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April 15, 2005

The Honorable Mark W. Everson
Commissioner of Internal Revenue
Internal Revenue Service
Room 5226
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on Section 409A Regarding Funding Issues

Dear Commissioner Everson:

Enclosed are comments on Section 409A regarding funding issues. These comments represent the individual views of those members who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

Sincerely,

Kenneth W. Gideon
Chair, Section of Taxation

Enclosure

cc: Carol Gold, Director – TEGE Employee Plans, IRS
Nancy Marks, Division Counsel/Associate Chief Counsel – TEGE, IRS
Stephen Tackney, Attorney, Office of Division Counsel/Associate Chief Counsel – TEGE, IRS
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COMMENTS ON CODE SECTION 409A REGARDING FUNDING ISSUES

The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments were prepared by individual members of the Employee Benefits Committee of the Section of Taxation. Principal responsibility was exercised by Don Norman. Substantive contributions were made by Bridgette Renaud, Catherine Thomson and Joel Wood. Contributions were also made by other members of the American Bar Association, Robert D. Albergotti and Trey Monsour. The comments were reviewed by Wayne R. Luepker, Chair of the Subcommittee on Executive Compensation, Greta E. Cowart and David A. Mustone, Vice Chairs of the Section's Employee Benefits Committee, and Priscilla E. Ryan, Chair of the Section's Employee Benefits Committee; by the Quality Assurance Group of the Employee Benefits Committee; which is chaired by Thomas R. Hoecker and whose members are former chairs of the 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 and members of the American Bar Association who participated in preparing these comments may have clients who would be affected by the federal tax principles addressed by these comments or have advised clients on the application of such principles, no such member (to 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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Date: April 15, 2005

I. EXECUTIVE SUMMARY

Section 409A(b)[1] contains rules relating to the taxation of deferred compensation involving certain (i) offshore trusts and (ii) trusts providing that their funds will be restricted to funding deferred compensation obligations when there has been a change in the employer's "financial health." Section 409A(e) authorizes the Secretary of Treasury (the "Treasury") to issue regulations to carry out the purposes of Section 409A, including the exemption of arrangements that "will not result in an improper deferral of United States tax and will not result in assets being effectively beyond the reach of creditors…." Section 409A(e)(3). We recommend that the Treasury exercise this authority to issue regulations or a notice ("Regulations") as summarized below.

We recommend that Regulations:

(1) address the scope and application of the key term "the employer's financial health";

(2) clarify that Section 409A(b) does not apply to a change in control or other similar corporate event;

(3) clarify that the grandfather rules set forth in Notice 2005-1, 2005-2 I.R.B. 274 ("Notice 2005-1") Q&A-16 through 23, that apply to any deferred compensation that became vested before January 1, 2005 also apply for purposes of Section 409A(b);

(4) apply the Notice 2005-1 transition relief for correcting noncompliant arrangements to trusts subject to Section 409A(b);

(5) clarify that Section 409A(b)(2) does not apply to trusts that fund Key Employee Retention Programs ("KERPs") established by a debtor in bankruptcy, as long as such a trust is established with the approval of the bankruptcy court; and

(6) provide that KERPs that provide for post-petition distributions to be made when certain business goals are achieved, which are not distribution events under Section 409A(a)(2)(A), are not deemed to be prohibited accelerations under Section 409A(a)(3) and are not deemed to be disqualifying distributions under Section 409A(a)(2).

[1] All references to Sections are to sections of the Internal Revenue Code of 1986, as amended (the "Code"), unless expressly stated otherwise.

II. BACKGROUND

Section III.A.(2) of Notice 2005-1 requests comments on funding arrangements for nonqualified deferred compensation that involve foreign trusts or similar arrangements, and identification of arrangements that will not result in an improper deferral of United States tax and will not result in assets being effectively beyond the reach of creditors. The following comments are submitted in response to that request.

III. COMMENTS

A. **FUNDING - FINANCIAL HEALTH TRIGGERS**

1. Summary.

Section 409A(b)(2) provides that a transfer of property under Section 83 occurs on the earlier of (i) the date on which a nonqualified deferred compensation plan first provides that assets will become limited to the payment of plan benefits in connection with a change in the employer's financial health, or (ii) the date on which the assets are so restricted (regardless of whether the assets are available to satisfy claims of general creditors). In general, this means that the mere presence of such a "financial health trigger" in a plan document causes assets set aside to fund plan benefits to become taxable to participants (unless the benefits are subject to a substantial risk of forfeiture).

2. Recommendations.

We recommend (i) that Regulations define "a change in an employer's financial health" to be limited to changes that involve the employer's continued financial viability and that specific exemptions be included in the Regulations to permit funding upon the occurrence of certain corporate events that may be related to an employer's financial condition but that are not likely to threaten the employer's ongoing financial viability, such as a work force reduction, plant closing or similar restructuring (a "Business Restructuring") and (ii) that the Regulations not extend the definition of "a change in an employer's financial health" to all changes involving an employer's financial condition. In addition, we recommend that Regulations provide that a "change in control" distribution event will not implicate Section 409A(b)(2).

3. Explanation.

The Conference Report states that the rules regarding financial health triggers were not intended to apply where (i) the assets become restricted for reasons other than a change in the employer's financial health (e.g., a change in control) or (ii) assets are periodically restricted under a structured schedule and the scheduled restrictions happen to coincide with a change in the employer's financial health. *See* H.R. Conf. Rep. No. 108-755, 2d Sess. (2004) at 734. Thus, the prohibition on financial health triggers is not intended to apply to all circumstances in which an employer's financial circumstances may cause the employer to desire to fund its nonqualified deferred compensation obligations.

While there were publicized deferred compensation funding abuses prior to the enactment of Section 409A, the Conference Report only discusses a transfer of assets or other funding of deferred compensation arrangements that occurs upon a change in the employer's financial health. Since positive changes do not raise abuse issues, we can only presume that this provision was targeted toward negative changes in financial health of the employer.

In light of this presumed purpose, it follows that the funding of deferred compensation tied to an initial filing for bankruptcy, insolvency or other significant financial event affecting the employer's continued financial viability should constitute an impermissible financial health trigger. However, it does not follow that deferred compensation arrangements that become funded in connection with a Business Restructuring (for example, a payout or funding of deferred compensation that is triggered by a workforce reduction, plant closing, change in product lines or similar restructurings) should not automatically be treated as a funding that occurs on account of an impermissible financial health trigger.

A reduction in force may occur as a result of a company's decision to close a plant or change product lines, but such an action ordinarily would not be an indication of the company's impending failure.Plants may also be closed due to changes in the legal environment, such as when the California "pay or play law" (Health Insurance Act of 2003, also known as Senate Bill 2, mandating that employers purchase health insurance for employees) was first enacted.[2] A research facility could be closed due to a competitor recruiting away key engineers or researchers; the funding of a deferred compensation arrangement upon such a closing would not violate the purpose of Section 409A. If a trust becomes funded only for the persons affected by a reduction in force or a plant closure, this is not likely to be an abusive situation, but merely a technique to provide assurance to the former employees affected by the change in the employment environment. Allowing the accelerated funding only to fund benefits for the persons who have had their employment adversely affected by such a change is in keeping with the purpose of Section 409A. Another alternative would be to allow accelerated funding of only the benefits for non-key employees.

Similarly, Regulations should confirm that a change in control or other similar corporate event does not constitute an impermissible financial health trigger under Section 409A(b)(2). Because a change in control can and often does occur in situations that are unrelated to any change in the financial health of the target company, inclusion of a change in control as an impermissible financial health trigger would impede normal business transactions. Since a change in control is a permitted acceleration event, it should also be a permitted funding event. If an amount can be paid directly to an employee, there should be no objection to it being held in a trust for the employee.

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[2]The "pay or play law" required employers to provide health benefits at certain levels or to pay an additional tax to fund those benefits through the state mechanism. This law was repealed before it became effective due to the defeat of California Proposition 72 on November 3, 2004.

B. GRANDFATHERING AND TRANSITION RELIEF FOR FUNDING REQUIREMENTS OF 409A(b)

1. Summary.

Notice 2005-1 addresses the grandfather rules for pre-2005 deferrals and provides transition rules for amending nonqualified deferred compensation plan documents during 2005 to bring them into compliance. The Notice does not expressly address whether the grandfather rules for pre-2005 vested deferrals apply to funding arrangements addressed in Section 409A(b), nor does it expressly provide any transition relief for trust arrangements otherwise subject to Section 409A(b). As a result, the Notice may be interpreted to mean that any trust arrangement in existence on December 31, 2004 that does not comply with Section 409A(b) makes its accompanying plan subject to Section 409A.

2. Recommendations.

We recommend that Regulations clarify that any pre-2005 vested deferrals (which are otherwise "grandfathered" under Section 409A) that prior to January 1, 2005 were in an offshore trust within the meaning of Section 409A(b)(1) or would be funded upon the occurrence of a change in an employer's financial health within the meaning of section 409A(b)(2) are not subject to taxation under Section 409A(b). In addition, we recommend that Regulations clarify that the transition relief provided in Notice 2005-1 also applies to noncompliant funded arrangements, thereby permitting a temporary grace period in which employers may either achieve compliance with Section 409A or terminate the arrangement. We recommend that Regulations provide that employers have until December 31, 2005 to bring a noncompliant funding arrangement into compliance.

3. Explanation.

The statutory language in section 885(d)(1) of the American Jobs Creation Act (the "Act") provided, "The amendments made by this section shall apply to amounts deferred after December 31, 2004". The Conference Report and Notice 2005-1 provide that Section 409A does not apply to any pre-2005 vested deferred compensation (unless a material modification occurs after October 3, 2004). There is nothing in Section 409A to suggest that section 885(d)(1) of the Act would not apply to funding arrangements under Section 409A(b).

Section 409A(e) provides that the Treasury shall prescribe regulations as may be necessary or appropriate to carry out its purpose, including regulations exempting arrangements from the application of subsection (b) if such arrangements will not result in an improper deferral of United States tax and will not result in assets being effectively beyond the reach of creditors. In our view, the Treasury is clearly authorized to provide the requested transition relief for amending trust arrangements to comply with Section 409A(b).

C. BANKRUPTCY LAW PROTECTIONS GENERALLY NEGATE THE REASONS FOR SECTION 409A WHEN A SERVICE RECIPIENT IS IN BANKRUPTCY

1. Summary.

Section 409A(b)(2) provides:

> In the case of compensation deferred under a nonqualified deferred compensation plan, there is a transfer of property within the meaning of Section 83 with respect to such compensation as of the earlier of –
>
> > (A) the date on which 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
> >
> > (B) the date on which the assets are so restricted,
>
> whether or not such assets are available to satisfy claims of general creditors.

When an entity undergoes a bankruptcy restructuring of its debts, it often makes arrangements using trusts or set asides ("Trusts") approved by an order of the bankruptcy court to retain key employees so that the business may continue operating and emerge from bankruptcy as a going concern after the reorganization. These Trusts fund payouts under a retention program or similar arrangement (a "KERP") that provides incentives for key employees to remain in employment until the entity's emergence from bankruptcy, a sale of the business after the entity's emergence from bankruptcy, or other similar event. KERPs are generally used to assist the employer or debtor in possession (the "DIP") to retain its key employees or executives through a restructuring of the company under Chapter 11 of the Bankruptcy Code. KERPs are established by order of the bankruptcy court after notice to the creditors and a hearing, but the order establishing the KERP is only presented to the court after the terms of the KERP are negotiated between the DIP and its creditors. Thus, each KERP can have its own unique features.

KERPs and the Trusts established to fund them generally provide that bonuses will be paid to designated individuals upon the occurrence of certain events occurring in the bankruptcy, such as confirmation of the plan of reorganization, attainment of a pre-established EBITDA amount, confirmation of the reorganization plan, or a set time period after achievement of such goals. In some situations where the creditors committees[3] are very aggressive in negotiating the KERP and the order, the KERP (i) may provide that payments are deferred for a period after the payment conditions are satisfied, or (ii) may require multiple conditions to be satisfied before payments are made. The amount to be paid to each employee pursuant to the KERP would be a set amount or established under a formula in the order establishing the KERP. An important fact

[3] Creditors committees include the common committees found in bankruptcy for secured creditors and the separate committees for unsecured creditors and other groups with a common type of claim.

to keep in mind when considering whether an exemption should be made for such KERPs and their related trusts is that while a DIP operates the business under a Chapter 11 bankruptcy, the DIP does so as a fiduciary with respect to the bankruptcy estate and its creditors under Section 1107 of the Bankruptcy Code.

Amounts in the Trust cannot be reached by creditors of the DIP after the Trust is approved by the bankruptcy court. Bankruptcy law provides protections for creditors and for the employees of the DIP that suggest that Section 409A(b)(2) would unnecessarily hamstring a DIP's ability to attract key employees who could successfully lead the debtor out of bankruptcy.

2. Recommendations.

We recommend that Regulations clarify that Section 409A(b)(2) does not apply to Trusts that fund KERPs established by a debtor in bankruptcy, as long as such a Trust is established with the approval of the bankruptcy court.

We recommend that Regulations provide that KERPs that provide for post-petition distributions to be made when certain business goals are achieved, which are not distribution events under Section 409A(a)(2)(A), are not deemed to be prohibited accelerations under Section 409A(a)(3) and are not deemed to be disqualifying distributions under Section 409A(a)(2).

3. Explanation.

It is quite common in a bankruptcy reorganization for a DIP to seek court approval of a KERP, which is often funded by a Trust or by a set aside, the funds for which are often included in the financing arrangements negotiated by the DIP after the bankruptcy petition is filed (such arrangements are commonly referred to as "set-asides"). Frequently a KERP provides payment only if an employee continues employment until a certain date or the occurrence of a certain event, such as the DIP emerging from bankruptcy or meeting certain financial or operational goals, or meeting key dates in the restructuring or reorganization plan. Thus, employees participating in these types of arrangements do not become vested in the amounts set aside until the goals are achieved or the relevant event occurs. For this reason, these types of arrangements are not covered by Section 409A at all and the fact that they are funded as described in Section 409A is immaterial. We request that Regulations confirm this.

However, there are situations where the amounts earned under such an arrangement are not paid out when they become vested, and we believe Regulations either should clarify that such arrangements are exempt from Section 409A(b)(2) or should provide an exemption from Section 409A(b)(2) because of the protections afforded under the bankruptcy laws. When an employer files for bankruptcy reorganization or liquidation[4], all decisions outside the ordinary course of business require bankruptcy court approval pursuant to 11 U.S. C. §363, after notice and hearing

[4] While many bankruptcies are filed with the intent of reorganizing and emerging from bankruptcy, some of these debtors will not emerge from bankruptcy and they convert to a bankruptcy proceeding for liquidating the debtor's assets to pay debts. In either a reorganization or a liquidation, any KERP would be established through the same procedures.

as defined in the Federal Rules of Bankruptcy Procedure and local bankruptcy court rules. KERPs that are funded through a Trust are considered outside the ordinary course of business and require the approval of the bankruptcy court. Rule 2002 of the Federal Rules of Bankruptcy Procedure ("Rules") provide that before any order is entered by the bankruptcy court, notice of at least 20 days (unless otherwise shortened by the court when cause is established) be given to any official committee(s) (such as the secured creditors committee or unsecured creditors committee) appointed in the case, the debtors, the secured creditors, various governmental agencies, the 20 largest unsecured creditors and parties requesting notice before the court rules on any request to approve employee retention bonuses and key employee retention. Rule 2002 and section 1109 of the Bankruptcy Code allow any party in interest to be heard on any matter. Thus, the Bankruptcy Code and the Rules provide safeguards to prevent abusive compensation arrangements by permitting any creditor or other interested party that objects to the funding arrangement of any KERP to challenge the KERP or its Trust (or both) in bankruptcy court. Furthermore, since the order establishing a Trust or KERP is only presented to the bankruptcy court after the terms have been negotiated with the creditors, the executives and key employees that may benefit under such arrangements are unable to control its terms.

It would be expected that one or more constituency groups represented in the bankruptcy (such as the secured creditors, unsecured creditors, employees or any party who desires to be heard on such matter) would object vociferously to the court approving a KERP or a Trust if amounts payable thereunder were excessive or were not necessary for the business to continue its operations and potentially emerge from bankruptcy as a viable business. Thus, unilateral abuses designed to favor executives over creditors are not possible and for this reason and the reasons stated above, the use of KERPs and Trusts established pursuant to a bankruptcy court order to provide payments to employees necessary to continue the business should be excepted from the application of Section 409A(b)(2). Moreover, the funds available to a debtor operating under a Bankruptcy Code Chapter 11 proceeding are typically the cash collateral posted with a secured creditor (or held in a lock box arrangement) or the proceeds of a post-petition loan approved by the bankruptcy court. Thus, it is unlikely that the funds would be available to pay benefits without the consent of the lenders and the approval of the court.

To subject these KERPs and Trusts to Section 409A would thwart the goals of the federal bankruptcy laws without advancing the purposes underlying Section 409A. Subjecting a KERP and its related Trust to the penalties related to noncompliance with Section 409A(b)(2) will only drive up the costs of these arrangements because retained key employees will likely demand tax gross-up payments. A bankruptcy court will have considered whether the KERP and the Trust are necessary and reasonable in order for the business to continue and retain the employees who are necessary to bring the debtor out of bankruptcy. Because these are not abusive tax deferral tools, we believe it is appropriate to make an exception for these arrangements and enable the debtor to reorganize its affairs in the most cost efficient manner.

In situations in which the Trusts for KERPs hold deferred compensation and pay upon an event other than one under Section 409A(a)(2), the distribution upon achievement of a financial trigger would present a potential violation of Section 409A(a)(2)(A) or a prohibited acceleration under Section 409A(a)(3) that would trigger the Section 409A(a)(1) tax penalties. We recommend that Regulations permit distributions from a Trust funding a KERP that was

established pursuant to a post-petition bankruptcy court order approving the terms of the KERP and the Trust, as permitted distributions at a specified time (or pursuant to a fixed schedule) and as distributions that do not violate the prohibition on acceleration of benefits under Section 409A(a)(3).

KERPs that are funded by Trusts in post-bankruptcy petition financings often require employees to perform substantial additional services in order to receive the funds and thus such employees are not vested until they perform the required services. Such KERPs should not be subject to Section 409A, provided the amounts are paid to the employees as soon as administratively feasible after the services are performed. If KERPs are not funded, they may not provide sufficient incentives to retain key employees and executives because employees of entities in bankruptcy will not have sufficient assurance that they will be paid for their services.