U.S. Tax Alert
Americas Tax

Compensation & Benefits

IRS Issues Proposed Regulations on Calculating Includible Amounts Under Section 409A(a)

The IRS has issued proposed regulations on calculating the tax for nonqualified deferred compensation (NQDC) that fails to satisfy the requirements of Section 409A(a). The regulations provide rules for determining the amount of NQDC that is subject to a Section 409A failure and the methodology for calculating the tax that is due on account of such a failure. Because these regulations are proposed and would have a prospective effective date, taxpayers may not rely on them; however, the preamble to the regulations indicates that the IRS intends to issue general guidance (presumably in the form of a notice or other ruling) in the near future that will provide for taxpayer reliance on the proposed regulations. Shortly after issuing the proposed regulations, the IRS issued Notice 2008-115, 2008-52 I.R.B. addressing the Forms W-2 and 1099 information reporting for ongoing deferrals in NQDC plans (the so-called "Code Y" reporting) and delaying such reporting until the first tax year that these regulations are effective. Finally, the proposed regulations state that future guidance will address the calculation of tax for NQDC plans that violate Section 409A(b) (e.g., arrangements funded through non-U.S. trusts).

Implications

Compliance with the regulatory requirements of Section 409A is required as of January 1, 2009. Prior to this date, taxpayers have enjoyed a reasonable and good faith compliance standard, combined with transition rules that have made it easier to avoid Section 409A violations and the inherent sanctions. As those more relaxed standards come to a close, taxpayers likely will face situations in which Section 409A errors have occurred and the calculation of the applicable Section 409A taxes will be required. While the tax under Section 409A is imposed on the recipient of the NQDC, employers and other service recipients that offer NQDC will have an obligation to report and, in the case of employees, withhold income taxes on NQDC at the time of inclusion. Once the informational reporting obligations for Section 409A become effective, these calculation rules also will be needed to determine how to value and report annually all NQDC on Forms W-2 and 1099s.

The proposed regulations address the three categories of Section 409A income taxes: the timing of the income tax inclusion at the taxpayer's ordinary rates, the 20% addition to tax, and the premium interest tax. In many situations, amended returns will be required, accompanied by detailed calculations. The preamble to the proposed regulations states that the Treasury and IRS are considering safe harbor alternatives, and comments are requested.

Background

Section 409A generally provides that, unless certain requirements are met, amounts deferred under a NQDC plan are currently includible in gross income to the extent they are not subject to a substantial risk of forfeiture. Taxation is imposed at the recipient's tax rate, plus an addition to tax of 20% and, with respect to deferrals that vested prior to the year of the violation, a premium interest rate tax equal to the underpayment rate, plus 1%. Section 409A is effective for amounts deferred in tax years beginning after December 31, 2004. Amounts that are in deferred status after January 1, 2004, are not subject to Section 409A if they satisfy a "grandfather" rule, which generally covers NQDC amounts deferred before January 1, 2005, subject to the terms of a plan in effect on October 3, 2004, which is not "materially modified" after that date. A NQDC plan must comply with the requirements of Section 409A(a) both in form and in operation. (See Tax Alerts 2007-669 and 2007-327 for a discussion.) Section 409A applies to employees and to other cash-method service-providers who are not otherwise exempted. This Alert refers generally to "employers," "employees," or

"participants" for ease of discussion.

Proposed Regulations

The proposed regulations are lengthy and provide specific calculation rules that would need to be carefully analyzed to consider the ramifications for specific fact patterns. This Alert provides a general overview on the methodology for calculating the amount deferred and the application of the tax under Section 409A(a).

Calculation of the Amount Deferred Under an NQDC Plan

The calculation of an amount deferred under all NQDC plans is subject to the definitional rules under the existing Section 409A regulations. Thus, all plans that are aggregated and treated as a single "plan" for purposes of Section 409A are treated as an amount deferred under such plan.

Last Day Rule

The total amount deferred for a tax year is the present value of all future payments under the NQDC plan. In making this determination, the proposed regulations adopt a "last day" valuation rule, which for the vast majority of taxpayers affected by Section 409A would be December 31. This last day concept means that gains and losses or other fluctuations in the value of NQDC during the tax year would be netted. The sum of any NQDC payments during a tax year would be added back to the December 31 value to arrive at the amount deferred.

Departure From 3121(v)(2)

Section 409A borrows a number of concepts from Section 3121(v)(2), which imposes the FICA special timing rules for deferred compensation. Under Section 3121(v)(2), amounts generally are not taken into account until they are reasonably ascertainable and once an amount deferred is taken into account for FICA purposes, subsequent earnings on the deferral generally are excludible. In contrast, Section 409A does not delay the calculation of the amounts deferred under a NQDC plan merely because it is not otherwise ascertainable. This difference in the calculation methodology between Sections 3121(v)(2) and 409A arises from the practical issue that a Section 409A violation may arise, and therefore tax would need to be calculated, before a "reasonably ascertainable" standard is satisfied. In addition, Section 409A defines deferred compensation to specifically include earnings. The proposed regulations' methodology would require that all earnings that have accrued to date be included in the total value of the NQDC and it requires assumptions to be made about events that have not yet occurred that will affect the present value of the NQDC. The differences between the methodologies for Sections 3121(v)(2) and 409A will have implications for employers subject to the NQDC reporting and withholding requirements. Assuming that the reporting rules follow the general principles in the proposed regulations, systems that are set up to capture NQDC amounts for FICA purposes will not necessarily comply with the Section 409A calculation methods.

Account Balance Plans

The standards for determining the total amount deferred is relatively straightforward under an account-balance plan. Assuming that the future earnings crediting rate is "reasonable," within the meaning of Section 409A, the present value of all future payments is the December 31 account balance, which would then be increased by any prior distributions from the NQDC plan for the tax year. Because the valuation is based upon the present value of the future payments, the right to future earnings generally is not taken into account in determining the present value. If, however, the future earnings are not based upon a reasonable rate of return or a predetermined actual investment, as defined in the existing Section 409A final regulations, then the right to future earnings will instead be treated as a right to future deferrals. Accordingly, the present-value of such right to future earnings (deemed deferrals for this purpose) would have to be valued and included in the December 31 account balance.

Stock Rights Plans

The value of a stock right that has not been exercised is the "spread" on the valuation date, which is the excess of the fair market value on December 31 less the "exercise" price. If the stock right has been exercised, then the value on December 31 is the spread at exercise.

Non-Account Balance Plans and "Formula" Plans

More complex valuation methodologies are required for determining the present value of the future payment stream in a non-account balance plan. If the NQDC plan provides a legally binding right to a series of future payments — e.g., a defined benefit design — the present value of the NQDC as of December 31 is the present value of such future stream of payments multiplied by the probability that any conditions that affect those payments will occur. Reasonable actuarial assumptions may be utilized in determining the present value and reasonableness is determined as of the calculation date (i.e., December 31 of each year). Notwithstanding, no discount is allowed for certain types of contingencies. For example, the risk of the employee's death is not a factor in determining the present value unless the NQDC being valued would be forfeited upon death. In addition, no discounting is allowed for the unfunded status of the plan, the risk that the employer will refuse to pay, the possibility of future plan amendments, the risk of forfeiture, or currency risk (in the case of NQDC paid in other than U.S. dollars).

Most Valuable Form of Payment

In determining the present value, the proposed regulations generally would require the *most valuable* form of payment to be taken into account on the basis of the employee's status on the valuation date. Thus, if a different future benefit stream is payable contingent upon marital status, the value of the NQDC for the participant is determined based upon whether he or she is married as of December 31 (and regardless whether he or she was married or unmarried at any other time during the year). In determining which future stream of payments would be most valuable, consideration is given only to those forms of payment for which the employee is currently eligible (assuming that he or she attains any age requirements for commencing payments). No form of payment is taken into account if the employee would be required to provide services after December 31 in order to have a right to an alternative payment form.

Example: If an employee who is age 45 participates in a NQDC plan that provides for a single life annuity stream at age 65 for unmarried participants and a joint and survivor annuity stream for married participants, the present value of that future annuity stream for the 45-year old would be determined based upon whether he or she is married as of the valuation date. If the NQDC plan also provides for a subsidized "early retirement" annuity stream at age 62, but only if a participant has 20 years of service at age 62, the value of that early retirement annuity stream would be taken into account in determining the value of the 45-year-old's NQDC only if he or she has 20 years of service as of December 31. If the participant must perform services after the December 31 valuation date in order to attain the requisite 20 years of service, then the early retirement annuity stream is not taken into account in determining the present value of his or her NQDC benefit.

Contingent Payment Triggers

Generally, if a payment "trigger" is based upon a future event, then the value of NQDC is calculated assuming that the "trigger" occurs on the earliest possible date. If such event requires that the employee also separate from service in order to receive payment on the event, then such separation is assumed to occur. A distribution upon an "unforeseeable emergency" is specifically excluded from this payment "trigger" rule. Thus, one never assumes that an unforeseeable emergency payout will occur in the future in determining the value of NQDC.

The proposed regulations also state generally that if the conditions of a payment trigger would constitute a "substantial risk of forfeiture" if it were the only payment trigger under the plan, then such payment trigger should be ignored and not taken into account for purposes of valuing the NQDC. Thus, in a severance plan

that pays an amount only upon an involuntary termination or a "good reason" termination that satisfies the existing Section 409A regulatory requirements, no amount would be treated as deferred until such involuntary termination or good reason termination occurred (and then, only if such amounts were not exempt from Section 409A). This is the result under the proposed regulations' rule that a payment trigger that is based upon involuntary termination is not taken into account because the Section 409A regulations treat an involuntary termination as a substantial risk of forfeiture. It appears, however, that the proposed regulations may require a change-in-control payment trigger to be assumed to have occurred when calculating the most valuable payment stream.

Comments requested. The IRS and Treasury acknowledge that for some service providers, the earliest possible time that a payment trigger reasonably could occur will not be the most likely time the trigger will occur and specifically request comments on this proposed rule.

Formula Plans

The proposed regulations also provide specific rules for formula plans in which the accrual of an NQDC amount under the plan is determined by a future event (other than a payment trigger). In determining the present value, the possibility of such future even occurring must be taken into account under reasonable methods and reflected in the December 31 valuation of NQDC. A formula plan does not include the possibility of fluctuating earnings rates. For example, a phantom share plan in which the value of the NQDC is based upon the value of the stock price is not a formula plan because the value is determined by the December 31 stock price and not an event that occurs beyond December 31. In contrast, if an amount will be accrued under the NQDC plan only if the enterprise attains certain profits in a future year, then the NQDC plan would be subject to the rules for formula plans because, as of December 31 of the current year, the events have not occurred for determining a future year's profits. A probability of attaining the future goal would need to be assigned in order to calculate the total amount deferred as of December 31.

Reimbursement and "In Kind" Plans

NQDC that provides for the reimbursement of certain post-employment expenses or the provision of certain "in kind" benefits are generally treated as formula plans. If the reimbursement arrangement includes a dollar limit — e.g., $30,000 per year for certain expenses — it is presumed that the participant will incur and be reimbursed $30,000 for such expenses at the earliest possible date. The presumption does not apply to medical expenses, however. The proposed regulations would not require that a NQDC plan that reimburses medical benefits assume that the maximum level of benefits will be paid at the earliest possible date. Presumably, if the NQDC includes the right to the reimbursement of medical expenses, reasonable assumptions should be made as to the probability of future reimbursements (i.e., incurring medical costs) in determining the present value of the benefit.

Split Dollar Plans

To the extent that a split-dollar arrangement creates a right to NQDC, the value of the NQDC is the amount of future payments that would be includable in the participant's income calculated in a manner that is consistent with the applicable split-dollar rules (e.g., Reg. Section 1.61-22 or Section 1.7872-15).

Calculating the Tax Under Section 409A(a)

If a Section 409A violation occurs, taxation is imposed on the amount deferred for the tax year of the violation plus all previously deferred amounts, provided that such amounts are no longer subject to a substantial risk of forfeiture. Because the total amount deferred under a NQDC plan in any year is cumulative, the present value of the NQDC that was earned during the year (or years) of the violation, plus all prior deferrals and earnings, will be includable in income and subject to the 20% addition to tax and the premium interest tax.

Consistent with the last day rule discussed above, the proposed regulations provide that the portion of the total amount deferred for a tax year that is subject to a substantial risk of forfeiture (nonvested) is determined

as of the last day of the year. Thus, all amounts that vest during the tax year in which a failure occurs would be treated as vested, regardless whether the vesting event occurs before or after the failure to meet the requirements of Section 409A(a).

If a failure to meet Section 409A(a)'s requirements occurs during more than one tax year, which might arise as a result of a failure to satisfy the documentary requirements of Section 409A or as a result of an operational error that continues for more than one year, the proposed regulations would require taxation in each year of the failure. The Section 409A tax obligation is not satisfied unless a return is filed and the tax is paid for the total amount deferred for each tax year in which a failure occurs. Thus, if an error occurs in multiple years, the tax obligation is not satisfied merely by including in income the total amount deferred in the current year of a violation. Rather, the proposed regulations would specifically require amended returns to be filed for each year (assuming that those years are not closed under the applicable statute of limitations). The implication is that if a return (including an amended return) for a tax year in which a violation occurred does not include the NQDC amount that is subject to tax under Section 409A(a), then the liability for such tax is not satisfied even if the taxpayer includes the total amount deferred on a return for a later tax year.

For example, if a violation occurs in Year 1 and Year 2, the violation would be required to be reported on a return for both Year 1 and Year 2. Even though the total amount deferred as of Year 2 cumulatively includes the total amounts deferred in Year 1, the liability for Year 1 is not satisfied unless the NQDC amounts are reported on a return (or amended return) for Year 1. The starting point for the calculations is the total amount deferred that is vested as of December 31 in Year 1, which would be reflected on a return for Year 1. The return for Year 2 would include income equal to the total amount deferred that is vested as of December 31 of Year 2, reduced by the amount that was includible in income for Year 1 (so that there is no double-counting of deferrals).

Application of the Premium Interest Tax

If compensation must be included in gross income under Section 409A(a), the tax imposed includes an amount equal to the amount of interest for underpayments of tax under Section 6621, plus one percentage point. The proposed regulations make clear that the premium interest tax is an income tax and not interest. The premium interest tax applies to each year from the year in which a deferral vested to the year in which a Section 409A violation occurs.

The premium interest tax is calculated as if the NQDC amounts were paid in cash to the participant in the tax year deferred or, if later, the tax year in which the substantial risk of forfeiture lapses. The proposed regulations refer to this deemed cash payment as the "hypothetical underpayment."

Example. An employee participates in a NQDC plan in which deferrals vested in Year 3. A violation of Section 409A occurs in Year 5. In calculating the tax that is owed in Year 5, the premium interest tax must be applied as if amounts that were deferred in Years 3, 4, and 5 were paid in cash and should have been includable in income for those years.

The hypothetical underpayment is calculated under special rules that generally allocate all investment losses and all unvested amounts to the first year in which the hypothetical underpayment occurred (i.e., the first tax year in which the substantial risk of forfeiture lapsed). This allocation of investment losses and unvested amounts generally favors the taxpayer because, as discussed below, the premium interest tax will be calculated on the lowest possible amount.

The calculation would be based on the taxpayer's taxable income, credits, filing status, and other tax information for the year from the taxpayer's original filed return, as adjusted as a result of any examination for that year or any amended return the taxpayer filed for the year that the IRS accepted. The hypothetical underpayment would reflect the effect that this additional compensation would have had on the amount of federal income tax the taxpayer owed for the year, including the continued availability of any deductions taken, and the use of any carryovers such as carryover losses. When calculating a hypothetical underpayment in a subsequent year, changes to the taxpayer's federal income tax liability for the subsequent

year that would have occurred if the portion of the deferred amount that was first deferred and vested during the previous tax year had been included in the taxpayer's income for the previous year would be taken into account.

Recognizing that these calculations can be cumbersome, the IRS and Treasury are seeking comments on possible safe harbor calculation methods, particularly those that would more easily identify the tax year or years during which an amount includible in income under Section 409A(a) was first deferred and vested, and determine the hypothetical underpayments applicable to those years.

Treatment of Payments, Forfeitures, and Losses After the Amount Is Included in Income Under Section 409A(a)

Basis

Any amount included in gross income under Section 409A is not required to be included in gross income under any other provision of the IRC or any other rule of law later than the time provided in Section 409A. Consistent with this rule, the proposed regulations provide for a type of deemed "basis" or "investment in the contract" such that the amount would not be required to be included in income again (for example, when the amount was actually paid).

Deductions for Forfeited Amounts

The proposed regulations provide that a participant who must include an amount in income under Section 409A(a) with respect to a NQDC plan is entitled to a deduction at the time the service provider's legally binding right to all deferred compensation under the plan is permanently forfeited under the plan's terms, or the right to the compensation is otherwise permanently lost. The available deduction would equal the excess of the amount included in income under Section 409A(a) in a previous year over the amount actually or constructively received by the service provider. For service providers who are employees, this deduction is a miscellaneous itemized deduction subject to the "2% floor" deduction limitation. The proposed regulations specifically state that Section 1341 (claim of right) would not be available. The deduction is not available if the participant has any remaining rights under the NQDC plan; only when all rights under the plan are extinguished does the deduction arise.

It should be noted that the value of the deduction likely would be at a tax rate that is significantly less than the rate for inclusion under Section 409A(a) (because on inclusion the 20% addition to tax applies and the premium interest tax may apply). If a participant is entitled to a deduction for forfeited or unpaid amounts, the employer/service recipient may be required to recognize income or make other appropriate adjustments under the tax benefit rule.

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