

List of Technical Issues Regarding JCT Description of Chairman's Mark/ Possible Conference Report Language

Treasury transition guidance – The report language should clarify as follows with respect to transition time needed to comply with 409A by adding the following **immediately at the end of the last paragraph under Effective Date**:

The transition period prescribed by the Secretary will be sufficiently long to allow employers a reasonable period of time to review the additional guidance provided by the Secretary, determine the specific changes that are then to be made to their plans, and secure the necessary approval from their governing bodies for such changes

Transfers to rabbi trusts – On **page 299 of the JCT description** (carryover paragraph at the top of the page), the section on financial health triggers includes a sentence stating that: "The proposal applies in the case of a plan that provides that upon a change in financial health, assets will be transferred to a rabbi trust." This sentence is not consistent with the statutory provisions, which provide that there is a transfer under sec. 83 with respect to deferred amounts as of the date the "plan first provides that assets will become restricted to the provision of benefits under the plan in connection with a change in the employer's financial health" or " the date on which assets are first restricted."

This sentence in the JCT description should not be included in the conference report because: (1) a transfer to a rabbi trust is not considered a transfer under sec. 83, and (2) a transfer to a rabbi trust does not result in the transferred assets being restricted to the provision of benefits because the assets will be available to the claims of general creditors.

Fiscal Year plans – On p. **297 of the JCT description** (first paragraph under the subheading "Requirements with respect to elections"), the Secretary is given authority to issue guidance providing rules regarding the timing of elections where the fiscal year of the employer and the taxable year of the individual are different and a bonus is determined on the basis of the employer's fiscal year. The next sentence provides an example under which Treasury guidance "could provide that the election requirement is satisfied in such case if the election is required to be made prior to the end of the close of the employer's preceding fiscal year." These sentences appear to contemplate stricter election-timing rules for fiscal year bonuses than for calendar year bonuses. For example, in the case of a calendar year bonus payable the March of the following year, the election would be required by June 30 (approximately 9 months in advance). In the case of an employer with a July 1 to June 30 fiscal year and a bonus payable in September, it appears that the election could be required, e.g., by June 30, 2005 with respect to a bonus payable in September 2006 that is attributable to the July

1, 2005-June 30, 2006 fiscal year (approximately 15 months in advance). There does not appear to be any policy justification for this distinction.

These sentences should not be included in the conference report.

Stock appreciation rights (SARs) – Report language is needed to make clear that Treasury would have authority not to treat as NQDC those arrangements that are economically equivalent to stock options. The language in the **JCT description on p. 299** (second full paragraph) could be augmented as follows:

For purposes of the provision, it is not intended that the term "nonqualified deferred compensation plan" include an arrangement taxable under section 83 providing for the grant of an option on employer stock with an exercise price that is not less than the fair market value of the underlying stock on the date of grant if such arrangement does not include a deferral feature other than the feature that the option holder has the right to exercise the option in the future. *The Secretary has authority to define the term also to exclude arrangements that are economically equivalent to such a stock option, e.g., a stock appreciation right under which compensation does not exceed the appreciation on the stock from the date of grant regardless of whether the compensation is paid in cash or stock.*

Supplemental retirement plans (CERPs) – Report language is needed to ensure that Treasury has authority to write rules allowing for payout elections in supplemental retirement plans. The language in the **JCT description on p. 298** (last sentence of the first full paragraph) could be augmented as follows:

It is expected that in limited cases, the Secretary shall issue guidance, consistent with purposes of the proposal, regarding to what extent elections to change a stream of payments are permissible, *including elections with respect to retirement payments under nonelective, supplemental retirement plans.*

Payments to satisfy taxes – The committee report should clarify that the payment of employment taxes or a distribution reasonably intended to satisfy tax liabilities is not an impermissible distribution in violation of 409A.. This clarification is needed for 457(f) arrangements sponsored by tax-exempts in which taxation is required under 457 at vesting but prior to a distribution event under the plan. In addition, a similar situation may arise with respect to a "key employee" who is subject to employment taxes under Code section 3121(v) but for whom distributions are restricted for 6 months after separation from service. Language should be added at the end of the first paragraph on page 297 of the committee report to the paragraph that begins "It is intended that the Secretary will provide other, limited, exceptions to the prohibition on accelerated distributions. ." as follows: *"In addition, it is intended that, in cases where deferred compensation is subject to income taxes prior to payment (such as in the case of deferred*

compensation subject to section 457(f)) Treasury regulations permit a plan to make distributions reasonably calculated to cover the applicable Federal, state and local taxes payable by the employee. For this purpose, except as otherwise provided by the Secretary, a plan would be permitted to assume that the deferred compensation is subject to the highest marginal income tax rate for both Federal and state purposes. Thus such payments would neither constitute an impermissible distribution or an acceleration of benefits.

ISOs, ESPPs and restricted stock – Report language is needed to make clear that incentive stock options under Code section 422 and employee stock purchase plans under Code section 423(b) are “qualified employer plans” under Code section 409A(d)(2) and that grants of restricted stock and other compensatory transfers of property governed by Code section 83 are not subject to the provisions of Code section 409A.

Add the following sentence to footnote 520 on p. 299 of the **JCT description under Definition of nonqualified deferred compensation plan**:

“Incentive stock option plans under Internal Revenue Code Section 422 and employee stock purchase plans under Code section 423(b) are qualified employer plans.”

Add the following sentence immediately following the sentence on **line 14** of the section entitled Definition of nonqualified deferred compensation plan on **page 299 of the JCT description** (relating to the exclusion of stock option plans from the definition of deferred compensation):

“It is intended that grants of restricted stock and other compensatory transfers of property governed by Code section 83 are not subject to the provisions of 409A.”

Plan failures – Under the statute, it appears that all amounts deferred under a “plan” by or for a participant would be subject to tax, interest, and penalties if there is a violation of sec. 409A with respect to the participant. Report language is needed to make clear that if a violation of 409A occurs under a deferred compensation plan with respect to amounts deferred after 2004 by or for the participant under the plan, only the post-2004 amounts will be subject to tax, interest, and penalties.

Committee report language should be modified to add the following sentence at the end of the last paragraph under Description of Proposal, In General, pages 295 and 296 of the JCT description:

Amounts deferred by or for the participant before 2005 under the plan will not be subject to tax, interest, and penalties, provided such amounts have not become subject to the provisions of 409A because of a material modification to the plan.

“Separation from service” – Committee report language should be added on page 295 under the header “separation from service,” as follows: *“In the case of compensation deferred for services as an employee, “separation from service” shall mean termination of the employment for which the deferred compensation has been earned.”* Otherwise, there is a concern that “separation from service” will include the “same desk rule” that has applied to qualified retirement plan area and, in this context, would preclude a distribution under Code section 409A even when an employee terminates from employment but may continue performing services for a new employer that does not sponsor the deferred compensation plan.

Employer-initiated transfers of employees – A sentence should be added to the first full paragraph on page 297 providing another example on exceptions to the prohibition on accelerated distributions. The sentence should read: *“The prohibition on accelerated distributions does not apply where a participant is moved from one deferred compensation arrangement to another as a result of employer initiated employment transfers or corporate restructurings”*. Otherwise, a mere difference in distribution conditions between the two arrangements could result in a prohibited change in the terms of deferral or acceleration of distributions.

Foreign trusts – The bill excludes from its offshore trust provision *“any assets located in a foreign jurisdiction if substantially all of the services to which the nonqualified deferred compensation relates are performed in such jurisdiction.”* The wording would suggest that a global company that frequently transfers employees from country to country could not maintain a single trust for the deferred compensation of all of its global employees, but would have to establish a separate trust for each jurisdiction in which employees work and determine each year where “substantially all” the services of each employee were performed. The serious practical problems created by the wording are compounded by the fact that some countries do not have well developed trust laws and others do not even recognize trusts as legal entities and a single trust makes it possible to treat employees equitably.

The committee report should clarify that it is permissible to have a single foreign trust that provides deferred compensation to employees who work multiple jurisdictions outside the United States by clarifying the sentence referenced above in the JCT description of Foreign trusts, page 298 as follows:

The proposal does not apply to assets located in a foreign jurisdiction if substantially all of the services to which the deferred compensation relates are performed in that jurisdiction or to assets located in a foreign jurisdiction maintained as part of one or more trusts by an employer for employees substantially all of whose services to which the deferred compensation relates are performed in one or more foreign jurisdictions.

Commission income – The proposed bill provides that an initial election to defer compensation must be made before the beginning of the first taxable year of the participant in which the services are performed. It is unclear how this requirement applies (if at all) to deferrals of commission income because, in case of commission income, it is difficult, if not impossible, to relate a commission payment to the performance of specific service (it may depend on the actions of a third-party over time: such as the execution of a contract, the renewal of a contract, taking delivery, not canceling a contract, making payment, etc.).

The committee report language should be modified under the Requirement with respect to elections, **page 297 of the JCT description** to add the following sentence (immediately before the last sentence in the first paragraph):

It is expected that the Treasury Department would issue guidance to address the unique circumstances affecting compensation derived from commissions.

Definition of when amounts are deferred – The committee report language should clarify when amounts are deferred for purposes of the effective date and the grandfather and for purposes of applying the section 409A rules on an ongoing basis. The following two sentences should be added **after the first sentence in footnote 517**.

The guidance is expected to recognize that amounts deferred under existing programs have varied times when they are considered “earned and vested” and will provide for appropriate opportunity to make changes to those programs so as to allow amounts earned with respect to performance before the effective date to be treated as “irrevocably earned and vested” prior to the effective date if subject to an election before the effective date. For purposes of a non-elective plan the amount deferred as of the effective date is the accrued vested benefit as of December 31, 2004.