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BY ELECTRONIC MAIL

CC:PA:LPD:PR, (Notice 2007-62), Room
5203
Internal Revenue Service
P. O. Box 7604, Ben Franklin Station
Washington, DC 20044

Re: Comments Regarding Notice 2007-62

Dear Sir or Madam:

This letter is submitted by Polsinelli Shalton Flanigan Suelthaus PC, a 300-attorney law firm based in Kansas City, Missouri, in response to a request for comments on Notice 2007-62 (2007-32 IRB 331), as published by the Treasury Department ("Treasury") and the Internal Revenue Service ("Service") on August 6, 2007. The purpose of this letter is to comment regarding the announcement, in Part IV of Notice 2007-62, that Treasury and the Service anticipate issuing guidance regarding a "substantial risk of forfeiture" for purposes of Section 457(f)(3)(B) of the Internal Revenue Code (the "Code") under rules similar to those set forth under the final regulations issued under Code Section 409A (specifically, Treas. Reg. Section 1.409A-1(d)). For the reasons set forth below, our firm strongly recommends that Treasury and the Service reconsider whether the definition of "substantial risk of forfeiture" described in the final regulations under Section 409A is appropriate for purposes of Section 457(f), particularly as it relates to the treatment of "elective" deferrals of compensation.

Section 457(f)(1)(A) of the Code provides that, if a plan of a tax-exempt or governmental entity provides for a deferral of compensation, the compensation must be included in the service provider's gross income in the first year in which there is no substantial risk of forfeiture of the rights to such compensation. Section 457(f)(3)(B) provides that a service provider's rights to compensation are subject to a substantial risk of forfeiture if the provider's rights to such compensation are conditioned upon the future performance of substantial services by any individual.

By contrast, Section 409A(a)(1)(A)(i) of the Code provides that, if at any time during a taxable year a nonqualified deferred compensation plan fails to satisfy (in form or operation) certain requirements set forth in that section of the Code, all compensation deferred under the plan is includible in the service provider's gross income to the extent that it is not subject to a substantial risk of forfeiture and has not been previously included in gross income. These

requirements (which primarily govern the circumstances under which deferred compensation amounts may be paid) were designed to prevent certain abusive practices that primarily involve inappropriate access to fully vested deferred compensation amounts by executives of for-profit entities. Section 409A(a)(1)(B) provides that, if compensation is includible in income because of the failure to comply with Section 409A requirements, the service provider is also subject to interest and a 20% additional tax.

Thus, Section 457(f) governs the timing of the inclusion in income of amounts deferred by individuals providing services to governmental and tax-exempt entities, while Section 409A imposes a 20% penalty, interest and an acceleration of income recognition for noncompliant deferred compensation arrangements maintained by any type of employer. Section 457(f) provides that deferred compensation is includible in income when it is no longer a substantial risk of forfeiture, while Section 409A imposes penalties on amounts deferred under noncompliant plans to the extent those amounts are no longer subject to a substantial risk of forfeiture. Because Section 409A is a penalty statute, and because the penalty only applies to the extent amounts are no longer subject to a substantial risk of forfeiture, there are valid reasons why "substantial risk of forfeiture" should be more narrowly defined for purposes of that statute. In addition, because amounts payable within a short period of time after they are no longer subject to a substantial risk of forfeiture are exempt from Section 409A and its penalty provisions under the "short term deferral" exception, there are additional reasons to define the term more narrowly for purposes of Section 409A.

Notwithstanding these significant differences, in Notice 2007-62, Treasury and the Service propose to issue guidance regarding the definition of a "substantial risk of forfeiture" under Section 457(f)(3)(B) under rules similar to those set forth in the final regulations under Section 409A. Under Treas. Reg. Section 1.409A-1(d), a right to an amount of compensation is said to be subject to a substantial risk of forfeiture if entitlement to that amount is conditioned on either:

i. the performance of substantial future services by any person; or
ii. the occurrence of a condition that is related to a purpose of the compensation, and the possibility of forfeiture is substantial.

This is similar, at least in part, to the statutory definition of "substantial risk of forfeiture" set forth in Section 457(f)(3)(b), which provides that a person's rights to compensation are subject to a substantial risk of forfeiture if that person's rights to such compensation are conditioned upon "the future performance of substantial services by any individual."

However, the final 409A regulations go on to provide that:

i. an amount is not subject to a substantial risk of forfeiture merely because the right to the amount is conditioned, directly or indirectly, upon refraining from the performance of services (such as a covenant not to compete);
ii. the addition of any risk of forfeiture after the right to the compensation arises, or any extension of a forfeiture period (*i.e.*, a "rolling risk of forfeiture") is generally disregarded in determining whether an amount is subject to a substantial risk of forfeiture; and
iii. an amount is generally not considered subject to a substantial risk of forfeiture beyond the date or time at which the recipient otherwise could have elected to receive the compensation (*i.e.*, "elective" deferrals generally cannot be subject to a substantial risk of forfeiture).

The *basic* definition of "substantial risk of forfeiture" set forth in the 409A regulations is appropriate for purposes of Section 457(f)(3)(b). Thus, amounts deferred by individuals providing services to governmental and tax-exempt employers should not be includible in income so long as the individual's right to such amounts is conditioned upon either (i) the performance of substantial future services, or (ii) the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial. However, the limitations on that definition described above (in particular, the limitation that effectively precludes elective deferrals of compensation) should not be automatically applied for purposes of Section 457(f)(3)(b). Participants in Section 457(f) arrangements should be allowed to "electively" subject compensation to a substantial risk of forfeiture in order to defer the taxation of such amounts (just as employees of for-profit corporations are allowed to make elective deferrals of fully vested compensation).

The following are a few of the many reasons why the 409A definition of a substantial risk of forfeiture (which generally precludes an elective deferral from being treated as subject to a substantial risk of forfeiture) should not be applied for purposes of determining the timing of income inclusion under Section 457(f):

1. As noted above, the statutory purposes of Section 457(f) and Section 409A are very different. Section 457(f) determines the timing of income when there is a deferral of compensation payable to an individual providing services to a tax-exempt or governmental employer. Section 409A is a penalty statute for nonqualified deferred compensation arrangements that do not comply with the new statutory requirements regarding the timing of deferral elections and the circumstances under which fully vested amounts may be paid. Under Section 457(f), amounts are includible when the risk of forfeiture lapses. Under Section 409A, whether there is risk of forfeiture is only relevant for (i)

determining whether an arrangement is exempt from 409A under the "short term deferral" exception, and (ii) determining the extent of the penalty and interest in a noncompliant plan. Even the final 409A regulations apply a different definition of risk of forfeiture (the Section 83 definition) for purposes of determining what amounts were "earned and vested" as of December 31, 2004, and therefore "grandfathered" from 409A. Thus, it would not be inconsistent to apply a different definition of a "substantial risk of forfeiture" for purposes of Section 457(f).

2. There is nothing in the statute to suggest that Congress intended to exempt elective deferrals from the types of compensation that could be deferred under Section 457. If Congress had intended a different result under Section 457(f) for "elective" deferrals of compensation, it could have made a distinction between elective and non-elective contributions (just as it did under Section 457(e)(12) for payments of non-elective compensation to non-employees). The fact that Congress created an exemption from Section 457 for certain nonelective deferred compensation for non-employees suggests that Congress was aware that a "deferral of compensation" under Section 457 could include both elective and non-elective contributions. Therefore, Treasury and the Service should not create a regulatory definition of "substantial risk of forfeiture" that effectively precludes elective deferrals under Section 457(f).

3. The rationale set forth in Section 1.409A-1(d)(1) and in Notice 2007-62 for why amounts deferred at the election of a participant are not subject to a substantial risk of forfeiture is flawed. The regulations and the Notice provide that, absent "tax considerations," a rational participant normally would not agree to subject a right to amounts that are earned and payable as current compensation, such as salary payments, to a condition that subjects the participant's right to those same payments to a real possibility of forfeiture. The regulations (and the Notice) go on to conclude that, in this situation, agreeing to subject those amounts to a risk of forfeiture indicates that the recipient is confident that there is not a real risk of forfeiture, and is only subjecting the amount to the purported risk of forfeiture "as a means of avoiding taxation." There are several problems with this argument. First, there is nothing in Section 457 (or in any other section of the Code) that prohibits the deferral of compensation for tax considerations. A participant who makes an elective deferral under an eligible Section 457(b) plan (or a Section 401(k) plan, or a Section 403(b) arrangement, or a Section 125 cafeteria plan) generally does so for tax considerations. Second, subjecting an amount to a risk of forfeiture merely *defers* the tax, it does not *avoid* taxation (unless a forfeiture occurs, in which case the participant does not receive any

compensation to tax). Most elective contributions under Section 457(f) arrangements vest in 3 to 7 years, and the participant is taxed at that time (regardless of whether the participant is in actual or constructive receipt of the deferred amounts at that time). Third, there is no guarantee that a "non-elective" contribution is any more or less certain to vest than an elective contribution. If an employee is relatively certain that he or she will remain employed by the same employer for at least 4 years, there is no greater "risk of forfeiture" if the employer offers a 4-year golden handcuff (a nonelective contribution) than if the employee elects to defer a portion of his "regular" salary. Finally, what a "rational" individual might or might not do is not an appropriate consideration in drafting tax regulations. Under current law, "rational" employees of governments and tax-exempt entities are electing to defer receipt of compensation, knowing full well that, if they don't remain employed for the agreed forfeiture period, they will forfeit the amounts deferred. This is in addition to the risk that the amounts deferred may be lost to other creditors (in the event the employer becomes insolvent). Those employees weigh the desire for tax deferral against these risks, and make an educated choice. They make the exact same choice when deciding whether they are ever likely to enjoy a non-elective "golden handcuff" that an employer offers them. Therefore, there is no real logic to the assumption that an elective deferral of compensation can never be subject to a "substantial" risk of forfeiture.

4. If employees of governmental and tax-exempt employers are not allowed to make elective deferrals under Section 457(f) arrangements, this will make it even more difficult for such employers to attract and retain executives, officers, managers and other highly compensated employees (such as physicians). These entities are already at a competitive disadvantage in terms of available compensation arrangements (they cannot offer "stock-based" incentive plans, and all nonqualified deferred compensation must be subject to both creditor risk and a risk of forfeiture.) Removing the option to make elective deferrals under Section 457(f) will create an even larger disparity in these organizations' ability to compete with similar for-profit entities.

If, despite the reasons set forth above, Treasury and the Service do issue guidance applying the 409A definition of "substantial risk of forfeiture" for purposes of Section 457(f)(3)(B), existing deferral arrangements should be grandfathered, and there should be a transition period before any limitation on elective contributions becomes effective. There are thousands of legitimate 457(f) arrangements currently in place (most of which provide for a forfeiture period of less than 10 years), and these arrangements should be allowed to continue without change (at least until the end of the current forfeiture period). Many employees of tax-

exempt and governmental employers have entered into employment agreements with the expectation that they would be allowed to make elective deferrals of all or a portion of their compensation. These individuals should be afforded a reasonable transition period before any new rules become effective. Governmental and tax-exempt employers may also need a transition period to restructure compensation packages with the appropriate levels of non-elective deferred compensation (in order to properly incent and retain key employees, who will no longer be allowed to make elective deferrals under nonqualified plans).

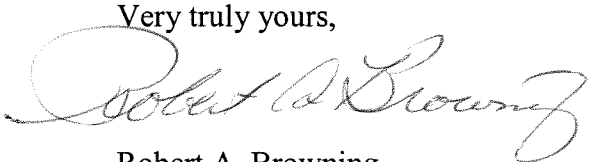
This law firm appreciates the fact that Treasury and the Service have provided advance notice of their intent to issue regulations under Section 457(f), and have given interested parties an opportunity to comment on Notice 2007-62. It is our hope that any regulations issued under Section 457(f) will:

1. expand the definition of "substantial risk of forfeiture" to include both the performance of substantial future services and the occurrence of an event related to a purpose of the compensation, where the possibility of forfeiture is substantial; and

2. allow elective deferrals of compensation under Section 457(f).

Thank you in advance for your consideration of these comments on behalf of the firm and its tax-exempt and governmental clients.

Very truly yours,



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