March 9, 2009

CC:PA:LPD:PR (REG-148326-05)
Internal Revenue Service
Room 5203
PO Box 7604
Ben Franklin Station
Washington, D.C. 20044

RE: Code Section 409A – Comments on Proposed Regulations

Dear Sir or Madam:

On behalf of the American Benefits Council (the "Council"), I am writing to provide comments on Prop. Treas. Reg. §1.409A- 4 (73 Fed. Reg. 74380) (the "Proposed Regulations"). The Council is a public policy organization principally representing Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits and compensation programs to employees. Collectively, the Council's members either sponsor directly or provide services to compensation, retirement and health arrangements that cover more than 100 million American employees. The Council has submitted numerous comments during the course of the consideration and finalization of regulations under Internal Revenue Code (Code) section 409A because these rules directly affect the long term incentive, pension and other compensation arrangements provided by our members. We appreciate your consideration of these comments on the Proposed Regulations.

The Proposed Regulations interpret the statutory provisions of Code section 409A(a), which imposes early inclusion upon vesting, a 20-percent addition to tax and, in some cases, a premium interest tax with respect to deferred compensation arrangements that fail to conform to statutory requirements. The Council is most concerned about inadvertent errors that result in the imposition of tax under Code section 409A. The Council believes that there are several areas in which the Proposed Regulations may be simplified without departing from the overall statutory requirements. Specifically, the Council urges the Internal Revenue Service and the Department of the Treasury to modify the rules in final regulations as follows:

- Provide a "single year" inclusion method that would avoid the filing of amended returns upon a failure to satisfy Code section 409A.

- Clarify that the inclusion amount for unvested deferred compensation that fails to satisfy Code section 409A results in a "zero" violation.
- Reverse the position in the proposed regulations that requires an assumption of the most valuable payout option.
- Clarify the methodology for calculating the amount deferred as of a tax year.
- Clarify the application of the taxpayer deduction rule in certain cases.

In addition to these specific comments, which are discussed more fully below, the Council's members continue to raise numerous questions and concerns about the distinction between "operational" and "form" errors under Code section 409A. Such distinctions are particularly important in light of the guidance under Notice 208-113, which provides for self-correction for certain operational errors but does not provide any relief for inadvertent "form" errors. We urge the consideration of a correction method for errors in a plan document that have not been given effect with respect to any individual. For example, if a document describes a payment methodology that does not conform to the regulatory requirements for a fixed schedule under Code section 409A(a), such error could be corrected with no additions to tax provided that no individual has been paid out under such schedule. We believe that such a rule is appropriate given the highly punitive effect of the Code section 409A tax regime.

While the Council views the Code section 409A tax regime as draconian, the Council believes that given the strictures of the statutory provisions, the Proposed Regulations generally interpret the rules appropriately for calculating taxable amounts. For example, we believe that the adoption of the "last day" rule under which the amount includable under Code section 409A(a) is determined as of the last day of the calendar year is a practical approach. We agree with the principle that once an amount is includable under Code section 409A future accruals that conform to the statutory requirements are not tainted and, therefore, not subject to income inclusion and the additions to tax. In our view, however, certain other rules could be clarified or modified to make the final rules less complicated and, in some cases, less onerous, while still continuing to impose the statutory requirements. Our specific comments are as follows:

1. Allow a single year correction method that avoids the requirement of multi-year amended returns.

The Proposed Regulations require that in the case of multi-year failures an amount has not been properly included in income until it is included for the earliest taxable year of the error. As a result, the taxpayer would be required to file amended returns for all open years in which the error occurred. The preamble states that allowing the taxpayer to instead include an amount in income under Section 409A on a current basis would "undermine the statutory purpose" and specifically cites the problem of allowing

inclusion in the current taxable year where distributions of deferred compensation have been received in intervening years and the problem of allowing taxpayers to choose the most favorable year in which to include income.

We urge the reconsideration of this position in the final regulations. We believe that the concerns expressed in the preamble may be addressed sufficiently. The final regulations should provide that if a taxpayer is not under examination, the inclusion of the deferred compensation in the current year will relieve the taxpayer of the obligation to file amended returns for prior open years in which the error occurred. Such a rule could also require that in the cases of intervening distributions since the occurrence of the error, the value of such distributions would have to be taken into account in calculating the tax. By limiting the rule allowing current year inclusion to those taxpayers for whom an examination has not commenced, the final regulations could reduce the administrative burdens under what is already an onerous statutory regime.

2. Clarify that the "correction" of an error prior to vesting results in no inclusion and addition to tax.

As defined in the Proposed Regulations, an amount deferred includes only those amounts that are not subject to a substantial risk of forfeiture. Thus, if an error occurs with respect to an unvested amount but the error is no longer applicable in the taxable year in which such amounts are vested, such amounts are not includable in income or subject to the additions to tax under Section 409A. If, however, a "pattern and practice" of ignoring the Section 409A requirements is discerned, then such amounts would be treated as vested and, therefore includable. The preamble also notes that if deferred compensation amounts of the same "type" are vested and would be aggregated with the unvested amounts subject to the error (*e.g.*, all nonelective deferrals under all account balance plans), then the operational error with respect to the unvested amounts would in fact "taint" the vested deferred compensation amounts and cause those amounts to be includable subject to the additions to tax.

Under the proposed regulations, the question arises as to what steps may be taken to avoid a future penalty once it is discerned that an unvested amount does not conform to the Code section 409A(a) requirements. The implication of the Proposed Regulations is that the unvested amount may be corrected prior to the calendar year in which the substantial risk of forfeiture lapses. What is less clear, however, is whether the unvested deferred compensation simply may be forfeited and, if so, whether any subsequent deferral is subject to the anti-substitution rules. We urge that the final regulations clarify that such a form of "correction" is permissible.

In addition, we urge that the final regulations provide further guidance on the effect of an operational error with respect to an unvested deferred compensation amount in cases where the taxpayer also has vested deferred compensation that under the plan aggregation rules would be aggregated with such unvested amounts. The final regulations should provide that there is no inclusion under Code section 409A with

respect to any vested amounts that are subject to the plan aggregation rules with the unvested amounts subject to the error, provided that such vested amounts were not subject to the same operational error. For example, if there is an error as to the timing of a deferral election for an unvested amount but such error did not occur with respect to an amount that is now vested, the vested amounts should not be includable in income and subject to the Code section 409A additions to tax. We believe that the final regulations may avoid any invitation to ignore the statutory rules by treating any amounts that are part of a "pattern and practice" as having been vested at the time of the deferral.

3. Reverse the assumption that taxpayers will receive the most valuable form of payment in calculating the "amount deferred" that is subject to inclusion and the addition to tax.

In the case of a deferred compensation amount that fails to conform to Code section 409A(a), the Proposed Regulations require that in calculating the "amount deferred" that is subject to tax, the most valuable payment options and the earliest possible payment date should be assumed. We urge that this assumption be reversed in the final regulations and that any assumptions be based upon the least valuable payment options. Given that the statute imposes an extraordinary rate of tax at the time of the failure and prior to any actual payment of deferred compensation, we believe it would be appropriate for the Internal Revenue Service and the Department of the Treasury to adopt a more conservative, albeit more taxpayer-friendly, definition of the "amount deferred."

Assuming that the most valuable form of payment will be made merely exacerbates the problem of individuals paying tax on amounts that they may never actually receive. We do not read the statute as requiring that the "amount deferred" be calculated in a manner that maximizes taxation particularly given the highly punitive nature of the Code section 409A tax regime. We urge that the final regulations adopt an approach that would impose the tax on the least valuable form of payment available to the participant at the time of the error. Otherwise, the Proposed Regulations merely exacerbate the problem of imposing tax on amounts that may not in fact be paid in the future. In such case, the taxpayer's only relief under the Proposed Regulations is a miscellaneous itemized deduction in the year of payment, which would not offset the 20-percent addition to tax or the premium interest tax that is paid on the earlier included amount (and this difference would be magnified by any future limitations on itemized deductions).

4. Clarify the methodology for calculating the deferred amounts under a non-account balance plan, such as a supplemental pension.

The Proposed Regulations provide specific rules for determining the value of an amount deferred including the requirement that if a payment "trigger" is contingent upon a separation from service that the taxpayer will be deemed to have separated as of the last day of the taxable year. It is not clear, however, how this methodology is to be applied in the case of a plan that provides multiple payment contingencies. The Proposed Regulations include two examples under Prop. Reg. §1.409A-4(b)(2)(ix) indicating that when payment occurs upon the earlier of separation from service or a fixed date that the

amount deferred is the greater of the present value of the amount that would be payable upon the fixed date or the present value of the amount that would be payable upon separation from service. (See Examples 8 and 9). These examples are confusing, however, and do not seem consistent with the general rule that the taxpayer be deemed to have separated from service at year end, which would appear to fix the payment date. In such case, there would be no other fixed date in which to compare with the separation-from-service payment. The final regulations should clarify the operation of this rule.

In addition, the Proposed Regulations do not include any examples illustrating how to calculate the value of the amount deferred that is subject to the Code section 409A additions to tax where certain amounts are "grandfathered" because they were accrued and vested prior to January 1, 2005, and not materially modified thereafter. It would be helpful to include such an illustration in final regulations.

5. Clarify the rules for deducting a previously-included amount that is not ultimately received.

The proposed regulations provide for a taxpayer deduction to the extent that an amount that has been included in income in an earlier tax year is permanently lost or forfeited. See Prop. Reg. §1.409A-4(g). It is not clear, however, how to apply the standards under the Proposed Regulations in all cases. For example, it is not clear whether a deduction may be taken upon the exercise of a stock right that was previously includable in income or whether the included amount is an adjustment to basis that is taken into account when the underlying stock is sold. In addition, the final regulations should include an example illustrating how the deduction rule applies in the case of a benefit that is paid in the form of a life annuity.

* * * *

Thank you for consideration of these comments. Should you have any questions or desire to discuss the comments further, please contact the undersigned at 202-289-6700.

Sincerely,

Jan Jacobson
Senior Counsel, Retirement Policy
American Benefits Council