March 9, 2006

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

Re: Deferral Elections under IRC Section 409A Proposed Regulations

Dear Commissioner Everson:

Enclosed are comments under Internal Revenue Code Section 409A Proposed Regulations concerning Deferral Elections. 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  
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Bill Bortz, Office of Benefits Tax Counsel, Department of Treasury  
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COMMENTS REGARDING PROPOSED TREASURY REGULATIONS UNDER SECTION 409A—DEFERRAL ELECTIONS

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 Kurt Lawson and David Mustone. Substantive contributions were made by Scott Austin and Andrea Dudek. The comments were reviewed by James R. Raborn, 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 Pamela Baker of the Section’s Committee on Government Submissions and by Elaine Church, on behalf of the 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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March 2, 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 Fed. Reg. 57930, October 4, 2005) for Prop. Reg. § 1.409A-1 et seq. ("Proposed Regulations") issued under section 409A of the Internal Revenue Code of 1986, as amended ("Code"). These comments address various aspects of the Proposed Regulations concerning the application of the deferral election rules.

We recommend that:

1. The Regulations, as finalized, be modified to provide that the plan aggregation rules will not apply in determining whether a newly eligible participant is eligible to make a “first year of eligibility” deferral election under an elective deferred compensation plan ("Subject Plan") pursuant to Section 409A(a)(4)(ii) where:

   a. The participant is, for bona fide business reasons unrelated to the Subject Plan, either (i) moved from a nonparticipating controlled group member to a participating one or (ii) moved by a participating group member from an ineligible position to an eligible one;

   and

   b. Any of the following applies:

      (i) the Subject Plan has been in existence (and actually covering participants) for at least twelve months;

      (ii) before the move, the participant did not participate in another elective deferred compensation plan; or

      (iii) if the participant did participate in another elective plan, (A) the participant’s deferral election under the other plan is automatically carried over and put into effect under the Subject Plan upon entry and (B) the resulting deferrals (and any corresponding matching contributions) for the remainder of the plan year under the Subject Plan do not separately exceed the applicable Section 402(g) limit for that year.

2. The Regulations, as finalized, be modified to provide that another deferred compensation plan will not be taken into account in applying the plan aggregation rules to Section 409A(a)(4)(ii) if:

   a. The participant was not eligible to participate in the other plan in the current or the previous calendar year; or
b. The other plan was maintained by another member of controlled group before it became a controlled group member, and not afterwards.

3. The Regulations, as finalized, be clarified to state whether the plan aggregation rules apply to the “first year of eligibility” rule for nonelective plans in Prop. Reg. § 1.409A-2(a)(6).

4. The Regulations, as finalized, be clarified to provide that a newly eligible service provider, whether or not eligible for the “first year of eligibility” rule for nonelective plans in Prop. Reg. § 1.409A-2(a)(6), may nevertheless commence participation in a nonelective plan upon becoming eligible, as long as the form and time of payment is set no later than the time the service provider first has a legally binding right to the compensation.

5. The Regulations, as finalized, be clarified to provide that the proration rule in Prop. Reg. § 1.409A-2(a)(6) is a safe harbor only, and that, as a safe harbor, it applies to all compensation payable for a specified service period (not merely a specified performance period).

6. The Regulations, as finalized, be clarified to provide that the automatic cessation of a participant’s deferral election during the year is not an impermissible mid-year election change under Section 409A(a)(4) where the participant ceases to be eligible to participate in the plan during the year because, for bona fide business reasons unrelated to deferred compensation plan participation, he or she is either (i) transferred (or otherwise moved) to a nonparticipating affiliate or (ii) transferred to a position under which the participant ceases to be a member of the employer’s “top hat” group or otherwise ceases to eligible under plan terms.

7. The Regulations, as finalized, be clarified to allow deferral elections to be suspended or terminated when a participant is “disabled” within the meaning of Section 409A(a)(2)(A).

8. The Regulations, as finalized, be clarified to provide that an election to defer compensation that would otherwise be covered by the thirteen-month rule in Prop. Reg. § 1.409A-2(a)(4) does not fail to be covered merely because the compensation could vest earlier than twelve months after the election is made on account of the participant’s death or disability.

9. Prop. Reg. § 1.409A-2(a)(7), as finalized, be clarified to apply to performance-based compensation earned by service providers who are hired after the beginning of the performance period but before the performance criteria are established.

10. An exception be added to the contingent benefit rule in Prop. Reg. § 1.403(b)-5(b)(2) (2004) that is similar to the exception in Reg. § 1.401(k)-1(e)(6)(iii) for participants who have made the maximum elective deferrals under section 402(g) or the maximum elective contributions permitted under the terms of the annuity.
11. The linked plan rules in Prop. Reg. §§ 1.409A-2(a)(8)(iii) and (iv) and 1.409A-
3(h)(3)(iii) and (iv) be revised to eliminate the imposition of the Section 402(g) limits on
matching (and other contingent) contributions.

12. The linked plan rules in Prop. Reg. §§ 1.409A-2(a)(8)(iii) and (iv) and 1.409A-
3(h)(3)(iii) and (iv) be revised to make it clear:

   a. that the Section 402(g) dollar limits imposed on elective contributions on the one
      hand and (if it is not eliminated) on matching and other contingent contributions
      on the other hand are separate, additive limits and not single, coordinated limits;

   b. that the Section 402(g) dollar limits are increased by the limit on catch-up
      contributions under Section 414(v) for service providers age 50 or older; and

   c. that the Section 402(g) dollar limits are not applied to all of the service provider’s
      benefit under a linked nonqualified plan merely because he can get or keep that
      benefit only if he elects to contribute the maximum amount permitted under the
      linked qualified plan.

13. The Regulations, as finalized, make it clear that the linked plan rules in Prop. Reg.
§§ 1.409A-2(a)(8)(iii) and (iv) and 1.409A-3(h)(3)(iii) and (iv), as finalized, are not
applicable if both the deferral election under the nonqualified plan (including the pour-
over election in the case of a wrap-type plan) and the deferral election under the qualified
plan are made before the beginning of the year in which the services are provided and the
elections are irrevocable, and that if Prop. Reg. §§ 1.409A-2(a)(8) and 1.409A-3(h)(3), as
finalized, apply, the deferral election under the nonqualified plan need not be made
before the beginning of the year or be irrevocable, and in the case of a wrap-type plan,
the pour-over date need not be a specified date.

14. The special initial deferral election rule in Prop. Reg. § 1.409A-1(a)(9)(iii), as finalized,
for separation pay due to involuntary separation be expanded to apply to any situation in
which the service provider’s employment is terminated pursuant to a bona fide, legally
binding settlement agreement addressing substantial contractual or other existing rights,
and the special initial deferral election rule for separation pay due to a window program
be revised to clarify that it will apply to arrangements that cover only one person.

15. The Regulations, as finalized, be modified to provide that the special rule for
commissions in Prop. Reg. § 1.409A-2(a)(10) be applied to commissions paid by
“related” persons if the commissions were paid in bona fide, arm’s length business
transactions entered into in the ordinary course of business.
BACKGROUND

Section 409A of the Code (references to “Section” hereinafter are to sections of the Code except when specifically stated otherwise) was added by the American Jobs Creation Act of 2004 and, with some exceptions generally became effective January 1, 2005. The changes to nonqualified deferred compensation practices wrought by Section 409A, including the handling of deferral elections, are far reaching and complex. We commend the efforts made in the Proposed Regulations to apply the statutory exceptions to the basic deferral rule (under Section 409A(b)(4)(B)(i)) and to establish additional useful exceptions. These comments address those aspects of these exceptions that warrant further refinement or clarification.

COMMENTS

Sec. 1.409A-2 Deferral Elections.

I. Application of “First Year of Eligibility” Deferral Rule

A. Background

Section 409A(a)(4)(B)(ii) provides that, for the first year in which a participant becomes eligible to participate in a nonqualified deferred compensation plan, a deferral election may be made (for services to be performed subsequent to the election) within 30 days after the date the participant first becomes eligible to participate in the plan. The Proposed Regulations provide that the plan aggregation rules apply in determining whether a new participant has met the first year requirement for this purpose. See Prop. Reg. § 1.409A-2(a)(6) (cross-referencing Prop. Reg. § 1.409A-1(c)). The result is that, if a newly eligible participant is or was previously eligible to participate in another nonqualified plan of the same type maintained by the same service recipient (or any of its controlled group members), the rule is not available. In the case of an account balance program, this is true even if participation in the other plan is nonelective. The plan aggregation rules appear to apply regardless of how long ago participation in the other plan ended, or whether the other plan even still exists. Likewise, if the other plan is or was maintained by another controlled group member, the plan aggregation rules appear to apply even if participation ended long before the entity became a member of the controlled group.

In the preamble to the Proposed Regulations (the “Preamble”), comments are requested as to the application of plan aggregation rules in this context, specifically as to whether the initial deferral election rules provided in the Proposed Regulations—including the rule for certain forfeitable rights and the rule for short-term deferrals—adequately address the concerns raised by the application of those rules. 70 Fed. Reg. at 57944.

The Proposed Regulations also provide that, in the case of a nonelective plan, the form and time of payment must be set within 30 days after the service provider first becomes eligible to participate in the plan. See Prop. Reg. § 1.409A-2(a)(6). However, the Proposed Regulations do not expressly say whether the plan aggregation rules apply for purposes of this rule because, unlike the election timing rule for elective plans, the nonelective plan rule does not expressly
cross-reference Prop. Reg. § 1.409A-1(c). We assume that a new participant who cannot rely on the rule under Section 1.409A-2(a)(6) may enter the plan upon first becoming eligible, but that the rule in Prop. Reg. § 1.409A-2(a)(12), providing that the form and time of payment must be set no later than the time the service provider first has a legally binding right to the compensation, would apply instead of this rule.

The Proposed Regulations also provide that, in the case of compensation that is earned based upon a specified performance period, a “first year of eligibility” deferral election will be deemed to apply to compensation paid for services performed after the election, as required by Section 409A(a)(4)(B)(ii), if the election applies to a percentage of the compensation equal to the percentage of the performance period remaining after the election. It is not clear whether the reference to a “performance period” means that this rule applies only to performance-based pay. It also is not clear whether the pro-ration rule is a safe harbor or a mandatory rule.

B. Recommendations

We recommend that:

1. The Regulations, as finalized, be modified to provide that the plan aggregation rules will not apply in determining whether a newly eligible participant is eligible to make a “first year of eligibility” deferral election under an elective deferred compensation plan (“Subject Plan”) pursuant to Section 409A(a)(4)(ii) where:

   a. The participant is, for bona fide business reasons unrelated to the Subject Plan, either (i) moved from a nonparticipating controlled group member to a participating one or (ii) moved by a participating group member from an ineligible position to an eligible one;

   and

b. Any of the following applies:

   (i) the Subject Plan has been in existence (and actually covering participants) for at least twelve months;

   (ii) before the move, the participant did not participate in another elective deferred compensation plan; or

   (iii) if the participant did participate in another elective plan, (A) the participant’s deferral election under the other plan is automatically carried over and put into effect under the Subject Plan upon entry and (B) the resulting deferrals (and any corresponding matching contributions) for the remainder of the plan year under the Subject Plan do not separately exceed the applicable Section 402(g) limit for that year.
2. The Regulations, as finalized, be modified to provide that another deferred compensation plan will not be taken into account in applying the plan aggregation rules to Section 409A(a)(4)(ii) if:

   a. The participant was not eligible to participate in the other plan in the current or the previous calendar year; or
   
   b. The other plan was maintained by another member of controlled group before it became a controlled group member, and not afterwards.

3. The Regulations, as finalized, be clarified to state whether the plan aggregation rules apply to the “first year of eligibility” rule for nonelective plans in Prop. Reg. § 1.409A-2(a)(6).

4. The Regulations, as finalized, be clarified to provide that a newly eligible service provider, whether or not eligible for the “first year of eligibility” rule for nonelective plans in Prop. Reg. § 1.409A-2(a)(6), may nevertheless commence participation in a nonelective plan upon becoming eligible, provided the form and time of payment is set no later than the time the service provider first has a legally binding right to the compensation.

5. The Regulations, as finalized, be clarified to provide that the proration rule in Prop. Reg. § 1.409A-2(a)(6) is a safe harbor only, and that, as a safe harbor, it applies to all compensation payable for a specified service period (and not a merely specified performance period).

C. Explanation

Recommendation 1:

The Preamble states that the plan aggregation rules are being applied in this context because it is believed that “[w]ithout such a rule, service providers may attempt to take advantage of the new eligibility exception by establishing serial arrangements”. 70 Fed. Reg. at 57944. At the same time, requests to develop more specific, tailored standards were rejected because of the concern that “such rules would by necessity be complicated and burdensome, generally relying on the facts and circumstances of the individual arrangements and resulting in administrative burden and uncertainties.” Id.

In general, there are a variety of legitimate, nonabusive situations in which a service provider may—by transfer, promotion or otherwise—become eligible (for the first time) for a different nonqualified plan of a service recipient (or one of its controlled group members) during the year. Consequently, service providers should not be unduly restricted from using the special “first year of eligibility” rule solely because they previously participated in a similar arrangement. While the Service’s concerns as to the potential for abuse and avoiding unneeded complexity in this context are legitimate, the standards we recommend strike a fairer, more reasonable balance in this regard. First and foremost, we recommend that there must be a bona fide business reason for the service provider’s change in status (unrelated to the nonqualified
The aim of this standard is to preclude the use of position/employer changes designed to circumvent Section 409A. In addition, we recommend that, to minimize the potential for manipulation, an additional layer of easily understood and applied objective standards also must be met. Thus, to qualify as newly eligible, one of the following must be met—the plan has been in existence for at least twelve months, the prior plan was nonelective, or the participant’s prior deferral election is automatically carried over to the Plan. The election carryover exception also contains a further limit on any resulting deferral increase—a requirement contained elsewhere in the Proposed Regulations and, therefore, otherwise viewed as appropriate and workable safeguard. See Prop. Reg. § 1.409A-2(a)(8).

**Recommendation 2:**

To make the Proposed Regulations fairer and simplify plan administration, the Regulations, as finalized, should disregard eligibility under other plans that ended a significant period of time before eligibility under the current plan began, or where the other plans were maintained by other members of a controlled group only before they became members of the controlled group. The first of these two exceptions is designed to allow employers to disregard participation in other plans where the participation is “old and cold” (i.e., where contribution credits, accruals, or grants have not been made in the current or immediately preceding year, whether or not earnings or interest continue to be credited) and where serial plans, as described in the Preamble, are not a realistic concern. The second of these exceptions is similar, but recognizes the difficulty of obtaining information about participation in plans that were sponsored by other employers before they became affiliated with the current employer, and the unlikelihood of any kind of collusion in such cases. Absent such exceptions, coverage under an unrelated plan sponsored by another employer decades ago could prevent the use of the “first year of eligibility” rule.

**Recommendation 3:**

The fact that the first sentence of Prop. Reg. § 1.409A-2(a)(6) (dealing with elective arrangements) expressly cross-references Prop. Reg. § 1.409A-1(c), with the apparent intent of ensuring that the plan aggregation rules apply, while the second sentence (dealing with nonelective arrangements) does not, creates confusion as to whether the plan aggregation rules were intended to apply to nonelective arrangements for purposes of this rule. We recommend that the Regulations, as finalized, be clarified to state whether or not plan aggregation rules apply for nonelective plans under Prop. Reg. § 1.409A-2(a)(6).

**Recommendation 4:**

The Preamble generally provides that the election timing rules do not apply “where the participant is not provided any election with respect to the amount deferred, or the time and form of payment.” 70 Fed. Reg. at 57943. It follows, therefore, that whether or not a newly eligible participant otherwise qualifies for the “first year of eligibility” rule, the participant should be able to commence participation upon becoming eligible, as long as the form and timing of payout also is set at the time that he or she first obtains a legally binding right under the plan, as
provided in Prop. Reg. § 1.409A-2(a)(12). To avoid any uncertainty in this regard, we recommend that the Regulations, as finalized, expressly provide that a newly eligible service provider may commence participation in a nonelective plan upon becoming eligible, as long as the form and time of payment is set no later than the time when the service provider first has a legally binding right to the compensation.

**Recommendation 5:**

We recommend that the pro-ration rule simply be a safe harbor rule, since, other than base pay, compensation is rarely earned evenly throughout a service period. As a safe harbor, we also recommend that it apply to all forms of compensation payable for a specified service period (not merely a specified performance period).

**II. Exceptions to Irrevocability Requirement**

**A. Background**

The Proposed Regulations provide that, to be effective, a deferral election must be irrevocable by the applicable deferral election deadline for the year involved. See Prop. Reg. § 1.409A-2(a)(1). However, the Proposed Regulations do not expressly address whether it is permissible to terminate an election upon a participant’s transfer to a nonparticipating affiliate or position. Because “service recipient” is defined as including all controlled group members (see Prop. Reg. § 1.409A-1(g)), it is unclear whether it is still possible to provide an automatic termination of an election upon transfer. The Proposed Regulations also do not expressly address whether it is permissible to suspend or terminate deferral elections when a participant is disabled, as many deferred compensation plans do. The fact that Prop. Reg. § 1.409A-3(h)(2)(vii) contains an exception that allows deferral elections to be cancelled “due to an unforeseeable emergency or a hardship distribution” under a Section 401(k) plan, suggests that such a suspension is not allowed unless the disability fits within this exception.

**B. Recommendation**

We recommend that the Regulations, as finalized, be clarified to:

1. Provide that the automatic cessation of a participant’s deferral election during the year is not an impermissible mid-year election change under Section 409A(a)(4) where the participant ceases to be eligible to participate in the plan during the year because, for bona fide business reasons unrelated to deferred compensation plan participation, he or she is either (i) transferred (or otherwise moved) to a nonparticipating affiliate or (ii) transferred to a position under which the participant ceases to be a member of the employer’s “top hat” group or otherwise ceases to eligible under plan terms.

2. Allow deferral elections to be suspended or terminated when a participant is “disabled” within the meaning of Section 409A(a)(2)(A).
C. **Explanation**

*Recommendation 1:*

Allowing automatic cessation of deferral as we have recommended would make the Proposed Regulations, as finalized, fairer without making them susceptible to abuse. As explained above in the context of the “first year of eligibility” rule, there are a variety of legitimate circumstances in which a service provider may—by transfer or otherwise—move to an ineligible position or become employed by a nonparticipating affiliate. Also as explained above, where employment changes occur for bona fide business reasons unrelated to plan participation, the potential for abuse is minimal. This is particularly true where a participant is removed because he/she ceases to a member of the employer’s “top hat” group for purposes of Sections 201(2), 301(a)(3) and 401(a)(1) of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”). In these circumstances, the participant’s removal is done to ensure that the plan will not become subject to the funding, trust and other substantive requirements under ERISA.

This recommendation also makes sense from a practical and administrative standpoint. As is the case for all types of benefit programs, it is common practice to terminate automatically a participant’s nonqualified plan participation once he or she ceases to be employed by a participating employer or in an eligible capacity. At the same time, if deferral elections were required to be continued, the coordination of payrolls and procedures of disparate affiliates could easily result in substantial administrative/logistical difficulties from affiliate to affiliate and executive to executive. In short, the automatic termination of a participant’s deferral election upon a bona fide change in employment (unrelated to plan participation) to a position ineligible for plan participation or to a business whose employees to not participate should not result in abuse and, therefore, we recommend that it be permitted.

*Recommendation 2:*

Many deferred compensation plans are currently drafted to allow deferral elections to be suspended while a participant is disabled. A “disability” within the meaning of Section 409A(a)(2)(A) will often qualify as an “unforeseeable emergency”, but it is not appropriate to assume that permitting suspensions or terminations of deferral elections on account of an “unforeseeable emergency” is sufficient. Because of the unforeseeability requirement, and because many employees are covered by disability insurance, some disabilities may not qualify as “unforeseeable emergencies.” A “disability” also will often qualify as a “hardship” within the meaning of Section 401(k), but that will not always be true, and, even if it is, the participant either might not participate in a Section 401(k) plan or might not take a distribution from the plan.

Our recommendation to allow deferral elections to be suspended or terminated when a participant is “disabled” within the meaning of Section 409A(a)(2)(A) would simplify plan drafting by reducing the number of changes required to existing plans and avoiding the need for plans that do not otherwise use the concept of an “unforeseeable emergency” to add that concept.
in order to avoid harsh treatment of disabled participants. It would result in only a modest expansion of the existing exception to the irrevocability requirement and, because it would use the definition of “disability” in Section 409A and the regulations, it would not be susceptible to abuse. Therefore we recommend that the Proposed Regulations, when finalized, be clarified to allow deferral elections to be suspended or terminated when a participant is “disabled” within the meaning of Section 409A(a)(2)(A).

III. Application of “Thirteen-Month Rule” to Amounts that Vest on Death or Disability

A. Background

Section 409A(a)(4)(B)(i) generally requires deferral elections to be made before the beginning of the calendar year to which they apply. However, Prop. Reg. § 1.409A-2(a)(4) provides an exception (commonly known as the “thirteen-month rule”) that allows the deferral election to be made on or before the 30th day after the service provider obtains a legally binding right to compensation if the compensation is subject to a forfeiture condition requiring the service provider’s continued services for at least twelve months after the service provider obtains the legally binding right, and if the election is made at least twelve months before “the earliest date at which the forfeiture condition could lapse.”

B. Recommendation

We recommend that the Regulations, as finalized, be clarified to provide that an election to defer compensation that would otherwise be covered by the thirteen-month rule in Prop. Reg. § 1.409A-2(a)(4) does not fail to be covered merely because the compensation could vest earlier than twelve months after the election is made on account of the participant’s death or disability.

C. Explanation

A large percentage of—perhaps most—deferred compensation plans accelerate vesting if a participant dies or becomes disabled, because there is no way for the participant to satisfy any remaining service requirements after that occurs. If Prop. Reg. § 1.409A-2(a)(4) is read literally, the requirement that the substantial risk of forfeiture not lapse for at least 12 months could prevent the thirteen-month rule from ever applying to such a plan. Accordingly, we recommend that the thirteen-month rule apply even if the forfeiture condition requiring at least twelve months of service could lapse earlier on account of death or disability.

IV. Application of Performance-Based Compensation Rule to New Hires

A. Background

Section 409A(a)(4)(B)(iii) provides that, in the case of any performance-based compensation “based on services performed over a period of at least 12 months,” a deferral election may be made as late as 6 months before the end of the period. The Proposed Regulations not only limit the rule to compensation “based upon a performance period of at least
12 months”, but also require the service provider to perform services continuously “from a date no later than the date upon which the performance criteria are established”. See Prop. Reg. § 1.409A-2(a)(7). It is not clear whether a new service provider, who is hired before the performance criteria are established but cannot perform services for the entire twelve-month period, can take advantage of this rule.

B. **Recommendation**

We recommend that Prop. Reg. § 1.409A-2(a)(7), as finalized, be clarified to apply to performance-based compensation earned by service providers who are hired or first become eligible to make an initial deferral election after the beginning of the performance period but before the performance criteria are established.

C. **Explanation**

According to the Preamble, the Proposed Regulations incorporated the provision contemplating that the performance criteria could be established up to 90 days after the commencement of the performance period in response to a request from commentators that the Proposed Regulations contain a rule “similar to the provision contained in §1.162-27(e)(2) governing the requirements for establishing performance criteria for purposes of applying the deduction limit under Section 162(m).” 70 Fed. Reg. at 57943. The regulations under Section 162(m) address when a performance goal is considered “preestablished,” and do not require the employee to be employed at the commencement of the performance period. See Treas. Reg. §1.162-27(e)(2). Thus, parallelism with Section 162(m) would not dictate a requirement of performing services for an entire twelve months.

We see no compelling justification to deny the availability of the 6-month election rule for performance-based compensation to service providers who are like other participants in every regard except that they are hired or first become eligible for the performance-based compensation after—sometimes only days after—the beginning of a performance period of twelve months or more. As long they are hired or become eligible to make a deferral election before the performance criteria are established, there is no reason to be concerned that this will allow them to make a deferral election with respect to compensation that they have already earned. In many cases, a newly-hired or newly eligible participant will be able to take advantage of the “first year of eligibility” rule. We do not see a potential for abuse where anyone who is hired or otherwise first becomes eligible for performance-based compensation after the beginning of the performance period but before the performance criteria are established is nevertheless eligible to take advantage of the rule permitting an election to defer performance-based compensation to be made up to six months before the end of the performance period. Accordingly, we recommend that Prop. Reg. § 1.409A-2(a)(7), as finalized, be clarified to apply to performance-based compensation earned by service providers who are hired or first become eligible to make an initial deferral election after the beginning of the performance period but before the performance criteria are established.
V. Deferral Elections under Linked Qualified/Nonqualified Plans

A. Background

Some elective nonqualified plans are linked with elective qualified plans. Two kinds are common. One is an excess benefit-type plan that accepts contributions and makes allocations not permitted under the qualified plan because of statutory limits imposed by Sections 402(g), 401(a)(17), 414(v), 415 and the like, or plan limits intended to prevent violations of those limits. Typically, a participant in such a plan (1) must elect to contribute the maximum amount permitted under Section 402(g) to the qualified plan before he or she is entitled to contribute anything to or receive any allocations under the nonqualified plan, or (2) alternatively, will have his contributions and allocations returned or forfeited if he or she exceeds the limits but has not elected the maximum deferral permitted under Section 402(g). That is because the “contingent benefit rule” under Section 401(k) prohibits benefits under a nonqualified plan from being conditioned upon an employee’s electing to make or not to make elective contributions under a cash or deferred arrangement, unless the employee’s benefits under the nonqualified plan are “dependent on [the] employee’s having made the maximum elective deferrals under section 402(g) or the maximum elective contributions permitted under the terms of the plan” (emphasis added). See Reg. § 1.401(k)-1(e)(6)(iii). The Service has proposed a similar contingent benefit rule for Section 403(b) annuities, except that rule contains no exception for participants who have made the maximum elective contributions allowed under the Section 403(b) annuity. See Prop. Reg. § 1.403(b)-5(b)(2) (2004).

Another kind of linked nonqualified plan is a “wrap” plan similar to the one approved by the IRS in PLR 9530038 (May 5, 1995). A participant in a wrap-type plan elects before the beginning of the year in which services are performed to contribute a portion of his or her compensation for those services to the nonqualified plan. Once the nondiscrimination and other tests have been run on the qualified plan for the year, the maximum amount that the participant can contribute to the qualified plan for the year is calculated, and the nonqualified plan “pours over” that amount to the qualified plan pursuant to a cash-or-deferred election made at the same time as the initial deferral election under the nonqualified plan. The pour-over must occur no more than 2½ months after the end of the plan year being tested in order for it to be treated as an elective contribution for that year under the ADP nondiscrimination test for Section 401(k) plans. See Reg. § 1.401(k)-2(a)(4)(i)(B)(2). Because the maximum amount that the participant can contribute is poured over to the qualified plan, the contingent benefit rule is automatically satisfied.

The Proposed Regulations provide that, in the case of linked elective qualified and nonqualified plans, the everyday operation of the qualified plan with respect to changes in benefit limitations under the Code or other applicable law (e.g., increases in the Section 402(g) limit) will not result in deferral elections or accelerations of payments under the nonqualified plan. See Prop. Reg. §§ 1.409A-2(a)(8) and 1.409A-3(h)(3). They also permit a participant in the linked plans to take or fail to take actions under the qualified plan (e.g., make or change a deferral election) in certain circumstances without the actions or inactions resulting in deferral elections or accelerations of payments under the nonqualified plan. Id. One of the requirements
for the latter rule to apply is that the action or inaction not result in (i) an increase or decrease in
the amounts deferred as elective contributions under the nonqualified plan in excess of the
Section 402(g) limit for the year in which the action or inaction occurs, or (ii) an increase or
decrease in the matching or other contingent contributions under the nonqualified plan in excess
of the Section 402(g) limit for that year. Various aspects of these rules are unclear:

- It is unclear whether the Section 402(g) dollar limit for elective contributions in Prop.
  Reg. § 1.409A-2(a)(8)(iii) and the Section 402(g) dollar limit for matching and other
  contingent contributions in Prop. Reg. § 1.409A-2(a)(8)(iv) are separate, additive limits
  or a single, coordinated limit. The same uncertainty exists for the Section 402(g) dollar
  limits in Prop. Reg. §§ 1.409A-3(h)(3)(iii) and (iv).

- It is unclear whether, for this purpose, the Section 402(g) dollar limit is increased by the
dollar limit on catch-up contributions under Section 414(v) for service providers age 50
or older.

- It is unclear whether the fact that a service provider, typically, can get or keep his benefit
under the nonqualified plan only if he elects to contribute the maximum amount
permitted under the qualified plan means that all of his elective, matching and other
contributions under the nonqualified plan, and not just the amount that could be provided
under the qualified plan consistent with the qualified plan limits, must be counted against
the Section 402(g) dollar limits in Prop. Reg. §§ 1.409A-2(a)(8)(iii) and (iv). The same
uncertainty exists for the Section 402(g) dollar limits in Prop. Reg. §§ 1.409A-3(h)(3)(iii)
and (iv).

- Prop. Reg. §§ 1.409A-2(a)(8)(iii) and (iv) do not appear to be needed at all if both the
deferral election under the nonqualified plan and the deferral election under the qualified
plan are made before the beginning of the year in which the services are provided and are
irrevocable. Conversely, if Prop. Reg. §§ 1.409A-2(a)(8)(iii) and (iv) apply and are
available, there appears to be no need for the service provider to make an irrevocable
election to participate in the nonqualified plan before the beginning of the year (because
Prop. Reg. §§ 1.409A-2(a)(8)(iii) and (iv) are exceptions from the general requirements
of Prop. Reg. § 1.409A-2). However, neither the Proposed Regulations nor the Preamble
says this explicitly. The same uncertainty exists for Prop. Reg. §§ 1.409A-3(h)(3)(iii)
and (iv).

B. **Recommendations**

We recommend that:

1. An exception be added to the contingent benefit rule in Prop. Reg. § 1.403(b)-
5(b)(2) (2004) that is similar to the exception in Reg. § 1.401(k)-1(e)(6)(iii) for participants who
have made the maximum elective deferrals under Section 402(g) or the maximum elective
contributions permitted under the terms of the annuity.
2. The linked plan rules in Prop. Reg. §§ 1.409A-2(a)(8)(iii) and (iv) and 1.409A-3(h)(3)(iii) and (iv), as finalized, be revised to eliminate the imposition of the Section 402(g) limits on matching (and other contingent) contributions.

3. The linked plan rules in Prop. Reg. §§ 1.409A-2(a)(8)(iii) and (iv) and 1.409A-3(h)(3)(iii) and (iv), as finalized, be revised to make it clear:
   a. that the Section 402(g) dollar limits imposed on elective contributions on the one hand and (if it is not eliminated) on matching and other contingent contributions on the other hand are separate, additive limits and not single, coordinated limits.
   b. that the Section 402(g) dollar limits are increased by the limit on catch-up contributions under Section 414(v) for service providers age 50 or older.
   c. that the Section 402(g) dollar limits are not applied to all of the service provider’s benefit under a linked nonqualified plan merely because he can get or keep that benefit only if he elects to contribute the maximum amount permitted under the linked qualified plan.

4. The Regulations, as finalized, make it clear that the linked plan rules in Prop. Reg. §§ 1.409A-2(a)(8)(iii) and (iv) and 1.409A-3(h)(3)(iii) and (iv) are not applicable if both the deferral election under the nonqualified plan (including the pour-over election in the case of a wrap-type plan) and the deferral election under the qualified plan are made before the beginning of the year in which the services are provided and the elections are irrevocable, and that if Prop. Reg. §§ 1.409A-2(a)(8) and 1.409A-3(h)(3), as finalized, apply, the deferral election under the nonqualified plan need not be made before the beginning of the year or be irrevocable, and in the case of a wrap-type plan, the pour-over date need not be a specified date.

C. Explanation

 Recommendation 1:

Unless an exception is added to the contingent benefit rule in Prop. Reg. § 1.403(b)-5(b)(2) (2004) that is similar to the exception in Reg. § 1.401(k)-1(e)(6)(iii), it will be impossible to link a nonelective plan with a section 403(b) annuity, an arrangement that the linked plan rules in Prop. Reg. §§ 1.409A-2(a)(8) and 1.409A-3(h)(3), which define a qualified plan to include a section 403(b) annuity, appear to contemplate.

 Recommendation 2:

There is no real need to impose a Section 402(g) limit on matching contributions in Prop. Reg. §§ 1.409A-2(a)(8)(iv) and 1.409A-3(h)(3)(iv). The Preamble concedes that this will—and presumably was intended to—interfere with linkage arrangements involving qualified plans with rates of matching contribution over 100%. Such plans provide strong incentives for employees to save, and tend to be especially beneficial to younger and lower-wage employees. The Proposed Regulations would discourage employers from adopting or retaining these
recommendation 3:

a. Make it clear that the Section 402(g) dollar limits imposed on elective contributions on the one hand and (unless eliminated) on matching and other contingent contributions on the other hand, which appear in both Prop. Reg. § 1.409A-2(a)(8) and Prop. Reg. § 1.409A-3(h)(3), are intended to be separate, additive limits and not single, coordinated limits. The statement in the Preamble that the limit on matching and other contingent contributions will affect only qualified plans with rates of matching contribution over 100% strongly suggests that is what was intended. However, the Proposed Regulations do not state this expressly, and Prop. Reg. § 1.409A-2(b)(6), Example 12, does not provide any clarification because it (apparently) involves only elective contributions.

b. We believe that the Section 402(g) dollar limits in Prop. Reg. §§ 1.409A-2(a)(8)(iv) and 1.409A-3(h)(3)(iv) are intended to be increased by the limit on catch-up contributions under Section 414(v) for service providers age 50 or older. Any other result would make it difficult to create linkage arrangements involving qualified plans that permit catch-up contributions. However, the Proposed Regulations do not state this expressly, and we ask the Service to revise them to do so.

c. We believe that the Section 402(g) dollar limits in Prop. Reg. §§ 1.409A-2(a)(8)(iii) and (iv) and 1.409A-3(h)(3)(iii) and (iv) are not intended to apply to all of the service provider’s benefit under a linked nonqualified plan merely because the provider can get or keep that benefit only if he or she elects to contribute the maximum amount permitted under the linked qualified plan. However, the Proposed Regulations do not state this expressly, and we ask the Service to revise them to do so.

Consider a wrap-type plan like the one described in PLR 9530038. Assume that the qualified plan allows elective contributions up to 15% of Section 401(a)(17) compensation, but not in excess of the Section 402(g) limit, matches those elective contributions at 100%, and limits all contributions to the maximum permitted under Section 415(c). A service provider may not participate in the nonqualified plan unless he elects to contribute the maximum amount permitted to the qualified plan, and after the end of the year when all of the nondiscrimination and other tests have been performed, his elective contributions under the nonqualified plan and associated matching contributions are reduced by that amount and contributed to the qualified plan. The amount of elective contributions that shifts from the nonqualified plan to the qualified plan cannot exceed the Section 402(g) limit. The same is true of the amount of matching contributions that shifts from the nonqualified plan to the qualified plan. However, depending on the level of the service provider’s compensation, the amounts of elective contributions and
matching contributions, respectively, that remain in the wrap could each easily exceed the Section 402(g) limit. Those amounts are, in a sense, dependent on the service-provider’s election under the qualified plan in that they would not be allowed but for the service provider’s election to contribute the maximum amount permitted to the qualified plan. However, we assume that the Service did not intend to impose Section 402(g) dollar limits on them. That seems reasonably clear from the wording of Prop. Reg. § 1.409A-2(b)(6), Example 12, which focuses on the amount of elective contributions that shifts to the qualified plan and does not appear to place any limit on the amount remaining behind. However, the Proposed Regulations do not state this expressly, and we ask the Service to revise them to do so, perhaps by including a statement to that effect in Example 12.

We also recommend that the same principle apply to excess-type plans. Consider an excess-type plan that requires the service provider to elect before the beginning of the year to make elective contributions to the nonqualified plan equal to some dollar amount or percentage of compensation, reduced by the provider’s elective contributions to the qualified plan, and provides that he or she may not make any elective contributions to the nonqualified plan (or get any associated matching contributions) unless he or she makes the maximum elective contributions permitted under the qualified plan. Suppose the employer takes the approach of waiting until the date during the year when the service provider has, in fact, made the maximum elective contributions permitted under the qualified plan to allow the service provider to begin participating in the nonqualified plan. The effect is virtually the same as it would be if a wrap-type plan was involved, and we assume that, as in the case of a wrap-type plan, the only benefits that would be subject to the Section 402(g) limits in Prop. Reg. §§ 1.409A-2(a)(8)(iii) and (iv) and 1.409A-3(h)(3)(iii) and (iv) would be the elective and matching contributions under the qualified plan that are “carved out” under the excess-type plan formula. However, we request an express statement to this effect, perhaps in the form of another example dealing specifically with excess-type plans.

Recommendation 4:

The linked plan rules in Prop. Reg. §§ 1.409A-2(a)(8)(iii) and (iv) do not appear to be necessary if both the deferral election under the nonqualified plan and the deferral election under the qualified plan are made before the beginning of the year in which the services are provided and the elections are irrevocable. In that case, the general requirements of Prop. Reg. § 1.409A-2 will have been satisfied. However, practitioners are concerned that the mere fact that the actual date when participation in an excess-type plan will begin might depend on how quickly the employee reaches the maximum limit under the qualified plan, which could vary depending on what percentage of his or her pay the employee has elected to contribute to the qualified plan, the amount of pay he or she receives during the early part of the year, and the way the service recipient applies the Section 401(a)(17) limit to his compensation, is a basis for determining that the employee has not made the kind of advance election required by Section 409A. Similarly, the linked plan rules Prop. Reg. §§ 1.409A-3(h)(3)(iii) and (iv) do not appear to be necessary if the general conditions of Prop. Reg. § 1.409A-2 are satisfied and, in the case of a wrap-type plan, the pour-over election is also made in advance and is irrevocable, or, in the case of an excess-type plan, the rule requiring contributions to be returned or forfeited if the service provider fails.
to contribute the maximum permitted amount to the qualified plan (e.g., because he quits) is hard-wired into the nonqualified plan.

It also appears that, if Prop. Reg. §§ 1.409A-2(a)(8)(iii) and (iv) apply, it is not necessary for the employee to have made an irrevocable election to participate in the linked nonqualified plan before the beginning of the year, because those rules provide exceptions from the general requirements of Prop. Reg. § 1.409A-2. Similarly, if Prop. Reg. §§ 1.409A-3(h)(3)(iii) and (iv) apply, it appears that in the case of a wrap-type plan, the date of the pour-over may be whatever date the nondiscrimination and other tests are finalized, and need not be a specified date. We request that the Service confirm all of these conclusions.

VI. Separation Pay

A. Background

In general, the Proposed Regulations provide that (with certain exceptions) separation pay arrangements may provide for the deferral of compensation. See Prop. Reg. § 1.409A-1(a)(9)(i). One of the exceptions is for separation pay provided upon an actual involuntary separation from service (provided certain limits as to the timing and amount are met). See Prop. Reg. § 1.409A-1(a)(9)(iii). Participation in a window program is treated the same as involuntary separation for this purpose. Id. The Proposed Regulations also provide that, where an exception is not applicable, the initial deferral election for separation pay due to an actual involuntary separation from service may be made until the time that the service provider obtains a legally binding right to the payment, if the severance pay is the subject of bona fide, arms length negotiations. See Prop. Reg. § 1.409A-2(a)(9). While the Proposed Regulations do not contain a definition of what is involuntary, both Service and Department of Treasury representatives have informally stated the term is to be narrowly applied and will not include resignations for “good reason” or “good cause,” sometimes referred to as “constructive discharge” terminations. Similarly, the Proposed Regulations provide that the initial deferral election for separation pay due to a window program may be made up until the time the election to participate in the program is irrevocable. Id.

B. Recommendation

We recommend that the special initial deferral election rule in Prop. Reg. § 1.409A-1(a)(9)(iii), as finalized, for separation pay due to involuntary separation be expanded to apply to any situation in which the service provider’s employment is terminated pursuant to a bona fide, legally binding settlement agreement addressing substantial contractual or other existing rights, and the special initial deferral election rule for separation pay due to a window program be revised to clarify that it will apply to arrangements that cover only one person.

C. Explanation

The special initial deferral election rule for separation pay was created in response to a concern that, “[w]here the separation pay arrangement involves an agreement negotiated with a
specific service provider at the time of the involuntary separation from service,” it can be
difficult or impossible for “deferral elections [to] be provided that would meet the requirement
that the election be made in the year before the year in which the services were performed.” See
70 Fed. Reg. at 57940. The Service recognized that the same concern exists for separation pay
provided under a window program, even if participation is voluntary, presumably because, as in
the case of an involuntary termination, the service provider has little or no advance knowledge of
or control over the timing of the separation, and the final terms are frequently negotiated at the
time of the separation rather than being set in advance, making it difficult or impossible to make
a timely deferral election.

A voluntary, heavily negotiated termination of a single individual raises the same
concerns as an involuntary, heavily negotiated termination or a window program covering large
numbers of individuals. In all of these situations, it is the service provider’s lack of control over
the timing and the substance of the terms that makes it unfair—indeed, pointless—to require a
deferral election to be made far in advance of the termination date. We agree with the Service
that separation pay the terms of which are fixed in advance and which is payable upon voluntary
and involuntary separation resembles traditional nonqualified deferred compensation. However,
the analogy breaks down when the terms and/or timing are uncertain. Arm’s length negotiation
over the terms indicates that there are substantial rights and potential liabilities for both parties
that must be identified and resolved, akin to what happens in resolving disputed payments (for
which a separate exception is provided, see Prop. Reg. § 1.409A-3(e)). Requiring the parties to
label the termination “involuntary” does not result in better targeting of the special rule. In fact,
such targeting might be less accurate because in our experience the most heavily-negotiated
agreements, where the terms are most difficult to know in advance, are often the least likely to be
labeled “involuntary,” whereas terminations resulting from serious deficiencies on the part of the
service provider are less likely to be negotiated and more likely to result in nondiscretionary
payments under a preexisting plan. Likewise, there are situations where the service provider is
offered the opportunity to quit rather than being fired by the service recipient. While this
termination is technically "voluntary," it is in fact an involuntary termination. Requiring a
service recipient in this situation to chose to be fired in order to come within the exclusion for
payments on involuntary separation places an unfair and unnecessary burden on the individual
and does not serve a beneficial tax policy.

Similarly, when the service recipient makes an offer to provide a specific kind of
separation pay for a specific period of time—even if to only one individual—this indicates that
the terms and timing were not known to the individual in advance and he or she had no basis for
making an advance deferral election. In fact, the portion of the special initial deferral election
rule dealing with window programs could, even now, easily be interpreted to apply to
arrangements involving a single individual. Accordingly, we recommend the Regulations, as
finalized, be revised to clarify that the special initial deferral election rule for separation pay due
to a window program will apply to arrangements that cover only one person.
VII. Commissions

A. Background

In general, the Proposed Regulations provide that, if certain requirements are met, the initial deferral rule may be applied to commissions based on the year in which payment is made, and not the year in which the related services are first provided. See Prop. Reg. § 1.409A-2(a)(10). However, this special election rule cannot be used for commission payments made by a customer that is “related” to either the service provider or recipient. See id. (incorporating the “related person” and “management services” definitions in Prop. Reg. §§ 1.409A-1(f)(3)(ii) and (iv)).

B. Recommendation

We recommend that the Regulations, as finalized, be modified to provide that the special rule for commissions in Prop. Reg. § 1.409A-2(a)(10) be applied to commissions paid by “related” persons if the commissions have paid in a bona fide, arm’s length business transactions entered into in the ordinary course of business.

C. Explanation

While there is no explanation as to why the special rule only applies to unrelated customer commissions, presumably the concern here is that related customer commissions could be the subject of manipulation and abuse. While it is possible that abuse could occur in some circumstances, the service recipient or provider is often unaware that a customer is a related party of the other (or, if they are aware that it is, has no reason to believe that the customer relationship is not bona fide). In these circumstances, application of the proposed rule would effectively be a trap for the unwary. Therefore, related party commissions should not be excluded in all circumstances.

As a possible condition, the focus could be on whether (i) the service provider’s relationship with the customer is bona fide and arm’s length and (ii) the commissions were earned and paid in the ordinary course of the service recipient’s business. This standard should be easier for all to apply and police than the “related person” rule. At the same time, it is a fair and reasonable standard that is more closely aligned with business realities and, at the same time, should not easily be subject to manipulation.