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Benefits Tax Counsel
Department of the Treasury
1500 Pennsylvania Avenue, NW
Room 3050
Washington, DC 20220

Re: Deferred Compensation Legislation – Urgent Need for Guidance

Dear Bill:

We are writing on behalf of several of our clients to request guidance under section 409A of the Internal Revenue 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 section 409A on their compensation and benefit plans. We understand that Treasury and IRS personnel are trying to provide needed guidance under section 409A on an expedited basis, and we appreciate your considering the issues discussed below as you prepare this guidance.

A. Need for Specific Transition Relief

Code section 409A generally applies to amounts deferred under a nonqualified deferred compensation plan after 2004. The Statement of Managers included in the conference report for the Act (the "Conference Report") indicates that an amount will be considered deferred before 2005 for this purpose if the amount is "earned and vested" before 2005. Treasury staff have indicated informally that they intend to interpret the Act's effective date in accordance with the Conference Report, and that an amount may only be treated as earned and vested before 2005 if all events entitling a participant to an amount have occurred before 2005. Thus, discretionary annual and long-term bonuses payable in 2005 and other forms of incentive compensation generally would not be

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treated as earned and vested before 2005, and would be subject to the new rules under section 409A.

The Act directs Treasury to issue guidance by December 21, 2004 providing a limited period of time during which plans may be amended to permit participants to cancel an outstanding deferral election with regard to amounts deferred after 2004, provided that those amounts are includible in income as earned (or if later, when no longer subject to a substantial risk of forfeiture). The Conference Report states that it is expected that Treasury may provide exceptions to certain requirements of the Act during the transition period (e.g., the rules regarding timing of elections) for plans coming into compliance with the new rules.

We request that the transition relief address the following three items:

1. **Bonus Deferral Elections**

Deferral elections made prior to 2005 with respect to bonuses that are payable after 2004 and subject to the Act should be covered by the transition relief. These elections were made based on reasonable and good faith reliance on existing constructive receipt principles. Employers should be able to permit a participant a brief period in 2005 to affirm and conform such an election (with the understanding that distribution of the deferred amounts will be subject to the new rules under section 409A) or revoke the election. This should be the case regardless of the length of the period over which the bonus is earned (e.g., six months or three years).

2. **SARs and Discounted Stock Options**

The Act does not address whether certain common forms of equity compensation arrangements will be treated as "nonqualified deferred compensation plans" subject to the new rules under section 409A. The Conference Report states that Congress did not intend the new rules to apply to fair market value stock options, and states that Treasury "may also address in regulations issues relating to stock appreciation rights."

Treasury staff have informally indicated that stock appreciation rights ("SARs") may be subject to the new rules under section 409A. We believe that fair market value SARs should not be subject to the new rules consistent with the expected treatment of fair market value stock options. The two are economically equivalent and are often issued by employers in tandem. Further, SARs and options are treated identically for other purposes under the Code, such as the $1 million deduction cap under Code section 162(m) and the special FICA rules of Code section 3121(v)(2).

Treasury staff have also informally indicated that "discounted" stock options will be subject to the new rules under section 409A based on the Conference Report language. Understandably, concerns have been expressed with exempting "deeply discounted" options (e.g., those issued at a 99% discount to fair market value on date of grant) from the new rules. However, many employers issue options to broad-based employee groups at discounts of up to 25%. For example, an employer may have a "nonqualified" employee stock purchase plan that allows substantially all employees to purchase stock at a discount. Consideration should be given to exempting from the new rules options issued with discounts of 25% or less on the basis that such arrangements are subject to taxation under Code section 83.

To the extent Treasury determines that SARs and/or discounted stock options are subject to the new rules, unvested grants could become subject to the new rules on January 1, 2005 under the strict reading of the "earned and vested" standard discussed above. These grants would likely be out of compliance with the new rules immediately. Thus, individuals holding such grants could potentially be subject to taxation, penalties, and interest as soon as their grants vest.

Employees should not be penalized because their employers did not correctly anticipate passage of the Act in 2004 and its relatively restrictive grandfather rules, and that these grants would be subject to the Act while fair market value options would not. Employers may feel obligated to "gross-up" grant recipients who incur penalties and interest as a result of the Act.

Employers utilizing SARs and discounted stock options often provide these awards to a large percentage of their workforce. It is not practical for employers to re-negotiate these contractual arrangements with large numbers of employees before 2005 to avoid these adverse tax consequences. There could also be significant, unanticipated accounting consequences to employers if these arrangements had to be revised.

To the extent Treasury determines that SARs and/or discounted stock options are subject to the Act, we request that any such grants that were issued but not vested before 2005 be exempt from the new rules. At a minimum, we request that fair market value SARs that were issued but not vested before 2005, and that are converted to economically equivalent stock options during a reasonable period in 2005, be exempt from the Act.

3. <u>Grandfathering/Risks of Forfeiture</u>

As noted above, Treasury staff have indicated informally that an amount may only be treated as earned and vested before 2005 if all events entitling a participant to an amount have occurred before 2005. If this is adopted as the standard for determining whether compensation is grandfathered under the Act, the guidance should also clarify that compensation that is otherwise "earned and vested" before 2005, should not be treated as "unvested" simply because the compensation is subject to forfeiture if an employee violates a covenant not to compete or similar "bad boy" clause. For example, a bonus deferred prior to 2005 may contain a condition that the deferred amount is forfeited if the employee voluntarily separates from service during the deferral period and competes with the employer during the two years following the separation. The presence of the non-compete clause should not cause the bonus to be subject to section 409A if it would otherwise be treated as grandfathered under the "earned and vested" standard.

B. Scope of Section 409A Coverage

1. Exception for Certain Severance Arrangements

Section 409A defines a "nonqualified deferred compensation plan" as any plan that provides for the deferral of compensation. Only a limited number of plans are specifically excepted from the definition, including tax-qualified plans, tax-deferred annuities, SEPs, SIMPLEs, and any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. The fact that an exception was provided for these plans suggests that Congress did not intend for section 409A to apply to broad-based arrangements.

Neither section 409A nor the Conference Report specifies whether the new rules apply to severance arrangements. If severance arrangements were treated as subject to section 409A, then (among other things) they would be subject to the requirement that payments to key employees of public companies upon separation from service be delayed for six months. Applying this rule to severance payments would make it very difficult for public companies to provide severance to displaced officers. This is particularly the case because it is very difficult to determine which individuals should be classified as key employees for this purpose (as discussed below). Moreover, applying the section 409A election timing and distribution requirements to severance arrangements could cause many other difficulties, including where the terms of an agreement are negotiated upon the employee's termination in conjunction with the employee's agreement to release the employer from employment-related claims.

To avoid problems such as these, early guidance under section 409A should at a minimum provide an exception for severance arrangements that (1) 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, and (2) are broad-based. Such an exception would be consistent with the exception for the broad-based plans listed above and would recognize that severance plans that meet the limitations of the DOL safe harbor are not designed as a substitute for retirement-type programs.

2. Corporate Transactions and Discounted Options

As noted above, the Conference Report indicates that options granted at a discount to fair market value will be subject to Code section 409A. The exercise price of, and number of shares covered by, outstanding options will often be adjusted by a company based on an acquisition, spin-off, extraordinary dividend, or similar transaction (a "corporate transaction"). The adjustment could be treated as the cancellation of an outstanding option and the issuance of a new option. In some cases, the "new" option could have an exercise price below the fair market value of shares on the date of the adjustment and be considered a newly granted "discounted" option.

Recently finalized regulations under Code section 424 address the impact on incentive stock options ("ISOs") of adjustments for corporate transactions. For this purpose, corporate transactions include mergers, acquisitions, distributions (excluding ordinary dividends, stock splits and stock dividends) and similar transactions. The regulations provide that if a corporate transaction adjustment meets certain requirements, it will not be treated as a modification of the ISO. See Reg. § 1.424-1(a). Therefore, the option will not be treated as newly granted and thus will not need to meet the Code's requirements for an ISO on the new "date of grant." The requirements such an adjustment needs to meet (e.g., spread and ratio tests) ensure that the option is not made more valuable as a result of the adjustment.

Presumably, the rationale for the ISO corporate transaction rule is that an option adjustment that simply places an optionee back in the economic position he was in before a transaction should not be treated as a new option grant. For the same reasons, an option adjustment to address a corporate transaction that is made in accordance with the rules for such adjustments under Code section 424 should not be treated as the issuance of a new option under section 409A. We request that guidance under section 409A include such a rule.

C. Deferral Elections

1. Definition of Performance-Based Compensation

Under section 409A, an initial election to defer "performance-based compensation" earned over a period of at least twelve months may be made as late as six months prior to the end of such period. The Conference Report states that it is intended that the IRS will define "performance-based compensation" to include an amount to the extent it is: (1) variable and contingent on the satisfaction of pre-established organizational or individual performance criteria, and (2) not readily ascertainable at the time of the election. Further, the report provides that performance-based compensation may need to meet certain requirements similar to those under Code section 162(m), but would not be required to meet all requirements under that section.

The Conference Report clearly indicates that an amount may be treated as performance-based compensation under section 409A even if it would not qualify as such under section 162(m). Given this guidance -- as well as the very different policies, purposes, covered employers and employees, and implications for non-performance-based compensation under these two sections -- it is appropriate to have significantly fewer requirements for performance-based compensation under section 409A.

Based on the Report, it appears that the key requirements for performance-based compensation under section 409A are that the compensation is contingent on the attainment of some type of performance criteria and that the amount of the compensation is not ascertainable at the time of the election. Thus, if an employee is entitled to a payment based on the attainment of performance criteria during a service period, the payment should meet these requirements if the amount of the payment is determined by the employer (or its delegate) after the end of the period.

Neither the Act nor the Conference Report require that the terms of a performance-based compensation award be so objective or detailed that a third party could determine whether the performance criteria were attained and calculate the amount payable after the end of the relevant service period. Thus, an amount should qualify as performance-based compensation even if the employer (or its delegate) has some degree of discretion in determining whether the relevant criteria are attained and the amount to be paid.

The Act and the Conference Report also do not address whether equity awards (e.g., options, restricted stock, restricted stock units) will be subject to section 409A or will qualify as performance-based compensation. To the extent equity awards are subject to section 409A, we believe they should qualify as performance-based compensation since 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. Recent history demonstrates well that there is no certainty that the common stock of any company (large or small) will have value at some point in the future, and substantial swings in the price of a particular company's stock over relatively short periods have become quite common. If a cash amount payable upon achievement of subjective performance criteria may qualify for performance-based treatment, it is difficult to understand how an equity award would not qualify when its value is based on completely objective criteria, i.e., the value of employer stock.

To illustrate the above points, we describe a few common types of awards below and suggest the appropriate treatment of the awards under section 409A.

Example 1

At the beginning of 2006, an employer establishes a target annual bonus for an employee of $25,000. The employee will receive the target bonus amount only if, after 2006, the employer determines that criteria based on the employer's financial performance during 2006 are met. In making this determination, the employer may disregard unusual and non-recurring events that impact its financial performance. Even if such criteria are not met, the employee will receive a $5,000 bonus if he remains employed through the end of 2006.

> Result: Any bonus amount paid in excess of $5,000 is treated as performance-based compensation.

Example 2

At the beginning of 2006, an employer establishes a target bonus of $10,000 for an employee. The bonus will be payable after 2006 if the employee's immediate supervisor determines, in his or her discretion, that the performance criteria for the bonus are met. The performance criteria are that the employee's responsiveness to customers and his superiors must improve from his responsiveness in 2005 and the employee's performance is otherwise satisfactory in terms of skills and observing company policies.

> Result: The $10,000 bonus is treated as performance-based compensation.

Example 3

At the beginning of 2006, an employer awards an employee 10,000 restricted stock units. If the employee remains employed through the end of 2010 and after 2010 the employer determines that criteria based on the employer's financial performance (or that of a business unit or product line) are met, the employee will receive up to 10,000 shares of employer stock in settlement of the restricted stock unit award. The number of shares received will be between zero and 10,000 depending on the extent to which the criteria are met. In determining whether the criteria are met, the employer may disregard unusual and non-recurring events that impact its financial performance.

> Result: The 10,000 shares are treated as performance-based compensation.

We request that the guidance under section 409A make clear that the types of awards described above qualify as performance-based compensation.

2. Deferral Elections for Restricted Stock Units

Employers are increasingly granting restricted stock units ("RSUs") to large groups of employees, often in place of options or other forms of long-term incentive compensation. 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 normal RSU as described above may not be subject to section 409A, particularly if Treasury exempts from that section amounts paid within 2-1/2 months of the year in which they vest. For purposes of section 409A and any such exemption, an amount should be considered "paid" or "payable" under an RSU on the date that the RSU vests and a share is deliverable to the grantee. The date of vesting is also the date that the value of the share would normally be subject to federal income tax under Code section 83.

Whether or not a normal RSU is subject to section 409A, an election to defer receipt of shares payable under an RSU would still seem to be covered by these rules. As explained above, we believe amounts payable under an RSU (and other equity awards) should be treated as performance-based compensation under section 409A. This treatment is appropriate because the ultimate amount payable under an RSU, if any, will be based on the value of an employer's stock at the end of the relevant service period, and this amount can not be predicted in advance with any degree of certainty. Further, RSUs are increasingly replacing other forms of long-term incentive compensation, and thus, becoming a significant component of total compensation for many employees. Employers should not be discouraged from using such an important method of compensation because it is not treated as performance-based under section 409A while cash compensation payable upon the attainment of subjective goals qualifies as performance-based.

To the extent Treasury determines that RSUs are subject to section 409A, we request guidance that they will be treated as performance-based compensation. Under this approach, an election to defer receipt of a share payable under an RSU may be made as late as six months before the end of the relevant service period (i.e., the date the right to receive the share vests). The following example illustrates this rule:

Example

At the beginning of 2006, an employer awards an employee 10,000 restricted stock units. If the employee remains employed through the end of 2010, the employee will be entitled to receive 10,000 shares of employer stock in settlement of the restricted stock unit award.

> Result: The 10,000 shares are treated as performance-based compensation, and the employee may elect to defer receipt of the shares as late as June 30, 2010.

3. Initial Deferral Elections Under New Plans

Section 409A requires initial participant elections to defer compensation to be made before the beginning of the taxable year in which the services are performed giving rise to the compensation, or at such other time as provided in regulations. An exception to this general rule provides a 30-day election period for newly eligible participants.

Guidance should provide that when an employer adopts a new plan subject to section 409A, all eligible participants in the new plan may make a deferral election during the first 30 days after they become eligible. Guidance could also make clear that a plan will not be treated as a "new plan" for this purpose if it is substantially identical to a plan the employer had in place within a specified period before the effective date of the purported new plan. For this purpose, plans should not be considered substantially identical if there are two or more significant differences between the key provisions of the plans (e.g., eligibility, types of deferrals permitted, method for crediting earnings, vesting, timing of distributions). Differences that are required by (or integral to) section 409A would be ignored in such an analysis.

D. Distribution Issues

1. Permissible Distribution Triggers

Section 409A(a)(2)(A) provides generally that compensation deferred under a nonqualified deferred compensation plan may not be distributed earlier than separation from service, death, disability, a specified time or pursuant to a fixed schedule, a change in ownership or effective control of the employer, or an unforeseeable emergency. Section 409A(a)(3) generally prohibits the acceleration of payments before the time or schedule specified in the plan or by the participant at the time of deferral, except as provided by Treasury regulations. We request that the guidance issued by Treasury address the following two items related to these requirements:

a. "Earlier of" Rule

Treasury staff have informally indicated that a plan may provide that payments will be made (or begin) upon the earlier of two or more otherwise permissible distribution triggers. For example, it appears that a plan could provide for the distribution of a participant's benefit at age 55 or, if earlier, the participant's separation from service, death or disability. Similarly, it appears that a plan could provide for the payment of a participant's benefit on the date that is three years from the date the deferral arrangement begins or, if earlier, the participant's separation from service. We request that the guidance under section 409A clarify that a plan may provide for the commencement of payments upon the earlier of two or more permissible distribution triggers, and that such a provision will not be an impermissible acceleration under section 409A.

b. Payments on Termination of Plan

An employer's decision to terminate a deferred compensation plan is not one of the specified distribution triggers under section 409A. The Conference Report does, however, provide that it is intended that Treasury provide limited exceptions to the prohibition on accelerated distributions, such as when the acceleration "is required for reasons beyond the control of the participant and the distribution is not elective."

Pursuant to this authority, the guidance should provide a limited exception for non-elective distributions that are made upon the termination of a plan for "reasons beyond the control of the participant." Providing a limited exception for plan terminations is consistent with the general principle that employee benefit arrangements are voluntary and may be terminated at the discretion of the employer. Without such an exception, employers would effectively be precluded from ending a deferred compensation arrangement until all amounts are paid out under the plan pursuant to the specified section 409A distribution triggers, regardless of whether it is still in the employer's business interest to maintain the plan. If desired, this exception could be limited to plans that cover a minimum number of employees.

2. Determination of Key Employees

Section 409A provides that payments to a "key employee" 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). "Key employee" is defined by reference to the Code section 416(i) top heavy rules. The definition of key employee under section 416(i) includes "an employee who, at any time during the plan year, is . . . an officer of the employer having annual compensation greater than $130,000." The $130,000 amount is adjusted for inflation ($135,000 for 2005), and no more than 50 employees will be treated as officers.

Historically, large public companies with plans that will be subject to the Act have not had reason to identify their key employees under section 416(i). Further, the regulations under section 416 -- based primarily on a “facts and circumstances test” -- are not particularly helpful in determining the individuals that should be classified as officers for this purpose. See Reg. § 1.416-1, T-13. In addition, determining the "top 50" officers under Code section 416(i) can be complex. See Reg. § 1.416-1, T-14 and T-21.

Public companies are, however, required to identify their officers for purposes of section 16 of the Securities Exchange Act of 1934. Individuals treated as officers under section 16 are required to file reports with the SEC (Forms 3, 4, and 5) on their transactions in employer securities and are subject to the so-called “short-swing profit” rules. The definition of officer applicable under section 16 provides fairly specific guidance on the individuals who are considered “officers” (unlike the definition provided in the section 416 regulations). See SEC Rule 16a-1(f).

To facilitate compliance with the key employee rule, we request that early guidance under section 409A provide that:

a. An employer may determine its key employees for a plan year as of the first day of the plan year, based on their status on that date and their compensation (which may be based on Form W-2 compensation) from the employer during the prior plan year, and

b. At least during a reasonable transition period before issuance of final guidance, an employer's “officers” for purposes of this determination may be limited to those individuals treated as officers under section 16 of the Securities Exchange Act of 1934.

Absent reasonable guidance on this issue, cautious employers may treat many more employees as “key employees” than required, potentially resulting in disgruntled employees and costly disputes.

E. Fiscal Year Arrangements

The Conference Report provides that it is expected Treasury will provide for coordination rules, as appropriate, regarding the timing of elections in cases where the fiscal year of an employer and the taxable year of an individual are different. The guidance should provide that for bonuses based on performance during an employer's fiscal year that do not qualify as "performance-based compensation," participant deferral elections should be permitted at any time prior to the beginning of the relevant fiscal year. This type of coordination rule would simply put employees of fiscal year employers in the same position as employees of calendar year employers.

The Conference Report also provides that Section 409A is not intended to apply to annual bonus or other annual compensation paid within 2-1/2 months after the close of the taxable year in which the relevant services required for payment have been performed. The guidance should provide that Section 409A similarly does not apply to fiscal year bonuses or other fiscal year compensation paid within 2-1/2 months after the end of the fiscal year. Such a coordination rule also is necessary to provide parity between employees of fiscal year employers and employees of calendar year employers.

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

Sincerely,

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