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**VIA ELECTRONIC AND HAND DELIVERY**

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RE: Additional Requests for Code Section 409A Guidance

Dear Eric and Nan:

Following up on our June 3, 2005 letter, we are writing on behalf of our clients to request guidance on additional issues under section 409A of the Internal Revenue Code (the "Code"), enacted as part of the American Jobs Creation Act of 2004 (the "Act"). The issues discussed below are extremely important to our clients as they attempt to address the impact of Code section 409A and the transition guidance in Notice 2005-1 on their compensation and benefit plans. We understand that Treasury and IRS personnel are trying to provide additional guidance under Code section 409A on an expedited basis. We appreciate your considering the requests specifically discussed below.

### **Executive Summary**

1. **Application of the “Six-Month” Distribution Rule to Annuity and Installment Payments**

We request that distributions in the form of (i) an annuity payable over the life of a “key employee” (or joint lives of the key employee and his or her designated beneficiary), or (ii) substantially equal periodic payments made for a period of at least ten years be exempt from the “six-month” distribution rule of Code section 409A(a)(2)(B)(i).

2. **Definition of “Performance-Based Compensation”**

We request that regulations define “performance-based compensation” in a manner similar to the definition under IRS Notice 2005-1 (the “Notice”).

3. **Application of Code Section 409A to Foreign Pension Plans and Trusts**

We request that regulations provide express exclusions from section 409A coverage for (1) foreign pension plans (and their related trusts) that are subject to Code section 402(b), and (2) resident aliens and non-resident aliens who accrue benefits/contributions (and earnings thereon) under a foreign pension plan prior to, during, or after relocation to the United States.

### **Requests for Guidance**

1. **Application of the “Six-Month” Distribution Rule to Annuity and Installment Payments**

**Proposal:** We request that distributions in the form of (i) an annuity payable over the life of a “key employee” (or joint lives of the key employee and his or her designated beneficiary) or (ii) substantially equal periodic payments made for a period of at least ten years be exempt from the “six-month” distribution rule of Code section 409A(a)(2)(B)(i).

**Explanation:** Code section 409A(a)(2)(B)(i) provides that distributions from a nonqualified deferred compensation plan made to a “key employee” (as defined under Code section 416(i)) of a publicly traded corporation upon the employee’s separation from service may not be made for six months (or upon the earlier death of the employee).

July 1, 2005

Page 3

On its face, this restrictive rule applies to *any* form of distribution (e.g., lump sum distributions, annuity and installment payments). However, the apparent intent of the six-month rule was to prohibit an executive from receiving an immediate lump sum distribution of his nonqualified plan benefits just before his employer declares bankruptcy, thereby depleting company assets that would otherwise be available to company creditors. Because distributions in the form of an annuity or installments spread the payout of a participant's benefit over a number of years, the "run on the bank" pre-bankruptcy abuse rationale for the rule is inapplicable in these situations. Moreover, a very substantial portion of the stream of payments will actually be paid more than six months after termination. This can be contrasted with the administrative burdens caused by delaying the commencement of annuities and needing to calculate and pay lump sum "catch up" payments at some later date. Therefore, we believe it is reasonable to not require compliance with the six-month rule to accommodate distributions made to key employees in the form of a lifetime annuity or installment payments made over ten or more years.

The Pension Income Tax Limits Act ("PITLA") (P.L. No. 104-95 (Jan. 10, 1996)) provides that a state may not tax a non-resident on income from a nonqualified deferred compensation plan if the income is in the form of (i) a lifetime annuity or (ii) substantially equal periodic payments over a period of not less than ten years (see 4 U.S.C. 114(b)(1)(I)). The PITLA indicates a policy of providing more favorable tax treatment for annuity or installments paid from a nonqualified plan that should be applied in the regulations under section 409A.

2. Definition of "Performance-Based Compensation"

**Proposal:** We request that the definition of "performance-based compensation" in the regulations be similar to the definition in the Notice.

**Explanation:** Code section 409A(a)(4)(B)(iii) provides a special rule applicable to an election to defer "performance-based compensation." Specifically, an election to defer performance-based compensation based on services performed over a period of at least twelve months must be made no later than six months before the end of the service period. Code section 409A and its legislative history do not explicitly define the term "performance-based compensation." Q&A-22 of the Notice provides that Treasury and the IRS intend to define performance-based compensation in future guidance. In the interim, the Notice provides transitional guidance.

July 1, 2005

Page 4

Consistent with the legislative history of section 409A, the Notice provides a definition that is less exacting than that found in Code section 162(m). The Notice provides that during the transition period "bonus compensation" will be treated as performance-based and defined "bonus compensation" as

compensation where (i) the payment of the compensation or the amount of the compensation is contingent on the satisfaction of organizational or individual performance criteria, and (ii) the performance criteria are not substantially certain to be met at the time a deferral election is permitted. Bonus compensation may include payments based upon subjective performance criteria, but (i) any subjective performance criteria must relate to the performance of the participant service provider, a group of service providers that includes the participant service provider, or a business unit for which the participant service provider provides services (which may include the entire organization); and (ii) the determination that any subjective performance criteria have been met must not be made by the participant service provider or a family member of the participant service provider (as defined in § 267(c)(4) applied as if the family of an individual includes the spouse of any member of the family).

Companies are under increasing pressure from shareholders and other groups to subject larger and larger portions of employees' compensation to performance criteria. While often these criteria are purely objective (particularly in the case of executives covered by Code section 162(m)), in many cases the criteria require subjective decisions to be made by a Board, a committee or an employee's supervisor. From the employee's perspective, all such amounts are contingent and subject to the same significant risk that an independent party will determine whether or not he is entitled to receive the amount after the performance period ends. The fact that an amount payable is based to some extent on achievement of subjective criteria should not result in a more restrictive rule for deferral of such amount.

The IRS definition of "performance-based compensation" in the Notice properly accommodates the myriad bonus and performance-based compensation arrangements employers have implemented in recent years. The regulations under section 409A should maintain this definition.

July 1, 2005

Page 5

We note also that, when compensation under an award is conditioned on the achievement of performance goals, some minimum portion of the compensation is likely to be paid regardless of achievement of the performance goals even though often there is no legally binding commitment to do so. For example, a compensation structure might be composed of a base salary, an annual incentive bonus that can vary between 50% and 200% of a target amount based on performance standards, and long-term incentive payments that can also vary between 50% and 150% of a target level based upon other performance standards involving shareholder equity and other measures.

Q&A-22 of the Notice indicates that any portion of an award that is payable regardless of performance will not be treated as performance-based compensation. If a portion of an award does not qualify as performance-based compensation, an election to defer this portion must meet the general rule (*i.e.*, the election must be made prior to the year in which the payment is earned). Requiring two separate elections on the same award, particularly where the award as a whole is highly variable based on performance, will be administratively burdensome and confusing to employees. Therefore, we also request that the definition of performance-based compensation accommodate the common practice of providing a performance-based award that does not make every dollar of the bonus amount contingent on achievement of performance goals. Abuses could be avoided by providing that a bonus amount will not be treated as performance-based where, based on the facts and circumstances, all or a substantial portion of the bonus is substantially certain to be paid. This rule could contain a safe harbor to the effect that the full bonus will be considered performance-based if no more than 50% of the total award is likely to be paid regardless of the performance measurement and the employer is not under a legally binding obligation to pay the bonus at any time during the performance period.

### 3. Application of Code Section 409A to Foreign Pension Plans and Trusts

**Proposal:** We request that regulations provide express exclusions from section 409A coverage for (1) foreign pension plans (and their related trusts) that are subject to Code section 402(b), and (2) resident aliens and non-resident aliens who accrue benefits/contributions (and earnings thereon) under a foreign pension plan prior to, during, or after relocation to the United States.

**Explanation:** Many employers establish separate foreign deferred compensation plans for their global employees and allow international transferees to remain in their home

July 1, 2005

Page 6

country plan. These plans, which often apply to all levels of employees (not limited to high level executives), are either funded or unfunded, and either maintained in accordance with foreign tax-qualified provisions or are provided on a non-qualified basis. In many instances the employee's services are performed in multiple foreign or U.S. locations, on either a temporary or permanent basis, while the trust (if any) is located in a particular foreign jurisdiction. Many companies continue to provide accruals/contributions (or earnings thereon) in the global or home country plan even if the individual is performing services within the U.S. (or other foreign assignment location). This approach of maintaining the employee's pension benefits in a single plan, without interruption due to temporary foreign work assignments, is preferable from both the employer's and employee's prospective.

Code section 409A appears to severely restrict these types of long-standing global compensation structures. Code section 409A imposes restrictions on nonqualified deferred compensation plans, without reference to the location of the plan. It also generally prohibits the use of a foreign trust to fund such plan benefits. Code § 409A(b). (Although there is an exception if substantially all the services are performed where the trust is located, this limited exception provides no relief for employees with multiple international assignments.) Therefore, on its face, section 409A has the potential to impact all foreign plans and trusts (and participants therein), to the extent that the employer maintaining the plan or any one of the participants in the plan is subject to U.S. taxation. Appropriately, Congress recognized that the scope of section 409A may need to be restricted, particularly with respect to the foreign trust provision:

The provision is specifically intended to apply to foreign trusts and arrangements that effectively shield from the claims of general creditors any assets intended to satisfy nonqualified deferred compensation arrangements. The Secretary has authority to exempt arrangements from the provision if the arrangements do not result in an improper deferral of U.S. tax and will not result in assets being effectively beyond the reach of creditors.

Conference Report for the Act, p. 720.

Therefore, we request that the Secretary use its authority to expressly exclude from Code section 409A all foreign pension plans (and their related trusts) that are subject to Code section 402(b). The Code has a long-standing provision for taxing

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July 1, 2005

Page 7

nonqualified deferred compensation arrangements funded with a trust, which already prohibits an improper deferral of U.S. tax. Specifically, Code section 402(b) generally subjects the pension contributions to U.S. taxation when there is no substantial risk of forfeiture. Therefore, imposing the additional complexity of complying with these new U.S. standards for deferred compensation plans and the related tax penalties is unwarranted and threatens to disrupt retirement programs that have been in place for global employees for many years.

We also request that the Secretary use its authority to expressly exclude from Code section 409A all resident aliens and non-resident aliens who accrue benefits/contributions (and earnings thereon) under a foreign pension plan prior to, during, or after their relocation to the United States. In these cases, there is no improper deferral of U.S. taxation or placing of assets beyond the reach of creditors. These assets have historically been exempt from U.S. taxation and mere relocation of the employee to the United States, either on a temporary or permanent basis, should not result in a windfall to the United States government for failure to comply with Code section 409A.

We respectfully recommend also that any extension of Code section 409A beyond U.S. citizens performing services within the United States should be weighed carefully and not imposed without a grace period of at least one year after final guidance is issued. Cross-border transactions in today's global society are common place and the application of U.S. rules on international benefit plans will come as an unwelcome surprise to many employers (and their employees).

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July 1, 2005

Page 8

We hope that these comments are helpful to you in providing additional guidance under Code section 409A. Please contact us at 202-857-0620 if we can answer any questions or provide any further information.

Sincerely,

Louis T. Mazawey

Brigen L. Winters

John F. McGuiness

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