as a vehicle for nonqualified deferred compensation. They may, nevertheless, be subject to Section 409A absent appropriate clarification of the scope of Section 409A. This approach can be burdensome for employers as a result of, for example, the application of the six-month delay in distribution commencement for specified employees of a publicly traded company, deferred compensation reporting requirements, and the inability of the employer to accelerate severance payments scheduled over a relatively short period of time.

The Proposed Regulations provide a helpful framework for resolving many of these concerns. Our recommendations focus on clarifying and expanding the exceptions in the Proposed Regulations for separation pay arrangements to accommodate common and reasonable business practices that are consistent with the principles of Section 409A and present little potential for abuse.

COMMENTS

I. DEFINITION OF “SEPARATION FROM SERVICE”

A. Summary

One of the permissible distribution events under Section 409A(a)(2)(A) and Proposed Regulation § 1.409A-3(a) is a “separation from service” (as defined in Proposed Regulation § 1.409A-1(h)). This distribution trigger, as stated in the statute, does not on its face answer the question “separation from service with whom?” The definition of “separation from service” in Proposed Regulation § 1.409A-1(h)(i) explicitly defines a separation from service to mean a separation from service with the service recipient. The definition of “service recipient” in Proposed Regulation § 1.409A-1(g) cross-references the qualified plan controlled group rules to include as the service recipient all entities that would be considered a single employer under Sections 414(b) and (c). These provisions use an 80% ownership threshold to determine whether an entity is part of the same controlled group and therefore treated as a single employer. However, a “service recipient” is defined for purposes of stock rights in Proposed Regulation § 1.409A-1(b)(5)(iii)(D) using the controlled group rules but permitting modification of the “at least 80%” to “at least 50%” and permitting the service recipient to elect to substitute “at least 20%” for the “at least 80%” test if there is a legitimate business reason to do so. Thus, the Proposed Regulations create the potential for an internal conflict between the definition of a service recipient for stock rights and for purposes of defining a separation from service.

Accordingly, under the Proposed Regulations, a service provider’s transfer to, for example, a 50%-owned subsidiary could trigger an unintended separation from service distribution
non-stock right deferred compensation, while the same individual may continue to receive stock rights from the same service recipient.

B. **Recommendation**

We recommend that Regulations provide that for purposes of determining whether a service provider has a “separation from service” from a “service recipient,” a “service recipient” include all entities in the controlled group with the members of the controlled group determined by applying the same standard as that which applies in determining a “service recipient” for purposes of stock rights under Proposed Regulation §1.409A-1(b)(5)(iii)(D), as finalized, provided that the ownership percentage threshold to be used is specified by the service recipient when the time and form of payment is specified.

C. **Explanation**

In some situations, the separation from service definition in Proposed Regulations §§1.409A-3(a) and 1.409A-1(h), using the 80% ownership threshold for determining which related entities are treated as the service recipient, will not raise issues of inconsistent treatment of different types of deferred compensation. If an employee with a deferred compensation account payable on separation from service transfers from a parent company to a wholly owned subsidiary, the employee will not receive a distribution. This result is reasonable from the perspective of employee and employer expectations, and it prevents the possible abuse of transferring employees between wholly owned subsidiaries to accelerate deferred compensation payments. Accordingly, as a default rule, the 80% threshold appears reasonable.

However, there are many situations in which an 80% threshold is not adequate or will produce inconsistent results with stock rights and other types of deferred compensation, particularly when companies have a joint venture relationship. For example, three unrelated companies might be involved in a joint venture (“JV”) in which each owns 33% of a single “JV” entity. In this situation, it is common for parent company employees to be transferred to employment with the JV. If one of the employees has a deferred compensation account with a parent company, it would often be important to the employee and the parent company that the deferred compensation account not be paid merely as a result of the transfer. Triggering an early payout in such situation could discourage transfers, and delaying payout is consistent with the economic reality that the employee continues to have a business relationship with the parent company, which is the approach taken for defining the “service recipient” for stock rights. If the same individual had a stock right from the parent, Proposed Regulation § 1.409A-1(b)(5)(iii)(D) permits the service recipient to broadly define itself so that if the employee transferred to the JV, the employee (now of the JV) can still receive stock rights of the parent, yet he would be treated as separated from service for other types of deferred compensation plans. In such intercompany transfer situations, frequently the employee may be transferred back to employment with the parent company after several years with the JV. Furthermore, triggering a separation from service in such a situation for a deferred compensation arrangement, other than a stock right, could place the participant in the position of receiving distribution of non-stock right deferred compensation while not having a separation from service for the stock right because he would still be employed by a service recipient under Proposed Regulation § 1.409A-1(b)(5)(iii)(D) while employed by the JV. The inconsistency in the definitions of “service recipient” under the
Proposed Regulations does not promote tax simplification or consistency in administration, but adds complexity and a trap for the unwary.

We recommend that the service recipient be able to choose, within a range, the level of ownership that will be used to determine who is part of the “service recipient” for purposes of the separation from service rules. A transfer to an entity with an ownership connection of 1% or some other very low percentage is unlikely to constitute a continuation of any legitimate employment relationship, and should trigger a separation from service. For any ownership percentage of 20% or more, it is reasonable to presume that there is a continuing relationship between the service provider and the original service recipient at a level that should not necessarily trigger a separation-from-service distribution. Moreover, the fact that the recommendation described above requires the ownership percentage to be specified at the same time the time and form of payment is specified addresses any concerns about possible abuse in the form of changing the percentage thresholds to accelerate or delay payments.

Finally, permitting an ownership percentage lower than 80% is consistent with the Conference Report to the American Jobs Creation Act of 2004\(^5\) (hereinafter “Conf. Rep.”), which provided that the Secretary should define the aggregation rules necessary to carry out the intent of the provision and so that transfers within the controlled group are not separations from service. This approach is consistent with the approach in Proposed Regulation § 1.409A-1(b)(5)(iii)(D) for defining the service recipient for stock rights. Thus it promotes consistency and tax simplification. Although the Conf. Rep. references the controlled group rules as an example of when entities must be aggregated to determine whether a separation from service has occurred, it also references that service for an entity in the “group” may not be a distribution event.\(^6\) In fact, the language in the statute providing that the distribution event is a “separation from service as determined by the Secretary” suggests that Congress anticipated that there would be a need for flexibility in defining the boundaries of the term “separation from service.”

II. GOOD REASON TERMINATIONS

A. Summary

Notice 2005-1 and the Proposed Regulations contain an exception from Section 409A for short-term deferrals. Specifically, the Short-term Deferral Exception applies to amounts that are payable within 2-1/2 months following the end of the tax year of the service provider or service recipient in which the substantial risk of forfeiture lapses. The Preamble to the Proposed Regulations acknowledges that a separation payment that is due only on an involuntary termination of employment is subject to a substantial risk of forfeiture and that a separation pay arrangement that provides for payments upon an involuntary termination of employment may satisfy the requirements of the Short-term Deferral Exception if properly structured.

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\(^6\) Id.
In the preamble to the Proposed Regulations, the Service declined to provide “categorically” that separations for “good reason,” or particular types of “good reason,” would give rise to a substantial risk of forfeiture.\(^7\) As a result, a separation pay arrangement that permits an employee to receive separation pay following the employee’s termination of employment for good reason may or may not meet the requirements of the Short-term Deferral Exception.\(^8\)

The Proposed Regulations also contain an exception from Section 409A for separation pay that is limited in duration and amount. The Separation Pay Exception, however, is only available “upon an actual involuntary separation from service.” Based on the Preamble’s distinction between an involuntary termination and a termination for good reason, we assume that a separation pay arrangement that permits an employee to resign for good reason and receive benefits may not qualify for the Separation Pay Exception.

B. Recommendation

We recommend that the Regulations provide a safe harbor list of good reason termination events and that an actual termination of employment by an employee within a reasonable, specified period following the occurrence of one of the listed safe harbor good reason termination events be treated the same as an involuntary termination as long as the employer is not controlled by the employee. This recommendation is made for purposes of both the Short-term Deferral Exception and the Separation Pay Exception. We further recommend that the Regulations provide a rule that treats other good reason terminations the same as an involuntary termination if, based on an analysis of the facts and circumstances, it appears that the separation pay is not a mere substitute for deferred compensation that is available at the option of the employee. If the determination of whether a good reason event has occurred is made by a person who is not controlled by the service provider (using the definition in Proposed Regulation § 1.409A-1(d)(3)), we recommend that the Regulations provide a presumption that the determination is correct.

C. Explanation

Employment agreements and other arrangements often provide for severance payments upon an involuntary termination by the employer without cause or upon a termination by the employee with good reason. This basic approach has become quite common even outside of the change in control situation noted in the preamble to the Proposed Regulations.

Good reason definitions vary, but often include, among other elements, a significant reduction in the scope of an employee’s authority, position, title, or functions; a material or adverse change in job duties or responsibilities; the required relocation of the employee to a worksite or office more than a specified number of miles (e.g. 50) away from the employee’s current worksite or office; the reduction of an employee’s annual base pay or salary or annual potential bonus relative to the prior year’s bonus; a material reduction in benefits; or the failure of the employer to secure a

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\(^7\) 70 Fed. Reg. 57930, 57941 (Oct. 4, 2005).

\(^8\) References to “employee” are intended to refer to all “service providers” and references to “employer” are intended to refer to all “service recipients”.
satisfactory agreement from its successor to honor the employee’s employment agreement or change in control agreement following a change in control.


These cases and practical experience demonstrate that employers and other service providers do not routinely pay significant amounts based on feigned assertions of good reason circumstances. Although employers will occasionally, and perhaps even often, prefer to resolve employment related disputes amicably, this practical desire to avoid the acrimony, distraction and cost of litigation does not transform a good reason termination provision into a substitute for deferred compensation. Employers who are not controlled by the service provider have no incentive to waste corporate assets by paying a former employee when not warranted by a contractual obligation. Thus, the concerns raised in the Preamble to the Proposed Regulations that such pay could be a substitute for deferred compensation, while real, frequently are not applicable.9

In order to provide employers and other service recipients with the guidance they need, and at the same time avoid abuse, we recommend that the Regulations provide a safe harbor list of good reason termination events for purposes of both the Short-term Deferral Exception and the Separation Pay Exception. We recommend that if an employee elects to terminate employment following the occurrence of one of the listed safe harbor good reason termination events, the termination be treated the same as an involuntary termination as long as the employer is not controlled by the employee. A carefully crafted list of safe harbor good reason events will

provide the necessary assurance that entitlement to the separation payment is neither automatic
nor subject to manipulation by the service provider.

While the development of the safe harbor list of good reason events may be somewhat difficult,
current practice provides a good starting point. Many of the common good reason events noted
above are based on a somewhat relaxed version of the factors that determine whether an
individual is constructively discharged (i.e., involuntarily terminated by employer actions other
than a direct discharge) under the common law. Certainly these types of provisions would be
covered by the safe harbor. See, e.g., Criscuolo v. Joseph E. Seagram & Sons, Inc., 2003 WL
22415753 (S.D.N.Y. 2003) (“In principle, there is no reason why the constructive discharge
doctrine should not apply in interpreting the meaning of ‘involuntary termination’ in an ERISA-
governed benefit plan.”) See also Mesenbourg v. Dun & Bradstreet Software Services, Inc.,

We recommend that the safe harbor list also include other good reason events that are in
common use. We understand that a rule that treats all good reason termination provisions as
equivalent to an involuntary termination could open the door to avoidance of the rules of Section
409A by blurring the line between a voluntary termination for no reason (in which case the
severance pay is indistinguishable from deferred compensation) and a termination for good
reason (in which case the severance pay will be paid only if the employer agrees, or it is
determined, that good reason actually exists). As long as a particular listed good reason
termination event does not allow an employee to voluntarily terminate employment and receive
severance pay without some precipitating adverse action by the employer the risk of abuse will
be minimal. An employer is not likely to pay separation pay in the absence of one of the listed
events since, as noted above, employers have fiduciary duties to their shareholders not to waste
corporate assets. Employers that are independent from the employee have no financial incentive
to pay funds to departing executives without a reasonable basis for incurring the expense.

Since no list is likely to include all of the good reason termination events that might be relevant
in all employment relationships, we recommend that the safe harbor list of good reason
termination events be supplemented by a rule that treats other good reason terminations the same
as an involuntary termination if, based on an analysis of the facts and circumstances, it appears
that the separation pay is not a mere substitute for deferred compensation that is available at the
option of the employee.

If the good reason determination is made by a person not controlled by the employee (using the
definition in Proposed Regulation § 1.409A-1(d)(3)), we recommend that the Regulations
provide a presumption that the determination is correct. We recommend that this presumption
apply regardless of whether the good reason determination is being made in the context of the
safe harbor or the alternative facts and circumstances test.

III. DOLLAR LIMIT FOR SEPARATION PAY EXCEPTION

A. Summary.

The Separation Pay Exception provides that a separation payment that is tied to either
involuntary separation or participation in a window program does not constitute a Section 409A
deferral of compensation if the separation pay is sufficiently limited in amount and duration. Under the limit on the amount of separation pay, the separation pay (disregarding certain reimbursements) cannot exceed two times the lesser of (1) the Section 401(a)(17) limit or (2) the service provider’s compensation as an employee of (and as a consultant to) the service recipient, in each case for the calendar year preceding the year of separation. In defining compensation with respect to employees, the Proposed Regulations initially cross referenced Treasury Regulation § 1.415-1(d)(2), but this was corrected to cross reference Treasury Regulation § 1.415-2(d).10

B. **Recommendation.**

We recommend that the Separation Pay Exception provide that in applying the dollar limits of the Separation Pay Exception, the amount of a service provider’s separation pay be compared only to twice the Section 401(a)(17) limit in the calendar year in which the payments commence and not to twice the service provider’s prior year compensation.

C. **Explanation.**

Currently, the two-times exception contained in the Proposed Regulations is complicated by the need to determine the prior-year compensation of each separation pay recipient. In the case of group severance programs, which typically are implemented under very short deadlines, the burden of individual calculations is significant. In addition, the reference to actual compensation injects an arbitrariness into the operation of the two-times exception. For example, severance pay which is based on twice a service provider’s normal compensation may exceed the two times pay limit if the service provider took an unpaid leave in the prior year, even though the service provider’s severance is based on his or her normal compensation. Conversely, the severance pay of a service provider who received a large one-time bonus or other payment in the prior year may pass the two times prior pay test even though the service provider’s severance is based on three or four times his or her normal compensation.

In contrast to the Proposed Regulations, the Section 401(a)(17) limit for the current calendar year is easy to determine, and it provides a separation pay limit that is immune from the aberrations that affect actual compensation. Perhaps most importantly, the Section 401(a)(17) limit by itself properly targets the two-times exception so that it provides a limited amount of relief that, under the current structure, typically would not be available to the highest paid executives. In this regard, it is worth noting that the Section 401(a)(17) limit is relied on to regulate, by itself, the amount of compensation that can result in allocations or benefits in the qualified plan area (e.g., there is no additional limit that disregards compensation that is, for example, more than twice compensation in a prior year or years). We recommend that the two-times exception be revised to eliminate the alternative two-times pay limit that is difficult and data-intensive to apply. This change would support tax simplification by eliminating the more data intensive and complex test.

Therefore, deriving the limit for the two-times exception solely from the Section 401(a)(17) limit would result in (1) significant simplification in tax administration, (2) rationalization of the exception’s operation, so that its operation is not distorted by aberrant compensation results, and

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(3) preservation of the most important policy considerations relating to the amounts limit. In addition, it appears more appropriate to apply the Section 401(a)(17) limit for the calendar year of the separation, rather than the Section 401(a)(17) limit for the prior calendar year. The current calendar year’s limit is used for regulating qualified plans, thus this would promote consistency.

We compliment Treasury and the Service for issuing the corrections on December 19, 2005. As revised, the Proposed Regulations now cross reference a portion of the Section 415 regulations that sets forth several alternative compensation definitions, i.e., Treasury Regulation § 1.415-2(d). If an alternative limit based on prior year’s compensation must be retained, cross referencing the basic Section 415 definitions promotes ease of tax administration, because it allows service recipients to use a definition of compensation under the two-times exception that they may already use in administering their qualified plans. At the same time, the fact that several permissible definitions of compensation are included under Treasury Regulation § 1.415-2(d) points out another way in which simplification would be served if the two-times exception were tied only to the Section 401(a)(17) limit. Specifically, in close cases, service recipients will be under pressure to try applying the two-times exception using different Section 415 definitions of compensation, in order to find the greatest number. Indeed, there can be significant differences in how much compensation will fit within one definition versus another. In sum, this additional limit based on actual compensation is disproportionately complicated relative to what it contributes to tax policy.