May 1, 2008

Hon. Douglas H. Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments on a Correction Program for Nonqualified Deferred Compensation Plan Failures Under Section 409A

Dear Commissioner Shulman:

Enclosed are comments on a correction program for nonqualified deferred compensation plan failures under section 409A. 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,

Stanley L. Blend
Chair, Section of Taxation

Enclosure

cc: Hon. Donald L. Korb, Chief Counsel, Internal Revenue Service
    Hon. Eric Solomon, Assistant Secretary (Tax Policy), Department of the Treasury
These comments (“Comments”) 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 Comments should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Wayne R. Luepker, Chair of Executive Compensation Subcommittee of the Section’s Employee Benefits Committee (the “Committee”). Substantive contributions were made by Christine M. Daly, Edward J. Leyden, Andrew L. Oringer, Max J. Schwartz, Steven H. Sholk, Andrew Stumpff, Mark Wincek and Karen D. Youngstrom. The Comments were reviewed by Bruce D. Pingree of the Section’s Committee on Government Submissions and by Priscilla E. Ryan, Council Director for the 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 or have advised clients on the application of such principles, 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.

Contact Persons:

David A. Mustone
(p) 703.714.7509
(f) 703.918.4000
dmustone@hunton.com

Wayne R. Luepker
(p) 312.701.7197
(f) 312.706.9123
wluepker@mayerbrown.com

May 1, 2008
EXECUTIVE SUMMARY

These Comments are in response to the request by the Internal Revenue Service (the “Service”) and the U.S. Department of Treasury (“Treasury”) in Notice 2007-100, issued on December 3, 2007 (the “Notice”),¹ for public comments regarding a correction program for nonqualified deferred compensation plan violations involving section 409A.² By letter of June 14, 2007 (the “Prior Letter”), the Section requested the adoption of a program permitting self-correction of certain failures to comply with section 409A and also requested the adoption of a ruling program. We believe that the self-correction procedures set forth in the Notice provide relief of the type requested by the Prior Letter and others. We appreciate the substantial effort of Treasury and the Service that went into the Notice.

Following is a summary of our recommendations in response to the Notice:

1. We recommend that the self-correction procedures set forth in the Notice be made permanent, subject to the changes recommended in items 2 through 7 below.

2. We recommend that certain of the deadlines for self-corrections be extended from the end of the participant’s calendar year in which the error occurred to the last day of the calendar year following the calendar year in which the error occurred.

3. We recommend that the requirement that a participant repay overpayments be modified to permit the employer to loan the amount to the participant if repayment would result in a hardship to the participant.

4. We recommend that the correction program provide explanations and examples of the procedures that satisfy the level of diligence required by the Notice, including explanations of the terms “unintentional,” “inadvertent,” “diligent efforts,” and “commercially reasonable steps.”

5. We recommend that the correction program provide an explanation and examples of “financial downturn.”

6. We recommend that there be no dollar limit on the amount that may be corrected under the correction program.

7. We recommend that the Service establish a correction program for documentary failures.

² All “section” references are to the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise stated and references to “Regulations” are to the Treasury regulations promulgated under the Code.
DISCUSSION

Many service recipients (referred to in these Comments as “employers”) maintain nonqualified deferred compensation plans subject to section 409A (“nonqualified plans”). Nonqualified plans are often individually designed and complex. They serve the diverse business needs of employers, address the expectations of participants seeking the best compensation packages, and implement competitive compensation practices essential for attracting and retaining a qualified workforce. Nonqualified plan design varies substantially from employer to employer, and plans maintained by a single employer or by a group of affiliated employers often have different design features.

Failure to comply with section 409A’s sweeping and complex rules can result in the participant’s accelerated recognition of taxable income, imposition on the participant of an additional 20% tax and interest on deemed underpayments of tax at a higher rate than the rate on regular underpayments (collectively, the “Section 409A Taxes”). Although the rules cover a broad range of compensation practices, there are not only significant interpretive issues regarding these rules, but also many issues not addressed by them. Moreover, because section 409A and the guidance interpreting section 409A published by the Service are relatively new, there are neither well-developed lines of authority nor seasoned scholarly or practitioner analyses to assist an individual interpreting these rules. We expect that the number and type of interpretive issues under section 409A will continue to increase. Experience has shown that identifying and resolving issues under section 409A are often challenges for even the most experienced practitioners. Further, because of the complexity and diversity of plans and individual arrangements, practitioners are often faced with unique issues under section 409A. Accordingly, we believe that compliance failures are inevitable, even for conscientious employers that make vigorous efforts to satisfy section 409A’s requirements.

The challenges associated with section 409A compliance are often greater for small and medium-sized businesses. In large part, this is because cost constraints limit their ability to hire benefits advisors who are sufficiently familiar with the requirements of section 409A. Also, in part to address cost concerns, such businesses often use standard or prototype nonqualified plan documents to satisfy the requirements of section 409A. The conversion of individually designed plans to prototype documents can easily generate errors, and additional errors may arise because third-party administrators may not properly implement the decisions of employers and participants. As a result, we believe that compliance failures are especially likely to occur for plans maintained by small and medium-sized businesses.

We believe that the complexity of nonqualified plans and the requirements of section 409A give rise to a likelihood of errors that is at least as great as the likelihood of errors in the operation of plans qualified under section 401(a). Moreover, compliance with section 409A can be more difficult than compliance with section 401(a). The rules governing tax-qualified plans are more extensive and highly developed, have been in place for many years, and produce greater certainty than the rules under section 409A. The determination letter request program and the comprehensive correction program for
tax-qualified plans under Revenue Procedure 2006-27\(^3\) (providing for the Employee Plans Compliance Resolution System, or “EPCRS” procedures) recognize the broad array of possible errors in the form and operation of qualified plans. A similar recognition is warranted for nonqualified plans.

We believe that a correction program will encourage and increase compliance with section 409A.\(^4\) Even for employers employing skilled advisors and conscientious administrators, the operation of a nonqualified deferred compensation plan can fail to satisfy section 409A. We believe that the frequency of such failures will be substantially reduced if an employer engages in periodic section 409A self-audits. An employer is more likely to undertake self-audits if it knows that self-correction is available and will reduce or eliminate the amount of Section 409A Taxes otherwise due.

**Equitable Considerations**

In addition to encouraging compliance, we believe that a correction program will promote the equitable goal of not imposing the full Section 409A Taxes on a participant if the employer has made reasonable efforts to comply with the requirements of section 409A, but inadvertently fails to satisfy those requirements. We believe it will often be inequitable to impose the full amount of the Section 409A Taxes on a participant who may have had no involvement in the plan’s design or operation.

**Elimination of Bias in Plan Design**

Many nonqualified plans have complex design features. Increased complexity increases the risk of section 409A failures. In part, that is because a more complex design often raises a greater number of section 409A issues, and those issues are often more difficult to resolve than the issues that arise under simpler designs. It is also the result of the greater number of issues not addressed by the guidance. While simplifying plan design increases the likelihood of compliance with section 409A, many employers have determined that a more complex design is necessary to satisfy their business needs.\(^5\) Moreover, when employers and participants have operated under a complex plan design for years, changing the design disrupts the longstanding bargain employers and participants have made with each other and continue to expect.

We recommend that the Service’s approach to section 409A neither encourage nor discourage the use of nonqualified plans, and neither encourage nor discourage the

---

\(^3\) 2006-21 C.B. 945.

\(^4\) We believe that a correction program is consistent with the goal the Service expressed in providing transition relief in Notice 2007-86, I.R.B. 2007-46. That notice stated that the transition relief was “intended to permit and promote compliance with the requirements of section 409A.”

\(^5\) Many practitioners have advised plan sponsors that simplification of nonqualified plan design will reduce the administrative challenges and the likelihood of section 409A compliance failures. Notwithstanding that advice, employers have concluded in many cases that a more complex design is necessary fully to address its business needs. Accordingly, in many cases employers have not simplified the designs used for nonqualified plans, and in some cases made the design more complex to not only address the business needs, but also satisfy section 409A.
use of simpler or more complex plan designs. We believe that when an employer maintains a complex nonqualified plan and has been conscientious in its efforts to comply with section 409A, it is undesirable to impose the full Section 409A Taxes as a result of failures that may have been less likely under a simpler plan design. If employers conclude that the maintenance of a complex plan significantly increases the risk of imposition of Section 409A Taxes, it is likely that many employers will simplify their plans even if the simpler design is much less suited to their business needs. To the extent that a self-correction program enables an employer to reduce the risk of imposition of the full amount of Section 409A Taxes, section 409A would be less likely to discourage the use of complex plan designs that an employer has determined are best suited to its business needs.

Recommendation 1 – Make the Self-Correction Procedures in the Notice Permanent

Because a permanent self-correction program would encourage compliance with section 409A, permit more equitable application of the Section 409A Taxes, and better allow employers to structure their nonqualified plans to best meet their business needs, we recommend that the self-correction procedures set forth in the Notice be made permanent, subject to the changes in Recommendations 2 through 7, explained below.6

Recommendation 2 - Extension of Correction Period Without Section 409A Taxes

We recommend that the correction program extend the deadlines for certain requirements under the Notice. In some cases, we believe that novel questions may arise during operation of a nonqualified plan, and the individuals responsible for ongoing administration may not realize that issues are raised when deferral and payment decisions are made. In other cases, inadvertent ministerial or arithmetic errors can drastically change the amount of compensation actually deferred or the amount of deferred compensation paid.

We believe that an important purpose of a permanent correction program for nonqualified compensation plans would be to encourage periodic self-audits of the plan’s compliance with section 409A. Such audits would typically be performed by someone other than the person responsible for the plan’s day-to-day administration. Having a second person review the plan’s operation would enhance the detection of failures. However, it is unrealistic for compliance audits to be performed more frequently than once per year. Accordingly, we recommend extensions of the deadlines as set forth below.

(a) Section II.B and Section II.C of the Notice require that to avoid incurring Section 409A Taxes, correction of overpayments must be made in the same taxable year as the year of the incorrect payment. We recommend that this requirement be changed to

6 While some might argue that the correction program constitutes a relaxation of the Section 409A Taxes that would reduce the incentive for compliance, we believe that argument fails. A correction program would not meaningfully reduce the incentive for compliance because the procedures required for self-correction under the Notice impose significant additional burdens on the employer, as well as create the risk of deterioration of the employer-employee relationship resulting from disclosure of the errors.
permit correction not later than the last day of the calendar year following the calendar year in which the overpayment occurs. Such an extension is likely to be especially important for payments made later in the year. Permitting self-correction within the above-described time period would encourage employers to undertake compliance self-audits after the end of each year. If the December 31 deadline for calendar taxable years is retained for self-correction without incurring Section 409A Taxes, employers will have significantly less incentive to perform self-audits annually. Further, we believe that extending the time period for only a few weeks after the end of the year in which the error occurs, rather than through the end of the following year, is much less likely to encourage self-audits. If companies adopt an annual self-audit procedure, the audit, to be most efficient, is likely not to begin until after the end of the year in which the error occurs in order to detect and correct any mistakes that may have occurred in December. Any third-party conducting such an audit will want to be thorough and will want to provide a written report, which will take time. Moreover, it is likely that the third-party auditor will be conducting similar audits for other clients and may need a period of months to cover audits requested by its clients.

(b) Section IV.A and Section IV.B of the Notice generally require that, to the extent a participant is relying on the self-correction procedure, the participant must provide notice of this reliance “to the examining agent upon the commencement of an examination of taxpayer’s federal tax return.” We recommend that taxpayers who are individuals be permitted to provide the notice within a reasonable period after commencement of the examination. We believe this is appropriate because individuals are more likely inadvertently to overlook the notice requirement when first contacted regarding the audit.

(c) Section IV.B of the Notice provides:

A service provider who is relying on the relief provided in § III.B or III.C of this notice with respect to a failure to comply with § 409A must attach to the service provider’s timely-filed (including extensions) original federal income tax return for the year in which such failure was discovered the information required by § IV.B.3 of this notice.

In preparing their tax returns, individuals may inadvertently overlook both the reporting and payment requirements of the section 409A correction program. We recommend that taxpayers who are individuals be permitted to satisfy the reporting and payment requirements associated with the section 409A correction program with an amended return.

We believe that the recommended extension is consistent with the preamble to the Regulations\textsuperscript{7} which states, in connection with the rule that late payments may be treated as having been timely made:

\textsuperscript{7} Preamble to Reg. §1.409A-1 through 6, 72 Fed. Reg. 19234, 19266 (2007).
This provision is intended to address not only intentional refusals to pay, but also inadvertent delays (but, in either case, only if there is no collusion between the service provider and service recipient).

(d) Section II.D of the Notice requires that to avoid incurring Section 409A Taxes, correction of excess deferrals must be made in the same taxable year as the year of the incorrect crediting. Section II.D also provides that

This relief is not applicable to a service recipient’s failure to timely pay in the proper taxable year of a service provider amounts that were deferred in one or more previous taxable years of the service provider.

We believe that the considerations set forth above with respect to the extension of the period to correct overpayments are equally applicable to correction of failures involving the crediting of amounts to a participant’s account in excess of the proper amount, or not making timely distribution of required amounts. Accordingly, we recommend that the ability to correct overpayments, modified as described above, should also apply to correction of excess deferrals and correction of failures to timely pay amounts deferred in a prior year.

Recommendation 3 – Loans to Enable Repayment

Section II.B of the Notice requires that a repayment of a prior overpayment will not satisfy the self-correction requirements if the employer pays the participant or otherwise provides a benefit intended as a substitute for all or part of the amount the participant is required to repay the employer. In many cases, a participant will not have the funds available to make timely repayment of a distribution that the participant did not realize was made prematurely. As a result, the repayment requirement would result in a financial hardship. We recommend that the self-correction procedure permit an employer to make a loan (or assist in arranging for a loan) to the participant for the repayment of amounts to the extent necessary to avoid a financial hardship.

Recommendation 4 – Guidance on Conditions of Self-Correction Relief

The Notice provides that relief from some or all of the Section 409A Taxes will be available only if the failure is “unintentional” or “inadvertent,” or the employer has made “diligent efforts” or has taken “commercially reasonable steps” to avoid recurrence of the failure in question and has “established practices and procedures reasonably designed to ensure that such an operational failure would not recur.” We recommend that the Service provide explanations of these terms and provide examples of situations that would or would not satisfy these requirements. It would be particularly helpful for future guidance to describe safe-harbor procedures that would satisfy these requirements. As discussed earlier, we anticipate that the self-correction procedures will encourage

---

8 Generally, section 402 of the Sarbanes-Oxley Act of 2002 prohibits a public company from making a loan to an executive officer or director. While this will generally preclude the use of a loan for such participants, we believe that a financial hardship will more likely occur for participants who are not officers or directors.
employers to undertake steps to satisfy these requirements, which will then foster compliance with the requirements of section 409A. We believe that explanations of these terms would help achieve these results.

Recommendation 5 – Provide Further Guidance on Meaning of Financial Downturn

Section II.B and Section II.C of the Notice generally provide that the self-correction program will not be available for overpayments occurring during any taxable year of the employer in which the employer experiences a substantial financial downturn or otherwise experiences financial or other issues that indicate a significant risk that the employer would not be able to pay the amount deferred when the payment became due (collectively, “financial downturn”). We recommend that the Service provide explanations of the meaning of financial downturn and examples of situations that would or would not constitute payments being made in connection with the financial downturn. In the absence of such guidance, we believe that there could be a wide range of interpretations of this term by practitioners, from, at one extreme, inclusion of failure to achieve a level of performance that is at least equal to prior-year performance, to at the other extreme, excluding any event short of bankruptcy. We are also concerned that, in the absence of such guidance, the Service could make inconsistent determinations on audit for similarly situated taxpayers. We also recommend that there be a clarification of whether there is a level of diligence that is required by the employer before making any payments to avoid this concern.

Recommendation 6 - Limit on the Amount Subject to Correction

Section III.B and Section III.C of the Notice provide that certain correction procedures are not available for amounts in excess of the elective deferral limit under section 402(g)(1)(B) for the year of failure. We understand that the Service may have imposed this dollar limit in part because of a concern that failures with respect to large amounts are unlikely to have been “inadvertent.” However, in our experience, the issues that give rise to failures are as likely and frequently to occur, and are as unlikely to be immediately discovered, for large amounts as for smaller amounts. Further, plans providing larger benefits are often more complex than plans providing smaller benefits, thereby increasing the risk of inadvertent failures and the risk of encountering issues not addressed by the section 409A guidance.

Recommendation 7 - Plan Document Failures

We recommend that the program permit correction of certain inadvertent failures to comply with section 409A in the drafting of plan documents. Given the broad coverage, novelty and complexity of section 409A, and notwithstanding the reasonable good faith efforts of plan sponsors, there will inevitably be failures to comply with section 409A’s documentary requirements. The absence of a determination letter program for plan documents also increases the likelihood of documentary failures. Further, the consequences of a documentary failure can result in a draconian and inequitable application of Section 409A Taxes. Not only will the failure affect all the deferrals of a participant made under all plans subject to aggregation, but it is also likely
to have this same consequence on groups of participants. This multiplier effect will occur when a single plan document, or a single form of plan document, is used for all participants in the same plan, or all participants in another plan. The result could be a sweeping failure with devastating Section 409A Taxes on many participants as a result of limited, inadvertent noncompliance in form with section 409A. To avoid consequences that are disproportionate to the error, we recommend that the self-correction program be expanded to permit the correction of the following two categories of documentary failures:

(a) Documentary Error Without an Operational Error. An employer can correct a documentary error that has not resulted in an operational error not later than 24 months after the error first occurred. Reporting substantially similar to that required for errors corrected under Section III of the Notice would apply. If correction is made in accordance with these requirements and the additional requirements described below, no Section 409A Taxes would apply.

(b) Documentary Error with Insignificant Operational Errors. An employer can correct a documentary error that has resulted in an insignificant number of operational errors in accordance with the same timing and reporting requirements described above, and the additional requirements described below. The amounts that are affected by the operational errors would be subject to Section 409A Taxes. However, amounts that are not affected by operational error would not be subject to Section 409A Taxes.

In the case of an annuity or a series of payments treated as a single payment, the reduced tax would apply only to those payments that were erroneously made under noncompliant section 409A documents. After the documentary error is corrected, future payments would not be subject to Section 409A Taxes. Similarly, in the case of a series of deferrals, the reduced Section 409A Taxes would apply only to the deferrals erroneously made under noncompliant section 409A documents (or that should have already been made in accordance with compliant section 409A documents). After the documentary error is corrected, subsequent deferrals would not be subject to Section 409A Taxes.

We recommend that the requirements for the relief under (a) and (b) include that the plan document had been drafted with a good faith interpretation of the documentary requirements of section 409A. Good faith would be determined in light of all applicable guidance that was published at the time that the employer had adopted the noncompliant document.

---

9 Representatives of the Service have indicated that the correction procedure did not address failures in documentation in part because documentary compliance with section 409A generally is not required until January 1, 2009. We understand that the Service is unlikely to provide modified correction procedures before 2009. As the documentary requirements are likely to have taken effect by the time of the issuance of additional guidance regarding correction procedures, we recommend that documentary corrections be addressed in the next correction procedure guidance issued by the Service.
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 of authority for the Employee Plan Closing Agreement Program\(^\text{10}\) and the other administrative practices that led to the Employee Plans Compliance Resolution System until authorization was specifically codified in the Pension Protection Act of 2006, section 1101. Section 7121 is sufficiently broad to permit the Secretary to establish a permanent correction program 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 service providers’ tax liabilities triggered by the violations.

Further authorization can be found in the Pension Protection Act of 2006, 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.)

The language of Section 1101 of the Pension Protection Act of 2006 on its face authorizes the establishment and implementation of a permanent correction program for other employee plans and does not limit the types of plans to which it applies. Thus, additional authority for establishment of a permanent correction program for plans subject to section 409A exists. The legislative history contains substantially the same language. Both the statute and the legislative history provide that the authority extends to income, excise, and other taxes, and the legislative history emphasizes that any tax, penalty or other sanction should not be excessive, and bear a reasonable relationship to the failure’s nature, extent, and severity.\(^\text{11}\)

To those whose experience has focused 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

---

\(^\text{10}\) 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.

statute’s plain language. 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 reference to “correction policies” gives the Treasury the authority to create its own programs for the enforcement of section 409A.

Thus, we believe the Code and legislative history give the Treasury 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 permanent correction program limited in scope to resolution of non-abusive violations of section 409A comes within this authority.

Section 409A was enacted as part of the American Jobs Creation Act of 2004\(^{12}\) 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\(^{13}\) (the “Enron Report”). The Enron Report listed among its 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.\(^{14}\)

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.\(^{15}\)

Section 409A was enacted in part as a response to the issues identified in the Enron Report; however, section 409A is a broad and complex provision that covers

\(^{12}\) P.L. 108-326.

\(^{13}\) Staff of the Joint Committee on Taxation, JCS-3-03, February 2003.

\(^{14}\) Enron Report at p.19.

\(^{15}\) Enron Report at p.20.
arrangements that were not the subject of the Enron Report. Inevitably, thousands of taxpayers will violate section 409A through honest errors, and not due to any form of abuse. We believe that the establishment of a permanent correction program would promote the efficient and equitable administration of the tax laws (including voluntary compliance) by permitting self-correction of inadvertent violations of the complex requirements of section 409A. Nothing in the Enron Report or other legislative history precludes such a program.