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Major References: ***Proposed Treasury Regulations Section 1.409A-4***

Prior AALU Washington Reports: *08-114; 08-108; 08-80; 07-96; 07-50; 07-48; 07-44; 07-41; 07-38; 06-143*

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This past December the government issued Proposed Treasury Regulations Section 1.409A-4 ("Proposed Regulations"), which address the calculation of amounts includible in income and the additional taxes imposed if the requirements of Revenue Code section 409A are not satisfied. (See our Bulletin No. 08-108.) As promised in that Bulletin, this Washington Report provides a more detailed analysis of the Proposed Regulations.

Background

Section 409A imposes new rules on nonqualified deferred compensation arrangements and is generally effective for amounts deferred on and after January 1, 2005. There are significant adverse tax consequences if the new requirements are not satisfied: (1) all deferred compensation must be included in income in the current taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in income (including deferrals in prior years), (2) an additional tax is imposed equal to the interest, using the IRS' underpayment rate plus 1 percent, that would have been imposed during the deferral period if the deferred compensation had been includible in income when first deferred (or not subject to a substantial risk of forfeiture), and (3) an additional tax is imposed equal to 20% of the deferred compensation.

In April 2007, the Revenue Service issued final regulations under 409A which primarily addressed the substantive requirements that must be met in order to satisfy 409A (see Bulletin Nos. 07-50, 07-48, 07-44 and 07-41). The Proposed Regulations address the calculation, which was not addressed in the April 2007 final regulations, of the amounts includible in income and the additional taxes imposed, if the requirements of section 409A are not satisfied.

The IRS issued (i) Notice 2006-100 (see our Bulletin No. 06-143) to provide interim guidance for taxable years beginning in 2005 and 2006 on the calculation of the amount includible in income if the requirements of Section 409A were not then met, and (ii) Notice 2007-89 (see Bulletin No. 07-96) to provide similar interim guidance for taxable years beginning in 2007.

Overview

If the requirements of Section 409A(a) are not satisfied in a particular tax year, either in form or operation, the service provider (e.g., the employee) must include in income all compensation deferred under the plan for the taxable year and all preceding taxable years to the extent not subject to a substantial risk of forfeiture and not previously included in income. The Proposed Regulations provide guidance on how the amount required to be included in income is determined.

Note that the Proposed Regulations do not address the calculation of amounts includible in income if the requirements of Section 409A(b) are not satisfied. Section 409A(b) generally applies to a transfer of assets to a trust or similar arrangement, or to a restriction of assets, for purposes of paying nonqualified deferred compensation, if (i) such trust or assets are located outside the United States, (ii) such assets are transferred during a restricted period with respect to a single-employer defined benefit plan sponsored by the service recipient (e.g., employer), or (iii) such assets are restricted to the provision of benefits under a nonqualified deferred compensation plan in connection with a change in the employer's financial health. For purposes of calculating such amounts for taxable years beginning on or before January 1, 2007, the IRS provided interim guidance in Notice 2007-89 (see Bulletin No. 07-96). In the preamble to the Proposed Regulations, the Service indicates that it is anticipating the issuance of further interim guidance for later taxable years on the calculation of the amount includible in income under Section 409A(b) and the application of the federal income tax withholding requirements to such an amount.

The Proposed Regulations prescribe the following three step process for calculating the amount includible in income upon a failure to meet the requirements of Section 409A(a):

<u>First Step</u>: Determine the total amount deferred under the plan for the employee's taxable year and all preceding taxable years.

<u>Second Step</u>: Calculate the portion of the total amount deferred for the taxable year, if any, that is either subject to a substantial risk of forfeiture (nonvested) or has been included in income in a previous taxable year.

<u>Third Step</u>: Subtract the amount determined in the Second Step from the amount determined in the First Step.

The excess of the amount determined in the First Step over the amount determined in the Second Step is the amount includible in income and subject to the additional 20% tax and premium interest tax under Section 409A(a).

The preamble to the Proposed Regulations addresses the effect of a failure in one taxable year on amounts deferred in subsequent taxable years. The IRS initially noted that the statutory language of Section 409A could be construed to provide that a failure is treated as continuing during the taxable years beyond the year in which the initial failure occurs, if the failure continues to affect amounts deferred under the plan. That is, a failure in one year generally could taint future deferrals as well.

Recognizing that this interpretation could have harsh results and would add administrative complexity, the Proposed Regulations do not adopt it. Rather, the Proposed Regulations provide that the adverse tax consequences that result from a failure to comply with Section 409A(a) apply only with respect to amounts deferred under a plan in the year in which such noncompliance occurs and all previous taxable years, to the extent such amounts are not subject to a substantial risk of forfeiture and have not previously been included in income. As a result, under the Proposed Regulations, a failure to meet the requirements of Section 409A(a) during an employee's taxable year generally would not affect the taxation of amounts deferred under the plan for a subsequent taxable year during which the plan complies with Section 409A(a) in form and in operation with respect to all amounts deferred under the plan. Note that, by its nature, it is likely that a plan document, or form, defect will continue to cause 409A failures until it is corrected (unless, for example, the form defect only affects deferrals in specified years).

Because there would be no continuing or permanent failure with respect to a plan that fails to comply with Section 409A(a) during an earlier year, each taxable year would be analyzed independently to determine if there was a failure. Therefore, assessment of tax liabilities due to a plan's failure to comply with the requirements of Section 409A(a) in a closed year generally would be time-barred.

It should be emphasized that the Proposed Regulations require all amounts deferred to be calculated even if they are not "reasonably ascertainable." This should be contrasted with the regulations under Section 3121(v), which generally subjects certain nonqualified deferred compensation amounts to FICA taxes when they vest (as opposed to when they are paid). Under the Section 3121(v) regulations, if certain amounts are not reasonably ascertainable, they do not have to be taken into account until they are reasonably ascertainable.

Total Amount Deferred (First Step)

Under the Proposed Regulations, the amount deferred under a plan for a taxable year and all preceding taxable years is referred to as the "total amount deferred" and is determined as of the last day of the taxable year. Therefore, for calendar year taxpayers, such as most individuals, the relevant calculation date would be December 31. The Proposed Regulations also clarify that the total amount deferred is determined as of the last day of a taxable year regardless of the date upon which a failure occurs. Thus, if an amount is distributed in violation of section 409A(a) on May 1, the total amount deferred is determined as of December 31 of that taxable year.

The plan aggregation rules apply for purposes of determining the total amount deferred. Under the plan aggregation rules, all plans within the same category of plans must be aggregated and treated as a single plan if one or more of the plans in that category fail to satisfy the requirements under Section 409A(a). There are nine categories of plans for purposes of the plan aggregation rules - (1) elective account balance plans, (2) nonelective account balance plans, (3) nonaccount balance plans, (4) separation pay arrangements, (5) split-dollar life insurance arrangements, (6) reimbursement plans, (7) stock rights, (8) foreign plans, and (9) all other plans.

Although the total amount deferred is determined as of the last day of the taxable year, the Proposed Regulations provide that any payments made during the taxable year must be added to the amounts deferred outstanding as of the last day of the taxable year.

The Proposed Regulations also include a special rule for short-term deferrals which are excepted from the requirements of Section 409A(a). An amount is generally a short-term deferral if it is payable, and is paid, within 2-1/2 months of the end of the taxable year in which it is no longer subject to a substantial risk of forfeiture (i.e., when it vests). Whether an amount is treated as a short-term deferral or as deferred compensation subject to Section 409A(a) may not be determinable as of the last day of the employee's taxable year because it may depend upon whether the amount is paid on or before the end of the applicable 2-1/2 month period. For purposes of calculating the total amount deferred for a taxable year, the Proposed Regulations provide that the right to a payment that, under the terms of the arrangement and the facts and circumstances as of the last day of the taxable year, may or may not be a short-term deferral, is not included in the total amount deferred. In addition, even if such amount is not paid by the end of the applicable 2-1/2 month period so that the amount would be deferred compensation subject to Section 409A(a), the amount would not be includible in the total amount deferred until the employee's taxable year in which the applicable 2-1/2 month period expired.

The Proposed Regulations include detailed rules for computing the total amount deferred. In general, the total amount deferred under a plan for a taxable year is the present value as of the close of the last day of the employee's taxable year of all amounts payable to the employee under the plan, plus amounts paid to the employee during the taxable year. For this purpose, present value generally means the value as of the last day of the taxable year of the amount or series of amounts due thereafter, where each such amount is multiplied by the probability that the condition or conditions on which payment of the amount is contingent would be satisfied (subject to special treatment for certain contingencies), discounted according to an assumed rate of interest to reflect the time value of money. For purposes of calculating the present value of the benefit, the proposed regulations require the use of reasonable actuarial assumptions.

The Proposed Regulations provide that the present value cannot be discounted for (i) the probability that payments will not be made (or will be reduced) because of the unfunded status of the plan, (ii) the risk associated with any deemed investment of amounts deferred under the plan, (iii) the risk that the service recipient or another party will be unwilling or unable to pay amounts deferred under the plan when due, (iv) the possibility of future plan amendments, (v) the possibility of a future change in the law, or (vi) similar risks or contingencies. However, the present value can be discounted for the probability that the employee will die before commencement of payments under the plan to the extent that the payments would be forfeited upon the employee's death.

The Proposed Regulations provide other general rules that address issues such as plan terms under which the amount may be payable when a triggering event occurs, rather than on a fixed date, or plan terms under which the amount payable is determined in accordance with a formula, rather than being set at a fixed amount. For example, to calculate the total amount deferred, it is necessary to determine the time and form of payment under which the amount will be paid. Under the Proposed Regulations, if an amount deferred under a plan could be payable pursuant to more than one time and form of payment under the plan, the amount generally would be treated as payable in the available time and form of payment that has the highest present value. Similarly, the Proposed Regulations provide that, if the amount to be paid in a future year is computed by a formula, that amount must be determined using reasonable assumptions.

In addition, the proposed regulations provide specific rules for certain types of plans:

(1) Account Balance Plans: The total amount deferred under an account balance plan generally equals the aggregate balance of all accounts under the plan as of the close of the last day of the taxable year, plus any amounts paid from such plan during the taxable year.

(2) Nonaccount Balance Plans: The total amount deferred under a nonaccount balance plan generally is calculated under the general calculation rule, which generally provides that it is the present value as of the last day of the employee's taxable year of the amounts to which the employee has a right to be paid in the future year (assuming no payments were made under the plan during the year).

(3) Stock Rights: The total amount deferred under an outstanding stock right (e.g., nonqualified stock options and stock appreciation rights that are not excepted from Section 409A(a)) is generally equal to the spread as of the last day of the taxable year. For example, for an outstanding stock option, the total amount deferred generally would equal the underlying stock's fair market value on the last day of the taxable year, less the sum of the exercise price and any amount paid for the stock option.

(4) Separation Pay Arrangements: The preamble to the Proposed Regulations notes that a deferred amount that is payable only upon an involuntary separation from service generally will be treated as subject to a substantial risk of forfeiture until the employee involuntarily separates from service. Accordingly, under the Proposed Regulations the amount of deferred compensation generally would not be required to be calculated until the employee has involuntarily separated from service.

(5) Reimbursement Arrangements: The Proposed Regulations include a number of special rules for determining the amount deferred under a reimbursement arrangement, including an arrangement where the benefit is provided as an in-kind benefit from the employer or the employer will pay directly the third-party provider of the goods or services to the employee. For example, the Proposed Regulations provide that if an employee has a right to reimbursements but only up to a specified maximum amount, it is presumed that the employee will incur the maximum amount of expenses eligible for reimbursement, at the earliest possible time such expenses may be incurred and payable at the earliest possible time the amount may be reimbursed under the plan's terms. The employee can rebut this presumption if the employee demonstrates by clear and convincing evidence that it is unreasonable to assume that the employee would expend (or would have expended) the maximum amount of expenses eligible for reimbursement.

(6) Split-Dollar Life Insurance Arrangements: The Proposed Regulations provide that the amount deferred under a split-dollar arrangement that is subject to Section 409A(a) (see our Bulletin Nos. 07-50; 07-48; 07-41; 07-38) would be determined based upon the amount that would be required to be included in income in a future year under the applicable split-dollar life insurance rules. If the split-dollar life insurance arrangement is not subject to Regulations Section 1.61-22 or 1.7872-15 due to application of the effective date provisions under Regulations Section 1.61022(j), the amount payable would be determined by reference to Notice 2002-8 and any other applicable guidance. If the split-dollar life insurance arrangement is subject to Regulations Section 1.61-22 or 1.7872-15, the amount payable would be determined by reference to such regulations, based upon the type of arrangement. The preamble notes that the applicable split-dollar guidance is generally applied in conjunction with the general rules under the Proposed Regulations, but noted further that in the case of an arrangement subject to Regulations section 1.7872-15, to the extent the rules regarding time and form of payment and other payment assumptions under the Proposed Regulations conflict with the provisions of Regulations Section 1.7872-15, the provisions of Regulations Section 1.7872-15 would apply instead of the conflicting rules under the Proposed Regulations. The preamble also notes that as provided in Notice 2007-34 (see our Bulletin Nos. 07-50; 07-48; 07-41; 07-38), the portion of the benefit provided under the split-dollar life insurance

arrangement consisting of the cost of current life insurance protection is not treated as deferred compensation for this purpose.

(7) Foreign Arrangements: Although certain foreign arrangements are a separate category under the plan aggregation rules, the Proposed Regulations provide that the amounts deferred under such arrangements would be determined using the same rules that would apply if the arrangements were not foreign arrangements.

(8) Other Plans: The Proposed Regulations provide that the total amount deferred under a plan that does not fall into any of the other categories would be determined by applying the general calculation rules.

Amounts Previously Included in Income or Subject to a SROF (Second Step)

The second step in determining the amount includible in income under Section 409A(a) for a taxable year is to determine the portion of the total amount deferred (as determined in the First Step) that was either subject to a substantial risk of forfeiture or had previously been included in income. That portion of the total amount deferred for the taxable year would not be includible in income.

In general, the Proposed Regulations provide that the portion of the total amount deferred for a taxable year, which amount is subject to a substantial risk of forfeiture (nonvested), is determined as of the last day of the employee's taxable year. Accordingly, all amounts that vest during the taxable year in which a failure occurs would be treated as vested for purposes of Section 409A(a), regardless of whether the vesting event occurs before or after the failure.

The Proposed Regulations include special rules for purposes of determining the portion of the total amount deferred that has been previously included in income. For a deferred amount to be treated as previously included in income, the Proposed Regulations would require that the employee actually and properly have included the amount in income in accordance with a provision of the Internal Revenue Code. In addition, a deferred amount would be treated as an amount previously included in income only until the amount is paid. For example, if all or a portion of an amount previously included in income is allocable to a payment made under the plan (as determined in accordance with specific rules prescribed in the Proposed Regulations), in subsequent taxable years that amount would not be treated as an amount previously included in income.

Additional 20% Tax

The Proposed Regulations provide that the additional 20% tax imposed under Section 409A(a) is equal to 20% of the amount required to be included in income (as discussed above). The preamble notes that this amount, like the additional premium interest tax (discussed below), is an additional income tax and is subject to the rules governing the assessment, collection, and payment of income tax, and is not an excise tax.

Additional Premium Interest Tax

Under Section 409A(a)(1)(B)(ii), the additional premium interest tax is determined as the amount of interest at the underpayment rate (established under Section 6621) plus one percentage point on the underpayments that would have occurred had the deferred compensation been includible in gross income for the taxable year in which first deferred or, if later, the first taxable year in which such deferred compensation is not subject to a substantial risk of forfeiture (vested). Thus, under the Proposed Regulations, the additional premium interest tax is applied to hypothetical underpayments where the hypothetical underpayments are determined by (i) first allocating the amounts deferred under the plan required to be included in income under Section 409A(a) to the initial year (or years) the amount was deferred or vested, then (ii) determining the hypothetical underpayment that would have resulted had such amounts been includible in income at that time, and (iii) determining the interest that would be due upon that hypothetical underpayment based upon a premium interest rate equal to the underpayment rate plus one percentage point.

The Proposed Regulations include detailed rules for calculating this amount, which would require an allocation of the amount includible in income to the year initially deferred (or vested) and a hypothetical recalculation of an employee's income tax liability for each year in which an amount deferred is allocated. For example, the Proposed Regulations include a "taxpayer-friendly" rule for allocating amounts to the year initially deferred (or vested) with respect to payments, deemed investment or other losses and amounts previously included in income. These amounts generally are attributed to amounts deferred and vested in the earliest year or years in which there are amounts deferred. The preamble notes that this should result in the lowest possible amount of additional premium interest tax because deferred amounts includible in income under Section 409A(a) would be treated as first deferred and vested in the latest possible years, resulting in less premium interest on the hypothetical underpayments.

Recognizing the complexity and burdens of calculating the additional premium interest tax under the methodology prescribed in the Proposed Regulations, the preamble indicates that the IRS is considering whether safe harbor calculation methods could be devised that would reduce the calculation burden but still result in an appropriate amount of tax applicable to the amount includible in income. The IRS requested comments on calculation methods that would more easily identify the taxable year or years during which an amount includible in income under Section 409A(a) was first deferred and vested, and that would more easily determine the hypothetical underpayments applicable to such year or years.

Other Guidance

The Proposed Regulations include a number of additional items of guidance:

(A) Payments of Deferred Compensation After Inclusion: The Proposed Regulations provide that if an employee includes an amount in income under Section 409A(a), the employee will have a deemed "basis" or "investment in the contract" such that the amount would not be required to be included in income again (e.g., when the amount is actually paid). The Proposed Regulations adopt a "first in, first out" approach for allocating the "basis" to subsequent distributions. The basis is allocated to the first distributions made after the income inclusion until the basis is fully allocated.

(B) Permanent Forfeiture or Loss of Deferred Amount Previously Included in Income: The Proposed Regulations recognize that the application of Section 409A(a) may require inclusion in income of amounts that the employee ultimately never receives. To address this situation, the Proposed Regulations provide that an employee who is required to include an amount in income under Section 409A(a) is entitled to a deduction at the time the employee's legally binding right to all deferred compensation under the plan (including all plans treated as a single plan under the plan aggregation rules) is permanently forfeited under the plan's terms, or the right to such compensation is otherwise permanently lost. The available deduction would equal the excess of the amount included in income under Section 409A(a) in a previous year over any amount actually or constructively received by the employee. In the case of an employee, the available deduction generally would be treated as a miscellaneous itemized deduction, subject to the deduction limitation applicable to such expenses. In addition, the employer may be required to recognize income under the tax benefit rule and Section 111, or make other appropriate adjustments, to the extent the employer benefited from a deduction or increased the basis of an asset because the deferred amount was previously included in the employee's income.

(C) Annual Deferral Reporting: The new rules under Section 409A generally require that all deferrals for a year must be separately reported on a Form 1099-Misc or Form W-2, as applicable, regardless of whether such compensation is includible in gross income under Section 409A. The IRS has permanently waived this deferral reporting requirement for calendar years 2005 - 2008 (see Notices 2005-94, 2006-100, 2007-89 and 2008-115 and our Bulletin No. 08-114). In addition, this waiver may apply to a future calendar year if further guidance is not issued within a certain timeframe.

The preamble to the Proposed Regulations indicates that the IRS anticipates that this deferral reporting requirement will be implemented beginning with the first taxable year for which the Proposed Regulations are finalized and effective. Because the Proposed Regulations will not be finalized and effective for the 2009 calendar year, the earliest the deferral reporting requirement will be applicable will be the 2010 calendar year. The preamble notes further that the IRS anticipates that the deferral reporting rules will be based upon the principles set forth in the income inclusion regulations as finalized, except that taxpayers will not be required to report deferred amounts that are not reasonably ascertainable (as defined in Regulations Section 31.3121(v)(2)-1(e)(4)(i)(B)) until such amounts become reasonably ascertainable. The IRS further anticipates that the deferred amounts required to be reported will reflect earnings on the amounts deferred in previous years, if the amount of such earnings is reasonably ascertainable. The IRS specifically requested comments on the potential application of the standards set forth in the Proposed Regulations to the deferral reporting requirement, including suggestions for possible adaptations or modifications that may decrease the administrative burden of compliance while maintaining the integrity of the information reported.

Effective Date

The regulations are proposed to be generally applicable for taxable years beginning on or after the date the regulations are finalized. In addition, before the Proposed Regulations become final, the IRS indicated that taxpayers may rely on them only to the extent provided in future guidance.

The IRS subsequently issued Notice 2008-115, which addresses the reporting and withholding requirements under Section 409A (see our Bulletin No. 08-114). The new Section 409A rules provide that amounts includible in the gross income of an employee under Section 409A are treated as wages for federal income tax reporting and withholding purposes. In Notice 2008-115, the IRS indicated that until the proposed regulations are finalized, for purposes of complying with the reporting and withholding requirements (with respect to amounts includible in income under Section 409A), employers and employees can rely on either the interim guidance in Notice 2008-115 or the Proposed Regulations. However, if a taxpayer relies on the Proposed Regulations, the taxpayer must comply with all of the requirements of the Proposed Regulations.

Any AALU member who wishes to obtain a copy of the Proposed Regulations may do so through the following means: (1) use hyperlink above next to “Major References,” (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* with your social security number and select *Current Washington Report* for linkage to source material or (3) email Anthony Raglani at raglani@aalu.org and include a reference to this *Washington Report*.

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