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VIA ELECTRONIC AND HAND DELIVERY

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RE: Need for Code Section 409A Guidance

Dear Eric and Nan:

We are writing on behalf of several clients to request guidance 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 our requests specifically discussed below.

<u>Executive Summary</u>

1. *<u>Extension of Good Faith Compliance Period and Deadline for Plan Amendments</u>*

We request an extension of the good faith compliance period and the December 31, 2005 deadline for amending plans to conform with Code section 409A until 180 days after the publication of final regulations.

2. *<u>Identification of Key Employees</u>*

For purposes of the special distribution rule for "key employees," we propose that the identification of key employees be based on a one-year look-back rule, and with respect to "compensation," as defined under Code section 415, earned during the prior year. For example, the identification of key employees for a 2006 plan year should be based on status as of December 31, 2005 and on section 415 compensation earned during 2005.

3. *<u>Permanent Exception for Certain Severance Arrangements</u>*

We request that regulations include a permanent exception from Code section 409A for certain severance arrangements that either satisfy the Department of Labor safe harbor for severance pay plans, or under which benefits are payable only upon an employee's involuntary termination from employment.

4. *<u>Application of Deferral Election Rules to RSUs</u>*

We request that regulations provide for the application of the performance-based compensation exception under section 409A(a)(4)(B)(iii) and the deferral election rules under Code section 409A(a)(4)(C) (the "subsequent election rules") to deferrals under restricted stock unit ("RSU") arrangements.

5. *<u>Application of Material Modification Rule</u>*

We request that regulations provide that only a modification that <u>materially</u> enhances a participant's benefits or rights under an arrangement will be considered a "material modification" subjecting an otherwise exempt arrangement to the section 409A rules. (We include examples illustrating this concept.) In addition, we request that regulations provide a correction procedure for changes to arrangements that inadvertently result in material modifications.

6. *Addition of Domestic Relations Order Feature*

We request that regulations provide that the addition of a domestic relations order feature with respect to otherwise-grandfathered amounts is not a material modification.

7. *Reduction in Notional Investment Measure/Additional Deferred Compensation Benefit*

We request that regulations confirm that an employer's decision to reduce the plan's notional earnings measure, accompanied by a grant of additional deferred compensation benefits that will be subject to section 409A, will not result in a material modification.

8. *Limited Application of Plan Aggregation Rules*

We request that regulations provide that amounts deferred under the same category of plans be aggregated for purposes of the adverse tax treatment under section 409A only in the case of intentional or otherwise egregious violations.

9. *Alternative Method of Complying with Information Reporting Requirements*

We request that further guidance permit (but not require) employers to report pre-2005 deferrals (and earnings thereon) that are subject to section 409A, on box 12 of Form W-2 (or box 15a of Form 1099-MISC), using Code Y.

10. *Permissible Accelerations*

We request that regulations clarify that the permissible distribution event rules under Code section 409A(a)(2), including the six-month delay on distributions to key employees, generally do not apply when an accelerated distribution is permitted under the regulations.

Requests For Guidance

1. *Extension of Good Faith Compliance Period and Deadline for Plan Amendments*

Proposal: We request an extension of the good faith compliance period and the December 31, 2005 deadline for amending plans to conform with Code section 409A until 180 days after the publication of final regulations.

Explanation: Q&A 19 of Notice 2005-1 (the "Notice") provides generally that plans must be operated in good faith compliance with Code section 409A and the Notice during 2005, and must be amended to conform to Code section 409A by December 31, 2005. We understand that Treasury and IRS are working diligently on further guidance and plan to issue proposed regulations this summer. We are concerned, however, that it will be very difficult, if not impossible, for employers to digest the new guidance, implement the new requirements, and amend their plans in the few remaining months of 2005. Because the term "plan" is defined broadly to include even individual employment agreements, many employers will be required to review and amend hundreds or possibly even thousands of "plans." Further, publicly held employers will be required to satisfy securities and shareholder approval requirements in many cases. We therefore believe that an additional transitional period is essential to conform plans to Code section 409A and the new guidance. If Treasury and IRS decide to extend the transition period, we also ask that notice of the extension be provided as soon as practicable so that employers may plan accordingly.

2. *Identification of Key Employees*

Proposal: We propose that regulations provide a one-year look-back rule for identifying key employees, and permit the identification to be based on status as of the last day of the prior year and on compensation, as defined under Code section 415, earned during the prior year.

Explanation: Code section 409A(a)(2)(B)(i) provides that distributions to a "key employee" (as defined under Code section 416(i)) of a publicly traded corporation upon separation from service may not be made for six months (or upon the earlier death of the employee). While this section could be read to require the determination of key employee status at the time of distribution, the date on which the determination is to be made is unclear. Moreover, Code section 416(i) does not clearly specify as of which date plan sponsors must determine key employee status under that section.

Requiring that the key employee determination under section 409A be made at the time of distribution would be administratively burdensome and may result in abuse, thereby obviating the underlying intent of the six-month rule. The lack of a clear rule may also contribute to inadvertent failures to comply with section 409A, resulting in substantial penalties.

IRS Notice 2001-56 and the conference report for the Economic Growth and Tax Relief Reconciliation Act ("EGTRRA") describe the use of a look-back rule to determine key employee status under Code section 416(i). The EGTRRA conference report provides that an employee is considered a key employee if, <u>during the prior year</u>, the employee was (i) an officer with compensation in excess of $135,000 (for 2005); (ii) a five-percent owner; or (iii) a one-percent owner with compensation in excess of $150,000. Moreover, Notice 2001-56 provides that, "for a plan with a calendar plan year (other than a plan in its first plan year), the determination of whether the plan is top-heavy for the <u>plan year beginning January 1, 2002</u>, is made as of <u>December 31, 2001</u>. For these purposes, officers with annual compensation greater than $130,000 <u>for 2001</u> are key employees." A similar look-back rule should be used for purposes of determining key employees under section 409A.

Code section 416(i) and regulations thereunder suggest that any acceptable definition of "compensation" under Code section 415, including Form W-2 compensation, may be used in determining key employee status under section 416(i). The flexibility provided in defining compensation under the section 415 rules accommodates the many different payroll practices of U.S. employers. This same flexibility should be provided to employers as they make key employee determinations under Code section 409A.

3. Permanent Exception for Certain Severance Arrangements

Proposal: We request that regulations provide a permanent exception from Code section 409A for certain severance arrangements that either satisfy the Department of Labor safe harbor for severance pay plans that do not constitute employee pension benefit plans, or under which benefits are payable only upon an employee's involuntary termination from employment.

Explanation: Neither section 409A nor the Notice specifies whether and to what extent the section 409A requirements apply to severance arrangements. Q&A 19(d) of the Notice does, however, provide a temporary exception from section 409A for 2005 for certain severance payments made to non-key employees or under a plan that is collectively bargained. To be considered "severance pay" for purposes of the transition relief, the arrangement must either satisfy the conditions in the DOL severance pay safe harbor (29 CFR § 2510.3-2(b)(1)(i)-(iii)) or pay benefits only upon involuntary termination of employment. The Notice also requests comments regarding the application of section 409A to severance plans and whether to exclude specific types of severance plans from coverage under section 409A.

We believe that the temporary exception for severance pay should be expanded and made permanent. First, there should be a permanent exception for severance arrangements that satisfy the Department of Labor safe harbor for severance pay plans (29 CFR § 2510.3-2(b)) that do not constitute employee pension benefit plans. Such an exception would recognize that severance payments that meet the limitations of the DOL safe harbor provide minimal opportunity for deferral – either in time or in amount – and are not designed as a substitute for nonqualified deferred compensation. Such an exception also would be consistent with the exception in the FICA regulations for nonqualfied deferred compensation plans. Treas. Reg. § 31.3121(v)(2)-1(b)(4)(iv)(B).

Second, there should be a separate exception for severance benefits that are payable only upon an involuntary termination of employment. Providing an exception for payments made only upon an involuntary separation would be consistent with the principle in Q&A 4 of the Notice that payments made upon the occurrence of a condition related to a purpose of the compensation may fall within the short-term deferral exception to section 409A. It also would recognize that the greatest need for severance where termination is involuntary and an individual is not in a position to plan for lost employment.

4. *Application of Deferral Election Rules to RSUs*

Proposal: We request that regulations provide for the application of the performance-based compensation exception under section 409A(a)(4)(B)(iii), and the subsequent election rules under Code section 409A(a)(4)(C), to deferrals under RSU arrangements.

Explanation: Employers are increasingly granting RSUs to large groups of employees, often in place of stock options or other forms of long-term incentive compensation. For many employers, RSUs represent a significant portion of the compensation of large numbers of employees. Normally, an RSU represents the right to receive a share of employer stock upon vesting. An award of RSUs typically vests on a quarterly or annual basis, provided the grantee remains employed.

A. *Performance-Based Compensation Exception*

A statement in Q&A 22 of the Notice provides that an amount that is based solely on an increase in value of the stock of an employer does not qualify as performance-based compensation under the special 6-month election timing rule in section 409A(a)(4)(B)(iii). We see no reason to have a blanket prohibition on the use of the performance-based compensation exception with respect to compensation that is based on the value of the employer’s stock, and request that Treasury and IRS reconsider this position. In particular, regulations should provide that RSUs generally qualify as performance-based compensation because the amount ultimately payable under such an award depends upon the performance of the employer over the relevant service period. Specifically, the value of an equity award, if any, is determined at the end of the service period based on the value of the employer’s stock at that time, and this amount can not be predicted in advance with any degree of certainty. Employees who are awarded RSUs should have the same opportunity to elect a deferral of payment under the 6-month rule for performance-based compensation exception as employees who receive cash awards based upon some performance criteria other than (or in additional to) stock price.

B. *<u>Subsequent Election Rules</u>*

The regulations should specify that the subsequent election rules apply to any election by an employee as to the timing or form of payment made after the commencement of the relevant service period, regardless of whether the participant makes an initial deferral or payment election. For example, this principle should apply to supplemental retirement plans and other arrangements that may not provide for up-front deferral elections.

Similarly, the regulations should confirm that the subsequent election rule may be used to defer the payment of amounts that otherwise would be paid upon the satisfaction of a vesting requirement (and thus would fall within the short-term deferral exception in Q&A 4(c) of the Notice). For example, an employee may be awarded a specified number of RSUs under which the right to receive the employer's stock vests and shares are transferred in accordance with a service-based vesting schedule. As previously noted, we believe that RSUs that vest in accordance with a service-based schedule generally should be treated as performance-based compensation for purposes of the initial deferral rules. Even if that change is not adopted, the employee should be permitted to elect to defer the receipt of shares under the RSU award in accordance with the subsequent election rule. Under this approach, each such deferral election would need to be made at least 12 months prior to the date shares would otherwise be transferred and the election would need to provide an additional deferral of at least five years.

5. *<u>Application of Material Modification Rule</u>*

Proposal: We request that regulations provide that only a modification that <u>materially</u> enhances a participant's benefits or rights under an arrangement will be considered a "material modification" subjecting an otherwise exempt arrangement to the section 409A rules. In addition, we request that regulations provide a correction procedure for changes to arrangements that inadvertently result in material modifications.

Explanation: An amount deferred and vested under a nonqualified plan before January 1, 2005 (and earnings thereon) is grandfathered and exempt from the requirements of section 409A, provided that the grandfathered amount is not "materially modified" after October 3, 2004.

A. *“Materiality” Concept*

Q&A-18 of the Notice provides that a nonqualified plan is materially modified if a benefit or right existing as of October 3, 2004 is enhanced or a new benefit or right is added. While this general rule does not explicitly contain a materiality standard, guidance under the Act to date has indicated that certain changes that arguably enhance a participant’s rights under an arrangement do not result in a material modification. For example, the Notice provides that the following will not result in material modifications:

- the grant of an additional benefit if it is consistent with an employer’s historical compensation practices,
- certain changes in a plan’s investment measures, and
- certain exercises of discretion by an employer.[1]

While the exceptions to the material modification rule listed in the Notice are helpful, the regulations should more clearly provide that a material modification will only result from a change to a grandfathered arrangement that materially enhances a participant’s benefits or rights under the arrangement. Further examples of changes that will not result in a material modification would also be helpful.

In recent regulations on split dollar life insurance arrangements, the IRS took this suggested approach on grandfathered pre-existing arrangements. As under section 409A, the split dollar regulations provide that an arrangement will lose its grandfathered status if it is materially modified. The regulations acknowledge that not all modifications are material and provide a non-exclusive list of changes that are not material modifications. See Treas. Reg. 1.61-22(j)(2).

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[1] During the 2005 transition relief period, Q&A 18 of the Notice provides that other changes, such as terminating a plan and distributing benefits, will not result in material modifications.

B. *Examples of Non-Material Modifications*

In particular, we request that regulations confirm that the following two changes do not result in material modifications:

Establishing a rabbi trust to informally fund grandfathered amounts

Amounts an employer places in a rabbi trust to assist it in meeting its obligations under a nonqualified plan remain subject to the employer's creditors upon insolvency. Thus, depositing amounts in a rabbi trust does not ensure that a participant will receive his benefits under a nonqualified plan or otherwise enhance a participant's existing benefits or rights under the plan itself.

Revising actuarial assumptions under a qualified retirement plan

Employers periodically revise the actuarial assumptions they use to calculate optional forms of distribution under a qualified retirement plan (e.g., updating mortality table used). This type of change, which may be required by law, could marginally increase (or decrease) the amount of an optional form of payment under a nonqualified plan that automatically supplements the qualified plan. This type of de minimis, highly technical enhancement of a nonqualified plan benefit should not be treated as a material modification.

C. *Inadvertent Material Modifications*

As the above examples indicate, many non-abusive, routine changes to a nonqualified plan, a related qualified plan, or an informal funding arrangement could result in a material modification, even though an employer clearly does not intend this result. If an employer does not realize that a material modification has occurred and continues to administer a nonqualified plan as if it is grandfathered, a violation of 409A can easily occur. Thus, an employee could incur dramatic penalties under section 409A if his grandfathered arrangement is inadvertently materially modified by his employer.

To make grandfathering of an arrangement a feasible alternative, regulations under section 409A should provide a mechanism whereby an inadvertent material modification could be rescinded within a limited period of time. Recently finalized regulations under Code section 422 provide a similar rule for inadvertent modifications of incentive stock options. See Treas. Reg. 1.424-1(e)(4)(viii) (inadvertent change not treated as a modification to the option to the extent the change is removed by the earlier of the date the option is exercised or the last day of the calendar year during which the change occurred).

6. *Addition of Domestic Relations Order Feature*

Proposal: We request that regulations provide that the addition of a domestic relations order feature with respect to otherwise-grandfathered amounts is not a material modification.

Explanation: As noted above, amounts deferred and vested under a nonqualified plan before January 1, 2005 (and earnings thereon) are grandfathered and exempt from the requirements of section 409A as long as the grandfathered amount is not "materially modified" after October 3, 2004. The Notice provides certain helpful examples of changes that do not result in a material modification, but does not address many other common situations. In addition to the guidance requested above, we request that regulations provide certain other examples of common changes that do not result in material modifications.

In particular, we request that the regulations specifically confirm that the payment of an amount under a nonqualified plan pursuant to a domestic relations order – when none has been allowed (formally or informally) before – is not a material modification. Q&A 15(b) of the Notice already provides that a payment under a nonqualified deferred compensation plan to an individual other than the participant to fulfill a domestic relations order is not an impermissible acceleration for purposes of section 409A. The requested guidance is consistent with the view that such a payment does not constitute a material modification because, from the perspective of the participant, adding a domestic relations order feature generally has the effect of reducing, not enhancing, the participant's benefits or rights under the plan. It also helps avoid putting nonqualified plan participants in the position of either defying a court order or triggering negative tax consequences.

7. *Reduction in Notional Investment Measure/Additional Deferred Compensation Benefit*

Proposal: We request that the regulations confirm that an employer's decision to reduce a plan's notional earnings measure, accompanied by a grant of additional deferred compensation benefits that will be subject to section 409A, does not result in a material modification.

Explanation: Q&A 18 of the Notice provides that the reduction of an existing benefit is not a material modification. Further, it is not a material modification to change a notional investment measure to an investment measure that qualifies as a predetermined actual investment under the FICA regulations applicable to nonqualified deferred compensation arrangements. Thus, an employer's decision to reduce a notional investment measure from one based on an investment's return plus a certain percentage (e.g., 2 percent over a mutual fund's actual return) to an earnings measure based upon the investment's actual rate of return should not be treated as a material modification.

We request that the regulations confirm that the grant of additional deferred compensation benefits to offset a participant's loss of expected future earnings as a result of a reduction in the earnings measure will not result in a material modification, so long as the additional benefit is subject to section 409A and the plan specifically identifies it as such. Confirmation of this result would be consistent with the statements in Q&A 18(b) of the Notice regarding the grant of additional benefits.

8. *Limited Application of Plan Aggregation Rules*

Proposal: We request that regulations provide that amounts deferred under the same category of plans will be aggregated for purposes of the adverse tax treatment under section 409A only in the case of intentional or otherwise egregious violations.

Explanation: A "plan" is defined under the Notice as any agreement, method, or arrangement, even if it applies only to one person or individual. Under the Notice, each individual participant is treated as having his own plan for purposes of section 409A, and all compensation deferred for a participant under similar plans maintained by one employer is generally treated as deferred under one plan. For this purpose, plans in each of the following categories will be aggregated and treated as one plan:

- account balance plans,
- nonaccount balance plans, and
- all other plans (e.g., equity compensation subject to section 409A).

A severance plan subject to section 409A may be either an account balance or nonaccount balance plan, depending upon its structure.

A significant effect of this plan aggregation rule is that a violation of section 409A under one plan could result in dramatic tax consequences applicable to all amounts deferred under that plan and all other plans in the same category covering that individual. Under this approach, even non-abusive, inadvertent violations of section 409A with respect to one plan could result in the imposition of significant taxes and interest on other, wholly unrelated plans. For example, a minor, unintended violation with respect to a severance benefit could result in immediate tax and penalties on the participant's nonqualified pension excess plan benefit.

Instead, we request that amounts deferred under the same category of plans be aggregated for these purposes only in the case of intentional or otherwise egregious violations.

9. Alternative Method of Complying with Information Reporting Requirements

Proposal: We request that further guidance permit (but not require) employers to report pre-2005 deferrals (and earnings thereon) that are subject to section 409A, on box 12 of Form W-2 (or box 15a of Form 1099-MISC), using Code Y.

Explanation: Notice 2005-1, Q&A 28 provides that the information reporting requirements are effective for amounts "actually deferred" in calendar years beginning after December 31, 2004 (and earnings thereon). Amounts "actually deferred" before January 1, 2005 (and earnings thereon) are not subject to the information reporting requirements, regardless of whether such amounts are subject to section 409A. As a result, certain amounts that are (or will become) subject to section 409A (i.e., pre-2005 deferrals that were not vested as of December 31, 2004, and otherwise-grandfathered amounts that become subject to section 409A as a result of a material modification) are not reported.

Although many employers view this provision as helpful administrative relief, it is administratively burdensome for employers who would otherwise simply track grandfathered amounts and amounts that are subject to section 409A. Because this approach apparently is mandatory, such employers are required to track multiple "buckets" of deferrals for various section 409A and information reporting purposes. To avoid the administrative burdens created by this mandatory approach to reporting, we request that, on an optional basis, employers instead be permitted to treat all amounts subject to section 409A as subject to Code Y reporting.

10. Permissible Accelerations

Proposal: We request that regulations clarify that the permissible distribution event rules under Code section 409A(a)(2), including the six-month delay on distributions to key employees, generally do not apply when an accelerated distribution is permitted under the regulations.

Explanation: Code section 409A(a)(3) prohibits the acceleration of the time or schedule of any payment under a nonqualified deferred compensation plan, except as provided in IRS regulations. Q&A-15 of the Notice provides that accelerated payments in certain situations will not violate this requirement. However, the Notice does not address whether such accelerated payments would be subject to the six-month delay on payments to key employees upon a separation from service under Code section 409A(a)(2)(B)(i).

In accordance with the Conference Report on the Act, Q&A-15 of the Notice provides – and presumably IRS regulations will provide – exceptions to the "no acceleration" rule for payments in the following situations:

- payments to meet FICA tax (and related federal withholding) obligations on plan benefits;

- payments pursuant to a domestic relations order;

- payments to meet income tax obligations upon vesting under a Code section 457(f) plan; and

- payments necessary to comply with a certificate of divestiture.

Payments in these situations often will not be made upon a separation from service or at the time of another permissible distribution event under Code section 409A(a)(2). For example, FICA taxes are generally due on a nonqualified plan benefit at the time of vesting, or if later, at the time that the amount of the benefit becomes reasonably ascertainable. IRS regulations should clarify that payments may be made in these and similar situations without regard to the permissible distribution event rules in Code section 409A(a)(2), including the six-month delay on distributions to key employees.

The regulations should also provide an exception to the prohibition on accelerations for payments made to meet other employment tax obligations, such as state and local income tax withholding. Such an exception would be consistent with the Conference Report on the Act, which indicates Congress intended regulations to provide an exception for all employment-related taxes, not just federal ones.

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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

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