AMERICAN BENEFITS COUNCIL

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VIA ELECTRONIC AND HAND DELIVERY

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RE: New Code Section 409A – Transition Guidance

Dear Bill and Nan:

We are writing on behalf of the member companies of the American Benefits Council (the "Council") to request immediate and broad transition relief under new Internal Revenue Code Section 409A, which was enacted as part of the American Jobs Creation Act of 2004, P.L. 108-357 (the "JOBS Act"), and will govern the taxation of deferred compensation effective January 1, 2005. Because the Council and its member companies have serious concerns and questions about the application of Code Section 409A, we have formed a special task force on deferred compensation issues. The task force is writing at this time to address the most time-sensitive questions under Code Section 409A that require immediate guidance and transition relief in light of the January 1, 2005 effective date. We will follow up in the near future to provide more comprehensive comments.[1]

[1] For example, our members fundamentally disagree with statements that have been made asserting that Treasury does not have the authority to except from section 409A awards of stock appreciation rights and other equity arrangements that are economically equivalent to fair market value stock options.

Overview

Now that the President has signed the JOBS Act, we strongly encourage the Department of the Treasury ("Treasury") and Internal Revenue Service (the "Service") to issue guidance setting forth the parameters for transition relief under Code Section 409A as soon as possible. We have been very appreciative of the willingness of your staffs to discuss with us their views on an informal basis with the understanding that written guidance is forthcoming. We recognize that Section 885(f) of the JOBS Act instructs the Treasury and Service to provide transition guidance within a sixty-day time frame after enactment. This is a short window for issuing official guidance under a complicated statute, and we know that the staffs at Treasury and the Service are working hard to meet this deadline. We want to underscore the need for this guidance as soon as possible given that employers are facing a January 1, 2005 effective date. Where practicable, consideration should be given to the issuance of model language to facilitate compliance.

Need for Immediate Guidance. The need for immediate guidance is apparent when one considers that Code Section 409A affects all employers,[2] regardless of size, including both public and private companies, and including foreign companies that have U.S. employees even if those employees are working abroad.[3] All employers must undertake a comprehensive review and potentially make fundamental changes to the design of virtually all compensation arrangements other than base salary and tax-qualified plans. Employers must assess the application of Code Section 409A to equity plans, supplemental pensions, elective deferred compensation arrangements, incentive arrangements, and severance plans. The plans potentially subject to Code Section 409A are not limited to top executives or officers. Supplemental pensions, for example, may cover thousands of employees at a large single employer, many of whom are in the ranks of "middle management" rather than controlling officers or shareholders. Broad-based equity plans may cover all employees of an employer. In addition, equity-based programs such as stock appreciation rights are used by many companies to replicate the incentives obtained through stock option plans and thus cover very significant numbers of employees.

Fundamental Questions on Scope and Application of Code Section 409A. A number of fundamental questions as to the scope and application of Section 409A are not addressed in the statute and are left to regulatory guidance. Thus, employers are facing an extremely difficult time frame for compliance, and the basic rules under Section 409A are not yet clear or well understood even for those employers who have been closely following the legislative developments and trying to anticipate enactment

[2] Throughout this letter, we refer to "employers" and "employees" because deferred compensation arrangements arising in the employment context are our primary focus. We recognize, however, that Code section 409A is not limited to employees and many of our comments also include issues that arise with respect to deferred compensation for outside directors, consultants, and vendors.
[3] We will need to discuss with you further the particular concerns of foreign and multi-national employers.

of new rules in this area. For example, there is no statutory definition of when an amount is deferred. Many of the substantive provisions were changed or introduced for the first time during the conference on the JOBS Act.

> *Example*: The concept of "performance-based compensation," arose for the first time in the chairman's mark on the JOBS Act.

> *Example*: The scope of the grandfather rule for amounts deferred prior to the effective date is unclear because the conference report states that compensation that is "earned and vested" prior to the effective date is grandfathered. This "earned and vested" concept was introduced for the first time in the Conference report. At minimum, the "earned and vested concept" has led to confusion and at worst it has created a situation in which outstanding contractual arrangements between employers and employees would generate immediate taxation, interest, and a 20-percent penalty as of January 1, 2005. A grandfather rule based upon an "earned and vested" concept also raises significant recordkeeping concerns for employers.

As discussed more fully below, we urge Treasury and the IRS to consider ways in which employers may be granted the flexibility to change their deferred compensation arrangements in order to mitigate administrative and recordkeeping burdens without causing a material modification of all deferred compensation.

> *Example*: If Treasury and IRS guidance provides that all "unvested" deferrals as of January 1, 2005, are not grandfathered, employers will need to keep separate records with respect to the vested deferred compensation and subsequent earnings and the unvested deferred compensation accounts and subsequent earnings under a plan. As a conceptual matter, distinguishing between vested and unvested amounts is not straightforward, particularly in the case of defined benefit type arrangements. Even in a defined contribution type arrangement, which may be viewed as less complicated in this regard, the recordkeeping systems being utilized today cannot readily account for vested and unvested deferrals based on a date in time cut-off, such as December 31, 2004. Adopting an ad hoc or manual system will not be possible for recordkeepers that must make these calculations with respect to thousands of deferred compensation accounts for their clients. As a result, employers need the flexibility to make changes to the plan design without causing material modifications or other negative ramifications under Code Section 409A.

Recommendations

Three Priorities. Given the scope of the changes in law and the need to comply, for all practical purposes, on an immediate basis, we have focused on what guidance is needed as a first priority. We have identified three areas in which guidance is needed and we have not distinguished any one of those areas as having priority over the others. In our view, priority guidance is needed in the following areas.

1) *Appropriate Time Period for Compliance*. Transition guidance is needed to ensure that there is an appropriate time period for compliance and that actions taken under old law, such as 2004 deferral elections, do not result in retroactive violations.

2) *Specific Interpretive and Definitional Guidance*. Transition guidance is needed on specific interpretive and definitional questions so that employers and service providers can take appropriate steps during the transition period, which include determining the general scope of the new rules, conforming existing plans or adopting new arrangements, developing recordkeeping and administrative compliance measures, and ensuring that grandfathered amounts are not inadvertently materially modified.

3) *A Reasonable and Good Faith Interpretive Standard*. Guidance is needed that provides for a reasonable and good faith interpretive standard of Code Section 409A to the extent that the answers to other questions under the statute cannot be provided immediately. In prioritizing our requests for guidance, we realize that many important questions related to the application of Code Section 409A cannot realistically be considered and resolved now. Every day employers are raising new issues and questions that we believe were never considered during the legislative process. The full impact of the new law is still being absorbed by the entire business community, a significant segment of which is not yet aware of the new law or its potential scope. Treasury and IRS need much more time to fully consider the issues than the present circumstances allow. The dramatic change in law under Code Section 409A and the extreme penalties imposed for even an inadvertent failure provide good reason to create reliance on a reasonable and good faith standard. Employers, service providers and counsel will need to make reasonable determinations and carry on day to day business while Treasury and IRS conduct a notice and comment period to determine final rules.

Our specific comments for transition relief are set forth below.

<u>Priority Issues: Transition Guidance for an Appropriate Time Period for Compliance and to Avoid Potential Retroactive Violations</u>

<u>1. A significant transition period is needed to comply with the rules under Code Section 409A</u>. Employers need final guidance under Code Section 409A before adopting new plans or significantly modifying existing arrangements to satisfy the new law. We urge you to consider a transition period that would not end until one year from the publication date of final regulations. If there are concerns about the timing of publication of final regulations, employers will need, at minimum, a transition period no shorter than 18 months from the effective date, assuming that interpretive guidance is issued shortly. During this transition period, any requirement for operational

compliance should be based upon a reasonable and good faith standard. We believe that it will take employers at least six to twelve months from the timing of substantive guidance to fully assess their current deferred compensation arrangements and develop the parameters of new arrangements or amendments to existing arrangements. In many cases, that process will require consultation with and approvals by outside directors and compensation committees of the board. In some situations, the adoption of a new plan or the employer's corporate governance standards may require new shareholder approval. In some cases, employers will need to obtain consent from participating employees to change the terms of existing contractual compensation arrangements. In addition, employers and their recordkeepers will need time to build systems that comply with the new rules and communicate these changes to employees, which realistically requires an additional six-month process after the terms of the plans are established. For these reasons, full compliance earlier than the close of 18 months will be extremely difficult, if not impossible, for many employers and their recordkeepers.

2. Relief is needed to avoid retroactive failures on account of elections made to defer compensation related to services performed prior to January 1, 2005. Transition guidance should provide that taxation will not be imposed with respect to any amount deferred that is attributable to services performed prior to January 1, 2005, solely because the timing of a deferral election does not satisfy the election timing requirements of Code Section 409A(a)(4)(B). Deferral elections would continue to be subject to the current-law rules of constructive receipt.

3. Until final rules are published, employers need to rely on the election timing rules for performance-based compensation with respect to any deferred compensation for services performed for 12 months or more. Transition guidance should provide that taxation will not be imposed under Code Section 409A if an election to defer compensation satisfies the election timing rules in Code Section 409A(a)(4)(B)(iii) (the exception for performance-based compensation) rather than the election timing rules in Code Section 409A(a)(4)(B)(i) (the general rule) with respect to any amount deferred that is attributable to services for 12 months or more and that includes services in 2005 or an earlier period. This transition rule would allow employers to rely on the performance-based compensation exception for annual bonuses and ongoing incentive pay arrangements until further guidance on the definition of "performance-based compensation" is provided. We will be providing comments on the "performance-based compensation" definition in our follow up letter, but in the interim, we believe that it is most expedient to create a transition safe harbor for these types of arrangements while the full scope of the performance-based exception is considered. For purposes of the transition, clarification should be provided that equity arrangements, including stock options and restricted stock units, are treated as performance-based for purposes of Code Section 409A because the value of the compensation is based upon stock price. The transition rule would not waive

constructive receipt and would not be available for deferrals of salary, for example, which is earned periodically rather than over 12 months or more.

4. Employees or employers should be allowed to revoke elections or terminate nonelective deferrals subject to Code section 409A in whole or in part. Section 885(f) of the JOBS Act recognizes that employers and employees may desire to revoke ongoing elections with respect to amounts that are not grandfathered under Code Section 409A. To that end, the transition guidance should provide that taxation will not be imposed under Code Section 409A if a person may revoke a deferral election with respect to any or all amounts that are subject to Code Section 409A, provided that such election to revoke is made on or before the close of the transition period. The opportunity to revoke during the transition period should apply to both elective and nonelective deferrals and should encompass revocations that occur by employee election and those revocations that are made unilaterally by the employer sponsor of the deferred compensation arrangement. Thus, under such a transition rule, an employer might choose to give some or all employees an election with respect to whether they wish to continue the deferral of compensation that is subject to Code Section 409A or, if an employer has authority to make unilateral changes, the employer would be allowed, if it so chose, to revoke any or all elective or nonelective deferrals that are subject to Code Section 409A and pay out those deferrals immediately. Such revocations would result in current income inclusion by the recipients but no penalties or interest would be imposed under Code Section 409A. Transition guidance also should make clear that a revocation (or conforming modification discussed below in item 5) in the transition period does not cause a "material modification" for purposes of Code Section 409A with respect to grandfathered amounts that are not revoked (or modified, as discussed below in item 5).

5. Employees or employers should be allowed to modify any or all deferrals in whole or in part to conform to section 409A. During the transition period, the opportunity to make conforming amendments to new or existing plans should correspond to the opportunity to revoke deferrals discussed above and should encompass both elective and nonelective deferred compensation. Broad transition relief for conforming amendments will be necessary to address difficult situations arising immediately in 2005, such as employees who are retiring and eligible for supplemental pension benefits, and who must elect a date and form of payout in order to satisfy Code Section 409A. Transition guidance should provide that taxation is not imposed under Code Section 409A if a person has the opportunity to modify any or all deferrals that are subject to Code Section 409A or if an employer unilaterally makes such a modification in order to conform the terms of the deferral to the Code Section 409A requirements for payouts (*e.g.*, a modification to choose a date of payment and form of payment that complies with Code Section 409A), provided that such modification is made at any time on or before the close of the transition period. Under the transition guidance we propose, such election could be made retroactive to December 31, 2004, and made with respect to any or all such compensation deferred after December 31, 2004. The

transition period for conforming amendments should include compensation deferred prior to January 1, 2005, that, because of a material modification made in the course of day-to-day business,[4] no longer is a grandfathered amount. We believe that appropriate transition relief should make clear that modifications may be made during the transition period to specify a form of payout where no form of payout was previously elected or stated and that such modifications are not subject to the limitations in Code Sections 409A(a)(3) (precluding "accelerations") or 409A(a)(4)(C) (imposing a 5-year "redeferral" rule). Transition relief also should make clear that the opportunity to revoke and the opportunity to make conforming modifications in the transition period are not mutually exclusive; thus, an employee or employer should be able to revoke part of a deferral but also modify the portion that is not revoked to satisfy Code Section 409A.

Priority Issues: Transition Guidance Related to Definitions and Scope

6. Treasury needs to provide a definition of deferred compensation under Code Section 409A at the earliest possible time. There is no definition of deferred compensation in the statute, and employers cannot reasonably plan for transition and compliance after the effective date until there is general understanding as to what arrangements are covered by Code Section 409A. Once again, this is an area where we expect to provide more detailed comments for future guidance.[5] For purposes of transition, however, Treasury and the Service should communicate a general rule for determining whether a compensatory arrangement provides deferred compensation within the meaning of Code Section 409A.

From our oral conversations, we understand that Treasury interprets Code Section 409A as applying where, under the cash method of accounting, there is a delay in the taxation of a payment or the taxation of a transfer of property beyond 2-1/2 months after the taxable year in which compensation is earned and vested.[6] Thus, any amount taxed in the year of vesting (or within 2-1/2 months after the close of the year of vesting) would not be subject to Code section 409A. We agree that on a going forward basis under Code Section 409A, an "earned and vested" concept appears to be a reasonable approach, provided that Treasury and the Service intend to define vesting in a manner that is consistent with existing law principles. Under this definition, any transferred property interest that is taxed upon vesting, such as restricted stock, would not be subject to Code Section 409A. A restricted stock unit ("RSU") under which stock is transferred upon vesting also would not be subject to Section 409A because there is no delay between vesting and transfer of stock.

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[4] Such "material modifications" may have occurred in the course of corporate transactions, for example.
[5] One example is whether Code section 409A should be interpreted to exclude severance arrangements.
[6] Guidance also should clarify that similar rules apply to arrangements that are based upon a fiscal year rather than a calendar year.

Immediate guidance also should clarify other types of arrangements that are not deferred compensation within the meaning of Code Section 409A.

> *Example*: We understand from the statements in the Conference report that the grant of a fair market value stock option is not subject to Section 409A, which we believe is appropriate given the particular rules for taxation of stock options that are set forth under Code Section 83. The transition guidance also should make clear that a fair market value stock option will not lose its status as such if its terms are adjusted to reflect a corporate transaction (*e.g.*, acquisitions, spin-offs, extraordinary dividends and similar transactions) in a manner similar to that provided for an incentive stock option adjustment in the regulations under Code Section 424(a).
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> *Example*: If a stock option agreement allows for an election to defer delivery of stock, that election would be analyzed in the same manner as an arrangement providing for the deferral of cash in a performance-based compensation arrangement but would not cause the stock option to be treated as subject to Section 409A from the date of grant. A similar analysis should apply to a deferral election under an RSU.
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> *Example*: We understand that from the Conference report that a discounted stock option issued under an employee stock purchase plan ("ESPP") described in Code Section 423(b) is not subject to Code Section 409A. We believe that transition guidance should clarify that an option that otherwise satisfies the requirements of Code Section 423(b) is not subject to Code Section 409A even if the employer opts not to utilize the special tax rules for ESPPs.[7]
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> *Example*: Questions also are raised with respect to compensation paid in the form of trailing commissions or as a percentage of assets under management over a multi-year period. The commission or fee is earned upon the consummation of the sale, but is to be paid pursuant to a fixed percentage based on the continuation of the asset. The amount to be paid is unknown and contingent upon premium renewals or revenue generated on assets under management. If there are no renewals or assets, then there are no commissions or fees paid. We believe this future right to income should not be treated as deferred compensation under Code Section 409A.

<u>7. Employers need clarification that Code Section 409A does not preclude changes in vesting, including accelerations of vesting</u>. Clarification also is needed that an acceleration or change in a compensation vesting schedule does not violate Code

[7] Some employers maintain plans that satisfy the rules for ESPPs but opt to treat the options for income tax purposes as "nonqualified" and, therefore, the employer does not forego the compensation deduction on the exercise of the option and the employee recognizes ordinary income on exercise of the option rather than capital gains on disposition of the stock.

Section 409A, provided that taxation of an amount is contemporaneous with vesting (*i.e.*, taxation occurs in the same year or within the 2-1/2 month window following the year of vesting). In our view, it logically follows that if an amount is not deferred unless taxation is delayed beyond vesting, there is no deferral subject to Code Section 409A if vesting is accelerated, as long as taxation of the payment or property transfer continues to be contemporaneous with vesting. We expect to address more broadly the issue of vesting changes under Code Section 409A in our follow up comment letter, but at minimum, the acceleration of vesting is a significant issue for the transition period.

> *Example*: Employers may have authority under outstanding restricted stock grants or RSUs to accelerate vesting.

> *Example*: Retirement "windows" or reduction in force benefits often are provided by accelerating vesting in a supplemental pension benefit to an age earlier than the normal retirement age.

In connection with our concerns on recordkeeping burdens, we note that the ability to accelerate or change a vesting schedule for amounts subject to Code Section 409A will provide important flexibility to employers that are making changes in 2005 and thereafter to conform to the new law.

> *Example*: Currently if an employer maintains a deferred compensation arrangement with "graded" vesting, the records for that plan typically assign one account record to each participant and vesting is determined on a percentage basis year by year to the dollars accrued under that account. For example, in a 5-year graded vesting plan, all deferrals and earnings vest in 20 percent increments for all employees based upon their initial date of service under the vesting schedule. If, however, in order to maintain grandfather treatment, records must now be maintained separately for each account to the extent that it is vested as of December 31, 2004, the resulting records for the plan will be significantly more complicated. It will not be a matter merely of maintaining two accounts for each employee instead of one. Rather, the recordkeeping system for the unvested accounts will have to reflect an individualized vesting schedule depending upon each participant's vesting service on December 31, 2004. For example, in a plan with 5-year graded vesting, a participant who had 2 years of service on December 31, 2004 will now vest in increments of 33 percent per year in the unvested account; whereas a participant with one year of service on December 31, 2004 will now vest in increments of 25 percent per year. Again, this is not conceptually difficult to determine, but it is extremely complicated to administer over multiple accounts and it will be costly to implement, particularly in light of the January 1, 2005 effective date. Thus, employers may desire to change the vesting schedule under a plan in order to avoid these complicated recordkeeping requirements and ensure that employees vest in their accounts subject to Section 409A on the basis of a uniform percentage.

8. The grandfather rule should be fair and equitable. We strongly urge Treasury and the Service to interpret Code Section 409A to provide a grandfather rule that produces appropriate results. The standard in the Conference report providing that, for purposes of the effective date, deferred compensation must be "earned and vested" before January 1, 2005, is not in the statute and, to our knowledge, was not widely discussed until very late in the legislative process. Moreover the phrase "earned and vested" does not have any technical or pre-existing meaning and should not be construed for purposes of a grandfather rule in a restrictive manner that would lead to surprising and fundamentally unfair results.

> *Example*: We are concerned that under a restrictive interpretation an employee's supplemental pension that is unconditionally payable only upon normal retirement age might not be grandfathered under Code Section 409A even if the employee has been accruing benefits over his entire working career and is near retirement.
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> *Example*: Similarly, if the grandfather rule is construed in a hyper-technical manner, the difficult legal issues faced by SAR owners are exacerbated where SARs granted many years earlier first become exercisable in 2005, and, therefore, may not be viewed as grandfathered.
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> *Example*: A cash bonus plan where an employee need not perform services after December 31, 2004 in order to receive the bonus may not be grandfathered under a restrictive interpretation if the board of directors or management retains any discretion with respect to that bonus, regardless of whether it is exercised.

As noted above in item 6, we do not view as unreasonable an interpretation of Code Section 409A that defines deferred compensation on a going forward basis as amounts that are subject to taxation in a year following the year in which the compensation is earned and vested, *i.e.*, no longer subject to a substantial risk of forfeiture. The interpretation of a grandfather rule, however, should take into account different considerations than the prospective interpretation of a new statutory regime. At a minimum, we urge you to clarify the differences between discretion that causes an amount not to be grandfathered under a cash bonus plan and other post-December 31, 2004 actions that would not cause a deferral to fail to be grandfathered.

> *Example*: If all services and events related to the bonus occur on or before December 31, 2004, but the board or management must obtain financial results, including certified financial results, in order to ascertain the actual bonus amounts, we do not believe that certification of results should be treated as "discretion" precluding grandfather treatment of the bonus.

As stated above, the purpose of a grandfather rule is to promote fairness and avoid changing fundamental rules with respect to existing transactions. Even if Treasury and IRS believe that a variation of the "earned and vested" concept must be utilized for purposes of defining grandfather amounts, we believe that long-standing principles under Code Section 83 may be interpreted in the context of a grandfather rule to provide greater flexibility in determining what is "earned and vested" than an accrual accounting method rule that limits any discretion or any post-effective date services. The regulations under Code Section 83 provide that property is subject to a substantial risk of forfeiture only if it is conditioned on *substantial* future services and establish guidelines for evaluating whether services are substantial. In the examples above, the supplemental pension that has been earned over a career and becomes unconditionally payable in 2005 is not conditioned on substantial future services if only post-effective date services are considered. Similarly, the SAR that becomes exercisable in 2005 should be considered vested because substantial future services after the effective date are not required. Moreover, consistent with long-standing principles under Sections 83 and 457(f), the mere fact that the employer has discretion with respect to whether a bonus will be paid for services already performed should not cause the bonus to be other than vested as of the effective date.

We believe that a broader interpretation of the grandfather rule also would appropriately include relief for binding contracts, which is the traditional rule utilized for Internal Revenue Code changes. A binding contract rule would alleviate many of the significant problems faced by employers with outstanding SARs without prejudging the question of how Code Section 409A applies to SARs generally.

Finally, allowing employers to vest an employee in deferred compensation as of December 31, 2004, and therefore treat an amount as "grandfathered" should be considered. The language in the Conference report suggesting that accelerated vesting is a material modification makes little sense. As a policy matter, where there is no other material modification to an existing arrangement post October 3, 2004, accelerated vesting should not present any real opportunity for "stuffing."

<u>9. Transition guidance should confirm that employers may reasonably calculate pre-January 1, 2005 grandfathered amounts in a reasonable manner</u>. In connection with the application of the grandfather rule, transition relief should make clear that employers may utilize reasonable methods for calculating grandfathered amounts. Particular concerns are raised with respect to calculating the grandfathered deferral if such deferral is expressed in the form of a defined benefit, such as a supplemental pension. We believe that the statute provides a basis for Treasury to allow greater flexibility in determining the grandfathered defined benefit deferral than merely calculating a termination benefit (*i.e.*, the value of an annuity if a participant terminated from service on December 31, 2004). The statute provides that amounts deferred prior to January 1, 2005, include "earnings" that accrue thereafter. To achieve parity between defined benefit and defined contribution arrangements, we urge Treasury and the Service to

allow employers to treat as grandfathered increases in benefits that occur after December 31, 2004, with respect to years of service performed prior to January 1, 2005.

> *Example*: In a final average pay type of plan, an employer should be permitted to include as grandfathered the "compensation upticks" that are earned on pre-effective date services. Similar rules were adopted for qualified plans for purposes of determining the pre-and post-effective date benefits when the Code Section 401(a)(17) compensation limit was decreased to $150,000. (See Treas. Reg. §1.401(a)(17)-1(d)).
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> *Example*: Alternatively, an employer should be able to determine the grandfathered portion of a defined benefit deferral by pro-rating the benefit on the basis of services performed prior to the effective date and services performed post-effective date.

We believe that reasonable calculations of grandfathered amounts may be performed in a number of different ways, as illustrated by the examples above, and employers should have the flexibility to adopt a reasonable approach, provided that it is administered consistently.

<u>10. SARs should not be treated as nonqualified deferred compensation for at least a reasonable transition period while the issue is studied more fully</u>. As stated above, we intend to provide additional comments on the application of Code Section 409A to awards that entitle the holder to compensation based upon the appreciation of an equity interest from the date of grant, which are referred to as stock appreciation rights or SARs. A SAR granted at fair market value is economically equivalent to fair market value stock options, which Treasury is directed to exclude from Section 409A by the Conference report. Moreover, the Conference report notes that Treasury has authority with respect to SARs and does not state that SARs are subject to Code Section 409A.

We do not believe that the full impact of precluding SARs under Code section 409A has been fully considered and we do not believe that Treasury is precluded from writing reasonable rules to accommodate SARs. During the transition period, however, Treasury at minimum should treat SARs granted prior to October 4, 2004, and that are based upon the fair market value of the underlying equity interest on date of grant as not being subject to section 409A even if the SARs are not vested on December 31, 2004. This transition period relief would give Treasury time to fully consider the application of Code Section 409A to SARs. We believe that this broad transition relief for SARs, as opposed to other arrangements, is appropriate not only because there are compelling reasons to exclude SARs grants from Code Section 409A altogether, but also because SARs cannot be restructured in any way that both complies with Code Section 409A and that allows the basic features of current SARs to continue. Employers could not have reasonably anticipated that a fair market value SAR would yield a different tax result than a fair market value option and Treasury should provide transition relief while the issue is fully considered.

11. Transition guidance should provide further guidance on "material modifications" and clarify, in particular, that certain investment and payout changes do not result in a material modification of grandfathered amounts. Employers need further guidance on what constitutes a material modification that causes a loss of grandfather protection for compensation deferred prior to January 1, 2005. Based on precedents in prior areas, we urge that, in general, this rule be limited to changes in the plan that would materially increase the amount of deferred compensation payable to a participant or provide a new payment option not previously available that would not satisfy Code Section 409A (*e.g.*, adding a penalty withdrawal right).

> *Example*: To permit ongoing transactions, it is especially critical that Treasury and IRS confirm that changing investment options -- including changing, deleting or expanding a family of investments or single investment option (*e.g.*, to conform to changes made in a related qualified plan) or changing the vehicle the employer has chosen to measure earnings on prior (and ongoing) deferrals -- is not a material modification, provided that the new investments are available to plan sponsors in the marketplace.

> *Example*: Employers that sponsor a plan where the crediting rate is reset every year or from time to time should not lose the grandfather because they follow past practices in resetting the crediting rate.

We believe that the exercise of discretion that exists under a pre-existing arrangement with respect to grandfathered amounts is not a material modification and it would be helpful if guidance confirmed this view.

> *Example*: An employer's exercise of discretion to pay out grandfathered amounts should not constitute a material modification.

Finally, it would be helpful if Treasury and the Service could provide a list of other changes that are not material modifications to the extent that those have been determined

12. Failure to comply with Code Section 409A should not result in taxation of pre-2005 deferred amounts that have not been materially modified. Finally, while employers are focusing primarily on how to conform arrangements to the new law during a transition period, nonetheless, it would be helpful to provide clarification on the scope of the tax and penalties under Code Section 409A should a failure occur. For example, guidance should clarify that a failure to satisfy Code Section 409A with respect to amounts deferred after December 31, 2004, will not cause taxation under Code Section 409A of amounts deferred prior to January 1, 2005, that have not been materially modified.

Priority Issues: Reasonable and Good Faith Interpretation in the Absence of Specific Guidance.

As stated above, employers and service providers will need to make reasonable determinations and carry on day to day business before the final rules under Code section 409A are known. An inadvertent failure to satisfy Code Section 409A leads to extremely punitive results and employers will have every incentive to comply with the new rules. Nonetheless, employers are concerned that reasonable judgments as to the application of Code Section 409A may be viewed negatively by an IRS agent many years later and with the benefit of final guidance. Treasury and the IRS should provide that the IRS will not challenge any practice or interpretation that is based on a reasonable and good faith interpretation of the statute, taking into account any transition guidance, during the transition period.

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The length and detail of our comments focusing only on the initial priority issues reflects the diversity of current compensation designs, the sea change in practices that will be imposed by the new statutory regime, and the critical importance of these issues to our members. We hope that these comments are helpful to you in providing immediate guidance for the transition period under Code Section 409A. We will follow up with you to discuss our comments in the near future. Please contact me in the interim if we can answer any questions or provide any further information.

Sincerely yours,

James A. Klein

James A. Klein
President

cc: Catherine Fernandez (IRS)
Dan Hogans (Treasury)
Catherine Livingston (IRS)
Bob Misner (IRS)
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