July 5, 2006

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

Re: Definition of a Plan under Proposed Treasury Regulations under Section 409A

Dear Commissioner Everson:

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

Sincerely,

Dennis B. Drapkin
Chair, Section of Taxation

Enclosure

cc: Donald L. Korb, Chief Counsel, Internal Revenue Service
    Eric Solomon, Acting Deputy Assistant Secretary (Tax Policy), Treasury
    Michael J. Desmond, Tax Legislative Counsel, Treasury
    Carol Gold, Internal Revenue Service, TEGE Employee Plans
    Nancy Marks, IRS Chief Counsel, CC: TEGE
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    Bill Bortz, Office of Benefits Tax Counsel, Department of Treasury
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COMMENTS CONCERNING DEFINITION OF A PLAN UNDER PROPOSED TREASURY REGULATIONS UNDER SECTION 409A

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, these Comments should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Greta E. Cowart and Tiffany E. Walker. These Comments were reviewed by James R. Raborn, Chair of the Section’s Employee Benefits Committee; by the Quality Assurance Group of the Employee Benefits Committee, which is chaired by Thomas R. Hoecker and whose members are former chairs of the Committee; by T. David Cowart 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 this comment have clients who will 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 government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of this comment.

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Date: June 27, 2006
EXECUTIVE SUMMARY

The following Comments are submitted in response to the request for comments made by the Internal Revenue Service (“Service”) in Notice of Proposed Rulemaking dated September 29, 2005 regarding Proposed Treasury Regulations § 1.409A-1 et. seq.¹ (the “Proposed Regulations”) issued under section 409A² of the Internal Revenue Code of 1986, as amended (the “Code”). These Comments address the definition of a “plan.” For the reasons described below, we believe that modifying the rules applicable to defining what constitutes a plan under final regulations or other guidance to be issued under Section 409A, as finalized (the “Regulations”) should focus on areas that show a potential for abuse.

We recommend the Regulations:

1. Allow in addition to the four categories shown in the Proposed Regulations, additional categories for the following categories of arrangements or plans:

   • The variety of post-employment benefits or payments that do not fit neatly in the account balance, non-account balance, separation pay or “other” categories should represent at least one additional category.

   • Non-U.S. plans should be treated separately from U.S. plans.

   • Other types of plans should be treated separately, as may be set forth in notices or other published authority of general application from time to time.

2. Address what we believe may be a typographical error in Proposed Regulations § 1.409A-6(a)(3)(v). We recommend that the Regulations, as finalized, change the reference in such section to “paragraph (a)(3)(i),” rather than “paragraph (a)(3)(ii).”

3. Provide that Proposed Regulations § 1.409A-6(a)(1) be clarified to state that a material modification to an individual arrangement will not result in amounts deferred under all plans of the same type as the modified plan (giving effect to plan aggregation rules) being subject to section 409A.


² All references to “section” herein shall be references to sections of the Code unless stated otherwise.
COMMENTS

1. **Definition of “Plan” for Purposes of Section 409A**

   **A. Proposal**

   For purposes of the application of the penalties for failure to comply with section 409A, in form or practice, the aggregation of arrangements that constitute a single plan should be refined beyond the four categories specified in Proposed Regulations § 1.409A-1(c). The presently identified categories could lead to inequitable results by requiring the grouping of arrangements with dissimilar characteristics and which are subject to different requirements under section 409A. If the arrangements have substantially different characteristics, they should be treated as separate plans and not aggregated for purposes of section 409A.

   **B. Recommendation**

   We recommend that the Regulations allow in addition to the four categories shown in the Proposed Regulations, additional categories for the following categories of arrangements or plans:

   - The variety of post-employment benefits or payments that do not fit neatly in the account balance, nonaccount balance, separation pay or “other” categories should represent at least one additional category.
   - Non-U.S. plans should be treated separately from U.S. plans.
   - Other types of plans should be treated separately, as may be set forth in notices or other published authority of general application from time to time.

   **C. Explanation**

   Proposed Regulations § 1.409A-1(c) groups “plans” into four separate categories (account balance, nonaccount balance, separation pay arrangements and all “other” deferred compensation arrangements, such as certain equity-based arrangements). Non-compliance for one plan would taint all plans in the same category for the individual and could result in significant taxation with associated penalties for all vested accounts under plans in the same broad category. The categories of plans were derived from the regulations relating to the timing of taxation for FICA purposes under section 3121(v). However, the section 3121(v) regulations cover only limited types of plans compared to the broad reach of section 409A. For example, section 3121(v) does not cover stock options, stock appreciation rights or restricted stock, nor does it cover reimbursement arrangements or certain post-employment benefit coverages. Merely borrowing the categories from the section 3121(v) regulations does not adequately address the many different types of arrangements subject to section 409A. We recommend the categories of plans be increased to reflect the fundamental differences between the purposes of the two statutes and their breadth.
We recognize that proper administration of section 409A requires that service providers and recipients be prevented from manipulating the documentation of deferred compensation arrangements and plans to avoid the statutory requirements and penalties by creating many ostensibly separate plans that are in fact substantively one plan (e.g., separate documents for separate tax years). To preclude avoidance, the Proposed Regulations aggregate, for most purposes, all plans in each of four broad categories: account balance, nonaccount balance, separation pay and other (largely equity-based arrangements but it is unclear what other arrangements may fall within this category).

The four broad categories set forth in the Proposed Regulations aggregate plans that can be dissimilar in meaningful and critical respects such as aggregating post-employment benefit continuations with stock options granted with an exercise price less than fair market value on the date of the grant. Post-employment health benefits do not permit the individual to manipulate the timing of benefits, but a stock option issued with a discounted strike price does permit control over the timing of recognition of income.

The definition of “plan” for purposes of section 409A(a)(1) should protect the integrity of the penalty structure but not extend the penalties beyond what is necessary for the purpose, which is to deter intentional violations by providing a meaningful downside (rather than just a loss of the benefits of deferral plus a 20% penalty) and to encourage employers to pay serious attention to the new requirements. As structured, the Proposed Regulations could produce unfair results, especially since the penalties are triggered by inadvertent as well as intentional violations.

The term “plan” as used in the phrase “under the plan” in section 409A(a)(1)(A)(i) should be construed to preclude the fragmenting of arrangements that are substantially similar in their essential characteristics (that is, that are a single plan in substance) into multiple plans in order to limit the scope of penalties. For example, an attempt to establish a purportedly “separate plan” for each year’s deferrals under an arrangement that does not materially differ from year to year should properly be disregarded, based on the traditional principle that substance rather than form should be determinative (and that subterfuges to frustrate statutory intent will not be tolerated).

We recommend that post-employment benefits, such as car or airplane use or allowances, financial counseling services, office space, club dues and other taxable post-retirement compensation or benefits considered to be deferred compensation under section 409A should be considered separately from conventional nonqualified deferred compensation arrangements and traditional severance or separation pay. Some of the rules designed for conventional plans, such as requiring that the time and form of payment be fixed at the date of deferral, do not readily fit the universe of post-employment benefits, especially where the individual may have no ability to control when the benefit is utilized.

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3 Section 409A(a)(1) imposes a 20% penalty, plus current income inclusion and possible retroactive interest at an enhanced rate on the resulting income tax liability, both on any noncompliant deferrals and on all other deferrals “under the plan.”

4 The likelihood that penalties designed to deter intentional violations will fall heavily on unintentional compliance failures should not be underestimated. Humans make errors and violations will occur because employees (or outside service providers) do not understand the rules or otherwise fail to carry out instructions intended to ensure compliance, or simply err in interpreting a statute of unanticipated complexity.
Classifying post-employment benefits where the service provider generally has no control over their payment or utilization, such as continued indemnification or health insurance coverage, as one type of plan does not foster or provide an opportunity for abuse. For example, health plans do not reimburse claim expenses on specified dates and participants generally do not manipulate or control when they use medical care. Individuals have little incentive to time their use of health care services, nor do they seek to become ill to just receive additional benefits. Taxable post-employment benefits should not be aggregated with traditional deferral arrangements. At a minimum, such post-employment benefits collectively should be viewed as a separate plan and not aggregated with equity compensation as “other benefits.” “Other benefits” is an overly broad and vague category which could potentially cover many totally unrelated types of plans solely because they do not fit within account balance or nonaccount balance categories. Post-employment benefits differ dramatically from equity compensation arrangements that constitute a deferred compensation plan or arrangement. For example, the continued use of an office may facilitate the former executive in obtaining a new position, but it does not in itself provide the opportunity for a financial gain in the same way as equity compensation. Continued health insurance coverage or an indemnification may protect an individual from a potential economic loss, but it does not provide the same opportunity for earning the type of economic gain as an equity award would provide.

If the Treasury and the Service agree that post-employment benefits are fundamentally different from account balance and nonaccount balance plans and that such benefits are not properly grouped together with equity arrangements, then consideration also should be given as to whether two categories of post-employment benefits are appropriate, based upon whether the individual has control over the utilization of the benefit. For example, continued indemnification might be separate from continued use of the corporate jet because a former employee would not have much control over when the need for indemnification arises, but he would have control over when he used the corporate jet.

Non-U.S. plans require special consideration because such plans may be locally qualified or nonqualified and subject to regulatory regimes that may have little or no relationship to U.S. requirements, and may be adopted and administered without any connection to, or knowledge of, applicable U.S. laws (including section 409A). While the potential impact of section 409A on all non-U.S. plans is not fully delineated, a U.S. taxpayer who participates in both U.S. and non-U.S. deferred compensation plans of a multinational company is at risk for having severe penalties applied because of the company’s non-U.S. plans’ non-compliance with section 409A. We recommend that non-U.S. plans not be aggregated with U.S. plans. For these purposes, the excluded “non-U.S. plans” could be defined as plans that are (i) maintained outside the U.S. primarily for the benefit of persons substantially all of whom are non-resident aliens, or (ii)

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6 For example, assume that a U.S. taxpayer who works for a period in the U.S. and accrues a deferred compensation balance under a U.S. account-based nonqualified deferral plan is transferred to another country, where he is covered by a different account-based deferral plan designed for employees based in that country, which does not comply with section 409A. In such a case, the U.S. taxpayer’s balance under the U.S. plan as well as the non-U.S. plan would be subject to acceleration and a 20% penalty.

7 This recommendation is based upon the provisions of Section § 4(b)(4) of the Employee Retirement Income Security Act of 1976, as amended (“ERISA”).
maintained outside the U.S. which for legitimate business reasons cover primarily non-resident aliens. Non-U.S. plans are governed by laws of other jurisdictions that may change and require changes to the plan that will cause the plan to violate section 409A. It would be inequitable to penalize all plans in one of the four (or more) specified categories merely because a foreign government has mandated a change in a foreign plan that fits in that category.

We recommend that the Regulations should expressly permit the issuance of notices or other published authority permitting specified departures from the ordinarily applicable aggregation rules. This flexibility would enable Treasury and the Service to address future developments.

We also believe it would be reasonable, on the basis that substance rather than form of documentation should control, to treat arrangements as separate plans where they possess such distinct characteristics, whether or not the documentation expressly refers to them as separate plans.

2. Grandfathering and Plan Aggregation

A. Background

Proposed Regulations § 1.409A-6(a)(3)(v) states that, for purposes of paragraph (a), “plan” has the same meaning as provided in Proposed Regulations § 1.409A-1(c), except that the provisions treating all nonaccount balance plans under which compensation is deferred as a single plan do not apply for purposes of the actuarial assumptions used in paragraph (a)(3)(ii) of such section.

B. Recommendation

We believe there may be a typographical error in Proposed Regulations § 1.409A-6(a)(3)(v). We recommend that the Regulations change the reference in such section to “paragraph (a)(3)(i),” rather than “paragraph (a)(3)(ii).”

C. Explanation

Proposed Regulations § 1.409A-6(a)(1) states, among other things, that section 409A applies to amounts deferred in taxable years beginning before January 1, 2005, if the plan under which the deferral is made is materially modified after October 3, 2004. Proposed Regulations § 1.409A-6 provides two separate definitions of “plan” – one in Proposed Regulations § 1.409A-6(a)(3)(v) and the other in Proposed Regulations § 1.409A-6(a)(4)(vi). Proposed Regulations § 1.409A-6(a)(3)(v) states that, for purposes of paragraph (a), “plan” has the same meaning as is provided in Proposed Regulations § 1.409A-1(c), except that the provisions treating all nonaccount balance plans under which compensation is deferred as a single plan do not apply for purposes of the actuarial assumptions used in paragraph (a)(3)(ii). However, paragraph (a)(3)(ii) relates to account balance plans and makes no reference to actuarial assumptions. We recommend that the correct cross-reference should be to paragraph (a)(3)(i), which relates to nonaccount balance plans.
3. **Material Modifications and Aggregation**

   **A. Background**

   There are two separate definitions of “plan” in Proposed Regulations § 1.409A-6 relating to grandfathered arrangements.

   **B. Recommendation**

   We recommend that the Regulations clarify the provision in Proposed Regulations § 1.409A-6(a)(1) to state that a material modification to an individual arrangement (without giving effect to plan aggregation rules) will not result in amounts deferred under all plans of the same type as the modified plan being subject to section 409A.

   **C. Explanation**

   Proposed Regulations § 1.409A-6(a)(1) provides that section 409A is effective with respect to amounts deferred in taxable years beginning before January 1, 2005, if the “plan” under which the deferral is made is materially modified after October 3, 2004. Proposed Regulations § 1.409A-6 has two separate definitions of “plans” – one in Proposed Regulations § 1.409A-6(a)(3)(v) and the other in Proposed Regulations § 1.409A-6(a)(4)(vi). Each is discussed below.

   Proposed Regulations § 1.409A-6(a)(3)(v) provides that “For purposes of this paragraph (a),” the term “plan” has the same meaning as provided in Proposed Regulations § 1.409A-1(c), with certain exceptions as described above. This reference could be read to mean that plan aggregation rules are applicable to the definition of “plan” used in Proposed Regulations § 1.409A-6(a)(1). Accordingly, one could read Proposed Regulations §§ 1.409A-6(a)(1) and 1.409A-6(a)(3)(v) as meaning that, if a single arrangement is materially modified after October 3, 2004, all amounts deferred under that arrangement and all arrangements of the same type (i.e., account balance plans, nonaccount balance plans, separation pay arrangements or all other plans) as the modified plan will be subject to section 409A. We believe that the correct rule is to have the “-6(a)(3)(v)” definition apply for purposes of Proposed Regulation § 1.409A-6(a)(3) only.

   On the other hand, Proposed Regulations § 1.409A-6(a)(4)(vi) provides that for purposes of paragraph (a)(4) (relating to the definition of material modification), the term “plan” has the same meaning as provided in Proposed Regulations § 1.409A-1(c), except that the provision treating all account balance plans under which compensation is deferred as a single plan, all nonaccount balance plans under which compensation is deferred as a separate single plan, all separation pay arrangements as a single separation pay plan, and all other nonqualified compensation plans as a separate single plan, does not apply. This paragraph implies that a material modification to one arrangement will not necessarily be a material modification to all arrangements of the same type. We believe that the correct rule is to have the “-6(a)(4)(vi)” definition of what constitutes a plan apply for all purposes of Proposed Regulations § 1.409A-6(a)(1) other than for “-6(a)(3)”.