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Mr. Kevin Brown  
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Re: Recommendations for Improved Tax Administration Related to Section 409A

Dear Acting Commissioner Brown:

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

We commend the Internal Revenue Service (the “Service”) and the U.S. Department of Treasury (“Treasury”) for the extensive and well considered final regulations under section 409A of the Internal Revenue Code of 1986, as amended (the “Code”).<sup>1</sup> The final regulations issued on April 17, 2007, under section 409A addressed numerous issues and were responsive to many of the comments.<sup>2</sup>

This letter is in response to a written request for comments on the need and authority for a correction program applicable to section 409A inadvertent non-compliance. In light of the broad scope of section 409A, its direct impact on service providers and the administrative burden on service recipients, we believe that there will be inevitably inadvertent errors despite the best efforts of both to comply with the Regulations. Furthermore, although there has been a continual effort to publicize the impact of the Regulations on employee plans, arrangements and contracts, we believe that the small business community and their advisors are still largely unaware of section 409A.

The Regulations are extensive, complicated and interrelated which will likely lead to many inadvertent errors both in operation and in documentation. The Regulations follow two other broad pieces of guidance<sup>3</sup> addressing the interim period between enactment and the issuance of the Regulations resulting in potentially three different ways in which the statute can be interpreted and an ever-changing landscape of compliance rules. While the changes generally provide some

<sup>1</sup> All references to a “section” herein are references to a section of the Code unless explicitly stated otherwise. All references herein to “Regulations” are to the Treasury Regulations.

<sup>2</sup> Principle responsibility for preparing these Recommendations was exercised by Greta E. Cowart, Chair of the Section’s Employee Benefits Committee and T. David Cowart of the Committee on Government Submissions, with substantial contributions from Greg Barton, George Bostick, Adam Cohen, Mark Iwry, Wayne Luepker, Andy Orringer, and Max Schwartz of the Section’s Employee Benefits Committee. These Recommendations were reviewed by Priscilla Ryan, Council Director of the Employee Benefits Committee.

<sup>3</sup> Notice 2005-1, 2005-2 IRB 274 (January 10, 2005); and Proposed Treasury Regulations 1.409A-1 et. seq., Application of Section 409A to Nonqualified Deferred Compensation Plans, 70 Fed. Reg. 57930 (October 4, 2005).

flexibility, other changes cut back on flexibility and cover arrangements that may have previously been thought to be exempt. A number of smaller more discreet pieces of guidance were also issued during the period following enactment of section 409A.<sup>4</sup> The changes in the Regulations will also likely contribute to inadvertent compliance errors not justifying the full sanctions and which could be more appropriately addressed under a voluntary compliance system under which the sanctions would bear a reasonable relationship to the nature, extent and severity of the failure.<sup>5</sup> We also expect inadvertent and unintentional errors to occur even if reasonable procedures and systems have been implemented -- resulting in thousands of taxpayers violating section 409A through honest errors, and not due to any form of abuse.

The purpose of this letter is to recommend the establishment of a section 409A correction program to enhance voluntary compliance, explain the reasons we believe that the Service has the existing authority to establish such a program, suggest the potential initial scope of such a program and request the creation of a ruling program with initially a limited scope. Establishing a correction program, limited in scope and duration under the authority granted in section 7121 and section 1101 of the Pension Protection Act of 2006 (the "PPA")<sup>6</sup> would encourage voluntary compliance, facilitate consistent tax administration by providing a mechanism to address inadvertent errors where the violation was not intentional, and promote equitable tax treatment by providing a forum to develop uniform responses to similar violations.

### **Section 409A Correction Program**

We recommend the initial adoption of a short-term correction program for section 409A inadvertent violations. We further recommend that the short-term correction program cover the period between January 1, 2005, section 409A's effective date and December 31, 2007, the date on which all arrangements or plans are required to be amended to comply (the "Transition Period"), and also cover the first three years of section 409A implementation after the Transition Period ends, i.e., January 1, 2008 through December 31, 2010 (the "Transition Compliance Period"), while service recipients are initially implementing the highly complex and interrelated documentation and operational rules. We believe this program is consistent with the principal statutory purpose of regulating taxpayer conduct because it will increase awareness of certain compliance issues and thereby foster compliance. After the Transition Period and the Transition Compliance Period, service recipients may fairly be expected to have developed processes and controls to avoid most of the administrative errors that are certain to occur in the short-term (and will likely occur after the Transition Compliance Period also). Following the initial Transition Period and the Transition Compliance Period, the need for continuation of a correction program can be reevaluated.

This Correction Program could be administered by the Service through a closing agreement program under the authorization provided by section 7121 or under a compliance program under the PPA as explained below. However, to the extent additional resources within the Service are

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<sup>4</sup> Notice 2005-94, 2005-52 IRB 1208 (December 27, 2005); Notice 2006-4, 2006-3 IRB 307 (January 17, 2006); Notice 2006-33, 2006-15 IRB 754 (April 10, 2006); Notice 2006-64, 2006-29 IRB 88 (July 17, 2006); Notice 2006-79, 2006-43 IRB 763 (Oct. 4, 2006); Notice 2006-100, 2006-51 IRB 1109 (December 18, 2006); and Announcement 2007-18, I.C., 2007-9 IRB 625 (Feb. 26, 2007).

<sup>5</sup> The complexity of the Regulations and section 409A is further demonstrated by the publication of an unofficial annotated version of the Regulations on June 11, 2007, in the BNA Daily Pension Reporter. See, "Special Report: Annotated: Application of Section 409A to Nonqualified Deferred Compensation," BNA Pension & Benefits Daily, Number 111, June 11, 2007.

<sup>6</sup> P.L. 109-280.

needed to implement the proposed correction program, we urge the Service to allocate such resources to this program.

Under the proposed section 409A correction program penalties could be mitigated or eliminated if the service recipient or the service provider could demonstrate that it was operating in good faith and the violation was not due to any collusion or intent to avoid the section 409A requirements but rather due to administrative or drafting errors. Such a correction program would thus encourage voluntary compliance.

We recommend the following types of errors be covered by the correction program during the Transition Period and the Transition Compliance Period and that such errors would justify a reduced or waived penalty. We would expect these errors to occur even if reasonable procedures and systems have been implemented and recommend reduced penalties only if such procedures were, in fact, in place or as part of the correction process are agreed to be put in place.

The types of errors that should be correctable under a section 409A closing agreement or similar program should include the following and any others determined by the Service not to involve collusion or intentional avoidance of section 409A's requirements.

*Correction via a filing should be permitted for:*

1. **Payroll Deduction Errors-** For example, a deferral election is timely made and should have started by means of salary reduction, but the service recipient's payroll processing unit or vendor did not commence the elective deferral in the payroll period in which it should have commenced or commenced it by inputting an incorrect rate of deferral entered into the system. Another example would be an error that occurs when employees are shifted to a new payroll or payroll system and an inadvertent gap or failure to continue payroll deductions occurs. Such errors or omissions should not be viewed to constitute a prohibited acceleration or deferral.
2. **Payment Errors-** Payment errors include starting payments too soon or too late, or an incorrect determination of separation from service (*e.g.*, miscounted hours), or scheduled installment payments begin on time but a calculation mistake results in too much or too little being paid, or the use of a wrong actuarial factor in calculating a benefit (*e.g.*, clerical error inputting a participant's age or years of service).
3. **Merger and Acquisition Based Issues-** In many entities ownership interests change over time, and the service recipient may not know that plans of recently acquired entities now are required to be aggregated under Regulation 1. 409A-1(c). Thus, the service recipient may be understandably unaware that a service provider already made election in a plan of an acquired entity before it became part of the service recipient's controlled group. This type of error can occur when several different payroll systems are utilized by entities in the same controlled group or when an acquired entity brings to the controlled group 409A plans with existing violations that must be aggregated with the service recipient's 409A plans.
4. **Documentary Failures-** This type of error arises when there is compliance in operation with section 409A, but not in form. For example, it may occur when a service recipient fails to recognize the need to amend or redraft a plan, agreement or arrangement for any employee other than a specified employee.

5. **Rank and File Option Grants or Broad Based Grants with Administrative Errors-** These errors could include option agreements stating the incorrect number of shares granted or over or under inclusion of employees granted awards that result in a delay in the actual delivery of option agreements. These are systemic failures involving broad-based rank and file grants that require post-grant date fixes. If by the time the fix is accomplished the price moves and creates price issues, the correction program should provide the service recipient the latitude to correct, or permit the forgiveness of any technical violation arising from de minimis price movements during a prompt correction of such a systemic failure or allow correction of such strike price errors within 10 days to correct the strike price or the number of shares granted, provided no service providers exercised the option grants before the error was discovered.
6. **Overseas Compliance-** The errors would include situations that arise when a non-resident alien comes to the U.S. and works longer than planned, a U.S. service recipient is unaware that a service provider has foreign plan coverage, or a foreign service recipient is unaware that a service provider is a U.S. citizen or green card holder.
7. **Other Errors-** The category of errors noted above reflect common types of errors which we typically see with respect to administration of employee plans. However, as the implementation of compliance with section 409A continues, there will be other inadvertent errors which you may find appropriate to cover in a section 409A correction program, especially with respect to the small business community. Thus, the proposed correction program should permit correction of other errors as determined by the Secretary in subsequent guidance.

*Self correction should be permitted for:*

A violation that arises from an inadvertent payment during the six-month period after a specified employee separates from service with a publicly traded service recipient. This could arise if the testing to determine the specified employees missed someone as a specified employee due to an error in the computer system. In such a case, a specified employee should be permitted to repay the distribution mistakenly made. This is equivalent to a rescission and should be permitted to correct this inadvertent violation. Rescission should be completed within the tax year in which the error arose plus the two and one-half months following such tax year. The relevant tax year being the tax year of the service provider.

Self correction should apply only to insignificant errors that are corrected within the same taxable year as the date on which the error occurred and which involve non-abusive situations similar to the manner in which items could be corrected under the administrative policy regarding sanctions prior to the establishment of the Employee Plans Compliance Resolution System. The service recipient should be required to have good administrative compliance procedures established and operating in order to be eligible to self correct.

Correction of a violation that could have been corrected by contract rescission outside of section 409A will promote the appearance of an equitable and fair tax administration by providing a procedure to obtain uniform methods of correction, improve consistent tax administration in such area and promote uniform application of the tax laws.

## Conditions for Use of a Section 409A Correction Program

Participation in any correction program should be permitted only if the service recipient is not under examination with respect to employment taxes for the year(s) involved in the correction. Participation in a correction program should only be available for unintentional (*i.e.*, no deliberate attempt to avoid the requirements of section 409A) errors and where there is no pattern of continuous noncompliance. The service recipient should be required to have, or to establish, an internal administrative compliance procedure which will assure compliance in the future in order to be eligible to participate in the correction program.

Sanctions under the program should initially be limited and moderated by the nature of the discrepancy. Sanctions should bear a reasonable relationship to the nature, extent and severity of the failure. Any sanction or tax should be paid by the service recipient, subject to appropriate income inclusion by the service provider.

## Authority for Section 409A Correction Program

Section 7121(a) authorizes the Secretary of the Treasury “to enter into an agreement in writing with any person relating to the liability of such person (or of the person or estate for whom he acts) in respect of any internal revenue tax for any taxable period.” Section 7121 authorizes offers in compromise by which individuals may abate taxes owed and was the source for the authority for development of the Employee Plan Closing Agreement Program<sup>7</sup> and the other administrative practices that lead to the Employee Plans Compliance Resolution System until authorization was specifically codified in PPA section 1101. Section 7121 is sufficiently broad to permit the Secretary to establish a correction procedure pursuant to which service recipients may correct inadvertent violations of section 409A and to address both the service recipient’s tax liabilities as well as the tax liabilities of the service provider(s) implicated in the violations.

Further authorization can be found in PPA section 1101 which provides:

The Secretary of the Treasury shall have ***full authority to establish and implement*** the Employee Plans Compliance Resolution System (or any successor program) ***and any other employee plans correction policies***, including the authority to waive income, excise or other taxes to ensure that any tax, penalty, or sanction is not excessive and bears a reasonable relationship to the nature, extent, and severity of the failure. (Emphasis added.)

Section 1101 of the PPA clearly authorizes the establishment and implementation of a correction program for other employee plans and does not limit the types of plans to which it relates. Thus, additional authority for establishment of a correction program for plans subject to section 409A exists. The legislative history contains substantially the same language, and the statute and the legislative history both indicate the authority extends to income, excise and other taxes and emphasizes that any tax, penalty or sanction should not be excessive and should bear a reasonable relationship to the nature, extent and severity of the failure.<sup>8</sup>

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<sup>7</sup> IRM [7(10)54](11)10-80 as reprinted by the Bureau of National Affairs, Inc. on April 4, 1994. Closing agreements on issues outside of the scope of EPCRS are contemplated by Internal Revenue Manual 7.2.2.10 (3-01-2002), reprinted in EPCRS-Plan Correction and Disqualification, Tax Management Portfolio no. 375, 2004, at B-207.

<sup>8</sup> TECHNICAL EXPLANATION OF H.R. 4, THE “PENSION PROTECTION ACT OF 2006,” AS PASSED BY THE HOUSE ON JULY 28, 2006, AND AS CONSIDERED BY THE SENATE ON AUGUST 3, 2006, Staff of the Joint Committee on Taxation, August 3, 2006, JCX-38-06, pp. 250-251.

To those whose background focuses primarily on plans meeting the requirements of section 401(a), the term “employee plans” might suggest limitations that would exclude plans subject to section 409A, but such an interpretation is contrary to the language of the statute. Section 1101 authorizes the establishment of new correction policies, not just the program already in place. Any plan subject to section 409A that covers “employees” is an employee plan. We believe the statute’s use of the reference to “correction policies” gives the Secretary the authority to create its own initiative and policy concerning the enforcement of section 409A.

Thus, we believe the Code clearly gives the Secretary the authority to develop procedures to resolve tax disputes and the authority to resolve disputes by settling them prior to referring such disputes to the Department of Justice. A correction program limited in scope and duration to resolution of non-abusive violations of section 409A would clearly fall within this authority.

Section 409A was enacted as part of the American Jobs Creation Act of 2004<sup>9</sup> to address abuses in deferred compensation noted in the Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations Volume I: Report<sup>10</sup> (the “Enron Report”). The Enron Report listed among the general findings relating to pensions and compensation:

Underlying Enron’s compensation programs was an apparent lack of consistent or centralized recordkeeping with respect to compensation arrangements in general and executive compensation in particular. Enron could not provide documentation relating to many of Enron’s special compensation arrangements for its top executives. Although Enron represented that it properly reported income with respect to employee compensation arrangements, the lack of recordkeeping made it impossible to verify whether this was true.<sup>11</sup>

The report went on to recommend the following:

Changes should be made to the rules relating to nonqualified deferred compensation arrangements to curb current practices that allow for the deferral of tax on compensation income while providing executives with inappropriate levels of security, control and flexibility with respect to deferred compensation. These changes include repealing the prohibition on the issuance of related Treasury guidance, and providing that certain plan features result in current taxation, including the ability to obtain accelerated distributions, participant directed investments, and subsequent elections.<sup>12</sup>

Section 409A was enacted in part as a response to the issues identified in the Enron Report; however, section 409A is an extremely broad and complicated provision. Inevitably, thousands of taxpayers will violate section 409A through honest errors, and not due to any form of abuse. It would be equitable and support efficient tax law administration and voluntary compliance to establish a program to permit correction when someone inadvertently violates one of the many complex requirements in section 409A and the Regulations. Nothing in the Enron Report or other legislative history precludes such a program.

Violations may come from form defects as well as from operational defects. Given the complexity and broad reach of section 409A and the Regulations, non-abusive situations that

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<sup>9</sup> P.L. 108-326.

<sup>10</sup> Staff of the Joint Committee on Taxation, JCS-3-03, February 2003.

<sup>11</sup> Enron Report at p. 19.

<sup>12</sup> Enron Report at p. 20.

occur due to insufficient security or controls which nonetheless prevent the service provider from access to the amounts deferred, should be correctable. We do not believe that taking a hard line approach and enforcing any technical violation without considering mitigating circumstances will foster voluntary compliance. Voluntary compliance has been enhanced in the qualified retirement plan arena by the addition of the Employee Plans Compliance Resolution System.<sup>13</sup> A voluntary correction program for unintentional and non-abusive violations of one of the many section 409A requirements would likely operate to encourage compliance as well.

### **Request for Ruling Program for Limited Issues**

A ruling program addressing limited issues, including publishing private letter rulings or revenue rulings, would facilitate compliance by providing interpretations of how the section 409A regulations apply to actual situations not addressed in the regulations. A ruling program that addressed limited issues and produced published rulings would facilitate voluntary compliance by providing additional guidance on which individuals could rely. Such a program could be structured in a manner similar to the current private letter ruling program whereby the ruling is conditioned upon all of the facts being disclosed. The ruling program should first address limited issues related to exemptions and exceptions to the application of section 409A since these are frequently occurring situations. The ruling program, for example, could initially address the following types of issues:

1. whether an arrangement constitutes a short term deferral under Regulation 1.409A-1(b)(4); and
2. whether an arrangement satisfies the separation pay exception, including reimbursement arrangements under Regulation 1.409A-1(b)(9),(10) and (11).

Plan sponsors of qualified plans can also obtain determination letters and private letter rulings to rely on or can follow revenue rulings when they need certainty regarding the application of the tax law to their situation or documents. Plan sponsors of, and participants in, qualified plans can rely on such determination letters, private letter rulings or other rulings to avoid retroactive disqualification under section 7805(b)(8) which provides:

The Secretary may prescribe the extent, if any, to which any ruling (including any judicial decision or administrative determination other than by regulation) relates to the internal revenue laws shall be applied without retroactive effect.

However, in accordance with Revenue Procedure 2007-3,<sup>14</sup> no rulings are available under section 409A so there is no way for service providers and service recipients to be able to reasonably rely on prior interpretations or prior Service positions. Further, there is no way to obtain any assurance that what a well intentioned practitioner, draftsman or taxpayer has written complies with the complex regulatory scheme.

### **Conclusion**

The Regulations under section 409A represent many new interpretations, and these new positions come without any ability to obtain a ruling or to obtain any relief similar to that provided for other areas of taxation under section 7805(b). Establishing a correction program, limited in scope and duration under the authority granted in section 7121 and section 1101 of the PPA would

<sup>13</sup> Rev. Proc. 2006-27, 2006-22 IRB 945 (May 30, 2006).

<sup>14</sup> Rev. Proc. 2007-3, 2007-1, IRB 108, p. 116 (January 2, 2007).

encourage voluntary compliance, facilitate consistent tax administration by providing a mechanism to address inadvertent errors where the violation was not intentional, and promote equitable tax treatment by providing a forum to develop uniform responses to similar violations.

We respectfully submit the above recommendations for your consideration. If you should have any questions, please contact Greta E. Cowart, Phone: (214) 651-5592, [greta.cowart@haynesboone.com](mailto:greta.cowart@haynesboone.com) or T. David Cowart, Phone: (214) 855-4355, [dcowart@sonnenschein.com](mailto:dcowart@sonnenschein.com).

Sincerely,



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Chair, Section of Taxation

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