June 15, 2006

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

Re:   Comments on Code Section 409A Proposed Regulations Regarding Distribution Issues

Dear Commissioner Everson:

Enclosed are comments under Internal Revenue Code Section 409A Proposed Regulations concerning Distribution Issues. 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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COMMENTS ON CODE SECTION 409A PROPOSED
REGULATIONS REGARDING DISTRIBUTION ISSUES

The following comments ("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.

These Comments were prepared by individual members of the Employee Benefits Committee of the Section of Taxation. Principal responsibility for preparing these Comments was exercised by David Mustone and Kurt L. P. Lawson. The Comments were reviewed by James R. Raborn, Chair of the Section’s Employee Benefits Committee. The Comments were further reviewed by the Quality Assurance Group of the Employee Benefits Committee, by Bruce D. Pingree of the Section’s Committee on Government Submissions and by Priscilla E. Ryan, Council Director-Elect 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 tax rules 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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June 8, 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 Proposed Treasury Regulation § 1.409A-1 et seq. (the “Proposed Regulations”) issued under Section 409A of the Internal Revenue Code of 1986, as amended (the “Code”). These Comments address certain aspects of the Proposed Regulations concerning distributions under the new deferred compensation rules. These Comments are in addition to, and revise, our earlier comments submitted on distribution restrictions on April 15, 2006.

We recommend that:

1. The regulations under Section 409A, as finalized (the “Regulations”), give service recipients greater flexibility to provide for alternative payment schedules for different types of separations from service, where the alternative schedules are (a) objectively identifiable and (b) based on legitimate, bona fide distinctions (such as voluntary and involuntary terminations).

2. The Regulations:
   a. Provide that an employee on a leave of absence of more than six months will not be treated as having terminated employment (even if there is no contractual or statutory right of re-employment) where there is a reasonable, bona fide expectation that the employee will return to work for the employer once the leave ends; and
   b. Either (i) eliminate the rule that in order for an employee to be considered to have separated from service, the employee must not continue to provide services to his or her former employer at a rate of remuneration in excess of 50% of his or her average remuneration as an employee over the previous three years, or (ii) make such a rule a safe harbor.

3. The Regulations provide that a plan provision providing for post-termination reimbursement of taxable expenses be treated as constituting a “nondiscretionary formula” where the amount payable is (a) conditioned upon events or determinations that are not effectively under the control of the service provider and (b) payable within the two and one-half months after the year in which all conditions have been satisfied.

1 All references to “Section” herein shall be references to sections of the Code unless stated otherwise.
2 The Section’s prior comments are available at the ABA website at http://www.abanet.org/tax/pubpolicy/2005/050415eb1.pdf.
4. The Regulations:

a. Expand the exception for distributions upon termination to include terminations made on account of any significant, bona fide, business-driven change in corporate structure or business operations (and not just on account of the service recipient’s dissolution or a change in control), unless (under all the facts and circumstances) the sole reason for terminating the plan was to accelerate distribution;

b. Limit the requirement under the transaction-related termination rules that all “substantially similar arrangements” be terminated to similarly situated service providers; and

c. Replace the five-year prohibition on establishing a replacement plan for discretionary terminations with a requirement that the service recipient not intend to establish a replacement plan at the time of termination.

5. The Regulations provide that an IPO is a separate, permissible acceleration or payment event under the authority of Sections 409A(a)(3) and 409A(e).

6. The Regulations provide that:

a. An impermissible payout provision in the written documents may constitute a form violation for only those service providers to whom the impermissible distribution is available under the terms of the arrangement; and

b. A general catch-all provision requiring that the plan be applied in accordance with Section 409A overrides any impermissible distribution provisions in the plan documents for purposes of complying in form.
BACKGROUND

On December 20, 2004, the U.S. Treasury Department (the “Treasury”) and the Service issued Notice 2005-1, 2005-2 I.R.B. 274 (Jan 10, 2005) (“Notice 2005-1”). Notice 2005-1 did not provide guidance on distribution timing, but did address specific topics such as the definition of change in control and circumstances in which accelerated distributions are permissible. The Proposed Regulations largely retain the substantive provisions of Notice 2005-1, but are more detailed and make some important changes. We commend the Treasury and the Service for the significant amount of thought and effort that was devoted to the development of the distribution rules. These Comments address some (but not all) aspects of the Proposed Regulations pertaining to the distribution rules that warrant clarification or refinement.

COMMENTS

I. Alternative Payment Schedules Upon Separation From Service

A. Summary

In general, the Proposed Regulations require a distribution on account of disability, death, separation from service, unforeseeable emergency or change in control to be made as of an objectively determinable date (or year) or pursuant to an objectively determinable schedule (collectively, “payment schedules”). See Prop. Reg. § 1.409A-3(b). The Proposed Regulations also generally allow only one such payment schedule to be specified for each distribution event. See id. However, the Proposed Regulations permit a plan to provide for one alternative payment schedule per event, provided that the application of the two schedules turns on whether the distribution event occurs before or after a specified date. See id. The example given in the Proposed Regulations for this is a plan that provides for a lump sum payment on separation from service before age 55 and installment payments on separation from service at or after age 55.

B. Recommendation

We recommend that the Regulations give service recipients greater flexibility to provide for alternative payment schedules for different types of separations from service, where the alternative schedules are (a) objectively identifiable and (b) based on legitimate, bona fide distinctions (such as voluntary and involuntary terminations).

C. Explanation

Section 409A limits the circumstances in which a distribution is permissible, and the legislative history generally requires that the timing of distributions be set at the time of the deferral.3 In implementing these rules, the Proposed Regulations permit distribution to be made at either the earliest or the latest of two or more permissible

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distribution events. See Prop. Reg. § 1.409A-3(b). The Proposed Regulations also permit a different payment schedule to be established for each distribution event. See id. For example, they allow a plan to provide for a lump sum distribution upon death and installment payments on other termination of employment.

Permitting different payment schedules depending on the circumstances of separation from service would not represent a material departure from what is currently permitted under the Proposed Regulations, nor from Section 409A’s intended purpose, where the schedules are objectively identifiable and based on legitimate, bona fide distinctions. With those safeguards in place, the service provider would not be able to manipulate the timing of the payment. At the same time, providing this additional flexibility would be beneficial to service recipients, as it is common practice to provide for different payment schedules based on the circumstances under which a service provider terminates employment. For example, it is common for a service recipient to provide for one form of payment upon involuntary termination (or termination following a change in control) and another form to those who voluntarily depart. Similarly, it is common for a service recipient to provide for a default payment schedule for a provider who leaves before retirement (as defined in the plan), but allow the provider to elect a specific payment schedule that would apply at retirement. Whether a distinction is legitimate and bona fide would be determined based on the facts and circumstances at the time the various payment schedules are put in place. A legitimate distinction would have to have to be based on objective business criteria. A bona fide distinction would have to have substantial non-tax significance for the service provider and the service recipient, such as one based on voluntary vs. involuntary termination, but not one based on the day of the week (or month of the year) in which termination occurs.

In sum, permitting service recipients to put into place alternative payment schedules for different types of separations from service—where those schedules are objectively identifiable and based on legitimate, bona fide distinctions—will not undercut the basic policies underlying Section 409A, but will allow service recipients to continue the common practice of providing different forms of payment for different types of terminations.

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4 Similar considerations also apply to other permissible payment events. For example, many plans provide for one form of death benefit payments for participants who die before beginning payout (e.g., in a single lump sum) and another form for participants who die after payout has begun (e.g., in the form in effect at death).

5 Plans do not always define retirement as separation from service after a certain age, so the limited relief provide in the Proposed Regulations would not cover all such situations. For example, some plans define retirement as including involuntary departures due to specified events (such as a reduction in force or a change in control).
II. Separation From Service

A. Summary

The Proposed Regulations address in some detail what constitutes a separation from service for an employee. See Proposed Regulation § 1.409A-1(h). Among other things, the Proposed Regulations provide that employment is considered to continue during a leave of absence, except where the leave exceeds six months, in which case employment is deemed to terminate (unless re-employment is guaranteed by statute or contract). See Proposed Regulation § 1.409A-1(h)(1)(i).

In addition, the Proposed Regulations generally provide that the determination as to whether a termination has occurred is to be based on the facts and circumstances. See Proposed Regulation § 1.409A-1(h)(1)(ii). However, the Proposed Regulations also provide special rules for (i) employees who continue to provide services (as an employee) on a reduced basis and (ii) employees who continue to provide services other than as an employee after termination. See id.

In the former situation, the Proposed Regulations provide that if the facts and circumstances show that the employer and employee did not intend for the employee to provide more than “insignificant services,” the employee will be treated as having separated from service. Id. For this purpose, the Proposed Regulations establish a “safe harbor” rule under which the employer and employee will not be treated as having intended that the employee would only be providing “insignificant services” where (i) the employee continues to provide services at a rate of no less than 20% of the average rate of services provided during the three previous calendar years, and (ii) the remuneration the employee receives for the services is at least 20% of the employee’s average annual remuneration over such three-year period (the “20% safe harbor”). See id.

In the latter situation, the Proposed Regulations establish a “bright line” rule under which the employee will not be treated as having separated from service if (i) the employee is providing services at an annual rate of 50% of the average rate of services the employee provided during the previous three calendar years, and (ii) the remuneration for such services is at least 50% of the employee’s average remuneration over that three-year period (the “50% deemed employee rule”). See Prop. Reg. § 1.409A-1(h)(i).

B. Recommendation

We recommend that the Regulations:

1. Provide that an employee on a leave of absence of more than six months will not be treated as having terminated employment (even if there is no contractual or statutory right of re-employment) where there is a reasonable, bona fide expectation that the employee will return to work for the employer once the leave ends; and
2. Either (a) eliminate the rule that in order for an employee to be considered to have separated from service, the employee must not continue to provide services to his or her former employer at a rate of remuneration in excess of 50% of his or her average remuneration as an employee over the previous three years, or (b) make such a rule a safe harbor.

C. **Explanation**

*Recommendation 1:*

Under the Proposed Regulations, employment continues during a leave of absence, but only for six months, unless there is a statutory or contractual right of re-employment. In practice, there are numerous situations involving bona fide leaves of absence that would not fit under these rules, but which typically are *not* treated by employers as resulting in a separation from service. While these arrangements do not ordinarily give rise to contractual rights, they do give rise to bona fide, reasonable expectations of re-employment.

For example, an employer may ask an employee to take an assignment at an entity that is related, but not in the same controlled group, of the employer (such as a joint venture or a foreign affiliate). It is not unusual in these circumstances for the assigned individual to become an employee of the affiliated entity, and be placed on a “leave of absence” or similar status with the initial employer. While there is usually an understanding that the employee will return upon completion of the assignment, the employee will ordinarily have no contractual or statutory right to do so.

Other situations in which extended leaves of absence are commonly allowed include extended maternity leave, absences while on long-term disability, and approved absences to accommodate the pursuance of a degree or to allow the employee to accompany a spouse on a temporary assignment. In these situations (and others in which a legitimate leave of absence may be granted), there is generally a reasonable, bona fide expectation that the employee will return, even though there is no contractual or statutory right of re-employment.

Extended leaves of absence of this kind are taken into account for a similar purpose under Treasury Regulation § 1.401(a)(4)-11(d)(3)(iv)(A). That section allows service to be credited under a tax-qualified retirement plan unless an individual has “permanently ceased to perform services as an employee.” As under the Proposed Regulations, whether this has occurred is determined taking into account all of the relevant facts and circumstances. However, the Section 401(a)(4) regulations also provide that:

There is a rebuttable presumption for a period of up to two years that an individual who has ceased to perform services as an employee for an employer is nonetheless expected to resume performing services as an employee for the employer, if the employer continues to treat the individual as an employee for significant purposes unrelated to the plan.
After two years, there is a rebuttable presumption that an individual who has ceased to perform services as an employee for the employer is not expected to resume performing services as an employee for the employer. The fact that an individual is absent to perform jury duty or military service automatically rebuts the latter presumption. Other evidence, such as the employer’s layoff policy, the terms of an employment contract, or specific leave to pursue a degree requiring more than two years of study, may also rebut this presumption. [emphasis supplied]

In sum, we recommend that the Regulations provide that a leave of absence in excess of six months will not result in a termination of employment, where the leave of absence is bona fide and there is a reasonable expectation that the employee will return to active employment. The determination of whether (and when) there is a later termination after such leaves of absence will be no more complicated than for a person on a leave of absence with a contractual or legal guarantee of re-employment, as the same process would be involved. In the alternative, should the potential for abuse be a concern, the rebuttable presumptions similar to those contained in the Section 401(a)(4) regulations described above could be incorporated in the Regulations to more tightly circumscribe the proposed rule.

Recommendation 2:

The 20% safe harbor rule provides helpful guidance in determining whether there has been a de facto separation from service when an employee’s work schedule is substantially reduced. The fact that it focuses solely on the amount of service provided after separation, and does not take into account other differences between the old and new services, is not a defect because the rule is only a safe harbor. However, the 50% deemed employee rule is mandatory, and, even with the service and compensation triggers set at 50%, there will be many times when it will prevent a separation from service from occurring even though the parties have every intention of terminating their old relationship and starting a new one.

It is not uncommon for an employee to continue to work for a former employer in a bona fide consulting or other independent contractor capacity after he terminates employment. It also is not uncommon for an employee to terminate employment with no expectation of returning to work, but for circumstances to change at a later time resulting in the former employee being hired as a consultant or independent contractor. Even if the parties expect at the outset that post-termination services and compensation will not exceed the 50% level, that assumption could easily change because bona fide consulting and independent contractor services are, by their nature, less predictable than services performed by an employee.

Thus, the application of a hard-and-fast rule would unfairly penalize many former employees who have entered into legitimate, arms-length consulting or other independent contractor arrangements with a former employer, or who might wish to do so in the future. To avoid this result, we recommend that the 50% rule be eliminated, or changed.
to a presumption more like the 20% safe harbor rule, so that the ultimate determination of employee status will take into account all relevant facts and circumstances.

III. Objective Distribution Formula

A. Summary

The Proposed Regulations provide that amounts are considered payable at a specified time or pursuant to a fixed schedule if “objectively determinable amounts are payable at a date or dates that are objectively determinable at the time the amount is deferred.” Prop. Reg. § 1.409A-3(g)(1). Under the Proposed Regulations, an amount is “objectively determinable” if it is identified or determined under a nondiscretionary formula. See id.

B. Recommendation

We recommend that the Regulations provide an exception to the nondiscretionary formula requirement for taxable in-kind benefits and expense reimbursements provided post-termination, where the amount payable is (a) conditioned upon events or determinations that are not effectively under the control of the service provider and (b) payable within the two and one-half months after the year in which all conditions have been satisfied.

C. Explanation

One of the primary purposes of Section 409A’s distribution rules is to restrict the ability of a service provider to control the timing of income by requiring that the time of a distribution be set on or before deferral. However, there are nonabusive arrangements where the scope of the deferral obligation is easily definable, but the exact dollar amount cannot be determined. This arises primarily in situations involving the post-termination provision of in-kind benefits to, or reimbursement of taxable expenses incurred by, a service provider. This would include, among other things, indemnification payments, tax gross-ups, payments and reimbursements of legal fees, taxable medical benefits,6 and taxable life and other insured benefits. We recommend that an exception to the nondiscretionary formula requirement be provided for those situations where the benefits or reimbursements are conditioned upon substantial events or determinations that are not effectively under the control of the service provider.

For example, a promise to indemnify and defend a terminated executive for any claim arising from his or her employment is subject to substantial conditions precedent over which the executive has no real control. The same is also true as to the reimbursement of taxable post-termination medical expenses since a service provider typically does not have any real control over when (and to what extent) he or she may

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6 To the extent post-termination medical expense reimbursements are taxable (by virtue of either Section 105(h) or 213), the promise to reimburse those expenses could constitute nonqualified deferred compensation.
need medical attention or services. By contrast, an open-ended promise to pay a service provider’s housing expenses over a specified period of time would not qualify as the service provider has the discretion to decide where to live and how long to live there and, therefore, effectively controls the amount.

We recommend that any benefits or reimbursements covered by this exception be required to be provided within two and one-half months after the year in which the underlying conditions have been met to ensure that the reimbursements or benefits will be promptly provided. This will minimize the potential for excessive delays in payment or other possible abuse.

IV. Plan Terminations

A. Summary

The Proposed Regulations generally provide that the anti-acceleration rule is not violated when distribution is made upon plan termination (i) due to the service recipient’s dissolution or change in control or (ii) where all plans of the same type are terminated. See Prop. Reg. § 1.409A-3(h)(2)(viii).

B. Recommendation

We recommend that the Regulations:

1. Expand the exception for distributions upon plan termination to include terminations made on account of any significant, bona fide, business-driven change in corporate structure or business operations (and not just on account of the service recipient’s dissolution or a change in control), unless (under all the facts and circumstances) the sole reason for terminating the plan was to accelerate distribution.

2. Limit the requirement under the transaction-related termination rules that all “substantially similar arrangements” be terminated to similarly situated service providers.

3. Replace the five-year prohibition on establishing a replacement plan for discretionary terminations with a requirement that the service recipient not intend to establish a replacement plan at the time of termination.

C. Explanation

Recommendation 1:

In general, the ability to modify or terminate nonqualified deferred compensation plans is important to service recipients for reasons independent of any income planning concerns or objectives of participating service providers. Service recipients establish nonqualified deferred compensation plans for a variety of reasons, and typically reserve
the right to modify or terminate these arrangements in the event legitimate business considerations or a bona fide change in circumstances warrant such actions. In these circumstances, the risk that plan terminations will function as a proxy for service provider-controlled distribution accelerations is minimal.

One example where legitimate business considerations outweigh any potential risk of service-provider-controlled accelerations is in the context of a significant business change, such as a reorganization or merger that is not a change in control of the parent company. While such an event may not constitute a change in control, the concerns are often the same from the service recipient’s perspective, i.e., what is the best business decision regarding its benefit programs and not how to accommodate a service provider’s desire for an accelerated payout. We recommend that the Regulations expand the exception for distributions upon termination to include terminations in response to any significant, business-driven change in corporate structure or business operations that affect the service recipient’s ability to maintain the plan or results in the plan no longer serving the business purposes for which it was adopted. Such events would be similar to the situations in which a tax-qualified plan is allowed to be terminated without violating the permanence requirement. See Treas. Reg. § 1.401-1(b)(2); Employee Plans Exam Handbook, Section 7.12.1 (Plan Terminations). However, carved out from our recommendation would be those situations where (looking at all the facts and circumstances) the sole reason for the termination was to accelerate payout.

Recommendation 2:

The exception for business transaction-related terminations requires that all “substantially similar arrangements” be terminated. See Prop. Reg. § 1.409A-3(h)(2)(viii)(B). The aim here is that the “participant in the arrangement and all participants under substantially similar arrangements” receive distributions at the same time. Id. We recommend that the rule be modified to apply to only those service providers who are similarly situated to the participant(s) in the arrangement that is to be terminated. This change would tie the rule more closely to underlying business transactions without becoming a proxy for service provider-controlled accelerations. For example, this would allow an acquirer to terminate the arrangements for employees of an acquired company without terminating any similar arrangements maintained for its original workforce.

Recommendation 3:

The Proposed Regulations provide that discretionary plan terminations are permissible only if “the service recipient does not adopt a new arrangement that would be aggregated with any terminated arrangement … if the same service provider participated in both arrangements, at any time within five years following the date of termination of the arrangement.” Prop. Reg. § 1.409A-3(h)(2)(viii)(C)(4). The apparent aim of this requirement is to ban what could be in effect an end-run around the rule prohibiting distribution accelerations. In comments submitted by the Tax Section on April 15, 2005
concerning Section 409A’s distribution restrictions⁷, we recommended that a plan sponsor should be permitted to make distributions upon a plan termination if, among other things, the plan sponsor does not establish a “substantially similar” program for three years. See id., at p. 16. Upon further reflection, we no longer believe that such a requirement is warranted in this context. For example, there is no potential for abuse if, within a few years after an employer terminated a nonqualified deferred compensation plan, the employer acquires an unrelated company with a nonqualified plan and decides to extend the acquired company’s nonqualified plan to its other executives, some of whom had participated in the terminated plan. The same is also true for an employer who adds a 3% “safe harbor” non-matching contribution to its 401(k) plan several years after it had terminated an elective nonqualified program and opts to establish a nonqualified plan to which a corresponding 3% credit is to be made for executives with compensation in excess of the Section 401(a)(17) limit. These are only two examples of situations where an employer would plainly not be attempting to make an end-run around the prohibition on accelerating distributions, as there are numerous situations in which a bona fide, unanticipated change in circumstances could occur within a short period of time after plan termination.

Thus, we recommend that the five-year rule be replaced with a requirement (similar to the rule contained in Prop. Reg. § 1.409A-1(h)(1)(ii), as described in Part II of this Comment) that at the time of termination, the service recipient does not intend to establish a replacement plan. At the same time, to minimize the potential for abuse, it may be appropriate to include a rebuttable presumption that the service recipient intended to adopt a replacement arrangement at the time of the termination if a similar arrangement for the same service provider(s) is adopted during a specified period following termination. In this regard, we recommend that, in keeping with the Section 401(a)(4) regulations discussed above, twenty-four months would be an appropriate period to apply the rebuttable presumption. This presumption could, of course, be rebutted by a showing of a substantial, bona fide change in circumstances which led to the adoption of the new arrangement.

VI. Initial Public Offerings as Distribution Events

A. Summary

An initial public offering (“IPO”) is not a separate distribution event under Section 409A. At the same time, it will not necessarily constitute a “change in control” for distribution purposes under the Proposed Regulations unless sufficient stock is offered and sold to the public to meet the requirements under Proposed Regulation § 1.409A-3(g)(5)(v).

B. **Recommendation**

We recommend that the Regulations be revised to provide that an IPO is a separate, permissible acceleration or payment event under the authority of Sections 409A(a)(3) and 409A(e).

C. **Explanation**

In general, an IPO is a significant event for any entity. It is (i) similar in many respects to a change in control (to the extent it does not otherwise result in such), (ii) objectively determinable and (iii) not something that service providers can use to manipulate the timing of payout. At the same time, private companies have historically used equity-based incentive grants to align the interests of service providers with those of the shareholders and to recruit and retain key talent. Further, IPOs typically serve as a “liquidity event” for service providers, as an IPO is often one of the exit events in which a service recipient’s equity-based incentive grants can be cashed in by its employees and other service providers.

While an IPO will not always fall within the definition of change in control (and, therefore, may not separately qualify as a permissible distribution event on that basis), Section 409A(a)(3) gives the Secretary the authority to designate (by regulation) permissible acceleration events. The Conference Report provides that such exceptions can include situations that are beyond the control of the participant. In addition, Section 409A(e) gives the Secretary general authority to issue necessary regulations. Because of (i) the significant time, effort and expense involved in going public and (ii) the consequences of becoming a public company, it is highly unlikely that an IPO would be used as a means for controlling the timing of payout of nonqualified deferred compensation. In short, an IPO is a legitimate exit strategy for equity-based grants which is effectively beyond the control of service providers. We recommend, therefore, that IPOs be treated as a separate acceleration or payment event under the Regulations.

VII. **Plan Document Failures**

A. **Summary**

The Proposed Regulations provide that to comply with Section 409A, the arrangement must comply in both form and operation. See Prop. Reg. § 1.409A-1(c)(3)(i).

B. **Recommendation**

We recommend that the Regulations provide that:

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8 The Conference Report provides that “[i]t is intended that the Secretary will provide other, limited, exceptions to the prohibition on accelerated distributions, such as when the accelerated distribution is required for reasons beyond the control of the participant and the distribution is not elective.” H.R Conf. Rep. 108-755, at 731.
1. An impermissible payout provision in the written documents may constitute a form violation for only those service providers to whom the impermissible distribution provision is available under the terms of the arrangement; and

2. A general catch-all provision requiring that the plan be applied in accordance with Section 409A overrides any impermissible distribution provisions in the plan documents for purposes of complying in form.

C. Explanation

Recommendation 1:

There are a multitude of arrangements governed by Section 409A, many of which will apply to more than one person. In many multi-person arrangements, there are provisions that apply to some, but not all participants (such as a provision that applies only to service providers in a certain division or who are eligible for retirement). By defining a “plan” as any arrangement that applies to one person, the Proposed Regulations effectively require that the Section 409A rules be applied on a participant-by-participant basis. See Prop. Reg. § 1.409A-1(c)(3)(i). It logically follows that only the written terms of the arrangement that apply to an individual are relevant in determining whether the arrangement complies in form as to that individual. This appears to be in keeping with the preamble to the Proposed Regulations (the “Preamble”), which provides that (i) “the terms of the arrangement with respect to each participant must be determined, based upon the rights the individual participant has under the plan” and (ii) such rights “will be determined based upon the written provisions applicable under a particular arrangement.” 70 Fed Reg., at 57942. Accordingly, we recommend that the Regulations clarify that in applying the form requirements for any “plan,” only those distribution provisions available to the individual involved be taken into account.

Recommendation 2:

It has already become common practice to include (as a precautionary matter) in the written terms of covered (or potentially covered) arrangements a general catch-all provision that is intended to override any potentially defective provisions by requiring that the program be interpreted and applied consistent with Section 409A. Where such a catch-all provision is present, the service recipient is, as matter of plan interpretation, precluded from following any defective distribution provisions. At the same time, giving effect to such a catch-all will not preclude the Service from disregarding such a provision and finding a form violation in appropriate circumstances. As pointed out in the Preamble, the Service may treat a service recipient’s repeated failure to follow plan terms as a separate form violation. See 70 Fed. Reg., at 57942. It may also be appropriate to do so for a plan that is rife with noncompliant provisions.
CONCLUSION

The foregoing recommendations are intended to facilitate compliance with the distribution and related rules in a fair and balanced way that reasonably reflects ongoing business realities without undermining the government’s legitimate compliance concerns.