MAY 2017 VOLUME 25, NUMBER 10

The Monthly Review of Taxes, Trends & Techniques

EDITOR-IN-CHIEF

Robert W. Wood
Wood LLP
San Francisco

PRODUCTION EDITOR

Mina Chung
Wood LLP
San Francisco

ADVISORY BOARD

Donald P. Board
Wood LLP
San Francisco

Michael R. Faber
Cooley LLP
New York

Jonathan R. Flora
Montgomery McCracken
Walker & Rhoads, LLP
Philadelphia

Stuart M. Finkelstein
Skadden, Arps, Slate,
Meagher & Flom LLP
New York

Steven R. Franklin
Gunderson Dettmer
Menlo Park

Lawrence B. Gibbs
Miller & Chevalier
Washington

Ivan Humphreys
Wilson Sonsini
Goodrich & Rosati
Palo Alto

Steven K. Matthias
Deloitte Tax
San Francisco

Mark J. Silverman
Steptoe & Johnson
Washington

Robert Willens
Robert Willens, LLC
New York

Regulatory Freezes and Code Sec. 409A

By Donald P. Board • Wood LLP

In its first 100 days, the Trump Administration has staked out a distinctive approach to managing federal regulation. Executive Order 13771 ("Reducing Regulation and Controlling Regulatory Costs") has introduced a new "two-for-one" rule: If an agency proposes a new regulation, it must designate at least two existing regulations for repeal.

EO 13771 was promulgated on January 30, 2017. IRS officials initially responded by telling practitioners that the IRS would not be issuing much guidance of *any* kind "for a while." This was an understandable reaction.

Under the Executive Order, regulations are not limited to those quasi-statutory pronouncements that blanket the Federal Register. Borrowing from the definition of "rule" in the Administrative Procedure Act [5 USC §551(4)], the EO defines "regulation" broadly to mean:

> [any] agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy or to describe the procedure or practice requirements of an agency.

Under this standard, revenue procedures and even revenue rulings could be branded as regulations subject to the two-for-one rule.

Taxpayers may have heaved a reflexive sigh of relief when they heard about the EO. Their tax advisors, on the other hand, may be having more mixed feelings. As practitioners know, IRS guidance frequently makes life easier for taxpayers, and often easier for practitioners too.

Restricting the IRS's ability to issue statements that interpret the tax law or that describe IRS procedures "reduces regulation" in one sense. Yet it can also increase uncertainty about what the tax rules are. Uncertainty is hard to quantify, but it seems like one of the "regulatory costs" that the EO is supposed to control.

Commissioner Koskinen apparently agrees. On March 21, he said that the IRS would resume issuing some forms of "sub-regulatory" guidance. The Commissioner reportedly pointed to revenue procedures, announcements about interest rates and FAQs about IRS initiatives.

The Commissioner reasserted the IRS's longstanding position that it can issue these statements interpreting and implementing the tax law without publishing a Notice of Proposed Rulemaking or considering public input. In the IRS's view, guidance published in the Internal Revenue Bulletin should not be mistaken for regulations subject to the APA.

Why weren't revenue rulings on the Commissioner's short list? They seem about as "sub-regulatory" as revenue procedures. Indeed, if EO 13771 did not refer to agency statements of "particular applicability," one might not think that revenue rulings should be counted as regulations in the first place.

The omission of revenue rulings may have been unintentional. Or perhaps the IRS prefers to take small steps as it wades back into the regulatory water. After all, that may be part of that swamp that was supposed to be drained.

The Monthly Review of Taxes, Trends & Techniques

EDITOR-IN-CHIEF
Robert W. Wood

MANAGING EDITOR
Michael Henaghan

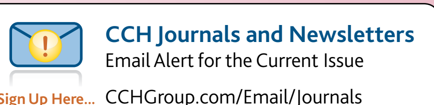
COORDINATING EDITOR
Raghavendra Kaup

M&A Tax Report is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought—From a Declaration of Principles jointly adopted by a Committee of the American Bar Association and a Committee of Publishers.

THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by Wolters Kluwer, 2700 Lake Cook Road, Riverwoods, Illinois 60015. Subscription inquiries should be directed to 2700 Lake Cook Road, Riverwoods, IL 60015.
Telephone: (800) 449-8114. Fax: (773) 866-3895. Email: cust_serv@cch.com.
© 2017 CCH Incorporated and its affiliates. All rights reserved.

Permissions requests: Requests for permission to reproduce content should be directed to Wolters Kluwer, permissions@cch.com.

Photocopying or reproducing in any form in whole or in part is a violation of federal copyright law and is strictly forbidden without the publisher's consent. No claim is made to original governmental works; however, within this product or publication, the following are subject to CCH Incorporated's copyright: (1) the gathering, compilation, and arrangement of such government materials; (2) the magnetic translation and digital conversion of data, if applicable; (3) the historical, statutory, and other notes and references; and (4) the commentary and other materials.


CCH Journals and Newsletters
Email Alert for the Current Issue
Sign Up Here... CCHGroup.com/Email/Journals

Regulatory Burdens and Code Sec. 409A

Congress enacted Code Sec. 409A in 2004 to rein in some controversial features of nonqualified deferred compensation ("NQDC") plans. The statute itself is no walk in the park. Even so, it cannot compete with the 397 pages of regulations that the Treasury and the IRS issued in 2007 ("Current Regulations"). Commentators typically describe the Current Regulations using terms like "intricate" and "labyrinthine." There's nothing fake about that news.

Of course, Congress gets some of the credit for the regulatory maze. By its terms, Code Sec. 409A applies to *any* arrangement that provides for "the deferral of compensation." [Code Sec. 409A(d)(1).] The statute carves out qualified plans and things like sick leave, but the Current Regulations must still cover a *lot* of ground.

The exquisite detail of the Current Regulations also owes something to the draconian consequences of noncompliance. Under Code Sec. 409A(a)(1), a service provider faces immediate inclusion of all of his vested but deferred compensation, as well as enhanced interest charges and a 20-percent excise tax. It's only fair that the Current Regulations should provide taxpayers with comprehensive guidance.

Helping taxpayers comply with Code Sec. 409A has become a small industry for lawyers, accountants, consultants and valuation specialists, none of whom work for free. We don't know whether the drafters of EO 13771 gave any thought to tax. If they did, the Current Regulations seem like just the sort of thing they would have had in mind.

Yet, we must also consider the other side of the coin. On June 21, 2016, the Treasury and the IRS proposed a set of amendments to the Current Regulations ("Proposed Regulations"). [*See* REG-123854-12.] Instead of lamenting the Proposed Regulations, practitioners have received them warmly.

This is not too surprising. The Proposed Regulations consist mostly of taxpayer-friendly clarifications and adjustments that were suggested by practitioners themselves. New tax regulations are a dreaded and costly burden—except when they're not.

In the wake of EO 13771, the Treasury will probably not finalize the Proposed Regulations any time soon. Fortunately for taxpayers, it

doesn't need to. The preamble tells them they can rely on the new rules *immediately*.

For practical purposes, the Proposed Regulations are now part of the jurisprudence of Code Sec. 409A. So, let's look at how some of the new rules fit into the regulatory edifice. Our main focus will be rules that touch on M&A.

Enron's Ghost

The Current Regulations are long and often complex. Yet their general thrust is surprisingly straightforward. In substantive terms, Code Sec. 409A simply tightens up some aspects of the constructive receipt and economic benefit doctrines as they apply to NQDC.

The extraordinary scope and severity of Code Sec. 409A, on the other hand, reflect public and Congressional outrage triggered by the collapse of Enron Corporation in 2001. Enron, headquartered in Houston, rose to prominence trading energy and derivatives. In 2000, it had 25,000 employees and occupied the number seven spot on the *Fortune* 500.

But even as the Astros were going to bat at Enron Field, investors were becoming concerned about the company's opaque financial reporting. As it turned out, Enron was hiding massive debts and losses. The house of cards collapsed, and several top executives went to prison. Arthur Andersen, Enron's "Big Five" auditor, lost its CPA license and went out of business.

In the investigation that followed, it was widely reported that roughly 150 senior Enron executives had managed to cash out of the company's NQDC plans shortly before it declared bankruptcy. Under the plans, the executives had to accept a 10-percent "haircut" to get their early distributions. But even the smartest guys in the room know that 90 percent of something is better than 100 percent of nothing.

Rank-and-file employees did not fare so well. They were participants in qualified plans, many of which were heavily invested in Enron stock. Within a matter of weeks, their shares became worthless. For thousands of newly unemployed workers, this added insult to injury.

Joint Committee Report

This disparity in outcomes was one focus of a 732-page report prepared by the staff of the Joint Committee on Taxation. [*See* Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations (February 2003).]

The drafters of Code Sec. 409A drew heavily on the JCT Report for its diagnosis of the essential problems affecting NQDC and its proposals to remedy them. As for diagnosis, the JCT Report began by pointing a polite finger at Congress for interfering in the normal regulatory process.

In 1978, Congress beat down a Treasury proposal to tax elective deferrals of compensation. Unfortunately, it did so with the bluntest of instruments.

Section 132 of the Revenue Act of 1978 ("Section 132") decreed that, until further notice, the year for including a taxpayer's NQDC in gross income would be determined based on the regulations, rulings and judicial decisions in effect on February 1, 1978. That blocked the Treasury's controversial proposal, which had been put forward on February 3.

Although Congress appears to have acted impulsively, the regulatory freeze remained in place for 25 years. During this period, the Treasury and the IRS were hamstrung in their efforts to respond to developments in the world of NQDC. Expanding to fill the regulatory void, corporations adopted more and more aggressive interpretations of what was permitted under the constructive receipt and economic benefit doctrines as they stood in 1978.

The JCT Report cited Enron's notorious "haircut" distributions as a case in point. A taxpayer constructively receives income when it is made available for him to draw on at any time. However, there is no constructive receipt if the taxpayer's ability to obtain the income is subject to "substantial limitations or restrictions." [Reg. §1.451-2(a).]

In the absence of administrate guidance, Enron and many other companies reached the mutually reinforcing conclusion that a 10-percent haircut should qualify as a substantial limitation or restriction. More aggressive planners claimed that imposing even a *five*-percent haircut was enough to avoid constructive receipt.

The JCT Report recommended that Congress repeal Section 132. This would give the Treasury and the IRS a chance to provide "much need guidance" concerning nonqualified plans. But the report also offered its own proposals for

reform, which became the core substantive provisions of Code Sec. 409A.

The JCT proposals reflected two basic policy judgments. First, service providers were exercising *too much control* over their NQDC. Second, nonqualified plans were giving service providers *too much security* against the risk of the service recipient's insolvency.

Curbing Participant Control

The JCT Report identified three main areas in which service providers were exercising inappropriate control over their deferred compensation: (1) timing of distributions, (2) timing and substance of deferral elections, and (3) investment of account balances.

Congress took no action on the "problem" of participant-directed investment. Participant direction is, after all, a standard feature of many qualified plans. But Congress dropped the hammer on distributions and elections.

Limiting Distributions

Recalling the abuses at Enron, one would expect Code Sec. 409A to have focused on preventing corporate *insiders* from taking early distributions. Officers, directors and senior management have privileged access to information about the service recipient and its prospects. If insiders see that the end is nigh, they will be tempted to cash out—with or without a haircut.

Code Sec. 409A, however, bans elective distributions of to *anyone*, insider or not. The baseline rule is that a nonqualified plan can make distributions only at the times specified in the plan when the compensation was deferred. [Code Sec. 409A(a)(2)(A)(iv).]

This is more restrictive than it sounds because distributions based on contingent events (*e.g.*, "when Participant's first child enrolls in college") do *not* meet the standard. However, there are exceptions for three serious life-events that pose little risk of abuse: death, disability and unforeseeable emergencies. [Code Sec. 409A(a)(2)(A)(ii), (iii) and (vi).]

There are also exceptions for two *business* life-events. A plan may permit distributions upon a service provider's separation from service or upon a change in control of the service recipient. [Code Sec. 409A(a)(2)(A)(i) and (v).]

A service provider cannot generally trigger a change in control. But it is usually not difficult to arrange a separation from service. So, permitting distributions upon a separation from service can give service providers what amounts to a right to elect an early distribution.

Congress apparently did not see much risk of abuse. But it did impose a restriction on distributions to service providers who are "key employees" (within the meaning of Code Sec. 416(i)(1)) of a publicly traded corporation. This will generally mean the corporation's 50 highest-paid employees.

Distributions to a key employee based on a separation from service cannot be made for at least six months following the employee's departure. [Code Sec. 409A(a)(2)(B)(i).] Hence, if the service recipient is teetering on the edge of bankruptcy, its top executives cannot simply resign and gain immediate access to their deferred compensation.

Change-in-Control Triggers

Under Code Sec. 409A(a)(2)(A)(v), a plan may provide for early distributions upon a "change in control" of the service recipient. Service providers are naturally concerned that a change in who is running the store could affect their deferred compensation. Like other creditors, they may want to call their loans.

The Current Regulations recognize four events as changes in control that may trigger distributions under a plan:

- *Change in Ownership*. A change in ownership of a corporation occurs when a person or group first acquires more than 50 percent of the total fair market value or total voting power of the corporation's stock. [Reg. §1.409A-3(i)(5)(v)(A).]
- *Change in Effective Control (Voting Stock)*. A change in effective control of a corporation occurs when a person or group first acquires stock representing at least 30 percent the total voting power, counting only shares acquired during the preceding 12 months. [Reg. §1.409A-3(i)(5)(vi)(A)(i)(1).]
- *Change in Effective Control (Hostile Directors)*. A change in effective control also occurs on the first day during any period of 12 months in which a majority of the board of directors has been replaced by directors whose election was not endorsed by a majority of the board before they were elected. [Reg. §1.409A-3(i)(5)(vi)(A)(2).]

- *Change in Ownership of a Substantial Portion of Corporate Assets*. A change in ownership of a substantial portion of a corporation's assets occurs on the day during any period of 12 months on which a person or group first acquires assets from the corporation representing 40 percent or more of its total gross fair market value. [Reg. §1.409A-3(i)(5)(vii)(A).]

The stated percentages are the *lowest* permissible values for each trigger. Plans are free to raise the bar or to omit these triggers altogether.

Transaction-Based Compensation

Nonqualified stock options and stock appreciation rights ("stock rights") reproduce the upside of actual share ownership. In an acquisition, the target's outstanding stock rights are often paid off for amounts calculated based on the value of the covered shares. Alternatively, the target or the acquirer may purchase the stock rights for a price reflecting their value.

In many acquisitions, earn-out and indemnification provisions require selling shareholders to be paid for their shares over time. There are generally good business reasons to pay holders of *stock rights* at the same times and on the same terms as actual shareholders.

This poses a problem. Even if a plan provides for distributions upon a change in control, the drafters of the plan cannot know the specific payment terms of an acquisition that will be negotiated in the future. The Current Regulations respond with a special rule for "transaction-based compensation."

Transaction-based compensation is keyed to the value of the service recipient's stock that is paid in connection with a transaction that qualifies as a change in ownership of the target corporation or a change in ownership of a substantial portion of its assets. Transaction-based compensation will *not* violate Code Sec. 409A if (1) it is paid on the same schedule and under the same terms that apply to payments to target shareholders generally; and (2) it is paid no more than five years after the change in control. [Reg. §1.409A-3(i)(5)(iv)(A).]

The Proposed Regulations focus on the implications for stock rights. Nonqualified options and SARs are exempt from Code Sec. 409A if three conditions are met: (1) the exercise price of the stock right is at least 100 percent of the fair market value of the covered shares on the date the stock right is granted; (2) the stock right covers a fixed number of shares as of the date of grant; and (3) the stock right does not provide for the deferral of compensation past the exercise date. [Reg. §1.409A-1(b)(5)(A) and (B).]

Practitioners have worried about the consequences if, following an acquisition, holders of otherwise exempt stock rights are paid on the same schedule and subject to the same terms as shareholders. Could relying on the rules permitting transaction-based compensation introduce a "deferral of compensation" that will cause the stock rights to become subject to Code Sec. 409A?

Proposed Reg. §1.409A-3(i)(5)(iv)(A) is intended to reassure practitioners. Post-acquisition payments will *not* cause a stock right—or an ISO, for that matter—to violate Code Sec. 409A if the payments satisfy the rules applicable to transaction-based compensation in general.

Separation from Service

Because Code Sec. 409A(a)(2)(A)(i) permits a separation from service to trigger an early distribution under a plan, the Current Regulations must go to some lengths to distinguish between real and merely feigned separations. For example, should an executive be able to retire as an employee, obtain a distribution of NQDC, but continue to provide services as an independent contractor?

The Current Regulations say an employee has not separated from service unless the employer and the employee reasonably anticipated that (1) no further services would be performed; or (2) the level of post-separation services, whether as an employee or independent contractor, would be no more than 20 percent of the employee's average over the preceding 36 months. This is supplemented by rebuttable presumptions one way or the other based on the amount of services the employee *actually* performs after the purported separation. [Reg. §1.409A-1(h)(1)(ii).]

That's reasonably straightforward. However, the Current Regulations include an unfortunate statement to the effect that an employee who becomes an independent contractor will not be considered to have separated from service until he "has ceased providing services in both capacities." [Reg. §1.409A-1(h)(5).]

Some practitioners have worried about the implications for an executive who separates

from service as an employee but does *any* amount of consulting as an independent contractor. The problem is that an independent contractor does not separate from service until his contractual relationship with the service recipient has completely terminated. [Reg. §1.409A-1(h)(2)(i).]

If the executive must literally "cease providing services in both capacities," an executive who retires and provides even the most modest consulting services has not separated from service. That result was never intended. Hence, the Proposed Regulations would delete the confusing sentence.

Deemed Asset Sales

When a corporation sells a significant business unit, the buyer is counting on "acquiring" the existing workforce to keep the business running. This is true whether the corporation sells stock of a subsidiary or the assets of a plant or a division. The main difference is that an asset sale changes the identity of the employer.

In a legal sense, that is a clear separation from service—the employees will not be providing further services to the selling corporation. In a practical sense, however, the employees may find that nothing has really changed except the name of the corporation issuing their paychecks.

Should this kind of event count as a separation from service? In a *bona fide*, arm's-length transaction, the Current Regulations leave it up to the buyer and seller to decide. The only constraint is that their decision must apply to all continuing service providers in the same way. [Reg. §1.409A-1(h)(4).]

Now suppose that the parent of a consolidated group sells the *stock* of a subsidiary to an unrelated corporation. The buyer and seller make a joint election under Code Sec. 338(h)(10) to treat the stock sale as a sale of the subsidiary's assets for federal tax purposes.

Some practitioners have wondered whether the buyer and seller may be able to treat this *deemed* asset sale as a separation from service. This is borderline incredible because the employees of the subsidiary have experienced neither a formal nor a practical separation from service.

The Proposed Regulations are very accommodating, but they draw the line at allowing a fictional separation to trigger an actual distribution of NQDC. Accordingly, the Proposed Regulations would amend Reg. §1.409A-1(h)(4) to state explicitly that a sale or disposition of assets does *not* include a deemed asset sale under Code Sec. 338.

Plan Terminations

Distributions of NQDC may be accelerated if the plan is terminated. However, there are a variety of constraints, depending on the circumstances of the termination.

The simplest case is when the service recipient *dissolves* in a corporate liquidation taxable under Code Sec. 331 or executed with the approval of a bankruptcy court. Under Reg. §1.409A-3(j)(4)(ix)(A), deferred compensation may be distributed pursuant to the termination of the plan if it is promptly included in gross income. In view of the dissolution requirement, there is not much risk of abuse.

A service recipient may also terminate and liquidate a plan within 30 days before or 12 months following one of those *changes in control*. Under Reg. §1.409A-3(j)(4)(ix)(B), the service recipient must terminate *all* plans of the same type. All distributions must be paid within 12 months of the termination date.

If the service recipient wants to terminate a plan just because it feels like it, the rules are much more stringent. Congress clearly wanted to avoid another Enron:

- The termination cannot occur "proximate to a downturn in the financial health of the service recipient." [Reg. §1.409A-3(j)(4)(ix)(C)(1).]
- The service recipient must terminate all plans of the same category with respect to all participants. [Reg. §1.409A-3(j)(4)(ix)(C)(2).]
- No distributions are permitted until at least 12 months after all necessary action has been taken to terminate the plan. [Reg. §1.409A-3(j)(4)(ix)(C)(3).]
- All distributions must be completed within 24 months. [Reg. §1.409A-3(j)(4)(ix)(C)(4).]
- The service recipient may not adopt any new plans of the same type for at least three years following termination. [Reg. §1.409A-3(j)(4)(ix)(C)(5).]

The Proposed Regulations would rephrase Reg. §1.409A-3(j)(4)(ix)(C)(5) to clarify that the three-year embargo on new plans applies regardless of which service providers participate in the plan. Once again, the impetus for the change came from practitioners, who asked.

Deferral Elections

To prevent service providers from exercising inappropriate control over their deferred compensation, Code Sec. 409A also limits the timing and substance of deferral *elections*.

When applying the doctrine of constructive receipt, the courts traditionally took a lenient approach to timing. Thus, cash-basis taxpayers were permitted to defer compensation for services they had already performed, as long as they did so before payment was *due*. [*See H. Veit*, 8 TC 809 (1947) (*acq.*); *H. Veit*, 8 TC Memo. 919 (1949).]

However, under Code Sec. 409A(a)(4)(B)(i), a deferral election must be made *before* the start of the year in which the service provider will perform the services that earn the compensation. A service provider cannot generate a right to payment and then decide whether he wants to defer it to a later year.

There is a common-sense exception for new hires. They are given 30 days to elect to defer compensation to be earned in the current tax year. [Code Sec. 409A(a)(4)(B)(ii).] But even this exception applies only to compensation earned *after* the election is made.

Code Sec. 409A also restricts most subsequent elections. Obviously, a service provider cannot elect to *accelerate* distributions before they are due under the plan. [Code Sec. 409A(a)(3).] But what about an election to *delay* a distribution?

Here Code Sec. 409A provides at least a bit of leeway. Under Reg. §1.409A-2(b)(1), a nonqualified plan may permit a service provider to make a "subsequent deferral election," which can affect both the time and form of payment. There are three conditions:

- The election must be made at least 12 months before the distribution is scheduled to occur.
- The election cannot take effect for at least 12 months after it is made.
- The additional period of deferral must generally be at least five years.

A service provider who makes a subsequent deferral election is plainly exercising *some* control over his deferred compensation. But it can hardly be described as micromanagement. The service provider is just kicking the distribution five years down the road.

Preserving Insolvency Risk

Besides calling for enhanced restrictions on participant *control*, the JCT Report recommended action to ensure that participants' rights to their deferred compensation did not become too *secure*.

A participant in a nonqualified plan faces two principal risks. The first is the possibility that the service recipient will be *unwilling* to meet its obligations to the participant because it has had a "change of heart." The second is that the service recipient will be *unable* to meet its obligations because it has become insolvent.

Human nature being what it is, the risk of a change of heart increases if the service recipient undergoes a change in control. That is one of the main reasons that plan participants like change-in-control distribution triggers.

Of course, a plan participant can always sue to enforce his rights against a faithless service recipient. But a lawsuit against a former employer can get messy and expensive. The participant could lose or be forced to settle for less than was promised.

The most popular solution, if cash flow permits, is for the service recipient to contribute cash to an irrevocable trust for plan participants. With a fiduciary in charge and no danger that the trust will be revoked, participants do not have to worry about a double cross.

The JCT Report did not object to arrangements that protect participants from a service recipient's change of heart. Instead, it set its sights on attempts to insulate participants from the risk of the service recipient's insolvency.

Under the economic benefit doctrine, a taxpayer who is granted a right to receive cash or other property in the future is sometimes taxable on the present value of the future receipt. However, if the right relates to an unsecured and unfunded promise to pay, it does not generally trigger current tax. [*Cf.* Reg. §1.83-3(e) ("property" subject to Code Sec. 83 does not include "an unfunded and unsecured promise to pay money or property in the future").]

But if the right to future payment becomes too secure, the holder will be taxable on the current benefit. The classic example is when an employer contributes cash to an irrevocable trust established for the exclusive benefit of an employee. The employee may have to wait years to access the cash, but his legal rights are sufficiently fixed and secure to warrant current taxation. [*See E.T. Sproull*, 16 TC 244, Dec. 18,080 (1951), *aff'd per curiam*, CA-6, 52-1 USTC ¶9223, 194 F2d 541.]

That sounds ominous for the solution outlined above. But a "rabbi trust" saves the day. If the trust provides that the contributed assets remain subject to the claims of the employer's creditors, the employee's right to the trust assets is subject to a substantial risk of forfeiture. That is enough to avert immediate taxation. [*See* LTR 8113107 (Dec. 31, 1980); Rev. Proc. 92-64, 1992-2 IRB 11.]

The JCT Report had no beef with the rabbi or his trust. What it objected to were arrangements that would, as a *practical* matter, make the trust's assets less accessible to creditors. Establishing the rabbi trust offshore, especially in a country with laws designed to frustrate creditors, was an obvious concern.

Code Sec. 409A(b)(1) shuts this practice down. The service provider is taxable on any property transferred to a trust located outside the United States. Moving a domestic trust offshore will also trigger tax.

These rules apply regardless of how well or badly the offshore jurisdiction treats creditors. Congress apparently concluded that there is little reason to locate a rabbi trust offshore *except* to impede creditors. However, if the relevant services were performed in the foreign jurisdiction, the offshore trust is permitted under Code Sec. 409A(b)(1) (flush language).

Concluding Observations

One can view Section 132 of the Revenue Act of 1978 as an experiment in managing the tax regulatory process. If the Treasury and the IRS step on the wrong toes, why not just freeze the law as it stands on some specific date?

The freeze on regulating NQDC lasted for more than two decades. That left plans and participants pretty much free to do as they pleased. But when the music stopped, Congress and the public did not like what they saw. The result was Code Sec. 409A and its fearsome panoply of regulations.

It remains to be seen how EO 13771 will be applied to tax. On February 2, the Office of Management and Budget issued interim guidance stating that the EO applies only to "significant regulatory actions" as defined in EO 12866. The Treasury and the IRS have traditionally contended that that tax regulations, *per se*, are hardly ever "significant."

OMB has played along with this fiction since the 1980s. But that does not seem like a sure thing going forward. If EO 13771's two-for-one rule applies to tax regulations and guidance, taxpayers should expect a lot fewer gifts like the Proposed Regulations.

The longer-term implications are hard to predict. But it would be surprising if EO 13771 were exempt from the law of unintended consequences. After all, would the drafters of Section 132 ever have suspected that it would be replaced by Code Sec. 409A?

TO SUBSCRIBE TO THE M&A TAX REPORT CALL 1-800-638-8437.

2700 Lake Cook Road
Riverwoods, IL 60015

PRESORTED
FIRST-CLASS MAIL
U.S. POSTAGE
PAID
CCH

10028607-0520