February 22, 2006

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

Re: Nonqualified Deferred Compensation Focusing on Foreign Plan Aspects under IRC Section 409A Proposed Regulations

Dear Commissioner Everson:

Enclosed are comments under Internal Revenue Code Section 409A Proposed Regulations concerning Nonqualified Deferred Compensation Focusing on Foreign Plan Aspects. 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
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COMMENTS ON CODE SECTION 409A PROPOSED REGULATIONS REGARDING NONQUALIFIED DEFERRED COMPENSATION FOCUSING ON FOREIGN PLAN ISSUES

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 Russell Hall. Substantive contributions were made by David Ellis, James Klein, Andrew Oringer, John Wendeln and Susan Serota. The comments were reviewed by David Mustone and James R. Raborn, Vice Chair and Chair (respectively) 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 T. David Cowart of the Section’s Committee on Government Submissions and by Thomas A. Jorgensen, Council Director for the Employee Benefits Committee.

Although the 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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February 22, 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. (“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 numerous international implications of the new deferred compensation rules.

We recommend that:

1. The exception under the “nonqualified deferred compensation plan” definition for contributions under a scheme, trust or arrangement that are excludable for Federal income tax purposes under an applicable treaty be supplemented to exclude from the application of Section 409A any scheme, trust or arrangement under which credited allocations, accrued benefits, earnings credits or distributions are excludable from income under the terms of an applicable treaty.

2. The phrase “scheme, trust or arrangement” as used in the Proposed Regulations be revised to read “scheme, trust or plan” whenever referring to foreign plans.

3. The Regulations, as finalized, clarify that an individual will be treated as “eligible to participate” in a qualified employer plan for purposes of Proposed Regulation §1.409A-1(a)(3)(iii) only if (a) the individual is, under the plan’s terms and without further amendment or action by the plan sponsor, currently eligible to receive contributions or accrue benefits under the plan or (b) the requirements of Section 406 or Section 407 are met.

4. The de minimis exception for nonresident aliens who participate in a nonqualified deferred compensation plan maintained by a non-U.S. person be applied to the extent that amounts deferred do not exceed $10,000, regardless of how much compensation the nonresident alien receives for services performed in the United States.

5. The exception from Section 409A for amounts taxable under Section 402(b) be expanded to include any situation where a taxpayer would be taxable under Section 402(b), and not just when there is a “transfer to or from a trust.”

6. The exception contained in Proposed Regulation § 1.409A-1(b)(8)(ii)(B) be revised to provide that that exception is available if such deferred compensation is not only less than, but equal to, the difference between the maximum Section 911 exclusion amount for the year and the amount actually excludable for the year.

7. The Regulations, as finalized, provide that a non-U.S. plan otherwise subject to Section 409A will not be considered to violate the distribution rules (in form or operation):
a. Because of the mere presence of a provision that would accelerate distribution for an event associated with a change in control, provided (i) such distribution event has not yet occurred, and (ii) the service recipient is not, or is part of a controlled group the parent of which is not, a U.S. entity; or

b. Because a change in control takes place prompting a distribution under such a plan where such change satisfies any of the alternative criteria set forth in Proposed Regulation § 1.409A-3(g)(5).

8. For a foreign plan which primarily covers nonresident aliens with no U.S. source income:

a. The Regulations, as finalized, clarify that U.S. taxpayers participating in such a plan will not be subject to Section 409A penalties despite the fact that the plan contains provisions that do not comply with that section where such taxpayers are subject to a “sub-plan” (or other specific plan provisions) that comply with Section 409A while such persons are U.S. taxpayers (and thereafter to the extent plan benefits continue to subject a participant to U.S. tax).

b. Part XI of the preamble to the Proposed Regulations (the “Preamble”) be revised to provide for an extension of all the basic transition rules available under Notice 2005-1 (including cancellation) through the end of 2007.

9. The requirement under Proposed Regulation § 1.409A-1(b)(4) (the “Short-term Deferral Rule”) that the plan not provide for deferral beyond the short-term period be revised so that it does not apply where all of the following requirements are met: (i) A plan provides for nil-priced options (i.e., options under which the exercise price is zero or a nominal amount that is insignificant for U.S. income tax purposes), (ii) the service recipient timely reports the taxable income at the first time a distribution is available (whether or not the distribution is actually taken), (iii) the participant actually receives the distribution within the short-term deferral period (i.e., generally, within 2-1/2 months after the close of the year in which the option vests), (iv) the plan is maintained by a non-U.S. service recipient primarily for the benefit of non-U.S. service providers, and (v) the plan is designed, and in particular the nil-priced options are designed, specifically to meet requirements of applicable local substantive or tax law.

10. Part XI(D) of the Preamble be revised to provide that the transition relief described therein is also available with respect to the time and form of payment under a nonqualified plan that is controlled by a payment election made by the service provider (or beneficiary) under a bona fide foreign plan that qualifies for tax relief in the jurisdiction where such foreign plan is primarily maintained.

11. The Regulations, as finalized, provide that Section 402(d) plans (Section 401(a) plans with a foreign situs trust) and ERISA Section 1022(i)(1) and (2) plans (Puerto Rico retirement plans) also be treated as "qualified employer plans" within the meaning of Code Section 409A(d)(1)(A).
BACKGROUND

The Proposed Regulations address numerous international aspects of the new deferred compensation rules. We commend the U.S. Treasury Department (the “Treasury”) and the Service for the significant amount of thought and effort that was devoted to the development of the guidance on international issues. Overall, the Proposed Regulations are quite helpful and reasonable in addressing many of the concerns previously raised with respect to the statutory provisions and the initial guidance in Notice 2005-1, 2005-2 I.R.B. 274. These comments address those aspects of the Proposed Regulations that warrant clarification or refinement.

COMMENTS

I. Exception for Treaty Override

A. Summary

The Proposed Regulations provide an exception from the definition of the term “nonqualified deferred compensation plan” for any scheme, trust or arrangement maintained with respect to an individual where contributions made by or on behalf of such individual to such scheme, trust or arrangement are excludable for Federal income tax purposes under an applicable income tax treaty. See Proposed Regulation § 1.409A-1(a)(3)(i). However, the exception does not go far enough, as it does not exclude any scheme, trust or arrangement under which unfunded accrued benefits, earnings or distributions are excludable from U.S. income tax under the terms of a treaty.

B. Recommendation

We recommend that the exception under the “nonqualified deferred compensation plan” definition for contributions under a scheme, trust or arrangement that are excludable for Federal income tax purposes under an applicable treaty be supplemented to exclude from the application of Section 409A any scheme, trust or arrangement under which credited allocations, accrued benefits, earnings credits or distributions are excludable from income under the terms of an applicable treaty.

C. Explanation

An income tax treaty acts as a formal, international arbiter in regard to which of two jurisdictions has the right to tax an individual’s income where both jurisdictions would otherwise impose taxes. In the cross-border context, it is common for individuals who work outside of their home country to face double taxation problems, and in many situations an income tax treaty will provide an important measure of relief. For example, benefits earned under home country pension plans by foreign nationals working in the United States can be exempt from U.S. taxation by an applicable income tax treaty. Similarly, for an individual who is a resident of a treaty partner and who performs services in the jurisdiction of the other treaty partner for a period of not more than 183 days (and is not compensated by an employer in that other jurisdiction), the dependent services article of many income tax treaties often exempts the compensation he or she earns in the other jurisdiction. Other treaty articles cover distributions
from pension plans, “tie-breaker” residency rules, directors’ fees, services as an independent contractor, pensions, and so forth. In all such cases, the treaty decides which of the two jurisdictions has the right to tax the individual on his or her income.

Proposed Regulation § 1.409A-1(a)(3)(i) generally reflects the government’s overall intent to take into account the various income tax treaty exclusions in determining whether Section 409A is applicable. However, the Proposed Regulations do not go far enough, as the current exception only applies where contributions made by or on behalf of the individual to a scheme, trust, or arrangement would be exempt from U.S. federal income taxation under an income tax treaty. In actuality, there are other events (such as benefit accruals, earnings credits and distributions) that are excluded from taxation by treaty for which relief under Section 409A would be appropriate, but which may relate to an arrangement that does not qualify under the proposed exemption. For example, Section 409A might apply to a German resident working in the United States who vests while in the U.S. in an unfunded, book reserve executive plan in Germany. Since no contributions are made to such a plan, it does not appear to be covered by the exemption. It also appears that such plan would not meet the definition of a “broad-based retirement plan” in Proposed Regulation §1.409A-1(a)(3)(v), nor would the individual be taxable under Section 402(b) or otherwise meet any other exception under the Proposed Regulations. Nevertheless, the German resident’s benefit accruals under the German plan would, if he or she meets the 183-day exemption under the dependent services article of the U.S.-Germany income tax treaty, not be subject to U.S. taxation. It would logically follow that Section 409A would not apply as well. However, under the current language in Proposed Regulation § 1.409A-1(a)(3), the German resident would not qualify for the exception.

Accordingly, it would be appropriate to supplement the exemption of the Proposed Regulations to clarify that, where an applicable income tax treaty provides income tax relief with respect to an individual for benefit accruals or allocations, plan earnings or plan distributions under a covered scheme, trust or arrangement, the treaty overrides Section 409A.

II. Definition of “Scheme, Trust or Arrangement”

A. Summary

The Proposed Regulations use the terms “scheme, trust or arrangement” when referring to foreign deferred compensation plans in a number of places. See, e.g., Proposed Regulations §§ 1.409A-1(a)(3)(i) and (a)(3)(v).

B. Recommendation

We recommend that the phrase “scheme, trust or arrangement” as used in the Proposed Regulations be revised to read “scheme, trust or plan” whenever referring to foreign plans.

C. Explanation

Under Section 409A(d)(1), a “nonqualified deferred compensation plan” is defined as a “plan.” Section 409A(d)(3), in turn, defines a “plan” as including “any agreement or

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arrangement, including an agreement or arrangement that includes one person.” At the same time, the Proposed Regulations provide that an agreement, method or arrangement may constitute a “plan” regardless of whether it is an employee benefit plan under Section 3(3) of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”). See Proposed Regulation §1.409A-2(c). However, Proposed Regulation §1.409A-1(a)(3)(i) (which addresses the Treaty override) and Proposed Regulation §1.409A-1(a)(3)(v) (which defines “broad-based retirement plan”), among others, use the phrase “scheme, trust or arrangement” without reference to the term “plan”. Presumably, the intent is to apply these rules to any arrangement that could constitute a “plan” for Section 409A purposes. Therefore, to avoid any uncertainty as to foreign plans, we recommend that the phrase “scheme, trust or arrangement” as used in the Proposed Regulations be revised to read “scheme, trust or plan” wherever it appears in the provisions of the Proposed Regulations applicable to foreign deferred compensation plans.

III. Participation by U.S. Citizens and Lawful Permanent Residents In A Broad-Based Retirement Plan

A. Summary

Under Proposed Regulation §1.409A-1(a)(3)(iii), the broad-based retirement plan exemption will apply to a U.S. citizen or lawful permanent resident only if the citizen or resident is not eligible to participate in a qualified employer plan as defined in Proposed Regulation §1.409A-1(a)(2). Clarification is needed as to the circumstances under which an individual is deemed to be “eligible to participate in” such a plan.

B. Recommendation

We recommend that the Regulations, as finalized, clarify that an individual will be treated as “eligible to participate” in a qualified employer plan for purposes of Proposed Regulation §1.409A-1(a)(3)(iii) only if (1) the individual is, under the plan’s terms and without further amendment or action by the plan sponsor, currently eligible to receive contributions or accrue benefits under the plan or (2) the requirements of Section 406 or Section 407 are met.

C. Explanation

There are a number of different situations in which a U.S. citizen or resident working outside of the United States could participate in a U.S. tax-qualified plan. We recommend that the Proposed Regulations clarify the situations in which such a person will be deemed to be “eligible to participate” in a tax-qualified plan for purposes of the “broad-based retirement plan” exception.

In some cases, the U.S. citizen or resident is seconded from a U.S. employer to work overseas. In these circumstances, he or she remains employed by (directed and controlled by) the U.S. employer while performing services in another jurisdiction. Consequently, if the U.S. employer maintains a tax-qualified plan (which by its terms provides that such an individual is eligible to participate), it would logically follow that such an individual would be “eligible to participate” in a tax-qualified plan and the broad-based retirement plan exception would not be
available. Similarly, the U.S. citizen or resident will in some cases transfer to a foreign company that adopts a U.S. tax-qualified plan for its employees. Therefore, to the extent the individual is covered under plan terms, the same conclusion applies here as well.

However, what if the U.S. citizen or resident works for a foreign company that does not maintain a tax-qualified plan, but is a member of a controlled group where one of the other members is a U.S. company that does maintain a tax-qualified plan? Because of the application of the controlled group rules, employment with one company is deemed to be employment with all companies -- that is, employment with any member of the controlled group will generally be considered to be employment with the U.S. employer for testing purposes under Section 401(a). See, e.g., Priv. Ltr. Rul. 8228116 (April 19, 1982). What if a U.S. citizen or lawful permanent resident works for a foreign employer which is a member of a controlled group with a U.S. company that maintains a tax-qualified plan -- will the individual be deemed to be “eligible to participate in” a qualified employer plan or must the U.S. plan by its terms expressly provide that the employees working for that foreign employer are currently eligible to receive contributions or accrue benefits in order for the qualified plan exception to apply? As a logical matter, the exception should only apply in the latter circumstance.

Further, under Section 406, a U.S. citizen or resident employed by an entity in which an “American employer” (defined in Section 3121(h)) has a 10% or more interest (i.e., a “foreign affiliate”) will be deemed to be an employee of the American employer for purposes of the American employer’s tax-qualified retirement plan if the following three requirements are met:

(i) The American employer agrees to extend U.S. Social Security coverage to all of the foreign affiliate’s employees who are U.S. citizens or residents by a Section 3121(l) agreement;

(ii) The tax-qualified plan expressly provides for contributions or benefits for U.S. citizen and resident employees of the foreign affiliate to which a Section 3121(l) agreement applies; and

(iii) No contributions are made to any other (including non-U.S.) funded deferred compensation plan (whether or not tax-qualified) on behalf of the employees who are U.S. citizens or residents based on the compensation of such employees from the foreign affiliate.

See Section 406(a) and Proposed Regulation §1.406-1(b)(1). Therefore, a number of affirmative steps must be taken by the plan sponsor for Section 406 to apply, including, for example, the implementation of a Section 3121(l) agreement. For purposes of the broad-based retirement plan exception, will an individual be deemed to be “eligible to participate in” a tax-qualified plan if the plan sponsor does not take these affirmative steps, but could take these steps or only if the plan sponsor actually takes the affirmative steps to extend participation to the individual?1 Here too the individual should, as a logical matter, only be deemed to be eligible in the latter situation.

1 Similar questions arise under Section 407, which is a companion provision to Section 406.
In general, we recommend that a U.S. citizen or resident be deemed to be “eligible to participate” in a tax-qualified plan in this context only if the individual is currently eligible to receive contributions or to accrue benefits under the terms of the U.S. tax-qualified plan. Therefore, the mere fact that an expatriate is working for a foreign employer who is a member of the same controlled group does not mean that he is “eligible to participate” in a tax-qualified plan. Further, the mere fact that Section 406 or Section 407 could be used to provide coverage to the expatriate does not mean that he is “eligible to participate” in a tax-qualified plan, unless and until the employer actually meets the requirements of those Sections. In sum, we recommend that an expatriate employee be considered “eligible to participate” in a tax-qualified plan only if the employee is, under the Plan’s terms and without any further amendment or other action by the plan sponsor or the expatriate’s employer, currently eligible to receive contributions or to accrue benefits under the plan, or if the requirements of Section 406 and Section 407 are in fact met. To conclude otherwise would mean that a U.S. expatriate would be prevented from using the broad-based retirement plan exemption if, in theory, the plan sponsor or his employer could take action to have him participate in a tax-qualified retirement plan, but has in fact not done so.

IV. De Minimis Exception for Nonresident Aliens

A. Summary

Proposed Regulation §1.409A-1(a)(3)(vi) provides a de minimis exception for nonresident aliens who participate in a nonqualified deferred compensation plan maintained by a non-U.S. person where the amount deferred based upon the nonresident alien’s services performed in the United States does not exceed $10,000. It is unclear whether this $10,000 ceiling also applies to the amount of U.S. compensation that the nonresident earns but that is not deferred.

B. Recommendation

We recommend that the de minimis exception for nonresident aliens who participate in a nonqualified deferred compensation plan maintained by a non-U.S. person be applied to the extent that the amounts deferred do not exceed $10,000, regardless of how much compensation the nonresident alien receives for services performed in the United States.

C. Explanation

According to the Preamble, the Treasury Department and IRS determined that an exception was warranted in those situations where application of Section 409A to nonresident alien deferrals could be exceedingly burdensome because relatively small amounts are attributable to service in the United States. See 70 Fed Reg., at 57938. The Preamble describes the exception as applying to any individual service provider who is a nonresident alien for the calendar year whose amount deferred does not exceed $10,000. See id. The Proposed Regulations, on the other hand, contain the parenthetical: “(including compensation received due to services performed in the United States)” that could be read as applying the $10,000 maximum to not only the amounts deferred, but the compensation the nonresident receives for services performed in the United States. That is, the definition of “nonqualified deferred
compensation plan” in Proposed Regulation § 1.409A-1(a)(3)(vi) excludes any foreign plan maintained by a non-U.S. service recipient for a taxable year,

“to the extent that the amounts deferred under the foreign plan based upon the nonresident alien’s services performed in the United States (including compensation received due to services performed in the United States) do not exceed $10,000 in the taxable year.” (emphasis added).

The Proposed Regulations therefore suggest that in order for the exception to be available, both the amounts deferred and the compensation received for services performed in the United States for the taxable year involved cannot exceed the $10,000 maximum. This result is inconsistent with the Preamble, which states that the $10,000 maximum applies only to the deferred amounts.

Accordingly, we recommend that the Regulations, as finalized, be consistent with the Preamble, to provide that the $10,000 maximum only applies to the deferred amounts, and not the compensation received for services performed in the United States during the year. The simplest way to accomplish this result would be to delete the parenthetical “(including compensation received due to services performed in the United States)” in Proposed Regulation §1.409A-1(a)(3)(vi).

V. Exception for Transfer Subject to Sections 83, 402(b) and 403(b)

A. Summary

Proposed Regulation §1.409A-1(b)(6)(i) provides that if a service provider receives property from, or pursuant to, a service recipient plan, there is no deferral of compensation merely because the property (i) is not taxable in the year of receipt by reason of the property being substantially nonvested (as defined in Regulation §1.83-3(b)), or (ii) is includable in income solely due to a valid Section 83(b) election. The Proposed Regulations also provide that a transfer of property includes the transfer of a beneficial interest in a trust or annuity plan, or a transfer to or from a trust (or under an annuity plan), to the extent that such a transfer is subject to Section 83, Section 402(b) or Section 403(c). The language in the Proposed Regulations is identical to Q&A 4(e) of Notice 2005-1.

B. Recommendation

We recommend that the exception from Section 409A for amounts taxable under Section 402(b) be expanded to include any situation where a taxpayer would be taxable under Section 402(b), and not just when there is a “transfer to or from a trust.”

C. Explanation

The Proposed Regulations focus on the existence of a “transfer,” such as a transfer of a beneficial interest in a trust, or a transfer to or from a trust. See Proposed Regulation §1.409A-1(b)(6)(i). With respect to nonqualified deferred compensation plans funded through a trust, however, a participant’s taxability does not always depend on whether there is a “transfer.” In
general, Section 402(b)(1) provides that a participant is taxable on contributions made to a nonqualified trust to the extent the participant is vested in such contributions. However, Section 402(b)(4) provides that if one of the reasons a trust is not exempt under Section 501(a) is that the underlying deferred compensation plan does not meet the requirements of Section 401(a)(26) or Section 410(b), a highly compensated employee is taxable on his or her vested accrued benefit, in lieu of the amount determined under Section 402(b)(1).

A contribution to a trust can be viewed as a “transfer.” An individual who is taxable under Section 402(b)(1), therefore, would not be taxable under Section 409A in these circumstances since there is presumably “a transfer to or from a trust” that is subject to Section 402(b). However, in the case of a highly compensated employee, where the underlying plan does not meet the requirements of Section 401(a)(26) or Section 410(b), he or she is taxable under Section 402(b)(4) upon an event other than a “transfer.” Given the wording of Proposed Regulation §1.409A-1(b)(6)(i), it is unclear whether the exception would apply in the case of a highly compensated employee who is taxable under Section 402(b)(4) since a “transfer to or from a trust” is not needed for taxation.

U.S. expatriates who participate in foreign, funded retirement plans, such as an approved pension scheme in the U.K., a registered retirement plan in Canada and like arrangements, are taxable under Section 402(b) because more often than not such plans do not meet the requirements of Section 401(a)(26) or 410(b). Thus, should the expatriate be a “highly compensated employee,” the expatriate will be subject to taxation on his or her vested accrued benefit under such plan under Section 402(b)(4). In such a situation, we recommend that the Section 409A exception apply, since foreign, funded retirement plans are not the target of Section 409A.

In theory, if there were a contribution made to the foreign, funded retirement plan in a particular year, one might be able to argue that the “transfer” of the contribution in that year satisfies the wording of the exception, even where the highly compensated employee is taxable on his vested accrued benefit. However, it is not always known whether a contribution has been made every year to such plans. Further, in some cases there may be no contribution made, such as where the plan is overfunded, creating a “contribution holiday.”

The policy behind the exception seems to be to carve out those situations where the taxpayer is already currently taxable under another Code section, such as Section 402(b). The current wording of Proposed Regulation §1.409A-1(b)(6)(i), however, may not permit a highly compensated employee in a foreign, funded retirement plan who is taxable under Section 402(b)(4) to fit within the exception. Accordingly, it would be appropriate to expand the exception in the Proposed Regulations to apply to any situation where an individual is “taxable under Section 402(b),” rather than only where there is a “transfer to or from a trust” to the extent that “such transfer is subject to Section 402(b).”
VI. Exception for Amounts Hypothetically Excludable Under Section 911

A. Summary

The Proposed Regulations provide an exception for deferred compensation that would be hypothetically excludable under Section 911 if it were paid to the service provider and, together with other foreign earned income for that year, does not exceed the maximum Section 911 limit for the year. See Proposed Regulation § 1.409A-1(b)(8)(ii)(B). However, the description of this exception in the Preamble differs in a minor, but important respect, from the text of the Proposed Regulations. See 70 Fed Reg., at 57937.

B. Recommendation

We recommend that the exception contained in Proposed Regulation § 1.409A-1(b)(8)(ii)(B) be revised to provide that that exception is available if such deferred compensation is not only less than, but equal to, the difference between the maximum Section 911 exclusion amount for the year and the amount actually excludable for the year.

C. Explanation

Section 1.409A-1(b)(8)(ii)(B) of the Proposed Regulations provides that an arrangement with a service provider does not provide for a deferral of compensation to the extent that compensation under the arrangement would not have been includable in gross income if it had been paid to the service provider at the time that the legally binding right to the compensation first arose or, if later, the time that the legally binding right was no longer subject to a substantial risk of forfeiture, because:

(i) the service provider was a qualified individual under Section 911, and

(ii) the compensation would have been foreign earned income under Section 911 (if paid at such time) and would have been less than the difference between the maximum exclusion amount under Section 911 for such taxable year and the amount of foreign earned income actually excludable from gross income for such taxable year.

The Preamble provides that this exception is available to the extent that the deferred compensation hypothetically paid to the service provider “is less than or equal to” the difference between the maximum Section 911 exclusion amount for the taxable year and the amount actually excludable for the taxable year. 70 Fed Reg., at 57937. The Proposed Regulations, however, provide that the exception is available only if such deferred compensation “is less than” the difference between the maximum Section 911 exclusion amount for the taxable year and the amount actually excludable for the taxable year. Proposed Regulation §1.409A-1(b)(8)(ii)(B). While this inconsistency is minor, it is worth correcting the Proposed Regulations to be consistent with the Preamble.
VII. Change of Control and Certain Foreign Plans

A. Summary

Under Section 409A(a)(2)(A)(v), a change in the ownership or effective control of the employer is a permissible distribution event. Under Proposed Regulation § 1.409A-3(g)(5)(v), a change in control is, in accordance with the legislative history of Section 409A, given a detailed definition, similar to, but more restrictive than, the definition in Section 280G.

B. Recommendation

We recommend that the Regulations, as finalized, provide that a non-U.S. plan otherwise subject to Section 409A will not be considered to violate the distribution rules (in form or operation):

1. Because of the mere presence of a provision that would accelerate distribution for an event associated with a change in control, provided (i) such distribution event has not yet occurred, and (ii) the service recipient is not, or is part of a controlled group the parent of which is not, a U.S. entity; or

2. Because a change in control takes place prompting a distribution under such a plan where such change satisfies any of the alternative criteria set forth in Proposed Regulation § 1.409A-3(g)(5).

C. Explanation

Plans maintained outside the United States often have a very different change in control definitions than the one proposed for Section 409A. We believe that foreign companies generally will not be willing to depart from customary local practice to establish a Section 409A-compliant definition of a change in control for all plan participants when most are not U.S. taxpayers. Also, we believe such organizations would be unwilling to adopt a different, Section 409A-compliant definition of a change in control solely for U.S. taxpayers covered by a plan with an otherwise noncompliant definition for other participants. Companies generally have a high degree of sensitivity concerning their change in control arrangements and, given this, we believe they will be reluctant to adopt a special change in control definition for a subgroup that might cause divergent treatment among plan participants. We recommend that such U.S. taxpayers not be subject to the penalties under Section 409A because this change in control definition is in the plan and further, not until a distribution that violates Section 409A actually occurs.

The Proposed Regulations already provide for a number of exceptions for “certain foreign plans” and “certain foreign arrangements.” These exceptions reflect the sound policy of not interfering with the structure of essentially non-U.S. plans of non-U.S. employers. For a feature as sensitive as a change in control distribution event, it is not reasonable to expect employers to provide a different distribution event definition only in order to conform with Section 409A. Under the logic of Section 409A(a)(1)(A)(ii), we recommend that the failure of this type of plan to conform to the Proposed Regulations’ required change in control definition
not, solely for that reason, cause the U.S. taxpayer participants to be deemed to be covered by a plan with non-conforming distribution terms. To avoid any potential for abuse, we also recommend that this special exception be limited to employees of an employer which is, or is a part of a controlled group the parent of which is, not a U.S. entity.

For the same reasons, it is also appropriate to require only operational compliance with the distributions rules for changes in control in this context. Thus, if a change in control takes place under such a plan that satisfies one of the alternative definitions under Section 409A, any plan distribution to a U.S. taxpayer made on account of such a change in control will not violate Section 409A. Conversely, if distributions are made to U.S. taxpayers upon the occurrence of a change in control that does not meet one of the alternative definitions, the distributions should be a violation of Section 409A’s distribution restrictions at the time the distribution occurs.

VIII. “Sub Plans” for U.S. Taxpayers/Transition Relief

A. Summary

When U.S. taxpayers are covered by a foreign plan which primarily covers nonresident aliens with no U.S. source income with general provisions that do not comply with Section 409A, we recommend that such a plan be able meet Section 409A’s requirements if such U.S. taxpayers are covered by a “sub-plan” (or other specific plan provisions) that complies with Section 409A while such persons are U.S. taxpayers. We recommend that the transition rules in Notice 2005-1 continue to apply to such plans through 2007 to allow them to come into compliance under Section 409A.

B. Recommendation

We recommend that for a foreign plan which primarily covers nonresident aliens with no U.S. source income:

1. The Regulations, as finalized, clarify that U.S. taxpayers participating in such a plan will not be subject to Section 409A penalties despite the fact that the plan contains provisions that do not comply with that section where such taxpayers are covered by a “sub-plan” (or otherwise subject to specific plan provisions) that complies with Section 409A while such persons are U.S. taxpayers (and thereafter to the extent plan benefits continue to subject a participant to U.S. tax).

2. Part XI of the Preamble be revised to provide for an extension of all the basic transition rules available under Notice 2005-1 (including cancellation) through the end of 2007.

C. Explanation

Recommendation 1:

Among large, non-U.S. employers, it is common for deferred compensation plans of such an enterprise to cover U.S. taxpayers. While the Proposed Regulations exempt a number of such plans (funded plans, plans covered by treaties, broad based retirement plans), there are situations
in which a plan could generate Section 409A consequences for U.S. citizens, residents, green card holders, or those rendering services in the United States. It is not realistic, nor is it necessary to realize the objectives of Section 409A, to expect all of such plans to be changed to conform to Section 409A for all participants, including nonresident aliens with no U.S. source income. We recommend that the Regulations under Section 409A, as finalized, make clear that for a foreign plan which primarily covers nonresident aliens with no U.S. source income, the plan can include specific provisions, such as a “sub-plan”, which apply only (i) when the participants are U.S. taxpayers and (ii) once they cease to be a U.S. taxpayer, with respect to compensation that remains subject to U.S. income tax despite the loss of U.S. taxpayer status. For example, if a nonresident alien moves to the United States and continues participation in an unfunded executive deferred compensation program of a foreign company, that participant is expected to be subject to Section 409A, but only upon achieving U.S. taxpayer status. That is, the plan would apply special rules only when that individual becomes a U.S. taxpayer. Upon leaving the United States or otherwise terminating the individual’s U.S. taxpayer status, the Section 409A rules of the “sub-plan” would continue to apply to the compensation earned and deferred during the participant’s period of coverage under the sub-plan, assuming such benefits continue to subject such person to U.S. tax despite the loss of U.S. taxpayer status.

It should be noted that the approach of using a “sub-plan” is commonly used by U.S. employers who apply special rules for non-U.S. participants in order for those non-U.S. participants to secure non-U.S. tax benefits. Similarly, we recommend that this approach be available for non-U.S. employers to enable them to carve out a portion of their plan that would apply the rules of Section 409A to those participants who have any benefits subject to U.S. income tax. One way to accomplish this would be to add a new clause to Proposed Regulation §1.409A-1(a)(3) to read as follows:

(vii) Plans covering primarily nonresident aliens. The rules of Section 409A will be applied with respect to a plan which primarily covers nonresident aliens with no U.S. source income only to the portion of such plan that is specifically designated as applying only to U.S. taxpayers and at the time and for amounts deferred during the time such participants are U.S. taxpayers.

Recommendation 2:

We recommend that the Regulations, as finalized, provide additional time for foreign plans which primarily cover nonresident aliens with no U.S. source income to address Section 409A’s applicability. More specifically, we recommend that the basic transition rules under Notice 2005-1(including cancellation) be extended through December 31, 2007 for such plans, the result of which would be that (i) the current accruals of U.S. taxpayers in the foreign plan through December 31, 2007 would be eligible for the various transition rules and (ii) future deferrals would be subject to the applicable provisions of Section 409A. The extension would, of course, require good faith operational compliance, but would defer conforming document changes until the end of 2007.

Additional transition relief for such plans is necessary due to the varying structures of foreign plans and the "dual compliance" challenge of foreign companies who must comply with
both foreign law and Section 409A. A foreign company likely will encounter difficulty in attempting to conform the foreign plan to both foreign law and Section 409A for U.S. taxpayers, particularly where the vast majority of the participants are not U.S. taxpayers. This dual compliance challenge will be made more difficult because of (i) the need to reconcile any plan changes with the income tax aspects under both foreign and U.S. tax laws, including any applicable tax treaties, (ii) the different categories of possible U.S. taxpayers (such as U.S. citizens, lawful permanent residents, nonresident aliens, individuals who expatriate under Section 877, and so forth), and (iii) time and effort that will be needed to minimize/avoid adverse income tax consequences for its U.S. taxpayers (and any accompanying analysis and implementation of any tax equalization programs).

Accordingly, in light of all of the possible variations regarding laws and possible U.S. taxpayers, an additional period of transitional relief is needed by foreign companies to accomplish this substantial compliance challenge of reconciling and harmonizing foreign and U.S. tax laws under their plans. This will ensure that foreign companies have an adequate opportunity to evaluate and decide whether to (i) cease future benefits for the U.S. taxpayers (which, with cancellation, would permit the company to avoid Section 409A compliance altogether), (ii) conform the plan (via sub-plan or otherwise) to Section 409A or (iii) remove U.S. taxpayers from the foreign plan and move them into a new Section 409A compliant “U.S. taxpayer-only” stand alone plan.

Without this extension, Treasury and IRS may well see many instances of Section 409A non-compliance among foreign plans covering U.S. taxpayers, as many foreign companies currently have little (if any) knowledge of Section 409A, its implications, and what would be required for their plans to be compliant. On balance, we believe that providing an additional year to allow foreign plans to comply with Section 409A is preferable to extensive -- and unavoidable -- noncompliance.

IX. Nil-Priced Options Under Bona Fide Non-U.S. Plans

A. Summary

If a nonqualified deferred compensation plan permits distributions to occur beyond the applicable short-term deferral period prescribed by Proposed Regulation § 1.409A-1(b)(4), Section 409A could result in additional taxes and other adverse results on a service provider (i) even where the compensation in question is includable in income in the year in which it vests and (ii) even if the distribution actually occurs during the short-term deferral period. See Proposed Regulation § 1.409A-1(b)(4)(i). These results are particularly onerous in the case of a non-U.S. plan which provides for nil-priced options and which is designed in accordance with local corporate or tax rules, where the operation of the plan provides adequate safeguards against abuse.

B. Recommendation

We recommend that the requirement under the Short-term Deferral Rule that the plan not provide for deferral beyond the short-term period be revised so that it does not apply where all of
the following requirements are met: (i) a plan provides for nil-priced options (i.e., options under which the exercise price is zero or a nominal amount that is insignificant for U.S. income tax purposes), (ii) the service recipient timely reports the taxable income at the first time a distribution is available (whether or not the distribution is actually taken), (iii) the participant actually receives the distribution within the short-term deferral period (i.e., generally, within 2-1/2 months after the close of the year in which the option vests), (iv) the plan is maintained by a non-U.S. service recipient primarily for the benefit of non-U.S. service providers, and (v) the plan is designed, and in particular the nil-priced options are designed, specifically to meet requirements of applicable local substantive or tax law.

C. Explanation

Under the Proposed Regulations, an amount may be subject to Section 409A even if the amounts are constructively received upon vesting, if (i) the vesting event occurs in a year that follows the year in which the legally binding right to the compensation arose and (ii) the amounts could have been deferred beyond the short-term deferral period. See Proposed Regulation § 1.409A-1(b)(4)(i). Thus, Section 409A compliance includes a formalistic component that, if unsatisfied, could result in a 20% penalty (and other adverse Section 409A results), regardless of whether there is any tax-deferral benefit to the service provider as a result of the delayed distribution. The potential hardship of the application of these rules is exacerbated by the fact that a plan provision expressly allowing a deferred distribution could jeopardize compliance with Section 409A for the entire plan (i.e., by causing the short-term deferral rule to be unavailable), even where there is no potential for income-tax deferral.

Whatever the policy considerations that underlie the regulatory decision to require this form element, we recommend that the issue be reexamined in the context of certain bona fide non-U.S. plans. Plans in a number of foreign jurisdictions commonly provide for the grant of nil-price "options" as to which the U.S. tax advice in our experience typically is that taxation arises upon vesting, or shortly thereafter once any distribution restrictions have passed, regardless of whether there is then an actual distribution. For these purposes, we are considering a nil-priced option to be one under which the exercise price is zero or a nominal amount that is insignificant for tax purposes. In those cases, it might be expected that a service provider who is a U.S. taxpayer would take an immediate distribution once available, as there is no tax deferral to be achieved from a delay.

We note that, as a policy matter, nil-priced options operate in many ways like restricted stock (except that no Section 83(b) election is available at grant). In this regard, restricted stock is either not subject to Section 409A at all, or may generally be treated under the Proposed Regulations as distributed upon vesting (i.e., when taxed) when it is part of a deferred compensation arrangement. See Proposed Regulation § 1.409A-1(b)(6). We believe the

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2 For example, in our experience, these types of options are quite common under a number of U.K. plans designed to satisfy U.K. tax and securities laws.
similarity between nil-priced options and restricted stock supports the relief requested here, particularly in light of the strong cross-border implications at issue.  

In the types of cases we have identified, particularly where distribution is received within the short-term deferral period, the risk of abuse under Section 409A is absent. Thus, in light of comity considerations and a desire to avoid unnecessary extra-territorial effects, we recommend that a narrow exception to the form requirements for the Short-term Deferral Rule as described above be adopted for certain bona fide non-U.S. plans.

X. Transition Relief For Payments Based Upon Election Under Bona Fide Foreign Plan

A. Summary

Part XI(D) of the Preamble provides transition relief whereby an election as to the timing and form of a payment under a nonqualified plan that is controlled by a payment election made by the service provider (or beneficiary) under a qualified plan will not violate Section 409A provided that the determination of the timing and form of payment is made in accordance with the terms of the nonqualified deferred compensation plan as of October 3, 2004 that governs payments. See 70 Fed Reg., at 57955. This transition relief applies to payments that are made or commence on or before December 31, 2006. See id. However, the relief does not apply where the time and form of payment under a nonqualified plan is controlled by a payment election under a bona fide foreign plan that qualifies for tax relief in the jurisdiction where such foreign plan is primarily based.

B. Recommendation

We recommend that Part XI(D) of the Preamble be revised to provide that the transition relief described therein is also available with respect to the time and form of payment under a nonqualified plan that is controlled by a payment election made by the service provider (or beneficiary) under a bona fide foreign plan that qualifies for tax relief in the jurisdiction where such foreign plan is primarily maintained.

C. Explanation

As noted in the Preamble, this is a common arrangement with respect to nonqualified plans whose benefits are calculated in relation to benefits under a plan that is qualified under Section 401(a) of the Code. See 70 Fed Reg., at 57955. Such coordinated arrangements are also not uncommon outside of the United States. In many other jurisdictions, as in the United States, limits are imposed on the benefits available under retirement plans that will qualify for tax relief and employers seek to ameliorate the impact of these limits through arrangements that in some cases constitute nonqualified plans that will be subject to Section 409A. Canada is an example of a jurisdiction where such practices are common.

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3 While we believe our analysis is particularly compelling here in the case of bona fide non-U.S. plan designed in light of local rules, we would ask that consideration be given to extending our requested relief to all nil-priced options which do not result in tax deferral beyond the point of potential distributions and which otherwise meet the criteria we outline.
We recommend that the relief provided to nonqualified plans to have their time and form of payment controlled by a U.S. qualified plan also be available for a bona fide foreign plan that qualifies for tax relief in the jurisdiction where such foreign plan is primarily based. We believe the same reasons that led the IRS to extend the transition relief in a domestic context are applicable in an international context.

Since we are simply requesting similar treatment for foreign arrangements to that provided in a domestic context, we recommend that the same conditions apply to this relief. In particular, we recommend that the relief only apply if the terms of the nonqualified plan on October 3, 2004 provided for the time and form of payment under that plan to be controlled by the time and form of payment under a bona fide foreign plan. Also, this relief will not extend to other provisions of the Code (except Section 409A) or other tax doctrines that might apply to any election made under such an arrangement.

The bona fide foreign plan to which the nonqualified plan payment terms are linked must qualify for tax relief under the jurisdiction where such foreign plan is primarily based. The tax relief we are describing is such as to defer current taxation subject to the satisfaction of the plan of certain requirements, including limitations on the amount of total benefits that may be provided.

XI. Qualified Employers Plans—Addition of Section 402(d) Foreign Situs Trusts and ERISA Section 1022(i) Puerto Rico Plans

A. Summary

The Proposed Regulations do not include Section 402(d) plans (Section 401(a) plans with a foreign situs trust) and (2) ERISA Section 1022(i)(1) plans (Puerto Rico retirement plans) in the definition of "qualified employer plan" (see Proposed Regulation § 1.409A-1(a)(2)) even though the trusts of these plans are deemed to be trusts exempt from tax under Section 501(a).

B. Recommendation

We recommend that the Proposed Regulations be revised to provide that Section 402(d) plans (Section 401(a) plans with a foreign situs trust) and ERISA Section 1022(i)(1) and (2) plans (Puerto Rico retirement plans) also be treated as "qualified employer plans" within the meaning of Section 409A(d)(1)(A).

C. Explanation

A Section 402(d) plan is a retirement plan that would be exempt under Section 501(a) except that its trust is created or organized outside the United States, provided that the stock bonus, pension or profit-sharing trust meets all of the other requirements of Section 401(a). A Section 402(d) plan, therefore, meets the requirements for qualification under Section 401(a), except that the plan does not have a U.S. situs trust. Section 402(d) provides that the foreign situs trust will be deemed to be a trust exempt from U.S. income tax under Code Section 501(a). Thus, these plans are treated and function as a “qualified” retirement plans for Code purposes.
An ERISA Section 1022(i)(1) plan is a Puerto Rico retirement plan qualified solely under Puerto Rico tax law (Section 1165), with a Puerto Rico situs trust, and all of the participants of which are Puerto Rico residents. (An ERISA Section 1022(i)(1) plan often is referred to as a "Puerto Rico only" plan since it is qualified only under Puerto Rico tax law.) An ERISA Section 1022(i)(1) plan is treated as an exempt trust under Code Section 501(a) for U.S. tax purposes as though it were part of a qualified plan under Section 401(a). The contributions to an ERISA Section 1022(i)(1) plan are exempt under Section 933 (general income tax exclusion for Puerto Rico residents). Accordingly, an ERISA Section 1022(i)(1) plan is afforded essentially the same tax treatment under the Code as qualified retirement plans, and, therefore, we recommend that it be expressly recognized as such under the Proposed Regulations.

ERISA section 1022(i)(2) provides that a sponsor of a Puerto Rico plan can make an irrevocable election for the plan to comply with all of the Code’s qualification provisions except for the trust situs requirement. An ERISA Section 1022(i)(2) plan is a Puerto Rico retirement plan qualified under both Puerto Rico tax law (Section 1165) and U.S. tax law (Section 401(a)), with a Puerto Rico situs trust. (An ERISA Section 1022(i)(2) plan often is referred to as a "dual qualified" plan since it is qualified under both Puerto Rico and U.S. tax law.) As such, an ERISA Section 1022(i)(2) plan also is afforded essentially the same tax treatment under the Code as a qualified retirement plan with a domestic trust, and, hence, we recommend that it be treated as such under the Proposed Regulations as well.

**CONCLUSIONS**

The foregoing recommendations are intended to facilitate compliance of foreign plans in a fair and balanced way that reasonably reflects both United States and foreign law in this context and accommodates legitimate, long-standing practices of non-U.S. companies without undermining the government’s legitimate compliance concerns.