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April 25 2007

Hon. Mark. W. Everson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments under Internal Revenue Code Section 409A Concerning Calculation
and Timing of Income Inclusion, Reporting, and withholding

Dear Commissioner Everson:

Enclosed are comments under Internal Revenue Code section 409A concerning calculation and timing of incoming inclusion, reporting, and withholding. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Susan P. Serota
Chair, Section of Taxation

Enclosure

- cc: Donald L. Korb, Chief Counsel, Internal Revenue Service
- Eric Solomon, Assistant Secretary (Tax Policy), Department of the Treasury
- Michael J. Desmond, Tax Legislative Counsel, Department of the Treasury
- Nancy "Nan" J. Marks, Division Counsel/Associate Chief Counsel, Internal Revenue Service
- Alan N. Tawshunsky, Assistant Chief Counsel-Employee Benefits, Internal Revenue Service
- W. Thomas Reeder, Benefits Tax Counsel, Department of the Treasury
- William Bortz, Associate Benefits Tax Counsel, Department of the Treasury
- Daniel Hogan, Attorney Advisor (Benefits Tax Counsel), Department of the Treasury
- William C. Schmidt, Senior Counsel (Executive Compensation), Internal Revenue Service
- Stephen B. Tackney, Attorney (Executive Compensation), Internal Revenue Service

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**COMMENTS UNDER INTERNAL REVENUE CODE SECTION 409A CONCERNING
CALCULATION AND TIMING OF INCOME INCLUSION,
REPORTING, AND WITHHOLDING**

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility was exercised by John L. Utz. Contributions were also made by David E. Gordon and Brandon Jones. These Comments were reviewed by Greta E. Cowart, Chair of the Employee Benefits Committee; by the Quality Assurance Group of the Employee Benefits Committee, which is chaired by Thomas R. Hoecker and whose members are former chairs of the Committee; by T. David Cowart of the Section’s Committee on Government Submissions; and by Priscilla E. Ryan, Council Director for Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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April 25, 2007

EXECUTIVE SUMMARY

The following Comments pertain to Internal Revenue Service Notices 2005-1,¹ 2005-94,² and 2006-100³ and Regulations sections 1.409A-1 through -6,⁴ addressing the application of section 409A of the Internal Revenue Code 1986, as amended (the “Code”), to nonqualified deferred compensation plans. The following Comments are in response to a request by the Department of Treasury (the “Treasury”) and the Internal Revenue Service (the “Service”) for comments with respect to the calculation and timing of income inclusion under section 409A. Our recommendations regarding future notices or regulations (“Regulations”) to be published by the Treasury with respect to section 409A are as follows:

- A. We recommend that Regulations, when finalized, provide that where there is a failure to satisfy the section 409A(a)(2), (3), and (4) requirements, the determination of the amount of compensation deferred for a taxable year and all preceding taxable years be made as of the last day of the taxable year of the failure (the “**Income Inclusion Date**”).
- B. We recommend that Regulations, when finalized, provide that where there is a failure to satisfy the section 409A(a)(2), (3), and (4) requirements, the amount of the compensation deferred for a taxable year and all preceding taxable years and included in income be determined in a manner similar to that under the methodology set forth in Regulation § 1.409A-6(a)(3), with the following modifications:
 - 1. In the case of non-account balance plans, where a service provider has begun receiving payments by the Income Inclusion Date in a form which the service provider has no right to change, we recommend that the amount deferred and included in income by reason of the failure not be based on a payment of benefits with the maximum value on the earliest possible date allowed under the plan, but instead be based on the form of distribution in which benefits have commenced by the Income Inclusion Date;
 - 2. In the case of non-account balance plans, in determining whether reasonable actuarial assumptions and methods have been used in determining the present value of the amount to which the service provider would be entitled under the plan if the service provider voluntarily terminated services without cause on the Income Inclusion Date, we recommend the use of rules similar to those set forth in Regulation § 31.3121(v)(2)-1(d)(2)(iii); and

¹ 2005-2 I.R.B. 274 (Jan. 10, 2005) and shall be referred to herein as “Notice 2005-1.”

² 2005-52 I.R.B. 1208 (Dec. 27, 2005) and shall be referred to herein as “Notice 2005-94.”

³ 2006-51 I.R.B. 1109 (Dec. 18, 2006) and shall be referred to herein as “Notice 2006-100.”

⁴ Reg. § 1.409A-1 et. seq., 72 Fed. Reg. 19234 (2007). Hereinafter, all references to the “Code” are to the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise stated and references to the “Regulations” shall be references to the Treasury Regulations issued thereunder.

3. In the case of non-account balance plans that are not equity-based compensation plans, we recommend that the rules described above for income inclusion apply for purposes of determining amounts includable in income for wage withholding and reporting purposes as of the Income Inclusion Date. Consistent with this approach, we recommend that a rebuttable presumption be provided in favor of a service provider that the amount includable in gross income by the service provider is the amount determined by the service recipient as includable in gross income for reporting and, if applicable, withholding purposes, if the service recipient used reasonable actuarial assumptions and methods in making those determinations.
4. With respect to account balance plans, we recommend that the compensation considered to be deferred under the plan for a taxable year and all preceding taxable years be the portion of the service provider's account balance as of the Income Inclusion Date the right to which is no longer subject to a substantial risk of forfeiture as of that day.
5. With respect to equity-based compensation plans, we recommend that the amount of compensation deferred under the plan for a taxable year and all preceding taxable years be determined under the rules for account balance plans, with the account balance deemed to be the amount of the payment available to the service provider on the Income Inclusion Date (or that would be available to the service provider if the right were immediately exercisable) the right to which is no longer subject to a substantial risk of forfeiture as of that day. For this purpose, the payment available to a service provider should exclude any exercise price or other amount that must be paid by the service provider in order to obtain the payment.
6. We recommend that once amounts are included in gross income, section 409A no longer apply to earnings on (or increases in the value of) such deferred compensation beyond the year in which the amounts were included, unless (a) there is a continuing section 409A violation in succeeding years relating to such deferred compensation, and (b) then, only to the extent amounts have not been actually or constructively received in the year that includes the Income Inclusion Date or any year subsequent to the Income Inclusion Date and preceding the year under consideration.
 - a. For the purpose of determining earnings on amounts previously included in gross income, we recommend that earnings on amounts constructively received, rather than actually received, be determined under rules similar to those set forth in Regulation § 1.409A-6(a)(3) and Regulation §§ 31.3121(v)(2)-1(c)(2) and (d)(2). Accordingly, we recommend that earnings on amounts constructively received include both actual and notional earnings. In the case of an account balance plan, we recommend that

earnings on amounts previously constructively received (but not actually received) and included in gross income, and therefore not subject to further taxation, be limited to a reasonable interest rate or rate of return, as set forth in Regulation §§ 31.3121(v)(2)-1(c)(2) and (d)(2).

- b. In the case of a non-account balance plan, we recommend that earnings on amounts constructively received (but not actually received) include the increase, due solely to the passage of time, in the present value of future payments previously included in gross income, to the extent the amounts previously included in gross income were determined using reasonable actuarial assumptions and methods (within the meaning of Regulations §§ 31.3121(v)(2)-1(c)(2)(iii) and -1(d)(2)(iii)(B)). This should include any increase resulting from the shortening of the discount period before the future payments are made plus, if applicable, an increase in the present value resulting from the service provider's survivorship during the year. Earnings should not, however, include any increase in the potential benefits under a non-account balance plan due to application of an increase in compensation after amounts were constructively received under a final average pay plan, or subsequent eligibility for an early retirement subsidy.

C. With respect to negative earnings or other reductions in the amount deferred (collectively "Negative Earnings"), we recommend that Regulations, when finalized, provide that a deduction be allowed in general, to the service provide if the total payments made to the service provider that relate to amounts previously included in income under section 409A is less than the amounts so previously included in income (excluding the 20 percent additional tax and interest at the underpayment rate plus one percent as amounts previously included in income).

1. We recommend that this deduction be allowed to the service provider for the year in which the final payment to which the service provider is entitled is made, and that the amount of the deduction be the excess, if any, of the amount included in income by the service provider over the total of the payments received.
2. We recommend that in the event payments continue beyond the service provider's death to a beneficiary, the deduction be allowed to the beneficiary in the year in which the final payment due to any beneficiary is made (assuming the total payments made to the service provider and beneficiary are less than the amount previously included in the service provider's gross income).
3. Where property other than cash is distributed, we recommend that in determining whether the total amount distributed is less than the amount previously included in gross income, the fair market value of the property

at the time of distribution be treated as the amount distributed, without regard to any future appreciation or depreciation in the value of that property.

- D. With respect to Negative Earnings, we recommend that Regulations, when finalized, provide that an offset be permitted if there are continuing or additional violations of section 409A causing a service provider to have amounts includable in income following the year including the Income Inclusion Date.
1. Under this offset, in determining the amount includable in the gross income of a service provider as a result of any continuing or additional section 409A violation (whether under the same plan or an aggregated plan), we recommend that the amount includable in gross income with respect to that violation be reduced by Negative Earnings with respect to any amounts previously included in gross income under section 409A by that service provider.
 2. We recommend that for years after the taxable year for which compensation under a plan is first includable in gross income, any additional compensation includable in the service provider's gross income as a result of a continuing or additional section 409A violation be reduced by any Negative Earnings attributable to amounts previously included in gross income under section 409A under the plan or any aggregated plan. For this purpose, Negative Earnings would include any reduction in value under an account balance plan, to the extent those Negative Earnings are based on a predetermined actual investment or reasonable rate of interest under Regulations §§ 31.3121(v)(2)-1(c)(2) and (d)(2). In addition, Negative Earnings would include the value of any reduction in, or loss of, benefits resulting from the service provider failing to meet a condition for benefit eligibility, failing to become or remain entitled to an early retirement subsidy under a non-account balance plan, a reduction in a non-account balance plan due to an increase in the value of an offset under a qualified plan or otherwise failing to become or remain entitled to receive under a non-account balance plan a benefit as valuable as that previously included under section 409A.
- E. In the case of stock, stock options, stock appreciation rights, and other equity-based compensation, we recommend that the Regulation, when finalized, provide that when amounts are includable in gross income under section 409A, the value of stock that is readily tradable on an established securities market be considered for purposes of income tax withholding and information reporting under sections 6041 and 6051 to be (a) the fair market value of that stock based upon the last sale before the first sale on or after the Income Inclusion Date, (b) the closing price on the trading day before or the trading of the Income Inclusion Date, or (c) the value determined under any other reasonable basis using actual transactions in such stock as reported by such market and consistently applied, whichever method the

service recipient (or other party) with the withholding or reporting obligation chooses.

We recommend that Regulations, when finalized, provide that the rules described above apply only with respect to “stock of the service recipient,” as that term is defined in Regulation § 1.409A-1(b)(5)(iii).

- F. We recommend with respect to stock that is not readily tradable on an established securities market, that Regulations, when finalized, provide that the fair market value of the stock as of the Income Inclusion Date be, for purposes of income tax withholding and information reporting under sections 6041 and 6051, the value determined by the reasonable application of a reasonable valuation method. The determination of whether a valuation method is reasonable, or whether application of a valuation method is reasonable, should be based on the facts and circumstances as of the Income Inclusion Date.
1. We recommend that factors similar to those set forth in Regulation § 1.409A-1(b)(5)(iv)(B)(1) will apply for this purpose.
 2. We recommend that the presumption of reasonableness and the requirement for consistent use of a method, which are set forth in Regulation § 1.409A-1(b)(5)(iv)(B)(2) and (3), apply in these circumstances as well.
 3. We recommend that the rules described above apply only with respect to “stock of the service recipient,” as that term is defined in Regulation § 1.409A-1(b)(5)(iii).
- G. We recommend that Regulations, when finalized, provide that where a grandfathered plan loses its grandfathered status due to a material modification, a service provider be required to include amounts in gross income in the year in which that grandfathered status is lost, if in that year or a prior year (after 2004) the requirements of section 409A(a)(2), (3), or (4) are not satisfied, and to the extent compensation deferred under the plan for that taxable year and preceding taxable years is not subject to a substantial risk of forfeiture and has not previously been included in gross income.
- Further, we recommend that any interest under section 409A(a)(2)(B) apply as if the deferred compensation had been includable in gross income for the latest of (a) the taxable year in which first deferred, (b) the first taxable year in which the deferred compensation is not subject to a substantial risk of forfeiture, and (c) 2005. That is, we recommend that any interest under section 409A(a)(2)(B) not apply from any taxable year earlier than 2005, even if the service provider attained a legally binding right to the compensation prior to 2005.
- H. We recommend that that Regulations provide that if, following a plan termination under which the distribution of benefits is accelerated under Regulation § 1.409A-3(j)(4)(ix)(C), the service recipient violates any of the requirements of Regulation

§ 1.409A-3(j)(4)(ix)(C)(2), (3), (4) or (5), the year of income inclusion for any violation of the section 409A prohibition on acceleration be the taxable year in which the requirement was violated, not the earlier year in which the arrangement was terminated.

I. With respect to withholding taxes, we recommend that Regulations, when finalized, provide that:

1. The party responsible for withholding be permitted to treat, for purposes of withholding under section 3402, amounts includable in gross income under section 409A as a payment of wages made on the last day of the taxable year for which the amounts are includable in gross income, except to the extent the amounts are actually or constructively received earlier in the taxable year. If an amount includable in gross income for a taxable year by reason of section 409A is actually or constructively received on a day in the taxable year other than the last day, the amount includable should be considered a payment of wages on the day the amount is actually or constructively received.
2. Amounts includable in the gross income of an employee under section 409A be considered supplemental wages under section 3402, regardless of whether the employee has been paid regular wages.
3. Withholding be required with respect to amounts only if the service provider was an employee at the time the services were provided with respect to which the compensation is paid. No withholding should be required where the service provider was not an employee at the time the services were provided with respect to which the compensation is paid.
4. No additional amount be required to be withheld by reason of the 20 percent additional tax or interest described in section 409A(a)(1)(B).

J. With respect to reporting on Forms W-2 and 1099, we recommend that Regulations, when finalized, provide that:

1. Deferrals relating to services provided while a service provider was an employee be reported to the service provider on Form W-2, not Form 1099-MISC, even where those deferrals occur after the service provider is no longer an employee.
2. Similarly, we recommend that when deferred compensation relating to services provided while a service provider was an employee becomes includable in gross income under section 409A and subject to withholding, those amounts be reported to the service provider on Form W-2, and not Form 1099-MISC, even where reporting is required after the service provider is no longer an employee.

COMMENTS

IRS Notices 2005-1, 2005-94, and 2006-100, the preamble to the Proposed Regulations (the “Preamble”), and the Regulation sections 1.409A-1 through 6⁵ provide initial guidance under section 409A with respect to the calculation and timing of income inclusion under section 409A. We commend the Treasury and Service for the substantial guidance provided to date.

A. Amounts Includable in Gross Income: Income Inclusion Date

1. Summary

Section 409A(a)(1)(A) provides that if at any time during a taxable year a nonqualified deferred compensation plan fails to meet the requirements of sections 409A(a)(2), (3), and (4) or is not operated in accordance with those requirements, all compensation deferred under the plan for that taxable year and all preceding taxable years shall be includable in gross income for the taxable year, to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Neither the statute nor the legislative history provide guidance for determining the date as of which the amount is to be included in income.

Tax on the amount includable is increased by interest determined at the underpayment rate plus one percentage point, applied to the underpayments that would have occurred had the deferred compensation been includable in gross income for the taxable year in which first deferred or, if later, the first taxable year in which the deferred compensation is not subject to a substantial risk of forfeiture.⁶ The tax is also increased by an amount equal to 20 percent of the compensation required to be included in gross income.⁷

2. Recommendations

We recommend that Regulations, when finalized, provide that where there is a failure to satisfy the section 409A(a)(2), (3), and (4) requirements, the determination of the amount of compensation deferred for the taxable year and all preceding taxable years be made as of the last day of the taxable year of the failure (the “**Income Inclusion Date**”).

3. Explanation

Although the statute provides for amounts being includable in gross income when they are no longer subject to a substantial risk of forfeiture, the statute directs that all compensation deferred under the plan “for the taxable year” and all preceding taxable years be includable in gross income. The quoted language, which refers to amounts deferred for the entire taxable year, suggests that deferrals occurring within the year in which a substantial risk of forfeiture lapses, but which occur later than the date the substantial risk of forfeiture lapses, are to be included in income for the taxable year. This suggests that the amount which is no longer subject to a substantial risk of forfeiture should be determined as of the last day of the taxable year in which

⁵ 72 Fed. Reg. 19234 (2007).

⁶ Section 409A(a)(1)(B)(i)(I).

⁷ Section 409A(a)(1)(B)(i)(II).

the risk of forfeiture lapses. This is consistent with the December 31 date set forth in interim guidance in section III.B.1 of Notice 2006-100.

B. Calculation of Amounts Includable in Gross Income

1. Summary

Section 409A(a)(1)(A) provides that if at any time during a taxable year a nonqualified deferred compensation plan fails to meet the requirements of sections 409A(a)(2), (3), and (4) or is not operated in accordance with those requirements, all compensation deferred under the plan for that taxable year and all preceding taxable years shall be includable in gross income for the taxable year, to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. The statute provides little guidance for determining the *amount* to be included in gross income.

2. Recommendations

We recommend that Regulations, when finalized, provide that where there is a failure to satisfy the section 409A(a)(2), (3), and (4) requirements, the amount of the compensation deferred for a taxable year and all preceding taxable years be determined in a manner similar to that under the methodology set forth in Regulation § 1.409A-6(a)(3), with the following modifications:

a. In the case of non-account balance plans, where a service provider has begun receiving payments by the Income Inclusion Date in a form which the service provider has no right to change, we recommend that the amount deferred not be based on a payment of benefits with the maximum value on the earliest possible date allowed under the plan, but instead be based on the form of distribution in which benefits have commenced by the Income Inclusion Date;

b. In the case of non-account balance plans, in determining whether reasonable actuarial assumptions and methods have been used in determining the present value of the amount to which the service provider would be entitled under the plan if the service provider voluntarily terminated services without cause on the Income Inclusion Date, we recommend the use of rules similar to those set forth in Regulation § 31.3121(v)(2)-1(d)(2)(iii); and

c. In the case of non-account balance plans that are not equity-based compensation plans, we recommend that the rules described above for income inclusion apply for purposes of determining amounts includable in income for wage withholding and reporting purposes as of the Income Inclusion Date. Consistent with this approach, we recommend that a rebuttable presumption be provided in favor of a service provider that the amount includable in gross income by the service provider is the amount determined by the service recipient as includable in gross income for reporting and, if applicable, withholding purposes, if the service recipient used reasonable actuarial assumptions and methods in making those determinations.

d. With respect to account balance plans, we recommend that the compensation considered to be deferred under the plan for a taxable year and all preceding taxable years be the portion of the service provider's account balance as of the Income Inclusion Date the right to which is no longer subject to a substantial risk of forfeiture as of that day.

e. With respect to equity-based compensation plans, we recommend that the amount of compensation deferred under the plan for a taxable year and all preceding taxable years be determined under the rules for account balance plans, with the account balance deemed to be the amount of the payment available to the service provider on the Income Inclusion Date (or that would be available to the service provider if the right were immediately exercisable) the right to which is no longer subject to a substantial risk of forfeiture as of that day. For this purpose, the payment available to a service provider should exclude any exercise price or other amount that must be paid by the service provider in order to obtain the payment.

f. We recommend that once amounts are included in gross income, section 409A no longer apply to earnings on (or increases in the value of) such deferred compensation beyond the year in which the amounts were included, unless (a) there is a continuing section 409A violation in succeeding years relating to such deferred compensation, and (b) then, only to the extent amounts have not been actually or constructively received in the year that includes the Income Inclusion Date or any year both subsequent to the Income Inclusion Date and preceding the year under consideration.

i. For the purpose of determining earnings on amounts previously included in gross income, we recommend that earnings on amounts constructively received, rather than actually received, be determined under rules similar to those set forth in Regulation § 1.409A-6(a)(3) and Regulations §§ 31.3121(v)(2)-1(c)(2) and (d)(2). Accordingly, we recommend that Regulations provide that earnings on amounts constructively received include both actual or notional earnings. In the case of an account balance plan, we recommend that earnings on amounts previously constructively received (but not actually received) and included in gross income, and therefore not subject to further taxation, be limited to a reasonable interest rate or rate of return, as set forth in Regulations §§ 31.3121(v)(2)-1(c)(2) and (d)(2).

ii. In the case of a non-account balance plan, we recommend that earnings on amounts constructively received (but not actually received) include the increase, due solely to the passage of time, in the present value of future payments previously included in gross income, to the extent the amounts previously included in gross income were determined using reasonable actuarial assumptions and methods (within the meaning of Regulations §§ 31.3121(v)(2)-1(c)(2)(iii) and (d)(2)(iii)(B)). This should include any increase resulting from the shortening of the discount period before the future payments are made plus, if applicable, an increase in the present value resulting from the service provider's survivorship during the year. Earnings should not, however, include any increase

in the potential benefits under a non-account balance plan due to application of an increase in compensation after amounts were constructively received under a final average pay plan, or subsequent eligibility for an early retirement subsidy.

3. Explanation

Regulation § 1.409A-6(a)(3) sets forth rules for calculating the amount of compensation deferred prior to January 1, 2005, the general statutory effective date for section 409A. Those rules provide a reasonable methodology for determining the amount deferred as of a date. Although the amount considered deferred under a non-account balance plan under those rules may include amounts a service provider will never receive (because, for example, a condition precedent to receiving a benefit that does not constitute a substantial risk of forfeiture is never satisfied or, with respect to a non-account balance plan, the service provider does not begin receiving payments at a time or in a form that maximizes the value of the deferred compensation), the rules are workable in a variety of contexts and are practical and equitable if our recommendations below concerning (a) the ability of a service provider (or beneficiary) to claim a deduction where the total amount ultimately received is less than the amount includable in gross income (see discussion below concerning Negative Earnings), and (b) offsetting Negative Earnings against amounts includable in gross income by reason of later violations of section 409A, are adopted.

Non-Account Balance Plans. As noted above, the amount considered deferred under a non-account balance plan under the rules set forth in Regulation § 1.409A-6(a)(3) may include amounts a service provider will never receive, such as where the service provider does not begin receiving payments at a time or in a form that maximizes the value of the deferred compensation. This is appropriate where amounts are to be taxed before it is known when and in what form those amounts will be paid, to assure that the full amount of deferred compensation is included in gross income. An overstatement of the amount the service provider will receive (and, therefore, which should be taxed) is unnecessary and inappropriate, however, where the amount the service provider will receive is known, as where payments have begun by the Income Inclusion Date in a form which the service provider has no right to change.

In ascertaining whether reasonable actuarial assumptions and methods have been used in determining the present value of the amount to which a service provider would be entitled under the plan if the service provider voluntarily terminated services without cause in the year that includes the Income Inclusion Date, we recommend that rules similar to those set forth in Regulation § 31.3121(v)(2)-1(d)(2)(iii)(B) be utilized. These are rules with which employers and others are familiar; their use would provided for consistency in the calculation of amounts includable in gross income and amounts included as wages for Federal Insurance Contributions Act (“FICA”) taxation purposes; and the rules have proven workable in the FICA context. We recommend that the rules for determining amounts includable in income under non-account plans be applied as well for purposes of determining amounts includable in income for wage withholding and reporting purposes. This would provide consistency among the income taxation, withholding, and reporting rules. We also recommend that there be a rebuttable presumption that the amount includable in gross income by a service provider under a non-account balance plan be the amount determined by the service recipient as includable in gross income for reporting and, if applicable, withholding purposes, if the service recipient used

reasonable actuarial assumptions and methods in making those determinations. Service providers normally will not have the expertise, nor ready access to professionals with the expertise, necessary to make the actuarial calculations required to determine the amounts includable in their gross income. In addition, service providers' ability to use income calculations made by service recipients (and their professional advisors) should reduce the likelihood of a mismatch between income calculations made by a service recipient, using one set of reasonable actuarial assumptions, and calculations made by the service provider's professional advisor, using a different set of reasonable actuarial assumptions. We make these recommendations with non-account balance plans in mind because it is with respect to those plans that there would otherwise be the greatest potential for a mismatch between amounts reported by a service recipient as includable in gross income (or subject to withholding) and amounts calculated by a service provider as includable in gross income. That is due to the complexity of the required calculations and because more than one set of actuarial assumptions might be reasonable in making those calculations.

Account Balance Plans. Our recommendation that the compensation considered to be deferred under an account balance plan for a taxable year and all preceding taxable years be the portion of the service provider's account balance as of the Income Inclusion Date the right to which is no longer subject to a substantial risk of forfeiture is consistent with the rules set forth in Regulation § 1.409A-6(a)(3). As noted earlier, we believe those rules provide a reasonable methodology for determining the amount deferred as of a date.

Equity-Based Compensation Plans. We have recommended that with respect to equity-based compensation plans, the amount of compensation deferred under the plan for a taxable year and all preceding taxable years be determined under the rules for account balance plans, with the account balance deemed to be the amount of the payment available to the service provider on the Income Inclusion Date (or that would be available to the service provider if the right were immediately exercisable), the right to which is no longer subject to a substantial risk of forfeiture as of that date. For this purpose, the payment available to a service provider should exclude any exercise price or other amount that must be paid by the service provider to obtain the payment. These recommendations are consistent with the rules set forth in Regulation § 1.409A-6(a)(3). As noted earlier, we believe those rules provide a reasonable methodology for determining the amount deferred as of a date and are consistent with current treatment of similar types of awards when exercised.

Earnings. With respect to earnings, section 409A(d)(5) provides that references in section 409A to deferred compensation are treated as including references to income (whether actual or notional) attributable to such compensation or such income. As a consequence, earnings on deferred compensation are taxable under section 409A in the same way as the principal amounts to which they relate. Even so, section 409A(a)(1)(A) provides that amounts previously included in gross income are not to be taxed under section 409A. Section 3121(v)(2)(B) sets forth an analogous rule, under which amounts that have been taken into account as wages for purposes of FICA taxes are not thereafter treated as wages subject to FICA taxation. Regulations explaining this nonduplication rule provide that neither the principal amount previously taken into account nor the income attributable to that amount is treated as wages for FICA taxation purposes. Regulation § 31.3121(v)(2)-1(a)(2)(iii). The parallel rule in 409A(a)(1)(A) should be interpreted in a manner consistent with the section 3121(v)(2)(B) rule, so that once amounts have been

included in income under section 409A, subsequent earnings on those amounts should not be includable in income under section 409A. An exception to this general rule should apply, however, in recognition of the express rule stated in section 409A(d)(5) which earnings are treated as deferrals. Under that exception, if amounts previously included in income under section 409A have not been actually or constructively received in a previous year and there is a continuing section 409A violation in the current year relating to that previously included deferred compensation, earnings since the time of any earlier income inclusion should be treated as a deferral subject to taxation under section 409A in the current year. Our recommended approach would reconcile the provision of section 409A(d)(5), under which income on deferred compensation constitutes deferred compensation, with the provision of section 409A(a)(1)(A), under which amounts previously included in deferred compensation are no longer taxed under section 409A, and would do so in a manner consistent with the rules for applying FICA taxes to deferred compensation.

C. Negative Earnings

1. Summary

In the Preamble, the Treasury and Service requested comments with respect to the calculation and timing of income inclusion under section 409A, and specifically requested comments in two areas.⁸ The first area concerned the treatment of Negative Earnings – that is, where the amounts to which a service provider has a right in a particular year are less than the amounts to which the service provider had a right in a previous year, even where no actual payments have been made. The Treasury and Service requested comments with respect to whether and how such Negative Earnings may be accounted for in determining the amount of deferrals and the amount of income inclusion for a given taxable year, particularly where continuing violations of section 409A extend to successive tax years.

2. Recommendations

With respect to Negative Earnings, we recommend that Regulations when finalized, provide that a deduction be allowed in general, to the service provider if the total payments made to the service provider that relate to amounts previously included in income under section 409A is less than the amounts so previously included in income (excluding the 20 percent additional tax and interest at the underpayment rate plus one percent as amounts previously included in income).

a. We recommend that this deduction be allowed to the service provider for the year in which the final payment to which the service provider is entitled is made, and that the amount of the deduction be the excess, if any, of the amount included in income by the service provider over the total of the payments received.

b. We recommend that in the event payments continue beyond the service provider's death to a beneficiary, the deduction be allowed to the beneficiary in the year in which the final payment due to any beneficiary is made (assuming the total payments

⁸ 70 Fed. Reg. 57930, 57956 (2005).

made to the service provider and beneficiary are less than the amount previously included in the service provider's gross income).

c. Where property other than cash is distributed, we recommend that in determining whether the total amount distributed is less than the amount previously included in gross income, the fair market value of the property at the time of distribution be treated as the amount distributed, without regard to any future appreciation or depreciation in the value of that property.

3. Explanation

Section 409A(e) directs the Secretary of the Treasury to prescribe such regulations as may be necessary or appropriate to carry out the purposes of section 409A, including regulations providing for the determination of amounts of deferral in the case of a nonqualified deferred compensation plan which is a defined benefit plan.⁹ The need for relief from taxation where there are Negative Earnings is important because under section 409A amounts may be includable in gross income before those amounts are actually or constructively received, and therefore where there are Negative Earnings the amount a service provider actually or constructively receives may be less than the amount previously included in his or her gross income. This is particularly important in the context of non-account balance plans where the initial amount includable in gross income is determined prior to the commencement of distribution and may be based on a payment of benefits with the maximum value on the earliest possible date allowed under the plan to receive benefits following termination of services.

The statutory authorization to prescribe regulations is broad. The statute directs that “[t]he Secretary [of the Treasury] shall prescribe such regulations as may be necessary *or appropriate* to carry out the purposes of this section”¹⁰ The treatment described above represents only a slight expansion of the rules that would apply absent the Treasury's issuance of regulations under section 409A and is an appropriate exercise of the Treasury's regulatory mandate to issue regulations to carry out the purposes of section 409A. In particular, the purpose of the section 409A rules is to apply the special and adverse tax consequences to amounts of deferred compensation that run afoul of the section 409A requirements, not to apply those adverse tax consequences to additional amounts which neither a service provider nor his or her beneficiaries ever receive.

As to the rules that would apply absent the Treasury's issuance of regulations, if the total payments made to the service provider that relate to amounts previously included in income under section 409A are less than the amounts previously included in income (not counting the 20 percent additional tax and interest at the underpayment rate plus one percent as amounts previously included in income), then the tax treatment that would apply to the service provider would seem to depend on whether this difference were more than \$3,000. If the amount were more than \$3,000, the taxpayer would appear to be entitled to an adjustment under section 1341(a), the statutory codification of the claim of right doctrine, that would have the effect of allowing a current year deduction equal to that amount (under section 1341(a)(5)(A)), or would

⁹ Section 409A(e).

¹⁰ *Id.* (emphasis added)

be entitled to an even better result by applying the tax rules in effect in the prior years when the excess was previously included in income (under section 1341(a)(5)(B)).¹¹

If the difference between the total payments made to a service provider that relate to amounts includable in income under section 409A and amounts previously included in income under that section does not exceed \$3,000, and the 2% floor on employee business expenses as a miscellaneous itemized deduction, the taxpayer would seem to be entitled to a current year deduction equal to the difference under section 165(a) as an expense or loss incurred in the employee's trade or business of being an employee,¹² but only if the taxpayer were to itemize deductions and the last payment of benefits due under the arrangements aggregated as a plan under section 409A were to result in a closed and completed transaction for purposes of section 165.¹³ However, any benefit from a deduction may be nullified by application of the alternate minimum tax. To the extent the difference between the total of the payments made and the amounts previously included in income were not attributable to the service provider's voluntary deferrals, it would, however, seem that the two percent floor of section 67(a) would apply. In contrast, to the extent the difference were attributable to voluntary deferrals, the two percent floor of section 67(a) might not apply because that floor does not apply where a loss is the result of a loss incurred in a transaction entered into for profit, but not connected with a trade or business.¹⁴

Under our recommendation, the result would be to apply rules like those under sections 1341(a) and 165(a), but without distinctions based on whether the amount at issue was more than \$3,000, whether the amount related to voluntary deferrals, and whether there was a closed and completed transaction. Our recommendation is to apply a uniform and relatively simple rule under which a deduction is allowed if the total payments made to a service provider that relate to amounts included in income under where section 409A is less than the amounts previously included in income (not counting the 20 percent additional tax and interest at the underpayment rate plus one percent as amounts previously included in income). We recommend that this deduction be allowed to the service provider for the year in which the final payment to which the

¹¹ See Rev. Rul. 2002-84, 2002-2 C.B. 953 (concerning the repayment of overpayments from a qualified retirement plan). Although the revenue ruling concerned the repayment of overpayments from a qualified retirement plan, its analysis would seem equally applicable where a service provider has included other amounts in income which the service provider never receives.

¹² Section 1341(a).

¹³ *Id.* See also Rev. Rul. 72-15, 1972-1 C.B. 114 (no deductible loss was sustained under section 165(a) at the time an employee received a total distribution under a qualified retirement plan consisting of non-employer stock having a fair market value less than the employee's contributions because the transaction was not closed within the meaning of Reg. 1.165-1(b) where the employee had not disposed of the stock); and Rev. Rul. 72-305, 1972-1 C.B. 116 and Rev. Rul. 72-328, 1972-2 C.B. 224 (difference between an employee's contributions to a qualified defined contribution plan and the lesser amount received as a distribution is deductible under section 165(a) as an ordinary loss in the year of the distribution if the employee itemizes deductions).

¹⁴ Code section 67(b)(3). Rev. Rul. 72-305 and 72-328, *supra*, concluded that an employee's participation in a defined contribution qualified retirement plan was a transaction entered into for profit. In contrast, in Revenue Ruling 2002-84, *supra*, participation in noncontributory defined benefit qualified plans seemed to be considered part of carrying on a trade or business, rather than a transaction entered into for profit. The factual distinction leading to this difference appears to be that the earlier rulings, unlike the later ruling, involved a contributory plan, and the employee's "investment" in the plan was presumably a transaction entered into for profit and not part of a trade or business.

service provider is entitled is made, and that the amount of the deduction be the excess, if any, of the amount included in income by the service provider over the total payments received.

Permitting such a deduction would also be consistent with the doctrine regarding amounts received under a claim of right espoused in *North American Oil Consolidated v. Burnet*.¹⁵ The Court in *North American Oil Consolidated* stated:

They became income of the company in 1917, when it first became entitled to them and when it actually received them. If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return [report], even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent If in 1922 the Government had prevailed and the company had been obliged to refund the profits received in 1917, it would have been entitled to a deduction from the profits of 1922, not from those of any earlier year.¹⁶

While *North American Oil Consolidated* formally established that an amount must be included in income when received under a claim of right, it also hinted a deduction should be allowed in the subsequent year when the claim to the amount is lost. While there is no clear statutory basis for a deduction for Negative Earnings under section 409A, the U.S. Supreme Court's language in *North American Oil Consolidated* and equity support the provision of a deduction. The deduction for a loss on an amount previously included in an individual's income in his business of being an employee would later be deducted under section 162, 165 or 212. The reduction in the amount of deferred compensation in a subsequent tax year to the year in which the deferred amount is first included in income under section 409A should be provided a similar reduction or include a deduction in the subsequent year under the claim of right doctrine.

D. Continuing or Additional 409A Violations: Negative Earnings.

1. Summary

In the Preamble the Treasury and Service expressed interest in determining how Negative Earnings should be accounted for where continuing violations of section 409A extend to successive tax years.¹⁷

2. Recommendations

With respect to Negative Earnings, we recommend that Regulations, when finalized, provide that an offset be permitted if there are continuing or additional violations of section 409A causing a service provider to have amounts includable in income following the year including the Income Inclusion Date and preceding the year under consideration.

¹⁵ 286 U.S. 417 (1932).

¹⁶ *North Am. Oil Consol. v. Burnet*, 286 U.S. 417, 424 (1932).

¹⁷ 70 Fed. Reg. 57930, 57956 (2005).

a. Under this offset, in determining the amount includable in the gross income of a service provider as a result of any continuing or additional section 409A violation (whether under the same plan or an aggregated plan), we recommend that the amount includable in gross income with respect to that violation be reduced by Negative Earnings with respect to any amounts previously included in gross income under section 409A by that service provider.

b. We recommend that for years after the taxable year for which compensation under a plan is first includable in gross income, any additional compensation includable in the service provider's gross income as a result of a continuing or additional section 409A violation be reduced by any Negative Earnings attributable to amounts previously included in gross income under section 409A under the plan or any aggregated plan. For this purpose, Negative Earnings would include any reduction in value under an account balance plan, to the extent those Negative Earnings are based on a predetermined actual investment or reasonable rate of interest under Regulations §§ 31.3121(v)(2)-1(c)(2) and (d)(2). In addition, Negative Earnings would include the value of any reduction in, or loss of, benefits resulting from the service provider failing to meet a condition for benefit eligibility, failing to become or remain entitled to an early retirement subsidy under a non-account balance plan, a reduction in a non-account balance plan due to an increase in the value of an offset under a qualified plan or otherwise failing to become or remain entitled to receive under a non-account balance plan a benefit as valuable as that previously included under section 409A.

3. Explanation

Where there are future violations of section 409A with respect to amounts deferred by a service provider, determining any additional amounts includable in gross income as we have recommended effectively provides an offset for Negative Earnings and yields the fairest result, by permitting an appropriate adjustment prior to the conclusion of all payments being made to the service provider. The allowance of such an offset is consistent with the claim of right doctrine discussed above as espoused by the U.S. Supreme Court and codified in section 1341. Permitting an offset or deduction is similar to the result that applies where payments from a qualified retirement plan are reduced in an effort to recoup a prior overpayment.¹⁸ In that circumstance, the participant has effectively been taxed in an earlier year on an amount to which he was not entitled (but did, in fact, receive). Under section 402, as interpreted in Revenue Ruling 2002-84,¹⁹ the participant is in current and future years taxed on the smaller payments which reflect the offset or adjustment made to correct for the prior overpayments. This is similar to the self-correcting process we recommend apply where there are future violations of section 409A relating to deferred compensation of a service provider who has already been taxed under the special taxation rules that apply where the requirements of section 409A are not satisfied.

¹⁸ Rev. Rul. 2002-84, *supra*.

¹⁹ 2002 C.B. 953.

E. Valuation of Service Recipient Stock for Withholding and Reporting Purposes: Readily Tradable Stock

1. Summary

Where a nonqualified deferred compensation plan fails to meet the requirements of section 409A(a)(2), (3), or (4) or is not operated in accordance with those requirements, all compensation deferred under the plan for the taxable year and all preceding taxable years is includable in gross income for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. The statute does not provide guidance for determining how to value compensation for this purpose, and, in particular, does not provide guidance with respect to the valuation of equity-based compensation.

2. Recommendations

In the case of stock, stock options, stock appreciation rights, and other equity-based compensation, we recommend that Regulations, when finalized, provide that when amounts are includable in gross income under section 409A, the value of stock that is readily tradable on an established securities market be considered for purposes of income tax withholding and information reporting under sections 6041 and 6051 to be (a) the fair market value of that stock based upon the last sale before the first sale on or after the Income Inclusion Date, (b) the closing price on the trading day before or the trading on the Income Inclusion Date, or (c) the value determined under any other reasonable basis using actual transactions in such stock as reported by such market and consistently applied, whichever method the service recipient (or other party) with the withholding or reporting obligation chooses.

We recommend that the rules described above apply only with respect to “stock of the service recipient,” as that term is defined in Regulation § 1.409A-1(b)(5)(iii).

3. Explanation

Service recipients need flexibility in determining how to value stock for income tax withholding and reporting purposes. The rules we have recommended offer service recipients that flexibility and are generally consistent with the Final Regulations’ rules on valuing stock of a service recipient for purposes of determining whether equity-based compensation provides for the deferral of compensation.

We continue to recommend that the term “stock of the service recipient,” as defined in Regulation § 1.409A-1(b)(5)(iii).

F. Valuation of Service Recipient Stock for Withholding and Reporting Purposes: Stock Not Readily Tradable

1. Summary

Where a nonqualified deferred compensation plan fails to meet the requirements of section 409A(a)(2), (3), or (4) or is not operated in accordance with those requirements, all compensation deferred under the plan for the taxable year and all preceding taxable years is

includable in gross income for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. The statute does not provide guidance for determining how to value compensation for this purpose, and, in particular, does not provide guidance with respect to the valuation of equity-based compensation.

2. Recommendations

We recommend with respect to stock that is not readily tradable on an established securities market, that Regulations, when finalized, provide that the fair market value of the stock as of the Income Inclusion Date be, for purposes of income tax withholding and information reporting under sections 6041 and 6051, the value determined by the reasonable application of a reasonable valuation method. The determination of whether a valuation method is reasonable, or whether application of a valuation method is reasonable, should be based on the facts and circumstances as of the Income Inclusion Date.

a. We recommend that Regulations, when finalized, provide that factors similar to those set forth in Regulation § 1.409A-1(b)(5)(iv)(B)(1) will apply for this purpose.

b. We recommend that the presumption of reasonableness and the requirement for consistent use of a method, which are set forth in Regulations § 1.409A-1(b)(5)(iv)(B)(2) and (3), apply in these circumstances as well.

c. We recommend that the rules described above apply only with respect to “stock of the service recipient,” as that term is defined in Regulation § 1.409A-1(b)(5)(iii).

3. Explanation

Service recipients need flexibility in determining how to value stock for income tax withholding and reporting purposes. The rules we have recommended offer service recipients that flexibility, and are generally consistent with the Regulations’ rules on valuing stock of a service recipient for purposes of determining whether equity-based compensation provides for the deferral of compensation.

G. Loss of Grandfathered Status: Year for Inclusion in Income

1. Summary

Subsections (d)(1) and (d)(2)(B) of section 885 of the American Jobs Protection Act provide that section 409A does not apply to amounts deferred prior to January 1, 2005; provided, however, that amounts deferred prior to January 1, 2005, will be treated for purposes of section 409A as having been deferred after December 31, 2004, if the plan under which the deferral is made is materially modified after October 3, 2004, other than in a fashion permitted under guidance from the Treasury. Where this grandfathered status is lost by reason of such a material modification, and the requirements of sections 409A(a)(2), (3), or (4) are not satisfied, neither the statute nor the legislative history offer guidance on the year in which amounts are includable in gross income.

2. Recommendations

We recommend that Regulations, when finalized, provide that where a grandfathered plan loses its grandfathered status (due to a material modification), a service provider be required to include amounts in gross income in the year in which that grandfathered status is lost, if in that year or a prior year (after 2004) the requirements of section 409A(a)(2), (3), or (4) are not satisfied, and to the extent compensation deferred under the plan for that taxable year and preceding taxable years is not subject to a substantial risk of forfeiture and has not previously been included in gross income.

Further, we recommend that Regulations, when finalized, provide that any interest under section 409A(a)(2)(B) apply as if the deferred compensation had been includable in gross income for the latest of (a) the taxable year in which first deferred, (b) the first taxable year in which the deferred compensation is not subject to a substantial risk of forfeiture, and (c) 2005. That is, we recommend that any interest under section 409A(a)(2)(B) not apply from any taxable year earlier than 2005, even if the service provider had a legally binding right to the compensation prior to 2005. This is consistent with Notice 2006-79 which provides that many issues in plans can be addressed through December 31, 2007, the end of the transition relief.²⁰

3. Explanation

Our recommendation that amounts be includable no earlier than the year in which a grandfathered plan loses its grandfathered status is consistent with the general statutory scheme, under which amounts are includable in gross income no earlier than the first year in which the statutory requirements are not satisfied. A grandfathered plan will not be subject to the section 409A requirements until the year in which it loses its grandfathered status, even though amounts may then be includable in gross income by reason of a violation of the requirements of section 409A(a)(2), (3), or (4) that occurred in a year prior to grandfathered status being lost (and after 2004).

Any application of interest for taxable years prior to 2005 would be inconsistent with the statutory scheme. The interest imposed under section 409A(a)(2)(B) is in the nature of interest on an underpayment of tax.²¹ Prior to the effective date of the American Jobs Creation Act of 2004 enacted on October 22, 2004, the section 409A rules did not exist and there should not, therefore, be considered to have been an underpayment prior to that date. Consistent with this, the section 409A rules are generally effective only for amounts deferred after December 31, 2004.

²⁰ 2006-43 IRB 763 (Oct. 4, 2006).

²¹ The statute bases the interest rate on the underpayment rate (plus one percent). Section 409A(a)(1)(B)(ii). The legislative history indicates that under the House bill “[i]nterest imposed under the provision is treated as interest on an underpayment of tax.” H.R. Rep. No. 108-755, at 726 (2004). The Conference Agreement followed the House bill except that “interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includable in income when first deferred, or if later, when not subject to a substantial risk of forfeiture.” H.R. Rep. No. 108-755, at 729 (2004).

H. Plan Termination

1. Summary

Regulation § 1.409A-3(h)(2)(viii) permits the termination of a plan and distribution of benefits without violating section 409A's prohibition on acceleration of benefits, if certain requirements are met. One of those requirements is that the service recipient not adopt a new arrangement that would be aggregated with any terminated arrangement at any time within five years following the date of termination of the arrangement (if the same service provider whose benefits were accelerated participated in both arrangements). Regulation § 1.409A-3(h)(2)(viii)(C)(4). Another requirement is that no payments be made within 12 months of termination of the arrangement, other than payments that would be payable under the terms of the arrangement if termination had not occurred.²² In addition, all payments must be made within 24 months of termination of the arrangement.²³ The Regulations do not indicate in which tax year amounts are includable in gross income if any of the requirements are violated in a year later than the year in which the arrangement is terminated.

2. Recommendations

We recommend that that Regulations, when finalized, provide that if, following a plan termination under which the distribution of benefits is accelerated under Regulation § 1.409A-3(j)(4)(ix)(C), the service recipient violates any of the requirements of Regulation § 1.409A-3(j)(4)(ix)(C)(2), (3), (4) or (5), the year of income inclusion for any violation of the section 409A prohibition on acceleration be the taxable year in which the requirement was violated, not the earlier year in which the arrangement was terminated.

3. Explanation

This recommendation avoids the substantial administrative difficulties that would result from a need to include amounts in prior years. Any requirement that amounts be included in prior years would necessarily result in reporting and withholding complications, such as the need for service recipients and service providers to file amended or corrected income tax or information returns. That is because neither service recipients nor service providers would know that amounts were to be included in income in a prior year by reason of a plan termination until the later year when the requirements of Regulation § 1.409A-3(j)(4)(ix)(C)(2), (3), (4) or (5) were violated.

This is a more serious difficulty than might occur in the case of the termination of a qualified retirement plan meeting the requirements of section 401(k) (a "401(k) plan"). Where distribution is made upon termination of a 401(k) plan under authority of section 401(k)(10)(A), no other defined contribution plan (other than an employee stock ownership plan as defined in section 4975(e)(7)) may be established or maintained. The maintenance of another defined

²² Reg. 1.409A-3(j)(4)(ix)(C)(3).

²³ Reg. 1.409A-3(j)(4)(ix)(C)(4).

contribution plan will not, however, violate this condition if the other plan does not exist until at least 12 months after distribution of all assets from the terminated plan.²⁴

This relatively short 12-month standard is in contrast to the three-year rule which can come into play under Regulation § 1.409A-3(j)(4)(ix)(C)(5). Consider, for example, a nonqualified deferred compensation plan that is terminated by an employer on December 31, 2008. If the employer, perhaps following a change in ownership or management, were to establish a new arrangement that would be aggregated with the terminated plan in late 2011, requiring income inclusion for 2008, rather than 2011, would require that both employees and the employer (with respect to its deduction) file amended returns for a period three years in the past. In addition to the resulting administrative difficulties associated with this need to file amended returns, including amounts in income in the earlier year in which the plan was terminated would raise questions about open years if the individual did not become aware of the new plan promptly, possibly leading to different effective results for different taxpayers, since an employee for whom the amount to be included would not have resulted in a substantial underpayment for the prior year might escape taxation, while an employee for whom the amount would have resulted in a substantial underpayment would be taxed.²⁵ Using a twelve month standard will also avoid the statute of limitation defense being raised by the service providers who will be subject to the penalties and will not have control of what the service recipient does with respect to establishing any new arrangements.

I. Withholding

1. Summary

Section 3401(a) includes in the term “wages” for income tax withholding purposes any amount includable in gross income of an employee under section 409A, with payment of the amount for income tax withholding purposes to be treated as having been made in the taxable year in which the amount is so includable. The statute and existing regulations do not provide guidance as to the particulars of how withholding is to occur.

2. Recommendations

With respect to withholding taxes, we recommend that Regulations, when finalized, provide that:

- a. The party responsible for withholding be permitted to treat, for purposes of withholding under section 3402, amounts includable in gross income under section 409A as a payment of wages made on the last day of the taxable year for which the amounts are includable in gross income, except to the extent the amounts are actually or constructively received earlier in the taxable year. If an amount includable in gross income for a taxable year by reason of section 409A is actually or constructively received on a day in the taxable year other than the last day, the amount includable should be considered a payment of wages on the day the amount is actually or constructively received.

²⁴ Regulation § 1.401(k)-1(d)(4)(i).

²⁵ Section 6501(a) and (e)(1).

- b. Amounts includable in the gross income of an employee under section 409A be considered supplemental wages under section 3402, regardless of whether the employee has been paid regular wages.
- c. Withholding be required with respect to amounts only if the service provider was an employee at the time the services were provided with respect to which the compensation is paid. No withholding should be required where the service provider was not an employee at the time the services were provided with respect to which the compensation is paid.
- d. No additional amount be required to be withheld by reason of the 20 percent additional tax or interest described in section 409A(a)(1)(B).

3. Explanation

Section 3401(a) (last sentence) provides that amounts includable in gross income of an employee under section 409A are wages for purposes of withholding income tax and the payment of such an amount is to be treated as having been made in the taxable year in which the amount is so includable. The Service provided temporary relief from the withholding requirement in Q&A-32 of Notice 2005-1 and in Notice 2005-94. Under that temporary relief, for calendar year 2005 an employer is not required to include as wages for withholding tax purposes amounts includable in the gross income of an employee under section 409A that the employee has neither actually nor constructively received during calendar year 2005.

The Service provided further guidance in Notice 2006-100, including interim guidance for 2005 and 2006. Under that interim guidance, amounts includable in gross income under section 409A are supplemental wages if the employee has received regular wages from the employer during the calendar year. The amount required to be withheld is not increased on account of the additional taxes imposed under section 409A(a)(1)(B) (interest based on the underpayment rate and the 20 percent additional tax). Amounts includable in gross income under section 409A in 2006 are, for withholding tax purposes, considered a payment of wages on December 31 of the year, unless the amounts are actually or constructively received during 2006, in which case they are considered a payment of wages when received.

Our recommendation that amounts includable in gross income under section 409A be treated as a payment of wages made on the last day of the taxable year for which the amounts are includable (unless actually or constructively received earlier in the year) is consistent with our earlier recommendation that the amount includable in gross income for a taxable year be determined as of the last day of that taxable year and with the interim guidance set forth in Notice 2006-100.

Our recommendation that amounts includable in gross income under section 409A be considered supplemental wages under section 3402, regardless of whether the employee has been paid regular wages, is consistent with Regulation § 31.3402(g)-1(a)(1)(i), which provides that amounts includable in gross income under section 409A constitute supplemental wages. That is true whether or not the employee has been paid regular wages.²⁶ Our recommendation differs

²⁶ *Id.*; 71 Fed. Reg. 42049 (2006).

from the interim guidance under Notice 2006-100 in that we recommend that the provision of Regulation § 31.3402(g)-1(a)(i) treating amounts as supplemental wages even if no regular wages are paid be followed. We do so for the same reasons articulated by those who commented on the proposed version of the cited regulation, including the objective of avoiding the unduly complicated payroll administration that would result from characterizing the same type of compensation differently depending on the circumstances under which the payment were made.²⁷

We also recommend that withholding be required with respect to amounts only if the service provider was an employee at the time the services were provided with respect to which the compensation is paid, and that no withholding be required where the service provider was not an employee at the time the services were provided with respect to which the compensation is paid.

Our recommendation that no additional amount be required to be withheld by reason of the 20 percent additional tax or interest described in section 409A(a)(1)(B) is consistent with the interim guidance under Notice 2006-100. Section 3401 provides that, for purposes of income tax withholding, “the term ‘wages’ includes any amount includable in gross income of an employee under section 409A....” Section 409A(a)(1)(B) provides for the inclusion of deferred compensation in gross income, but does not treat the 20 percent additional tax or interest under section 409A(a)(1)(B)(ii) as gross income. Instead section 409A(a)(1)(B)(i) provides for increasing the tax by those amounts, without treating them as items of gross income. We are unaware of any statutory authority for requiring withholding of an additional amount to recover the amounts described in section 409A(a)(1)(B), since those amounts are not wages.

J. Reporting

1. Summary

Sections 6051(a)(13) and 6041(g)(1) require reporting on Forms W-2 and 1099 of the total amount of deferrals for a year under a nonqualified deferred compensation plan (within the meaning of section 409A(d)). Sections 6051(a)(3) and 6041(g)(2) require that amounts *paid* under nonqualified deferred compensation plans also be reported on Forms W-2 and 1099.

2. Recommendations

With respect to reporting on Forms W-2 and 1099, we recommend that Regulations, when finalized, provide that:

1. Deferrals relating to services provided while a service provider was an employee be reported to the service provider on Form W-2, not Form 1099-MISC, even where those deferrals occur after the service provider is no longer an employee.
2. Similarly, we recommend that when deferred compensation relating to services provided while a service provider was an employee becomes includable in gross income under section 409A and subject to withholding, those amounts be reported

²⁷ See 71 Fed. Reg. 42049 (2006).

to the service provider on Form W-2, and not Form 1099-MISC, even where reporting is required after the service provider is no longer an employee.

3. Explanation

We think clarification of whether amounts are reported on Form W-2 or instead on Form 1099-MISC is important because in a number of circumstances a service provider who earned compensation subject to section 409A while an employee will no longer be employed at the time amounts are includable in gross income under section 409A. The approach we recommend logically ties the form to be used for reporting with the service provider's status when the services were provided. In addition, it is consistent with the treatment for FICA purposes of amounts paid to a former employee for services performed while an employee.²⁸

²⁸ Regulation § 31.3121(a)-1(i).