

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-148326-05]

RIN 1545-BF50

Further Guidance on the Application of Section 409A to Nonqualified Deferred Compensation Plans

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations on the calculation of amounts includible in income under section 409A(a) and the additional taxes imposed by such section with respect to service providers participating in certain nonqualified deferred compensation plans. The regulations would affect such service providers and the service recipients for whom the service providers provide services. This document also provides a notice of public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by **[INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Outlines of topics to be discussed at the public hearing scheduled for April 2, 2009, must be received by March 9, 2009.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-148326-05), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044.

Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-148326-05), Courier's Desk, Internal Revenue

Service, 1111 Constitution Avenue, NW., Washington, DC or sent electronically, via the Federal eRulemaking Portal at [www.Regulations.gov](http://www.Regulations.gov) (IRS REG-148326-05). The public hearing will be held in the auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Stephen Tackney, at (202) 927-9639; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Funmi Taylor at (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

### **Background**

Section 409A was added to the Internal Revenue Code (Code) by section 885 of the American Jobs Creation Act of 2004, Public Law 108-357 (118 Stat. 1418). Section 409A generally provides that if certain requirements are not met at any time during a taxable year, amounts deferred under a nonqualified deferred compensation plan for that year and all previous taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Section 409A also includes rules applicable to certain trusts or similar arrangements associated with nonqualified deferred compensation.

On December 20, 2004, the IRS issued Notice 2005-1 (2005-2 CB 274), setting forth initial guidance on the application of section 409A, and providing transition guidance in accordance with the terms of the statute. On April 10, 2007, the Treasury Department and the IRS issued final regulations under section 409A. (72 FR 19234, April 17, 2007). The final regulations are applicable for taxable years beginning after

December 31, 2008. See Notice 2007-86 (2007-46 IRB 990). Notice 2005-1 and the final regulations do not address the calculation of the amount includible in income under section 409A if a plan fails to meet the requirements of section 409A and the calculation of the additional taxes applicable to such income. On November 30, 2006, the Treasury Department and the IRS issued Notice 2006-100 (2006-51 IRB 1109) providing interim guidance for taxable years beginning in 2005 and 2006 on the calculation of the amount includible in income if the requirements of section 409A were not met, and requesting comments on these issues for use in formulating future guidance. On October 23, 2007, the Treasury Department and the IRS issued Notice 2007-89 (2007-46 IRB 998) providing similar interim guidance for taxable years beginning in 2007. See §601.601(d)(2)(ii)(b).

Commentators submitted a number of comments addressing the topics covered by these proposed regulations in response to Notice 2005-1, Notice 2006-100, Notice 2007-89, and the regulations, all of which were considered by the Treasury Department and the IRS in formulating these proposed regulations.

## **Explanation of Provisions**

### **I. Scope of Proposed Regulations**

These proposed regulations address the calculation of amounts includible in income under section 409A(a), and related issues including the calculation of the additional taxes applicable to such income. Section 409A(a) generally provides that amounts deferred under a nonqualified deferred compensation plan in all years are includible in income unless certain requirements are met. The requirements under section 409A(a) generally relate to the time and form of payment of amounts deferred

under the plan, including the establishment of the time and form of payment through initial deferral elections and restrictions on the ability to change the time and form of payment through subsequent deferral elections or the acceleration of payment schedules. As provided in the regulations previously issued under section 409A, a nonqualified deferred compensation plan must comply with the requirements of section 409A(a) both in form and in operation.

Taxpayers may also be required to include amounts in income under section 409A(b). Section 409A(b) generally applies to a transfer of assets to a trust or similar arrangement, or to a restriction of assets, for purposes of paying nonqualified deferred compensation, if such trust or assets are located outside the United States, if such assets are transferred during a restricted period with respect to a single-employer defined benefit plan sponsored by the service recipient, or if such assets are restricted to the provision of benefits under a nonqualified deferred compensation plan in connection with a change in the service recipient's financial health. These proposed regulations do not address the application of section 409A(b), including the calculation of amounts includible in income if the requirements of section 409A(b) are not met. For guidance on the calculation of such amounts for taxable years beginning on or before January 1, 2007, including the application of the Federal income tax withholding requirements, see Notice 2007-89. The Treasury Department and the IRS anticipate issuing further interim guidance for later taxable years on the calculation of the amount includible in income under section 409A(b) and the application of the Federal income tax withholding requirements to such an amount.

## II. Effect of a Failure to Comply with Section 409A(a) on Amounts Deferred in Subsequent Years

Commentators asked how section 409A(a) applies if a plan fails to comply with section 409A(a) during a taxable year and the service provider continues to have amounts deferred under the plan in subsequent years during which the plan otherwise complies with section 409A(a) both in form and in operation. The statutory language may be construed to provide that a failure is treated as continuing during taxable years beyond the year in which the initial failure occurred, if the failure continues to affect amounts deferred under the plan. For example, if an amount has been improperly deferred under the plan, the statutory language could be construed to provide that the plan fails to comply with section 409A(a) during all taxable years during which the improperly deferred amounts remain deferred. However, this position could cause harsh results and would add administrative complexity. For example, a service provider could be required to include in income, and pay additional taxes on, amounts deferred over a number of taxable years even if the sole failure to comply with section 409A(a) occurred many years earlier. In addition, even if there were no failure in the current year, to determine a taxpayer's liability for income taxes with respect to nonqualified deferred compensation for a particular year, the taxpayer and the IRS would need to examine the plan's form and operation for every year in which the service provider had an amount deferred under the plan to determine if there was a failure to comply with section 409A(a) during any of those years.

For these reasons, the proposed regulations do not adopt this interpretation and instead generally would apply the adverse tax consequences that result from a failure to comply with section 409A(a) only with respect to amounts deferred under a plan in the year in which such noncompliance occurs and all previous taxable years, to the extent

such amounts are not subject to a substantial risk of forfeiture and have not previously been included in income. Therefore, under the proposed regulations, a failure to meet the requirements of section 409A(a) during a service provider's taxable year generally would not affect the taxation of amounts deferred under the plan for a subsequent taxable year during which the plan complies with section 409A(a) in form and in operation with respect to all amounts deferred under the plan. This would apply even though the amount deferred under the plan as of the end of such subsequent taxable year includes amounts deferred in earlier years during which the plan failed to comply with section 409A(a) (including, for example, amounts deferred pursuant to an untimely deferral election in the earlier year), as long as there was no failure under the plan in a later year. Because there would be no continuing or permanent failure with respect to a plan that fails to comply with section 409A(a) during an earlier year, each taxable year would be analyzed independently to determine if there was a failure. As a result, assessment of tax liabilities due to a plan's failure to comply with the requirements of section 409A(a) in a closed year would be time-barred. But, if a service provider fails to properly include amounts in income under section 409A(a) for a taxable year during which there was a failure to comply with section 409A(a), and assessment of taxes with respect to such year becomes barred by the statute of limitations, then the taxpayer's duty of consistency would prevent the service provider from claiming a tax benefit in a later year with respect to such amount (such as, for example, by claiming any type of "basis" or "investment in the contract" in the year the service recipient paid such amount to the service provider pursuant to the plan's terms).

Under the general rule in the proposed regulations, if all of a taxpayer's deferred amounts under a plan are nonvested and the taxpayer makes an impermissible deferral election or accelerates the time of payment with respect to some or all of the nonvested deferred amount, the nonvested deferred amount generally would not be includible in income under section 409A(a) in the year of the impermissible change in time and form of payment (although if there were vested amounts deferred under the plan, such amounts would be includible in income under section 409A(a)). In the subsequent taxable year in which the service provider becomes vested in the deferred amount, the plan might comply with section 409A(a) in form and in operation, so that under the general rule no income inclusion would be required and no additional taxes would be due for that year as a result of the late deferral election or acceleration of payment. In proposing to adopt this interpretation of the statute, the Treasury Department and the IRS do not intend to create an opportunity for taxpayers who ignore the requirements of section 409A(a) with respect to nonvested amounts to avoid the payment of taxes that would otherwise be due as a result of such a failure to comply. To ensure that this rule does not become a means for taxpayers to disregard the requirements of the statute, the proposed regulations would disregard a substantial risk of forfeiture for purposes of determining the amount includible in income under section 409A<sup>1</sup> with respect to certain nonvested deferred amounts, if the facts and circumstances indicate that the service recipient has a pattern or practice of permitting such impermissible changes in the time and form of payment with respect to nonvested deferred amounts (regardless of whether such changes also apply to vested deferred amounts). If such a pattern or

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<sup>1</sup> Under section 409A(e)(5), the Treasury Department and the IRS have the authority to disregard a substantial risk of forfeiture where necessary to carry out the purposes of section 409A.

practice exists, an amount deferred under a plan that is otherwise subject to a substantial risk of forfeiture is not treated as subject to a substantial risk of forfeiture if an impermissible change in the time and form of payment (including an impermissible initial deferral election) applies to the amount deferred or if the facts and circumstances indicate that the amount deferred would be affected by such pattern or practice.

### III. Calculation of the Amount Deferred under a Plan for the Taxable Year in which the Plan Fails to Meet the Requirements of Section 409A(a) and all Preceding Taxable Years

#### A. In general

Section 409A(a)(1)(A) generally provides that if at any time during a taxable year a nonqualified deferred compensation plan fails to meet the requirements of section 409A(a)(2) (payments), section 409A(a)(3) (the acceleration of payments), or section 409A(a)(4) (deferral elections), or is not operated in accordance with such requirements, all compensation deferred under the plan for the taxable year and all preceding taxable years is includible in gross income for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Accordingly, to calculate the amount includible in income upon a failure to meet the requirements of section 409A(a), the first step is to determine the total amount deferred under the plan for the service provider's taxable year and all preceding taxable years. The second step is to calculate the portion of the total amount deferred for the taxable year, if any, that is either subject to a substantial risk of forfeiture (nonvested) or has been included in income in a previous taxable year. The last step is to subtract the amount determined in step two from the amount determined in step one. The excess of the amount determined in step one over the amount determined in step two is the

amount includible in income and subject to additional income taxes for the year as a result of the plan's failure to comply with section 409A(a). Sections III.B through III.D of this preamble explain how the proposed regulations would address the first step in the process of determining the amount includible in income under section 409A, calculating the total amount deferred for the taxable year.

## B. Total amount deferred

### 1. In General

In general, under the proposed regulations, the amount deferred under a plan<sup>2</sup> for a taxable year and all preceding taxable years would be referred to as the total amount deferred for a taxable year and would be determined as of the last day of the taxable year. Therefore, for calendar year taxpayers, such as most individuals, the relevant calculation date would be December 31. Determining the total amount deferred for the taxable year as of the last day of the taxable year during which a plan fails to comply with section 409A(a) would allow taxpayers to avoid the administrative burden of tracking amounts deferred under a plan on a daily basis, because adjustments would not be made to reflect notional earnings or losses or other fluctuations in the amount payable under the plan as they occur during the taxable year, but would be applied only on a net basis as of the last day of the taxable year. For example, if a service provider has a calendar year taxable year, and if the service provider's account balance under a plan is \$105,000 as of July 1, but is only \$100,000 as of December 31 of the same year, due solely to deemed investment losses (with no

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<sup>2</sup> For this purpose, the term plan refers to a plan as defined under §1.409A-1(c), including any applicable plan aggregation rules.

payments made under the plan during the year), the total amount deferred under the plan for that taxable year would be \$100,000.

Similarly, the total amount deferred for a taxable year would not necessarily be the greatest total amount deferred for any previous year, even if no amount has been paid under the plan. For example, if a service provider has a calendar year taxable year, and if the service provider's account balance under a plan as of December 31, 2010 is \$105,000, as of December 31, 2011 is \$100,000, and as of December 31, 2012 is \$95,000, and if those decreases are due solely to deemed investment losses (and no payments were made under the plan in 2011 or 2012), then the total amount deferred for 2011 would be \$100,000 and the total amount deferred for 2012 would be \$95,000.

## 2. Treatment of Payments

If a service recipient pays an amount deferred under a plan during a taxable year, the amount remaining to be paid to (or on behalf of) the service provider under the plan as of the last day of the taxable year will have been reduced as a result of such payment. To reasonably reflect the effect of payments made during a taxable year, the proposed regulations provide that the sum of all payments of amounts deferred under a plan during a taxable year, including all payments that are substitutes for an amount deferred, would be added to the amounts deferred outstanding as of the last day of the taxable year (determined in accordance with the regulations) to calculate the total amount deferred for such taxable year. To lower the administrative burden of the calculation, the proposed regulations provide that the addition of such payments to the total amount deferred for the taxable year would not be increased by any interest or other amount to reflect the time value of money. The total amount deferred for a

taxable year would include all payments, regardless of whether the service recipient made some or all of the payments in accordance with the requirements of section 409A(a). For example, if during a taxable year an employee receives a single sum payment of the entire amount deferred under a plan, the employee would have a total amount deferred under the plan for the taxable year equal to the amount paid.

### 3. Treatment of Deemed Losses

Because the total amount deferred would be determined as of the last day of the taxable year, losses that occur during a taxable year (due to losses on deemed investments, actuarial losses, and other similar reductions in the amount payable under a plan) generally would be netted with any gains that occur during the same taxable year (due to deemed investment or actuarial gains, additional deferrals, or other additions to the amount payable under the plan). To that extent, deemed investment losses, actuarial losses, or other similar reductions could offset deemed investment or actuarial gains, additional deferrals, or other increases in the amount deferred under the plan for purposes of determining the total amount deferred for the taxable year. This would apply regardless of whether a deemed loss occurs before or after the date of any specific failure to comply with section 409A(a). For example, assume a service provider begins a taxable year with a \$10,000 balance under an account balance plan. During the year, the service provider has an additional deferral to the plan of \$5,000 and incurs net deemed investment losses of \$2,000. No payments are made pursuant to the plan during the year, the employee has no vested legally binding right to further deferrals to the plan, and there are no other changes to the account balance. The total amount

deferred for the taxable year would equal the \$13,000 account balance (\$10,000 + \$5,000 - \$2,000) as of the last day of the taxable year.

#### 4. Treatment of Rights to Deemed Earnings on Amounts Deferred

Under section 409A(d)(5), income (whether actual or notional) attributable to deferred compensation constitutes deferred compensation for purposes of section 409A. See §1.409A-1(b)(2). For example, if a service provider must include a deferred amount in income because an account balance plan in which the service provider participates fails to satisfy the requirements of section 409A(a), notional earnings credited with respect to such amount constitute deferred compensation and are subject to section 409A. If the plan also fails to comply with the requirements of section 409A(a) during a subsequent taxable year, the notional earnings must be included in income and are subject to the additional taxes under section 409A(a), notwithstanding that the “principal” amount of deferred compensation has already been included in income under section 409A(a) for a previous year.

In this respect, the treatment of earnings on nonqualified deferred compensation for purposes of section 409A is significantly different from the treatment of such earnings for purposes of section 3121(v)(2) (application of Federal Insurance Contributions Act (FICA) tax to nonqualified deferred compensation). As a result, notional earnings ordinarily are deferred compensation that is subject to section 409A even if such earnings would not constitute wages for purposes of the FICA tax when paid to the service provider because of the special timing rule under section 3121(v)(2) and §31.3121(v)(2)-1(a)(2). Accordingly, the proposed regulations provide that earnings that are credited with respect to deferred compensation during a taxable year

or that were credited in previous taxable years, and earnings with respect to deferred compensation that are paid during such taxable year, must be included in determining the total amount deferred for the taxable year.

#### 5. Total Amount Deferred for a Taxable Year Relates to the Entire Taxable Year, Regardless of Date or Period of Failure

Section 409A(a)(1)(A)(i) states that if at any time during a taxable year a nonqualified deferred compensation plan fails to meet the requirements of section 409A(a), all compensation deferred under the plan for the taxable year and all preceding years shall be includible in gross income for the taxable year to the extent not subject to a substantial risk of forfeiture (vested) and not previously included in gross income. The statutory reference to the deferred compensation required to be included in income under section 409A(a) does not distinguish between amounts deferred in a taxable year before a failure to meet the requirements of section 409A(a), and amounts deferred in the same taxable year after such failure. Accordingly, under the proposed regulations the total amount deferred under a plan for a taxable year would refer to the total amount deferred as of the last day of the taxable year, regardless of the date upon which a failure occurs. For example, if a plan is amended during a service provider's taxable year to add a provision that fails to meet the requirements of section 409A(a), the total amount deferred as of the last day of the taxable year would be includible in income under section 409A(a). This would include all payments under the plan during the taxable year, including payments made before the amendment (regardless of whether such payments are made in accordance with the requirements of section 409A(a)). Similarly, if the plan in operation fails to meet the requirements of section 409A(a) during the taxable year, the total amount deferred for the taxable year would

include all payments under the plan during the taxable year, including payments made before and after the date the failure occurred.

The proposed regulations provide that amounts deferred under a plan during a taxable year in which a failure occurs must be included in income under section 409A(a) even if such deferrals occur after the failure and are otherwise made in compliance with section 409A(a). For example, salary deferrals for periods during a taxable year after an impermissible accelerated payment under the same plan during the same taxable year would be required to be included in the total amount deferred for the taxable year and included in income under section 409A(a), regardless of whether the salary deferrals are made in accordance with an otherwise compliant deferral election.

#### 6. Treatment of Short-Term Deferrals

Under §1.409A-1(b)(4), an arrangement may not provide for deferred compensation if the amount is payable, and is paid, during a limited period of time following the later of the date the service provider obtains a legally binding right to the payment or the date such right is no longer subject to a substantial risk of forfeiture (generally referred to as the applicable 2 ½ month period). Whether an amount will be treated as a short-term deferral or as deferred compensation may not be determinable as of the last day of the service provider's taxable year, because it may depend upon whether the amount is paid on or before the end of the applicable 2 ½ month period. For purposes of calculating the total amount deferred for a taxable year, the proposed regulations provide that the right to a payment that, under the terms of the arrangement and the facts and circumstances as of the last day of the taxable year, may or may not be a short-term deferral, is not included in the total amount deferred. In addition, even if

such amount is not paid by the end of the applicable 2 ½ month period so that the amount would be deferred compensation, the amount would not be includible in the total amount deferred until the service provider's taxable year in which the applicable 2 ½ month period expired. For example, assume that as of December 31, 2010, an employee whose taxable year is the calendar year is entitled to an annual bonus that is scheduled to be paid on March 15, 2011, and that the bonus would qualify as a short-term deferral if paid on or before the end of the applicable 2 ½ month period, which ends on March 15, 2011. The bonus would not be included in the total amount deferred for 2010. This would be true regardless of whether the bonus is paid on or before March 15, 2011. However, the bonus would be includible in the total amount deferred for 2011 if the bonus is not paid on or before March 15, 2011.

### C. Calculation of total amount deferred – general principles

#### 1. General Rule

Generally, the proposed regulations provide that the total amount deferred under a plan for a taxable year is the present value as of the close of the last day of a service provider's taxable year of all amounts payable to the service provider under the plan, plus amounts paid to the service provider during the taxable year. For this purpose, present value generally would mean the value as of the close of the last day of the service provider's relevant taxable year of the amount or series of amounts due thereafter, where each such amount is multiplied by the probability that the condition or conditions on which payment of the amount is contingent would be satisfied (subject to special treatment for certain contingencies), discounted according to an assumed rate of interest to reflect the time value of money. A discount for the probability that the

service provider will die before commencement of payments under the plan would be permitted to the extent that the payments would be forfeited upon the service provider's death. The proposed regulations provide that the present value cannot be discounted for the probability that payments will not be made (or will be reduced) because of the unfunded status of the plan, the risk associated with any deemed investment of amounts deferred under the plan, the risk that the service recipient or another party will be unwilling or unable to pay amounts deferred under the plan when due, the possibility of future plan amendments, the possibility of a future change in the law, or similar risks or contingencies. The proposed regulations further provide that restrictions on payment that will or may lapse with the passage of time, such as a temporary risk of forfeiture that is not a substantial risk of forfeiture, are not taken into account in determining present value. However, any potential additional deferrals contingent upon a bona fide requirement that the service provider perform services after the taxable year, such as potential salary deferrals, service credits or additions due to increases in compensation, would not be taken into account in determining the total amount deferred for the taxable year.

For purposes of calculating the present value of the benefit, the proposed regulations require the use of reasonable actuarial assumptions and methods. Whether assumptions and methods are reasonable for this purpose would be determined as of each date the benefit is valued for purposes of determining the total amount deferred.

The proposed regulations also provide certain rules relating to the crediting of earnings, generally providing that the schedule for crediting earnings will be respected if the earnings are credited at least once a year. In general, if the rules with respect to the

crediting of earnings are met, any additional earnings that would be credited after the end of the taxable year only if the service provider continued performing services after the end of the year would not be includible in the total amount deferred for the year. If the right to earnings is based on an unreasonably high interest rate, the proposed regulations generally would characterize the unreasonable portion of earnings as a current right to additional deferred compensation. In addition, if earnings are based on a rate of return that does not qualify as a predetermined actual investment or a reasonable interest rate, the proposed regulations provide that the general calculation rules as applied to formula amounts would apply.

The proposed regulations provide other general rules that address issues such as plan terms under which amounts may be payable when a triggering event occurs, rather than on a fixed date, or plan terms under which the amount payable is determined in accordance with a formula, rather than being set at a fixed amount. In addition, the proposed regulations provide specific rules under which the total amounts deferred under certain types of nonqualified deferred compensation plans would be determined. The rules applicable to specific types of plans would apply in conjunction with the general rules. As a result, under the proposed regulations, an amount of deferred compensation may be includible in income under section 409A(a) even if the same amount would not yet be includible in wages under section 3121(v)(2).

## 2. Rules Regarding Alternative Times and Forms of Payment

To calculate the total amount deferred under a nonqualified deferred compensation plan, it is necessary to determine the time and form of payment pursuant to which the amount will be paid. Under the proposed regulations, if an amount

deferred under a plan could be payable pursuant to more than one time and form of payment under the plan, the amount would be treated as payable in the available time and form of payment that has the highest present value. For this purpose, a time and form of payment generally would be an available time and form of payment to the extent a deferred amount under the plan could be payable pursuant to such time and form of payment under the plan's terms, provided that if there is a bona fide requirement that the service provider continue to perform services after the end of the taxable year to be eligible for the time and form of payment, the time and form of payment would not be treated as available. If an alternative time and form of payment is available only at the service recipient's discretion, the time and form of payment would not be treated as available unless the service provider has a legally binding right under the principles of §1.409A-1(b)(1) to any additional value that would be generated by the service recipient's exercise of such discretion. If a service provider has begun receiving payments of an amount deferred under a plan and neither the service provider nor the service recipient can change the time and form of payment of such deferred amount without the other party's approval, then no other time and form of payment under the plan would be treated as available if such approval requirement has substantive significance.

In certain instances, a service provider will be eligible for an alternative time and form of payment only if the service provider has a certain status as of a future date. For example, a time and form of payment may be available only if the service provider is married at the time the payment commences. The proposed regulations generally provide that for purposes of determining whether the service provider will meet the

eligibility requirements so that an alternative time and form of payment is available, the service provider is assumed to continue in the service provider's status as of the last day of the taxable year. However, if the eligibility requirement is not bona fide and does not serve a bona fide business purpose, the eligibility requirement would be disregarded and the service provider would be treated as eligible for the alternative time and form of payment. For this purpose, an eligibility condition based upon the service provider's marital status, parental status, or status as a U.S. citizen or lawful permanent resident would be presumed to be bona fide and to serve a bona fide business purpose.

If the calculation of the present value of the amount payable to a service provider under a plan requires assumptions relating to the timing of the payment because the payment date is, or could be, a triggering event rather than a specified date, the proposed regulations specify certain assumptions that must be applied to make such calculation. First, the possibility that a particular payment trigger would occur generally would not be taken into account if the right to the payment would be subject to a substantial risk of forfeiture if that payment trigger were the only specified payment trigger. For example, if an amount is payable upon the earlier of the attainment of a specified age or an involuntary separation from service (as defined in the §1.409A-1(n)), the present value of the amount payable upon involuntary separation from service would not be taken into account if the payment would be subject to a substantial risk of forfeiture if that were the only payment trigger. However, if multiple triggers with respect to the same payment would, applied individually, constitute substantial risks of forfeiture, such triggers would not be disregarded under this rule unless all such triggers, applied in the aggregate, would also constitute a substantial risk of forfeiture.

Second, the possibility that an unforeseeable emergency, as defined in §1.409A-3(i)(3), would occur and result in a payment also would not be taken into account for purposes of calculating the amount deferred.

If an amount is payable upon a service provider's death, it generally would not be necessary to make assumptions concerning when the service provider would die because any additional value due to the amount becoming payable upon the service provider's death generally would be treated as an amount payable under a death benefit plan, and amounts payable under a death benefit plan are not deferred compensation for purposes of section 409A(a). Similarly, such assumptions generally would not be necessary for an amount payable upon a service provider's disability, because any additional value due to the amount becoming payable upon the service provider's disability generally would be payable under a disability plan, and amounts payable under a disability plan are not deferred compensation for purposes of section 409A. See §1.409A-1(a)(5).

In other cases where it is necessary to make assumptions concerning when a payment trigger would occur to determine the amount deferred under a plan, taxpayers generally would be required to assume that the payment trigger would occur at the earliest possible time that the conditions under which the amount would become payable reasonably could occur, based on the facts and circumstances as of the last day of the taxable year. However, the proposed regulations provide a special rule for amounts payable due to the service provider's separation from service, termination of employment, or other event requiring the service provider's reduction or cessation of services for the service recipient. In such a case, the total amount deferred would be

calculated as if the service provider had met the required reduction or cessation of services as of the close of the last day of the service provider's taxable year for which such calculation was being made. These rules would apply regardless of whether the payment trigger has or has not occurred as of any future date upon which the amount deferred for a prior taxable year was being determined.

The Treasury Department and the IRS recognize 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. Similarly, the Treasury Department and the IRS recognize that for many service providers, the assumption that the service provider ceases providing services as of the end of the taxable year may not be realistic. The Treasury Department and the IRS request comments on alternative standards that could be utilized for these payment triggers.

An alternative approach might presume a date upon which the service provider will separate from service such as, for example, 100 months after the last day of the service provider's taxable year for which the amount deferred is being calculated. Cf. §1.280G-1 Q&A 24(c)(4). Such a standard, however, would not reflect the value of additional deferred compensation that would be paid only if the service provider separates from service before the end of the 100-month period, such as an early retirement subsidy or a window benefit, unless special rules were developed to address such situations. Another issue that arises is whether such a standard should apply if the service provider is likely to retire during the next 100 months, such as if a service provider has attained a certain age, number of years of service, or level of financial independence. However, the Treasury Department and the IRS are concerned whether

an approach involving the application of individualized standards to determine the probability that a particular service provider will separate from service will be administrable in practice.

### 3. Treatment of Rights to Formula Amounts

Once the date that a payment will occur has been fixed (either as a specified date under the plan's terms or through application of the rules in the proposed regulations), it is necessary to quantify the amount of the payment to which the service provider will be entitled to calculate the total amount deferred under a nonqualified deferred compensation plan. However, certain plans may define the amount payable by a formula or other method that is based on factors that may vary in future years. In general, if, at the end of the service provider's taxable year, the amount to be paid in a future year is a formula amount, the proposed regulations provide that the amount payable in the future year for purposes of calculating the total amount deferred must be determined using reasonable assumptions.

A deferred amount generally would be a formula amount subject to the reasonable assumptions standard if calculating the payment amount is dependent upon factors that are not determinable after taking into consideration all of the assumptions and other calculation rules provided in the proposed regulations. For example, a future payment equal to one percent of a corporation's net profits over five calendar years generally would be a formula amount until the last day of the fifth year, because the corporation's net profits over the five calendar years could not be determined by applying the assumptions and rules set out in the proposed regulations until the end of the fifth calendar year.

A deferred amount would not be a formula amount at the end of the taxable year merely because the information necessary to determine the amount is not readily available, if such information exists at the end of such taxable year. For example, if a deferred amount is based upon the service recipient's profits for its taxable year that coincides with the service provider's taxable year, the amount would be considered a non-formula amount at the end of the taxable year because the information necessary to determine the service recipient's profits exists, although such information may not be immediately accessible.

The right to have a deferred amount credited with reasonable earnings that may vary, for example because the earnings are based on the value of a deemed investment, would not affect whether the right to the underlying deferred amount is a formula amount. In addition, the amount of earnings to which the service provider has become entitled at the end of a particular taxable year would not be treated as a formula amount, regardless of whether such earnings could subsequently be reduced by future losses. For example, assume a service provider has a \$10,000 account under an account balance plan, to be paid out in three years subject to earnings based on a mutual fund designed to replicate the performance of the S&P 500 index. At the end of Year 1, the account balance is \$10,500. For Year 1, the service provider would have a total amount deferred equal to \$10,500, notwithstanding that the amount could be reduced by future losses based on losses in the mutual fund.

#### D. Calculation of total amounts deferred – specific types of plans

##### 1. Account Balance Plans

Under the proposed regulations, the amount deferred under an account balance plan for a taxable year generally equals the aggregate balance of all accounts under the plan as of the close of the last day of the taxable year, plus any amounts paid from such plan during the taxable year, so long as the aggregate account balance is determined using not more than a reasonable interest rate or the return on a predetermined actual investment. This rule would apply regardless of whether the applicable interest rate used to determine the earnings was higher or lower than the applicable Federal rate (AFR) under section 1274(d), provided that the interest rate was no more than a reasonable rate of interest. For a description of the proposed rules on how to calculate the total amount deferred if the right to earnings is based on an unreasonably high interest rate, see section III.C.1 of this preamble.

## 2. Nonaccount Balance Plans

Under the proposed regulations, the total amount deferred for a taxable year under a nonaccount balance plan generally is calculated under the general calculation rule. See section III.C of this preamble. For example, if a service provider has the right to be paid on a specified future date a fixed amount that is not credited with earnings, the total amount deferred for a year generally would be the present value as of the last day of the service provider's taxable year of the amount to which the service provider has a right to be paid in the future year (assuming no payments were made under the plan during the year). Increases in the present value of the payment in subsequent years due to the passage of time would be treated as earnings in the years in which such increases occur. For example, a right to a payment of \$10,000 in Year 3 may have a present value in Year 1 equal to \$8,900, and a present value in Year 2 equal to

\$9,434, so that the total amount deferred in Year 1 would be \$8,900, the total amount deferred in Year 2 would be \$9,434, and the total amount deferred in Year 3 would be \$10,000 (assuming no payments were made during any year except Year 3). Any potential additional service credits or increases in compensation after the end of the taxable year for which the calculation is being made would not be taken into account in determining the total amount deferred for the taxable year.

### 3. Stock Rights

In general, the proposed regulations provide that the total amount deferred under an outstanding stock right is the amount of money and the fair market value of the property that the service provider would receive by exercising the right on the last day of the taxable year, reduced by the amount (if any) the service provider must pay to exercise the right and any amount the service provider paid for the right, which is commonly referred to as the spread. Accordingly, for an outstanding stock option, the total amount deferred generally would equal the underlying stock's fair market value on the last day of the taxable year, less the sum of the exercise price and any amount paid for the stock option. For an outstanding stock appreciation right, the total amount deferred generally would equal the underlying stock's fair market value on the last day of the taxable year, less the sum of the exercise price and any amount paid for the stock appreciation right. For this purpose, the stock's fair market value would be determined applying the principles set forth in §1.409A-1(b)(5).

The Treasury Department and the IRS recognize that the spread generally is less than the fair market value of the stock right, which is used for purposes of determining the amount taxable under other Code provisions such as section 83 (if a stock option

has a readily ascertainable fair market value), section 4999, and section 457(f). However, because these types of stock rights typically will fail to comply with section 409A(a) in multiple years, a taxpayer who holds such a stock right generally will be required to include amounts in income under section 409A in more than one taxable year. Therefore, the Treasury Department and the IRS believe that it is more appropriate to use the spread for purposes of applying section 409A(a) to stock rights.

#### 4. Separation Pay Arrangements

A deferred amount that is payable only upon an involuntary separation from service generally will be treated as subject to a substantial risk of forfeiture until the service provider involuntarily separates from service. Accordingly, under the proposed regulations the amount of deferred compensation generally would not be required to be calculated until the service provider has involuntarily separated from service. In addition, if the amount were payable upon either an involuntary separation from service or some other trigger, such as a fixed date, the possibility of payment upon an involuntary separation from service generally would be ignored for purposes of determining the total amount deferred under the arrangement. See section III.C.2 of this preamble. Once an involuntary separation from service has occurred, the amount deferred under the plan would be determined using the rules that would apply to the schedule of payments if the right to payment were not contingent upon an involuntary separation from service. For example, if the amounts payable are installment payments and the remaining installment payments include interest credited at a reasonable rate, the total amount deferred under the plan would be determined under the rules governing account balance plans. If more than one type of deferred compensation

arrangement were provided under the separation pay agreement, the amount deferred under each arrangement would be determined using the rules applicable to that type of arrangement. The total amount deferred for the taxable year would be the sum of all of the amounts deferred under the various arrangements constituting the plan.

## 5. Reimbursement Arrangements

The proposed regulations provide a method of calculating the amount deferred under a reimbursement arrangement, including an arrangement where the benefit is provided as an in-kind benefit from the service recipient or the service recipient will pay directly the third-party provider of the goods or services to the service provider. For example, the amount deferred under an arrangement providing a specified number of hours of financial planning services after a service provider's separation from service would be determined using the rules applicable to reimbursement arrangements, regardless of whether the service recipient reimburses the service provider for the service provider's expenses in purchasing such services, provides the financial planning services directly to the service provider, or pays a third-party financial planner to provide such services. The rules for reimbursement arrangements would apply to all such types of arrangements, including arrangements that would not be disaggregated from a nonaccount balance plan under §1.409A-1(c)(2)(i)(E) because the amounts subject to reimbursement exceed the applicable limits.

The proposed calculation rules provide that if a service provider has a right to reimbursements but only up to a specified maximum amount, it is presumed that the taxpayer will incur the maximum amount of expenses eligible for reimbursement, at the earliest possible time such expenses may be incurred and payable at the earliest

possible time the amount may be reimbursed under the plan's terms. The service provider could rebut the presumption if the service provider demonstrates by clear and convincing evidence that it is unreasonable to assume that the service provider would expend (or would have expended) the maximum amount of expenses eligible for reimbursement. For example, if a service provider is entitled to the reimbursement of country club dues the service provider incurs in the next taxable year, not to exceed \$30,000, if the service provider can demonstrate that the most expensive country club within reasonable geographic proximity of the service provider's residence and work location will cost \$20,000 per year, and that the service provider's level of compensation and financial resources make it unreasonable to assume that the service provider would travel periodically to the locales of other, more expensive country clubs, the service provider can calculate the amount deferred based upon the \$20,000 being eligible for reimbursement. The presumption of maximum utilization of expenses eligible for reimbursement generally would not apply if the expenses subject to reimbursement are medical expenses.

If a right to reimbursement is not subject to a maximum amount, the taxpayer would be treated as having deferred a formula amount, provided that the taxpayer would be required to calculate the amount based on the maximum amount that reasonably could be expended and reimbursed. The amount would be considered a nonformula amount as soon as the taxpayer incurs the expense that is subject to reimbursement, in an amount equal to the reimbursement to which the taxpayer is entitled. For example, a right to the reimbursement of half of the expenses the service provider incurs to purchase a boat without any limitation with respect to the cost would

be treated as a deferral of a formula amount, until such time as the service provider purchases the boat.

## 6. Split-Dollar Life Insurance Arrangements

The amount deferred under a split-dollar life insurance arrangement would be determined based upon the amount that would be required to be included in income in a future year under the applicable split-dollar life insurance rules. Determination of the amount includible in income would depend upon the Federal tax regime and guidance applicable to such arrangement. If the split-dollar life insurance arrangement is not subject to §1.61-22 or §1.7872-15 due to application of the effective date provisions under §1.61-22(j), the amount payable would be determined by reference to Notice 2002-8 (2002-1 CB 398) and any other applicable guidance. If the split-dollar life insurance arrangement is subject to §1.61-22 or §1.7872-15, the amount payable would be determined by reference to such regulations, based upon the type of arrangement. For this purpose, the amount includible in income generally would be determined by applying the split-dollar life insurance rules to the arrangement in conjunction with the general rules providing assumptions on payment dates of deferred amounts. However, in the case of an arrangement subject to §1.7872-15, to the extent the rules regarding time and form of payment and other payment assumptions under these proposed regulations conflict with the provisions of §1.7872-15, the provisions of §1.7872-15 would apply instead of the conflicting rules under these proposed regulations. As provided in Notice 2007-34 (2007-17 IRB 996), the portion of the benefit provided under the split-dollar life insurance arrangement consisting of the cost of current life insurance

protection is not treated as deferred compensation for this purpose. See §601.601(d)(2)(ii)(b).

## 7. Foreign Arrangements

Although certain foreign arrangements are a separate category under the plan aggregation rules (§1.409A-1(c)(2)(i)(G)), the amounts deferred under such arrangements would be determined using the same rules that would apply if the arrangements were not foreign arrangements. For example, the total amount deferred by a United States citizen participating in a salary deferral arrangement in France that meets the requirements of §1.409A-1(c)(2)(i)(G), but that otherwise would constitute an elective account balance plan under §1.409A-1(c)(2)(i)(A), would be determined using the rules applicable to account balance plans.

## 8. Other Plans

The calculation of the total amount deferred under a plan that does not fall into any of the enunciated categories (and accordingly is treated as a separate plan under §1.409A-1(c)(2)(i)(I)), would be determined by applying the general calculation rules.

### E. Calculation of amounts includible in income.

This section III.E of the preamble addresses the second step in determining the amount includible in income under section 409A for a taxable year – the determination of the portion of the total amount deferred for a taxable year that was either subject to a substantial risk of forfeiture or had previously been included in income. That portion of the total amount deferred for the taxable year would not be includible in income under section 409A.

#### 1. Determination of the Portion of the Total Amount Deferred for a Taxable Year that is Subject to a Substantial Risk of Forfeiture

In general, the proposed regulations provide that the portion of the total amount deferred for a taxable year that is subject to a substantial risk of forfeiture (nonvested) is determined as of the last day of the service provider's taxable year. Accordingly, all amounts that vest during the taxable year in which a failure occurs would be treated as vested for purposes of section 409A(a), regardless of whether the vesting event occurs before or after the failure to meet the requirements of section 409A(a). For example, if a plan fails to comply with section 409A(a) due to an operational failure on July 1 of a taxable year, and the substantial risk of forfeiture applicable to an amount deferred under the plan lapses as of October 1 of the same taxable year, that amount would be treated as a vested amount for purposes of determining the amount includible in income for the taxable year.

## 2. Determination of the Portion of the Total Amount Deferred for a Taxable Year that has been Previously Included in Income

For a deferred amount to be treated as previously included in income, the proposed regulations would require that the service provider actually and properly have included the amount in income in accordance with a provision of the Internal Revenue Code. This would include amounts reflected on an original or amended return filed before expiration of the applicable statute of limitations on assessment and amounts included in income as part of an audit or closing agreement process. In addition, a deferred amount would be treated as an amount previously included in income only until the amount is paid. Accordingly, if a deferred amount is paid in the same taxable year in which an amount is included in income under section 409A, or all or a portion of an amount previously included in income is allocable to a payment made under the plan

(see section VI.A of this preamble), in subsequent taxable years that amount would not be treated as an amount previously included in income. For example, if an employee includes \$100,000 in income under section 409A(a), and \$10,000 of the amount includible in income consists of a payment under the plan during the taxable year, only \$90,000 would remain to be treated as a deferred amount previously included in income. Similarly, if in the next year the employee receives a payment, to the extent any or all of that \$90,000 amount previously included in income is allocated to that payment so that all or a portion of the payment is not includible in gross income, the amount allocated would no longer be treated as an amount previously included in income.

F. Treatment of failures continuing during more than one taxable year

A plan term that fails to meet the requirements of section 409A(a) may be retained in the plan over multiple taxable years. In addition, operational failures may occur in multiple years. This section III.F of the preamble discusses how section 409A(a) applies in such cases.

Each of the service provider's taxable years would be analyzed independently to determine if amounts were includible in income under section 409A(a). See section II of this preamble. Thus, for any taxable year during which a failure occurs, all amounts deferred under the plan would be includible in income unless the amount has previously been included in income or is subject to a substantial risk of forfeiture. Generally, this means that a service provider who includes in income under section 409A(a) all amounts deferred under a plan for a taxable year would not be relieved of the requirement to include amounts in income for an earlier taxable year in which a failure

also occurred. It would undermine the statutory purpose to allow a service provider to include an amount in income under section 409A(a) (or otherwise) on a current basis with respect to a failure that occurred in a prior taxable year and thereby eliminate the taxes owed for the earlier year, especially if intervening payments of deferred amounts have reduced the total amount deferred as of the end of such current year. In addition, this rule generally would prohibit a service provider from selecting from among several previous taxable years the most favorable year in which to include income. However, if an amount was actually and properly included in income under section 409A(a) in a previous year, the amount would be treated as an amount previously in income for purposes of all subsequent years. Accordingly, this rule would never make the same amount includible in income twice under section 409A(a).

For example, assume an employee participates in a nonqualified deferred compensation plan and defers \$10,000 each year, credited annually with interest at 5 percent (assumed to be reasonable for purposes of this example), and receives no payments under the plan. The employee's total amount deferred would be \$10,500 for Year 1, \$21,525 for Year 2, and \$33,101 for Year 3. If the nonqualified deferred compensation plan fails to meet the requirements of section 409A(a) in each year, the employee would be required to include \$10,500 in income under section 409A(a) for Year 1, \$11,025 in income for Year 2, and \$11,576 in income for Year 3. If the employee includes \$33,101 in income under section 409A(a) for Year 3, the employee would not have properly reported income for Year 1 and Year 2. However, an amount included in income for Year 3 would be treated as previously included in income for purposes of any further failures in subsequent years. In addition, if the employee

subsequently properly includes amounts in income for Year 1 and Year 2 on amended returns, the employee could claim a refund of the tax paid on the excess amounts included in income for Year 3. Similar consequences apply to the employer. If the employer fails to report and withhold on amounts includible in income under section 409A(a) in Year 1 and Year 2, the employer could not avoid liability for the failure to withhold in Year 1 and Year 2 by reporting the full amount and withholding in Year 3.

Because each taxable year would be analyzed independently, the IRS could elect to audit and assess with respect to a single taxable year, and require inclusion of all amounts deferred under the plan through that taxable year (even if failures also occurred in prior taxable years). Under those circumstances, the taxpayer could simply include amounts in income under section 409A(a) for that taxable year. However, before expiration of the applicable statute of limitations, the taxpayer could amend returns for previous taxable years and include in income amounts required to be included under section 409A(a), lowering the amount includible in income under section 409A(a) for the audited taxable year because, for purposes of that taxable year, those amounts would have been included in income in previous years. For example, an audit of Year 3 in the example above could result in an adjustment requiring \$33,101 to be included in income under section 409A(a). However, before expiration of the applicable statute of limitations, the employee could amend the employee's Year 1 and Year 2 Federal tax returns to include \$10,500 in income under section 409A(a) for Year 1, and \$11,025 in income under section 409A(a) for Year 2, and accordingly include only \$11,576 in income under section 409A(a) for Year 3. However, the employee would be required to pay the additional section 409A(a) taxes for Year 1 and Year 2, including the

premium interest tax. In addition, if amounts deferred under the plan had been paid in Year 1 or Year 2, the employee would be required to include those additional amounts in income under section 409A(a) for the year paid (meaning, if the payment had been included in income for the year in which it was paid, the employee would be required to amend the previously filed tax returns to pay the additional section 409A(a) taxes on such income).

#### IV. Application of Additional 20 Percent Tax

Section 409A(a)(1)(B)(i)(II) provides that if compensation is required to be included in gross income under section 409A(a)(1)(A) for a taxable year, the income tax imposed is increased by an amount equal to 20 percent of the compensation that is required to be included in gross income. This amount is an additional income tax, subject to the rules governing the assessment, collection, and payment of income tax, and is not an excise tax.

#### V. Application of Premium Interest Tax

##### A. In general

Section 409A(a)(1)(B)(i)(I) provides that if compensation is required to be included in gross income under section 409A(a)(1)(A) for a taxable year, the income tax imposed is increased by an amount equal to the amount of interest determined under section 409A(a)(1)(B)(ii). This amount is an additional income tax, subject to the rules governing assessment, collection, and payment of income tax, and is not an excise tax or interest on an underpayment. Section 409A(a)(1)(B)(ii) provides that this premium interest tax is determined as the amount of interest at the underpayment rate (established under section 6621) plus one percentage point on the underpayments that

would have occurred had the deferred compensation been includible in gross income for the taxable year in which first deferred or, if later, the first taxable year in which such deferred compensation is not subject to a substantial risk of forfeiture (vested). Thus, section 409A(a)(1)(B) requires that the premium interest tax be applied to hypothetical underpayments where the hypothetical underpayments are determined by first allocating the amounts deferred under the plan required to be included in income under section 409A(a) to the initial year (or years) the amount was deferred or vested, then determining the hypothetical underpayment that would have resulted had such amounts been includible in income at that time, and then determining the interest that would be due upon that hypothetical underpayment based upon a premium interest rate equal to the underpayment rate plus one percentage point.

**B. Amounts to which the premium interest tax applies**

Section 409A(a)(1)(B)(ii) provides for an additional tax based upon the interest that would be applied to the resulting underpayments of tax if the deferred compensation includible in income under section 409A(a) had been includible in income in previous years. Because the total amount deferred for the taxable year in which a failure occurs (the current year) may be less than the amounts deferred under the same plan in a previous year due to payments or deemed investment or other losses in the previous year, so that a portion of the amount deferred in the previous year would not be includible in income under section 409A(a) for the current year, commentators have asked what amounts deferred under the plan must be taken into account in determining the premium interest tax. Section 409A(a)(1)(B)(i) refers first to the compensation required to be included in gross income under section 409A(a)(1)(A). Accordingly,

under the proposed regulations the amount required to be included in income under section 409A(a) for the taxable year is the only deferred amount required to be allocated to previous taxable years for purposes of determining the premium interest tax under section 409A(a)(1)(B)(i)(I).

For example, assume an employee who participates in a plan has a total amount deferred in Year 1 of \$100,000 and a total amount deferred in Year 2 of \$80,000 due to deemed investment losses in Year 2. If the plan fails to meet the requirements of section 409A(a) in Year 2 (and not Year 1), the employee is required to include \$80,000 in income under section 409A(a). In calculating the premium interest tax, the employee must allocate only the \$80,000 required to be included in income under section 409A(a) to the year or years the amount was first deferred or vested, even though additional amounts were deferred under the plan in previous taxable years.

### C. Identification of initial years of deferral for includible amounts

#### 1. Identification of Amounts Deferred in a Particular Taxable Year – General Principles

To calculate the premium underpayment interest tax, the taxable year or years during which the amount required to be included in income was first deferred or first vested must be determined. The proposed regulations provide that the amount deferred during a particular taxable year generally is the excess (if any) of the vested total amount deferred for that taxable year over the vested total amount deferred for the immediately preceding taxable year. For example, if a service provider first participated in a plan in the taxable year 2010 and has a vested total amount deferred under the plan for 2010 of \$10,000, a vested total amount deferred for 2011 of \$15,000, and a vested total amount deferred for 2012 of \$25,000, then the service provider would be

treated as having first deferred \$10,000 during 2010, \$5,000 during 2011, and \$10,000 during 2012.

## 2. Identification of Initial Years of Deferral – Treatment of Amounts Previously Included in Income, Payments, and Investment Losses

The general rule would apply in cases where during previous taxable years there have been no payments under the plan, no net deemed investment or other losses, and no amounts otherwise included in income. If a service provider has received a payment, incurred net deemed losses, or included an amount in income, the general rule would need to be modified. For example, assume that the vested total amount deferred for Year 1 is \$100,000, for Year 2 is \$200,000 (including a \$50,000 payment), and for Year 3 is \$250,000. If there is a failure to meet the requirements of section 409A(a) in Year 3, the service provider would be required to include \$250,000 in income. The service provider would also need to determine the year or years during which the \$250,000 was first deferred and vested for purposes of calculating the premium interest tax. The issue then arises whether the \$50,000 payment in Year 2 was a payment of an amount first deferred and vested in Year 1 or Year 2. If the \$50,000 payment is treated as a payment of an amount first deferred and vested in Year 1, then only \$50,000 of the \$100,000 deferred in Year 1 would remain to be treated as part of the \$250,000 includible in income in Year 3. In contrast, if the \$50,000 payment is treated as a payment of an amount first deferred in Year 2, then the entire \$100,000 deferred in Year 1 would remain to be treated as part of the \$250,000. Similar issues arise with respect to the treatment of deemed investment losses and amounts previously included in income.

Under the calculation method set forth in the proposed regulations, payments, deemed investment or other losses, and amounts included in income during taxable years before the year in which the failure occurs, generally are attributed to amounts deferred and vested in the earliest year or years in which there are amounts deferred. The proposed calculation method generally achieves this result by reducing the amount deferred for each year preceding the payment or deemed investment or other loss, and treating only the remaining deferred amounts as the source of the outstanding deferrals and payments includible in income under section 409A for the year in which the failure occurs. This proposed rule generally should result in the lowest possible amount of premium interest tax, because deferred amounts includible in income under section 409A would be treated as first deferred and vested in the latest possible years, resulting in less premium interest on the hypothetical underpayments.

D. Calculation of the hypothetical underpayment

The hypothetical underpayment would be calculated as if the amount were paid to the service provider as a cash payment of compensation during the taxable year. Further, the hypothetical underpayment would be calculated based on the taxpayer's taxable income, credits, filing status, and other tax information for the year, based on the original return the taxpayer filed for such year, as adjusted as a result of any examination for such year or any amended return the taxpayer filed for such year that was accepted by the IRS. The hypothetical underpayment would reflect the effect that such additional compensation would have had on the amount of Federal income tax owed by the taxpayer for such year, including the continued availability of any deductions taken, and the use of any carryovers such as carryover losses. For

purposes of calculating a hypothetical underpayment in a subsequent year (whether or not a portion of the deferred amount was first deferred and vested in the subsequent year), any 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 taxable year had been included in the taxpayer's income for the previous year would be taken into account. For example, if in calculating the hypothetical underpayment for one year, an additional amount of unused charitable contribution deductions is absorbed, the use of the additional charitable contributions would be reflected in determining the hypothetical underpayment for a subsequent year (meaning that the same portion of the charitable contribution could not be deducted twice in determining the hypothetical underpayments for more than one year).

Calculation of the premium interest tax would take into account only the consequences the additional income would have had on the Federal income tax due based on items of income and deduction, credits, filing status and similar information existing as of the end of the taxable year at issue. Other potential effects of the additional compensation payment on service provider or service recipient actions or elections would not be taken into account, including how such additional compensation could have affected participation in an employee benefit plan or other arrangement. For example, the impact such additional compensation would have had on contributions to a qualified plan, even if the additional compensation would have affected the amount the service provider would have been permitted or required to contribute, would be disregarded.

#### E. Potential safe harbor calculation methods

The Treasury Department and the IRS recognize that calculation of the premium underpayment interest tax may be cumbersome, potentially involving the recalculation of several years' tax returns. In response, the Treasury Department and the IRS are considering whether safe harbor calculation methods could be devised that would reduce the calculation burden but still result in an appropriate amount of tax applicable to the amount includible in income under section 409A(a). Specifically, the Treasury Department and the IRS request comments on calculation methods that would more easily identify the taxable year or years during which an amount includible in income under section 409A(a) was first deferred and vested, and that would more easily determine the hypothetical underpayments applicable to such year or years. Comments should consider both how the safe harbor method would be applied by taxpayers, and the extent to which such methods could be applied by the IRS in the examination context.

VI. Treatment of Payments, Forfeitures, or Permanent Losses of Deferred Amounts in Taxable Years after the Amount is Included in Income under Section 409A(a)

A. Payments of deferred compensation in taxable years after the inclusion of such amounts in income under section 409A(a)

Section 409A(c) provides that any amount included in gross income under section 409A is not required to be included in gross income under any other provision of the Code or any other rule of law later than the time provided in section 409A. Accordingly, if a service provider includes an amount in income under section 409A, 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). For this purpose, the amount previously

included in income would be treated as the inclusion in income of an amount deferred under the plan, but would not be allocated to any specific amount deferred under the plan. Accordingly, if an amount under the plan would be includible in income if section 409A were disregarded (for example, because an amount is paid under the plan), the amount previously included in income would be immediately applied to the amount paid under the plan such that the amount paid would not be required to be included in gross income a second time.

For example, assume that in Year 1 an employee defers \$10,000 under a salary deferral elective account balance plan and is required to include that amount in income under section 409A. Assume that in Year 2 the employee defers \$15,000 under the same salary deferral elective account balance plan, and an additional \$5,000 under a bonus deferral elective account balance plan, both of which are compliant with section 409A. Assume that in Year 3 the employee receives a payment of \$5,000 under the bonus deferral elective account balance plan. Because the payment would be treated for purposes of section 409A as made from a single elective account balance plan in which the employee participated, and because the employee has already included \$10,000 in income under section 409A due to participation in the plan, the employee would apply \$5,000 of the \$10,000 that was previously included in income to the \$5,000 payment and not include the \$5,000 payment in gross income in Year 3 (or any subsequent year). The remaining amount previously included in income would be \$5,000.

The employee could not elect the extent to which the amount previously included in income would be applied in this context. Rather, the amount previously included in

income would be required to be applied immediately to the extent an amount deferred under the same plan would otherwise become includible in income under a Code section other than section 409A. The inclusion of any amount in income and the resulting amount previously included in income for subsequent years would not affect the potential for earnings related to such amounts to be subject to section 409A or to be required to be included in income under section 409A.

B. Permanent forfeiture or loss of a deferred amount previously included in income under section 409A(a)

The application of section 409A(a) may require inclusion in income of amounts that the service provider ultimately never receives. This result may occur under four different circumstances. First, because a nonqualified deferred compensation plan generally involves an unfunded, unsecured promise of a service recipient to pay compensation in a future year, the funds to pay the deferred amount may not be available in the future year. For example, the service recipient may be insolvent, bankrupt or have ceased to exist at the time the payment is due.

Second, some amounts of deferred compensation may be included in income under section 409A(a) if the amounts are subject to a risk of forfeiture, but the risk of forfeiture does not qualify as a substantial risk of forfeiture. For example, a deferred amount payable only if the service provider does not compete with the service recipient for a defined period is not subject to a substantial risk of forfeiture. However, if the service provider actually competes with the service recipient, the service provider may forfeit the right to the amount.

Third, the deferred amount may be subject to deemed investment losses. If losses occur after the deferred amount has been included in income under section

409A(a), the amount paid to the service provider may be less than the amount included in income.

Fourth, in the case of a formula amount, the calculation of the deferred amount may result in the inclusion in income under section 409A(a) of an amount that is greater than the amount ultimately paid. For example, if a service provider receives a right to a certain percentage of the service recipient's profits payable at separation from service, and determines that the total amount deferred under the plan is \$100,000, once the profits are calculated the service provider may be entitled to a lesser amount.

#### 1. Effect on Service Provider

The proposed regulations provide that a service provider who is required to include an amount in income under section 409A(a) with respect to a deferred amount under a nonqualified deferred compensation plan is entitled to a deduction at the time the service provider's legally binding right to all deferred compensation under the plan (including all arrangements treated as a single plan under the aggregation rules) is permanently forfeited under the plan's terms, or the right to such 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 any amount actually or constructively received by the service provider. A right to an amount would not be treated as permanently lost merely because the deferred amount had decreased, for example due to deemed investment losses, if the service provider retains a right to an amount deferred under the plan. In addition, a right to an amount would not be treated as permanently forfeited or otherwise lost if the obligation to make such payment is substituted for another deferred amount or obligation to make a payment in

a future year. However, the right to an amount would be treated as permanently lost if the right to the payment of the amount becomes wholly worthless. A service provider would not be entitled to a deduction with respect to an amount previously included in income under section 409A(a) if the service provider retains a right to any amount deferred under all arrangements treated as a single plan under §1.409A-1(c)(2). However, if the entire deferred amount payable under the plan has been paid out and the service recipient has no remaining liability to the service provider under the plan, any remaining unpaid deferred amount that had previously been included in income would be treated as permanently lost.

For example, if at the end of Year 1 an employee has an account balance of \$100,000 which is required to be included in income under section 409A, and at the end of Year 2 an employee has an account balance of \$90,000 due to notional investment losses, the employee would not be entitled to a deduction for Year 2. However, if in Year 3 the entire account balance of \$95,000 is paid to the employee, so there no longer are any amounts deferred under the plan (determined after applying applicable aggregation rules) and nothing remains to be paid to the employee, the employee would be entitled to a \$5,000 deduction for Year 3.

In the case of a service provider that is an employee, the available deduction generally would be treated as a miscellaneous itemized deduction, subject to the deduction limitations applicable to such expenses. Section 1341 would not be applicable to such deduction because inclusion of an amount in income as a result of noncompliance with section 409A(a) would not constitute receipt of an amount to which it appeared that the taxpayer had an unrestricted right in the taxable year of inclusion.

In the first circumstance listed above, a service provider that does not receive payment of deferred compensation because of the bankruptcy or insolvency of the service recipient retains the legal right to the income even though the income is not collectible. In each of the three other circumstances in which such a deduction becomes available, the deferred compensation is not paid because of an event that occurred after the taxable year in which the amount deferred was included in income under section 409A, rather than from the absence of a right to the deferred compensation in the year in which it was includible in gross income. Finally, certain of such circumstances, such as the actual amount received differing from the amount included in income because the amount deferred was a formula amount, result from the inherent uncertainties in valuing rights to such amounts, rather than from a lack of a claim of right to income.

## 2. Effect on Service Recipient

If a service provider is entitled to a deduction with respect to a deferred amount included in income under section 409A(a) that is subsequently permanently forfeited or otherwise lost, to the extent the service recipient has benefited from a deduction or increased the basis of an asset because the deferred amount was included in the service provider's gross income, or such inclusion by the service provider has otherwise reduced or could otherwise reduce the service recipient's gross income, the service recipient may be required to recognize income under the tax benefit rule and section 111, or make other appropriate adjustments to reflect that the deferred amount included in income by the service provider under section 409A(a) has been permanently forfeited or otherwise lost, and thus will not be paid by the service recipient.

## VII. Service Provider Income Inclusion and Additional Taxes and Service Recipient Reporting and Withholding Obligations

A. Service provider income inclusion

The Treasury Department and the IRS anticipate issuing interim guidance during 2008 addressing the extent to which taxpayers may rely on the proposed regulations with respect to the calculation of the amounts includible in income under section 409A(a) and the calculation of the additional taxes under section 409A(a). The interim guidance is also expected to address the calculation of the amounts includible in income and additional taxes under section 409A(b) and service recipient reporting and withholding obligations with respect to amounts includible in income under section 409A(a) or (b) for taxable years beginning before the final regulations become applicable. The Treasury Department and the IRS anticipate that such interim guidance will provide that taxpayers may rely upon the proposed regulations in their entirety (but that taxpayers may not rely on part, but not all, of the proposed regulations).

B. Annual deferral reporting

Section 885(b) of the Act amended sections 6041 and 6051 to require that an employer or payer report all deferrals for the year under a nonqualified deferred compensation plan on a Form W-2, "Wage and Tax Statement" or a Form 1099-MISC, "Miscellaneous Income", regardless of whether such deferred compensation is includible in gross income under section 409A(a) (annual deferral reporting). Notice 2007-89 permanently waives this requirement for 2007 Forms W-2 and Forms 1099. Notice 2006-100 permanently waives this requirement for 2005 and 2006 Forms W-2 and Forms 1099. The Treasury Department and the IRS anticipate that this reporting will be implemented beginning with the first taxable year for which these proposed regulations are finalized and effective. The Treasury Department and the IRS further

anticipate that the annual deferral reporting rules will be based upon the principles set forth in these regulations as finalized, except that taxpayers will not be required to report deferred amounts that are not reasonably ascertainable (as defined in §31.3121(v)(2)-1(e)(4)(i)(B)) until such amounts become reasonably ascertainable. The Treasury Department and the IRS anticipate that the deferred amounts required to be reported will reflect earnings on the amounts deferred in previous years, if the amount of such earnings is reasonably ascertainable, because section 409A specifically treats earnings on deferred amounts as additional deferred amounts. The Treasury Department and the IRS request comments on the potential application of the standards set forth in these regulations to this reporting requirement, including suggestions for possible adaptations or modifications that may decrease the administrative burden of compliance while maintaining the integrity of the information reported.

C. Income inclusion reporting and income tax withholding

Section 885(b) of the Act also amended section 3401(a) to provide that the term “wages” includes any amount includible in the gross income of an employee under section 409A, and amended section 6041 to require that a payer report amounts includible in gross income under section 409A that are not treated as wages under section 3401(a) (income inclusion reporting). Notice 2005-1 provides that an employer should report amounts includible in gross income under section 409A and in wages under section 3401(a) in box 1 of Form W-2 as wages paid to the employee during the year and subject to income tax withholding, and that the employer should also report such amounts in box 12 of Form W-2 using code Z. Notice 2005-1 also provides that a payer should report amounts includible in gross income under section 409A and not

treated as wages under section 3401(a) as nonemployee compensation in box 7 of Form 1099-MISC, and should also report such amounts in box 15b of Form 1099-MISC. Notice 2006-100 provided guidance on income inclusion reporting for the 2005 and 2006 Forms W-2 and Forms 1099. Notice 2007-89 provided guidance on income inclusion reporting for the 2007 Forms W-2 and Forms 1099. The Treasury Department and the IRS anticipate issuing further interim guidance during 2008 on income inclusion reporting for 2008 Forms W-2 and Forms 1099 for taxable years beginning before the final regulations become applicable. The Treasury Department and the IRS anticipate that such interim guidance will provide that taxpayers may rely upon the proposed regulations in their entirety (but that taxpayers may not rely on part, but not all, of the proposed regulations).

Amounts includible in an employee's income under section 409A also are treated as wages for purposes of section 3401. Notice 2007-89 provides guidance on a service recipient's income tax withholding obligations for 2007. The Treasury Department and the IRS anticipate issuing further interim guidance during 2008 on a service recipient's income tax withholding obligations for calendar years beginning before the final regulations become applicable. The Treasury Department and the IRS anticipate that such interim guidance will provide that taxpayers may rely upon the proposed regulations in their entirety (but that taxpayers may not rely on part, but not all, of the proposed regulations).

### **Proposed Effective Date**

These regulations are proposed to be generally applicable for taxable years beginning on or after the issuance of final regulations. Before the applicability date of

the final regulations, taxpayers may rely on these proposed regulations only to the extent provided in further guidance.

### **Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### **Comments and Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for April 2, 2009 at 10:00 a.m., in the auditorium. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the

immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the “FOR FURTHER INFORMATION CONTACT” section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by March 9, 2009. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

#### **Drafting Information**

The principal author of these regulations is Stephen Tackney of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and the Treasury Department participated in their development.

#### **List of Subjects 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements

#### **Proposed Amendments to the Regulations**

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

##### **Part 1--INCOME TAXES**

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. Section 1.409A-0 is amended by adding entries for §1.409A-4 to read as follows:

**§1.409A-0 Table of contents.**

\* \* \* \* \*

§1.409A-4 Calculation of amount includible in income and additional income taxes.

(a) Amount includible in income due to failure to meet the requirements of section 409A(a).

(1) In general.

(i) Calculation formula.

(ii) Each taxable year analyzed independently.

(A) In general.

(B) Treatment of certain deferred amounts otherwise subject to a substantial risk of forfeiture.

(iii) Examples.

(2) Identification of the portion of the total amount deferred for a taxable year that is subject to a substantial risk of forfeiture.

(i) In general.

(ii) Example.

(3) Identification of amount previously included in income.

(i) In general.

(ii) Examples.

(b) The total amount deferred under a plan for a taxable year.

(1) Application of general rules and specific rules for specific types of plans.

(2) General definition of total amount deferred.

(i) General calculation rules.

(ii) Actuarial assumptions and methods

(A) Requirement of reasonable actuarial assumptions and methods.

(B) Use of an unreasonable actuarial assumption or method.

(iii) Crediting of earnings and losses.

(iv) Application of the general calculation rules to formula amounts.

(A) In general.

(B) Examples.

(v) Treatment of payment restrictions.

(vi) Treatment of alternative times and forms of a future payment.

(A) In general.

(B) Effect of status of service provider on available times and forms of payment.

(vii) Treatment of payment triggers based upon events.

(A) In general.

(B) Certain payment triggers disregarded.

(viii) Treatment of amounts that may qualify as short-term deferrals.

(ix) Examples.

- (3) Account balance plans.
  - (i) In general.
  - (ii) Unreasonable rate of return.
    - (A) Application
    - (B) Unreasonably high interest rate.
    - (C) Other rates of return.
- (4) Reimbursement and in-kind benefit arrangements.
- (5) Split-dollar life insurance arrangements.
- (6) Stock rights.
- (7) Anti-abuse provision.
- (c) Additional 20 percent tax under section 409A(a)(1)(B)(i)(II).
- (d) Premium interest tax under section 409A(a)(1)(B)(i)(I).
  - (1) In general.
  - (2) Identification of taxable year deferred amount was first deferred or vested.
    - (i) Method of identification.
    - (ii) Examples.
  - (3) Calculation of hypothetical underpayment for the taxable year during which a deferred amount was first deferred and vested.
    - (i) Calculation method.
    - (ii) Examples.
  - (4) Calculation of hypothetical premium underpayment interest.
    - (i) Calculation method.
    - (ii) Examples.
  - (e) Amounts includible in income under section 409A(b) [Reserved]
  - (f) Application of amounts included in income under section 409A to payments of amounts deferred.
    - (1) In general.
    - (2) Application of the plan aggregation rules.
    - (3) Examples.
  - (g) Forfeiture or other permanent loss of right to deferred compensation.
    - (1) Availability of deduction to the service provider.
    - (2) Application of the plan aggregation rules.
    - (3) Examples.
  - (h) Effective/applicability date.

\* \* \* \* \*

Par. 3. Section 1.409A-4 is added to read as follows:

§1.409A-4 Calculation of amount includible in income and additional income taxes.

(a) Amount includible in income due to failure to meet the requirements of section

409A(a)--(1) In general--(i) Calculation formula. The amount includible in income for a

service provider's taxable year due to a failure to meet the requirements of section 409A(a) with respect to a plan is the excess (if any) of--

(A) The service provider's total amount deferred under the plan for the taxable year, including the amount of any payments of amounts deferred under the plan to (or on behalf of) the service provider during such taxable year; over

(B) The portion of such amount, if any, that is either subject to a substantial risk of forfeiture (as defined in §1.409A-1(d) and applying paragraph (a)(1)(ii)(B) of this section) or has been previously included in income (as defined in §1.409A-4(a)(3)).

(ii) Each taxable year analyzed independently--(A) In general. An amount is includible in income under section 409A(a) for a taxable year only if a plan fails to meet the requirements of section 409A(a) during such taxable year. Whether an amount is includible in income for a taxable year due to a failure to meet the requirements of section 409A(a) during such taxable year is determined independently of whether such amounts are also includible in income due to a failure to meet the requirements of section 409A(a) in a previous or subsequent taxable year. Accordingly, an amount may be includible in income for a taxable year during which a plan fails to meet the requirements of section 409A(a), even if the same amount was includible in income in a previous taxable year, except to the extent provided in §1.409A-4(a)(3) (identification of amount previously included in income).

(B) Treatment of certain deferred amounts otherwise subject to a substantial risk of forfeiture. For purposes of determining the amount includible in income under section 409A(a) and paragraph (a)(1)(i) of this section, if the facts and circumstances indicate that a service recipient has a pattern or practice of permitting impermissible changes in

the time and form of payment with respect to nonvested deferred amounts under one or more plans, an amount deferred under a plan that is otherwise subject to a substantial risk of forfeiture is not treated as subject to a substantial risk of forfeiture if an impermissible change in the time and form of payment (including an impermissible initial deferral election) applies to the amount deferred or if the facts and circumstances indicate that the amount deferred would be affected by such pattern or practice.

(iii) Examples. The following examples illustrate the provisions of this paragraph (a)(1). For each of the examples, Employee A is an individual taxpayer with a calendar year taxable year. Employee A has a total amount deferred under a nonqualified deferred compensation plan of \$0 in 2010, \$100,000 in 2011, and \$250,000 in 2012. No payments are made under the plan. The plan under which the amounts are deferred fails to meet the requirements of section 409A(a) during 2011 and 2012. The examples read as follows:

Example 1. With respect to Employee A, at no time is any deferred amount subject to a substantial risk of forfeiture. Employee A has \$100,000 includible in income under section 409A(a) for 2011, because no portion of the total deferred amount for 2011 is subject to a substantial risk of forfeiture or has previously been included in income. If that \$100,000 is included in income for 2011, Employee A has \$150,000 includible in income under section 409A(a) for 2012 because for the taxable year 2012 the \$100,000 is previously included in income (see paragraphs (a)(1)(i)(B) and (a)(3) of this section). If that \$100,000 is not included in income for 2011, Employee A has \$250,000 includible in income under section 409A(a) for 2012. Employee A does not avoid the requirement to include \$100,000 in income under section 409A(a) for 2011 by including \$250,000 in income under section 409A(a) for 2012.

Example 2. The same facts as Example 1, except that, with respect to Employee A, the statute of limitations on assessments has expired for 2011, but has not expired for 2012. Employee A has \$250,000 includible in income under section 409A(a) for 2012, because no portion of the total deferred amount for 2012 is subject to a substantial risk of forfeiture or has previously been included in income.

(2) Identification of the portion of the total amount deferred for a taxable year that is subject to a substantial risk of forfeiture--(i) In general. The portion of the total amount deferred for a taxable year that is subject to a substantial risk of forfeiture (as defined in §1.409A-1(d)) is determined as of the last day of the service provider's taxable year. Accordingly, an amount may be includible in income under section 409A(a) for a taxable year even if such amount is subject to a substantial risk of forfeiture during the taxable year if the substantial risk of forfeiture lapses during such taxable year, including if the substantial risk of forfeiture lapses after the date the nonqualified deferred compensation plan under which the amount is deferred first fails to meet the requirements of section 409A(a).

(ii) Example. The following example illustrates the provisions of this paragraph (a)(2): Employee B is an individual taxpayer with a calendar year taxable year. Employee B has a total amount deferred under a nonqualified deferred compensation plan of \$0 for 2010, \$100,000 for 2011, and \$250,000 for 2012. No payments are made under the plan. Under the terms of the plan, if Employee B voluntarily separates from service before July 1, 2012, Employee B will forfeit 50 percent of the Employee B's total amount deferred under the plan. If Employee B voluntarily separates from service after June 30, 2012 but before July 1, 2013, Employee B will forfeit 20 percent of the total amount deferred under the plan. If Employee B voluntarily separates from service after June 30, 2013, Employee B will not forfeit any amount deferred under the plan. As of December 31, 2011, 50 percent of the total amount deferred under the plan (\$50,000) is subject to a substantial risk of forfeiture, and the remaining amount deferred under the plan (\$50,000) is not subject to a substantial risk of forfeiture. As of December 31, 2012, 20 percent of the total amount deferred under the plan (\$50,000) is subject to a substantial risk of forfeiture, and the remaining amount deferred under the plan (\$200,000) is not subject to a substantial risk of forfeiture. At all times the terms of the plan meet the requirements of section 409A(a) and the applicable regulations, and through May 31, 2012, the plan is operated in a manner that complies with the terms of the plan. On June 1, 2012, the plan is operated in a manner that fails to meet the requirements of section 409A(a). For purposes of determining the amount includible in income under section 409A(a), except as provided in paragraph (a)(1)(ii)(B) of this section, the portion of the total amount deferred for 2012 that is subject to a substantial risk of forfeiture is \$50,000 (20 percent of \$250,000).

(3) Identification of amount previously included in income--(i) In general.

For purposes of this section, an amount is previously included in income only if the service provider has included the amount in income under an applicable provision of the Internal Revenue Code for a previous taxable year. An amount is treated as included in income for a taxable year only to the extent that the amount was properly includible in income and the service provider actually included the amount in income (including on an original or amended return or as a result of an IRS examination or a final decision of a court of competent jurisdiction). For future taxable years, the amount previously included in income is reduced to reflect any amount that was paid during the taxable year for which the amount was included in income, any amount allocated to a payment made under the plan under paragraph (f) of this section, and any amount deductible under paragraph (g) of this section.

(ii) Examples. The following examples illustrate the provisions of this paragraph (a)(3). For all of the examples, Employee C is an individual taxpayer with a calendar year taxable year. Employee C has a total amount deferred under a nonqualified deferred compensation plan of \$0 in 2010, \$100,000 in 2011, and \$250,000 in 2012. With respect to Employee C, the statute of limitations on assessments has not expired for 2011 or 2012. Except as otherwise explicitly provided in the following examples, Employee C has not included in income for 2011 on any original or amended tax return any amount deferred under the plan, none of the \$250,000 total amount deferred for 2012 has previously been included in income, no payments are made under the plan, and at no time is any deferred amount subject to a substantial risk of forfeiture. The plan under which the amounts are deferred fails to meet the requirements of section 409A(a) during 2011 and 2012. The examples read as follows:

Example 1. After filing an original Federal income tax return for 2011 that did not include any amount in income under section 409A(a), on April 1, 2013, Employee C files an amended Federal income tax return for 2011 and properly includes \$100,000 in income under section 409A(a) for 2011. For purposes of determining the amount includible in income under section 409A(a) for 2012, \$100,000 of the \$250,000 total amount deferred for 2012 has previously been included in income with respect to the plan. For 2012, Employee C includes in income \$150,000 under section 409A(a) on Employee C's original Federal income tax return. As of January 1, 2013, the amount that Employee C has previously included in income under section 409A(a) with respect to the plan is \$250,000.

Example 2. The facts are the same as in Example 1, except that Employee C receives a \$10,000 payment in 2011 so that the total amount deferred for 2012 is \$240,000. For purposes of determining the amount includible in income under section 409A(a) for 2012, the \$100,000 amount previously included in income is reduced by the \$10,000 payment so that \$90,000 of the \$240,000 total amount deferred for 2012 has previously been included in income. For 2012, Employee C includes in income \$150,000 under section 409A(a) on Employee C's original Federal income tax return. As of January 1, 2013, the amount that Employee C has previously included in income under section 409A(a) with respect to the plan is \$240,000.

Example 3. The facts are the same as in Example 2. Due to deemed investment losses during 2013, Employee C has an \$80,000 total amount deferred under the plan for 2013. On December 31, 2013, Employee C's total amount deferred (\$80,000) is paid to Employee C as a single sum payment. Pursuant to paragraph (f) of this section, \$80,000 of the \$240,000 amount previously included in income is allocated to the \$80,000 payment so that none of the \$80,000 is includible in income. In addition, pursuant to paragraph (g) of this section, Employee C is entitled to deduct \$160,000 for 2013 equal to the remaining amount previously included in income the right to which is permanently lost. Because the entire \$240,000 amount previously included in income has been allocated to a payment under paragraph (f) of this section or was deductible under paragraph (g) of this section, no portion of such amount is treated as previously included in income for 2014 or any subsequent taxable year. As of January 1, 2014, the amount that Employee C has previously included in income under section 409A(a) with respect to the plan is \$0.

(b) The total amount deferred under a plan for a taxable year--(1) Application of general rules and specific rules for specific types of plans. Paragraph (b)(2) of this section provides general rules governing the determination of the total amount deferred under a plan for a taxable year, including the treatment of plans providing for alternative times and forms of payment and plans providing for certain payments the amount of

which is determined by a formula that includes one or more variables dependent upon future events (formula amounts). Paragraphs (b)(3) through (b)(6) of this section provide specific rules governing the determination of the total amount deferred under certain types of plans. Except as otherwise provided, any applicable rules of paragraphs (b)(3) through (b)(6) of this section are applied in conjunction with the general rules provided in paragraph (b)(2) of this section.

(2) General definition of total amount deferred--(i) General calculation rules.

Except as otherwise provided, the total amount deferred for a taxable year equals the present value of the future payments to which the service provider has a legally binding right under the plan as of the last day of the taxable year, plus the amount of any payments of amounts deferred under the plan to (or on behalf of) the service provider during such taxable year. For purposes of this section, present value means the value, as of a specified date, of an amount or series of amounts due thereafter, determined in accordance with the rules and assumptions of this paragraph (b)(2), as applicable, where each amount is multiplied by the probability that the condition or conditions on which payment of the amount is contingent will be satisfied, also determined in accordance with the rules and assumptions set forth in this paragraph (b)(2), as applicable, discounted according to an assumed rate of interest to reflect the time value of money. For this purpose, a discount for the probability that an employee will die before commencement of benefit payments is permitted, but only to the extent that benefits will be forfeited upon death. In addition, the present value cannot be discounted for the probability that payments will not be made (or will be reduced) because of the unfunded status of the plan, the risk associated with any deemed or

actual investment of amounts deferred under the plan, the risk that the service recipient, the trustee, or another party will be unwilling or unable to pay, the possibility of future plan amendments, the possibility of a future change in the law, or similar risks or contingencies. If the amount payable under a plan or the value of a benefit under a plan is expressed in a currency other than the U.S. dollar, the total amount deferred is translated from foreign currency into U.S. dollars at the spot exchange rate on the last day of the service provider's taxable year. No adjustment is made to the total amount deferred to reflect the risk that the currency in which the amount payable or the value of the benefit is expressed may in the future increase or decrease in value with respect to the U.S. dollar or any other currency.

(ii) Actuarial assumptions and methods--(A) Requirement of reasonable actuarial assumptions and methods. For purposes of this section, the present value must be determined as of the last day of the service provider's taxable year using actuarial assumptions and methods that are reasonable as of that date, including an interest rate for purposes of discounting for present value that is reasonable as of that date.

(B) Use of an unreasonable actuarial assumption or method. If any actuarial assumption or method used to determine the total amount deferred for a taxable year under a plan is not reasonable, as determined by the Commissioner, then the total amount deferred is determined by the application of the AFR and, if applicable, the applicable mortality table under section 417(e)(3)(A)(ii)(I) (the 417(e) mortality table), both determined as of the last month of the taxable year for which the amount deferred is being determined. For purposes of this section, AFR means the appropriate applicable Federal rate (as defined pursuant to section 1274(d)) based on annual

compounding, for the last month of the taxable year for which the amount includible in income is being determined. The period for which excess interest will be credited, beginning with the last day of the taxable year and ending with the date the excess interest will no longer be credited (determined in accordance with the payment timing assumptions set forth in paragraph (b)(2)(vi) and (vii) of this section) is used to determine the appropriate AFR (short-term, mid-term, or long-term).

(iii) Crediting of earnings and losses. The earnings and losses credited under a plan as of the last day of the service provider's taxable year pursuant to the plan are given effect only to the extent the plan's terms reasonably reflect the value of the service provider's rights under the plan. For example, a plan's method of determining the amount of such earnings or losses generally will be respected for purposes of determining the total amount deferred for the taxable year, provided that the earnings and losses are credited at least once per taxable year. If earnings and losses are not credited at least annually, the total amount deferred is calculated as if the earnings or losses were credited as of the last day of the taxable year. In addition, any change in the schedule for crediting earnings during the taxable year for which the total amount deferred is calculated that would reduce the earnings credited for a taxable year in which an amount is required to be included in income under section 409A(a) is disregarded for such taxable year. For example, if a plan is amended during a taxable year that is a calendar year to change the date for crediting earnings from December 31 to July 1 of that year and the plan fails to meet the requirements of section 409A(a) during that year, the amendment is disregarded for purposes of determining the total amount deferred for the year and December 31 is treated as the date for crediting

earnings and losses. If no further changes are made to the plan with respect to the crediting of earnings and losses, for subsequent taxable years, July 1 is treated as the date for crediting earnings and losses.

(iv) Application of the general calculation rules to formula amounts--(A) In general. With respect to a right to a payment to which this paragraph applies, the amount payable for purposes of determining the total amount deferred for the taxable year must be determined based on all of the facts and circumstances existing as of the close of the last day of the taxable year. Such determination must reflect reasonable, good faith assumptions with respect to any contingencies as to the amount of the payment, both with respect to each contingency and with respect to all contingencies in the aggregate. An assumption based on the facts and circumstances as of the close of the last day of a taxable year may be reasonable even if the facts and circumstances change in a subsequent year so that if the amount payable were determined for such subsequent year, the amount payable would be a greater (or lesser) amount. In such a case, the increase (or decrease) due to the change in the facts and circumstances is treated as earnings (or losses). This paragraph (b)(2)(iv) applies to the extent that the amount payable in a future taxable year is a formula amount to the extent that the amount payable in a future taxable year is dependent upon factors that, after applying the assumptions and other rules set out in this section, are not determinable as of the end of the taxable year for which the total amount deferred is being calculated, so that the amount payable may not readily be determined as of the end of such taxable year under the other provisions of this section. If a portion of a deferred amount is determinable under the other rules of this paragraph (b)(2), the determination of the

amount deferred with respect to such portion must be determined under the rules applicable to amounts that are not formula amounts, and only the balance of the deferred amount is determined under this paragraph.

(B) Examples. The following examples illustrate the provisions of this paragraph

(b)(2)(iv):

Example 1. On January 1, 2020, a service provider receives a legally binding right to a payment of one percent of the service recipient's net profits for the calendar years 2020, 2021, and 2022, payable on the later of January 1, 2024 or the service provider's separation from service. The amount payable is a formula amount and this paragraph (b)(2)(iv) applies.

Example 2. On January 1, 2020, a service provider receives a legally binding right to a payment of the greater of one percent of the service recipient's net profits for the calendar years 2020, 2021, and 2022 or \$10,000, payable on the later of January 1, 2024 or the service provider's separation from service. The portion of the amount payable that is a \$10,000 payment, payable at the later of January 1, 2024 or the service provider's separation from service, is not a formula amount. The portion of the amount payable that is the excess, if any, of one percent of the service recipient's net profits for the calendar years 2020, 2021, and 2022 over \$10,000 is a formula amount and this paragraph (b)(2)(iv) applies.

Example 3. On January 1, 2020, a service provider receives a legally binding right to payment equal to the value of 10,000 shares of service recipient stock, payable on the later of January 1, 2024 or the service provider's separation from service. Because the amount payable may increase or decrease only due to a change in value of a predetermined actual investment (10,000 shares of service recipient stock), the amount payable is not treated as a formula amount and this paragraph (b)(2)(iv) does not apply.

(v) Treatment of payment restrictions. Except as specifically provided, a restriction on the payment of all or part of a deferred amount that will or may lapse under the terms of the plan, including a risk of forfeiture that is not a substantial risk of forfeiture as defined in §1.409A-1(d) or is disregarded under §1.409A-4(a)(1)(ii)(B), is ignored for purposes of determining the total amount deferred under the plan.

Accordingly, in calculating the total amount deferred, there is no reduction to account for

a risk that the amount may be forfeited if the risk of forfeiture is not a substantial risk of forfeiture. For example, if an amount deferred is subject to forfeiture under a noncompetition provision applicable for a prescribed period, the forfeiture provision is disregarded for purposes of determining the total amount deferred for the taxable year.

(vi) Treatment of alternative times and forms of a future payment--(A) In general. For purposes of determining the total amount deferred for a taxable year, if payment of a deferred amount may be made at alternative times or in alternative forms, each amount deferred under the plan is treated as payable at the time and under the form of payment for which the present value is highest. A time and form of payment is available to the extent a deferred amount under the plan may be payable in such time and form of payment under the plan's terms. If the service recipient has commenced payment of a deferred amount in a time and form of payment under the plan, or the service provider or service recipient has elected a time and form of payment under the plan, and under the plan's terms neither party can change such time and form of payment without the consent of the other party (and such consent requirement has substantive significance), the time and form of payment elected or the time and form of payment in which payments have commenced is treated as the sole available time and form of payment for such amount. If an alternative time and form of payment is available only at the service recipient's discretion, the time and form of payment is not available unless the service provider has a legally binding right under the principles of §1.409A-1(b)(1) to any additional value that would be generated by the service recipient's exercise of such discretion. For purposes of determining the value of each available time and form of payment, the assumptions and methods described in this paragraph (b)(2)(vi) are

applied, and then the value of each available time and form of payment is determined in accordance with the other applicable rules provided in paragraph (b) of this section.

(B) Effect of status of service provider on available times and forms of payment.

For purposes of determining whether a time and form of payment is available, if eligibility for a time and form of payment depends upon the service provider's status as of a future date, the service provider is assumed to continue in the service provider's status as of the last day of the taxable year. However, if the eligibility requirement is not bona fide and does not serve a bona fide business purpose, the eligibility requirement will be disregarded and the service provider will be treated as eligible for the alternative time and form of payment. For this purpose, an eligibility condition based upon the service provider's marital status (including status as a registered domestic partner or similar requirement), parental status, or status as a U.S. citizen or lawful permanent resident under section 7701(b)(6) is presumed to be bona fide and serve a bona fide business purpose. Notwithstanding the foregoing, if eligibility for a certain time or form of payment includes a bona fide requirement that the service provider provide additional services after the end of the taxable year, the time and form of payment is not treated as an available time and form of payment. The rules of this paragraph (b)(2)(vi)(B) apply regardless of whether the service provider's status changes during a subsequent taxable year.

(vii) Treatment of payment triggers based upon events--(A) In general. For purposes of determining the total amount deferred for a taxable year, if a payment trigger has occurred on or before the last day of the taxable year, a deferred amount payable upon such trigger is treated as payable at the time the payment is scheduled to

be made under the terms of the plan. If the payment trigger has not occurred on or before the last day of the taxable year, the trigger is treated as occurring on the earliest possible date the trigger reasonably could occur based on the facts and circumstances as of the last day of the taxable year, and the deferred amount is treated as payable based upon the schedule of payments that would be triggered by such occurrence. Notwithstanding the foregoing, if the payment trigger requires a separation from service, a termination of employment, or other similar reduction or cessation of services, the service provider is treated as meeting such requirement as of the last day of the taxable year. For purposes of determining the earliest date the payment trigger reasonably could occur, whether the payment trigger actually occurs in a subsequent taxable year is disregarded. For purposes of this paragraph (b)(2)(vii), a payment trigger means an event (not including the mere passage of time) upon which an amount may become payable. Generally if an amount would be payable in a different time and form of payment depending upon some characteristic of an event, each type of event upon which an amount would become payable is treated as a separate payment trigger. For example, if an amount would be payable as a single sum payment if one subsidiary corporation of a service recipient that consists of multiple corporations is sold, but as an installment payment if another subsidiary corporation of the same service recipient is sold, then the sale of the one subsidiary corporation is treated as a separate payment trigger from the sale of the other subsidiary corporation.

(B) Certain payment triggers disregarded. The possibility that the following payment triggers will occur in the future is disregarded for purposes of determining the

total amount deferred (but not for purposes of determining whether the plan otherwise complies with the requirements of section 409A(a)):

(1) A payment trigger that, if the trigger were the sole trigger determining when the amount would become payable, would cause the amount to be subject to a substantial risk of forfeiture, provided that if there is more than one payment trigger applicable to an amount that otherwise would be disregarded under this paragraph (b)(2)(vii)(B)(1), none of such payment triggers will be disregarded unless all such payment triggers, if applied in combination as the only payment triggers, would also cause the amount to be subject to a substantial risk of forfeiture.

(2) An unforeseeable emergency (as defined in §1.409A-3(i)(3)).

(viii) Treatment of amounts that may qualify as short-term deferrals. For purposes of calculating the total amount deferred for a taxable year, the right to a payment that, under the terms of the arrangement and the facts and circumstances as of the last day of the taxable year, may be a short-term deferral as defined under §1.409A-1(b)(4), is not included in the total amount deferred. In addition, even if such amount is not paid by the end of the applicable 2 ½ month period so that the amount is deferred compensation, the amount is not includible in the total amount deferred until the service provider's taxable year in which the applicable 2 ½ month period expires.

(ix) Examples. The following examples illustrate the provisions of paragraphs (b)(2)(vi) through (viii) of this section. For all of the examples, the service provider is an individual taxpayer who is an employee of the service recipient, the service provider has a calendar year taxable year, and the total amount deferred is being calculated for the

taxable year ending December 31, 2010. In each case, the service provider is not entitled to earnings on the amount deferred. The examples read as follows:

Example 1. Employee D, who is employed by Employer Z, is entitled to commence receiving payments at age 65. The plan provides that Employee D will receive a single sum payment, except that, after Employee D attains age 62 but before Employee D attains age 64 (whether or not Employee D is then employed by Employer Z), Employee D can elect to receive payments as a single life annuity. Employee D is age 54 as of December 31, 2010. For purposes of determining the available times and forms of payment, Employee D is assumed to survive to age 62 and be eligible to elect a single life annuity. Accordingly, for purposes of determining the total amount deferred for 2010, the amount is treated as payable as either a single sum payment or a single life annuity, whichever is more valuable.

Example 2. Employee E is entitled to a single life annuity commencing on January 1, 2020 if Employee E is not married as of January 1, 2020. Employee E is entitled to either a single life annuity or a subsidized joint and survivor annuity commencing on January 1, 2020 if Employee E is married as of January 1, 2020. Employee E is not married as of December 31, 2010. For purposes of determining the total amount deferred for 2010, Employee E is assumed to remain unmarried indefinitely, so that the subsidized joint and survivor annuity is not an available form of payment. Accordingly, for purposes of determining the total amount deferred for 2010, the amount is treated as payable as a single life annuity commencing January 1, 2020.

Example 3. Employee F is entitled to a series of three payments of \$1,000 due on January 1, 2020, January 1, 2021, and January 1, 2022. Under the plan's terms, Employer X has the discretion to accelerate one or more of the payments, provided that no payment may be made before January 1, 2020. Because there is no reduction in the amount payable if a payment is accelerated, an accelerated payment is more valuable than a payment made in accordance with the three-year schedule of payments. If Employee F does not have a legally binding right to a single sum payment on January 1, 2020 (or any other form of accelerated payment), then an accelerated payment is not an available time and form of payment and, for purposes of determining the total amount deferred for 2010, the amount is treated as payable as a series of three payments of \$1,000 on January 1, 2020, January 1, 2021, and January 1, 2022.

Example 4. The facts are the same as in Example 3, except that Employer X has no discretion to accelerate one or more of the payments. Rather, Employee F has the right to accelerate one or more of the payments provided that a payment may not be paid at any date before the later of January 1, 2020 or the date 12 months after the date of such election. As of December 31, 2010, the earliest date upon which Employee F may elect to have a payment made is January 1, 2020. Because there is no reduction in the amount payable if a payment is accelerated, the earliest possible date of payment is the most valuable time and form of payment. Accordingly, for purposes of

determining the total amount deferred for 2010, the amount is treated as payable as a single sum payment of \$3,000 on January 1, 2020.

Example 5. Employee G is entitled to a single sum payment upon separation from service if Employee G separates from service before January 1, 2020 and a single life annuity if Employee G separates from service after December 31, 2019. As of December 31, 2010, Employee G has not separated from service. Under paragraph (b)(2)(vi)(A) of this section, the total amount deferred is determined based upon the amount that would be payable if Employee G separated from service on December 31, 2010. Accordingly, the single life annuity is not treated as an available time and form of payment, so that the amount is treated as payable as a single sum payment upon separation from service.

Example 6. Employee H is entitled to a single sum payment of deferred compensation upon the earlier of January 1, 2020 or an unforeseeable emergency. Because the payment upon an unforeseeable emergency is disregarded, for purposes of determining the total amount deferred, the deferred amount is treated as payable only on January 1, 2020.

Example 7. Employee I is entitled to a single sum payment of deferred compensation upon the earlier of January 1, 2020 or Employee I's involuntary separation from service. Under the facts and circumstances existing at the time the right to the payment was granted, if the deferred amount had been payable only upon Employee I's involuntary separation from service, the amount would have been subject to a substantial risk of forfeiture. Under paragraph (b)(2)(iv)(B) of this section, the right to a payment upon the Employee I's involuntary separation from service is disregarded, and the amount is treated as payable only on January 1, 2020.

Example 8. Employee J is entitled to a single sum payment of deferred compensation upon the earlier of January 1, 2020 or Employee J's separation from service. As of December 31, 2010, Employee J has not separated from service. Under paragraph (b)(2)(vi)(A) of this section, the total amount deferred is determined based upon the amount that would be payable if Employee J separated from service on December 31, 2010 and therefore had the right to receive the payment on December 31, 2010. The total amount deferred for 2010 is the greater of the amount that would be payable on December 31, 2010 or the present value of the amount that would be payable on January 1, 2020.

Example 9. Employee K is entitled to a single sum payment of deferred compensation upon the earlier of January 1, 2020 or the first day of the third month following Employee K's separation from service. As of December 31, 2010, Employee K has not separated from service. Under paragraph (b)(2)(vi)(A) of this section, the total amount deferred is determined based upon the amount that would be payable if Employee K separated from service on December 31, 2010, and therefore had a right to a payment on March 1, 2011. The total amount deferred for 2010 is the greater of the present value as of December 31, 2010 of the amount that would be payable on March

1, 2011 or the present value as of December 31, 2010 of the amount that would be payable on January 1, 2020.

Example 10. Employee L is entitled to a single sum payment of deferred compensation upon the earlier of January 1, 2020 or a separation from service that occurs on or before July 1, 2010. As of December 31, 2010, Employee L has not separated from service. For purposes of determining the total amount deferred, the right to be paid upon a separation from service on or before July 1, 2010 is ignored because it is no longer a possible payment trigger, and the amount is treated as payable only on January 1, 2020.

Example 11. Employee M is entitled to a single sum payment of deferred compensation upon the earliest of the date Employee M dies, Employee M attains age 65, or a child of Employee M becomes a full-time student at an accredited college or university (whether or not Employee M continues to be employed on such date). As of December 31, 2010, Employee M has a 10-year old child who is in the fifth grade. For purposes of determining the total amount deferred, the earliest time that the payment reasonably could be due upon Employee M's child entering a college or university is August 1, 2018. Thus, the total amount deferred for 2010 is the more valuable of the amount that would be payable on the Employee M's 65<sup>th</sup> birthday and the amount that would be payable on August 1, 2018. Because any additional value that would be payable upon Employee M's death is a death benefit excluded from the definition of deferred compensation under section 409A(d)(1)(B) and §1.409A-1(a)(5), that additional value, if any, is not required to be calculated.

(3) Account balance plans--(i) In general. For purposes of this section, if benefits are provided under a nonqualified deferred compensation plan that is described in §1.409A-1(c)(2)(i)(A) or (B) (an account balance plan), the present value of the amount payable equals the amount credited to the service provider's account as of the last day of the taxable year, including both the principal amount credited to the account, and any earnings or losses attributable to the principal amounts credited to the account through the last day of the taxable year. For purposes of this section, earnings or losses means any increase or decrease in the amount credited to a service provider's account that is attributable to amounts previously credited to the service provider's account, regardless of whether the plan denominates that increase or decrease as earnings or losses. For rules related to the crediting of earnings, see paragraph (b)(2)(iii) of this section. For

rules relating to earnings based on an unreasonable interest rate or a rate of return based on an investment other than a single predetermined actual investment or a single reasonable interest rate, see paragraph (b)(3)(ii) of this section.

(ii) Unreasonable rate of return--(A) Application. This paragraph (b)(3)(ii) applies to an account balance plan under which the amount of earnings or losses credited is not based on either a predetermined actual investment, within the meaning of §31.3121(v)(2)-1(d)(2)(i)(B) of this chapter, or a rate of interest that is not higher than a reasonable rate of interest, within the meaning of §31.3121(v)(2)-1(d)(2)(i)(C) of this chapter, as determined by the Commissioner.

(B) Unreasonably high interest rate. If the earnings or losses to be credited under a plan are based on an unreasonably high rate of interest, the amount deferred under the plan is equal to the present value as of the end of the taxable year (using a reasonable interest rate) of the amount that will be credited to the service recipient's account using the unreasonably high rate for the entire period for which the unreasonably high interest will be credited under the plan, beginning with the last day of such taxable year and ending with the date the unreasonably high interest will no longer be credited (determined in accordance with the payment timing assumptions set forth in paragraph (b)(2)(vi) and (vii) of this section). If the service recipient fails to use a reasonable interest rate to determine the amount includible in income, AFR will be used. For purposes of this section, AFR means the appropriate applicable Federal rate (as defined pursuant to section 1274(d)) based on annual compounding, for the last month of the taxable year for which the amount includible in income is being determined. The period described in the first sentence of this paragraph (b)(3)(ii)(B) is used to determine

the appropriate AFR (short-term, mid-term, or long-term). For purposes of this paragraph (b)(3)(ii)(B), an unreasonably high interest rate includes a fixed interest rate that exceeds an interest rate that is reasonable, within the meaning of §31.3121(v)(2)-1(d)(2)(i)(C) of this chapter.

(C) Other rates of return. If the amount of earnings or losses credited is based on a rate of return that is not an unreasonably high interest rate, within the meaning of paragraph (b)(3)(ii)(B) of this section, but is also not a predetermined actual investment, within the meaning of §31.3121(v)(2)-1(d)(2)(i)(B) of this chapter or a rate of interest that is no more than a reasonable rate of interest, within the meaning of §31.3121(v)(2)-1(d)(2)(i)(C) of this chapter , the amount payable is a formula amount.

(4) Reimbursement and in-kind benefit arrangements. For purposes of this section, if benefits for a service provider are provided under a nonqualified deferred compensation plan described in §1.409A-1(c)(2)(i)(E) (a reimbursement arrangement), or under a nonqualified deferred compensation plan that would be described in §1.409A-1(c)(2)(i)(E) except that the amounts, separately or in the aggregate, constitute a substantial portion of either the overall compensation earned by the service provider for performing services for the service recipient or the overall compensation received due to a separation from service, the arrangement is treated as providing for a formula amount to the extent that the expenses to be reimbursed are not explicitly identified to be a specific amount. Notwithstanding the foregoing, if the expenses eligible for reimbursement are limited, it is presumed that the limit reflects the reasonable amount of eligible expenses that the service provider will incur at the earliest possible date during the time period to which the limit applies, and for which the service provider will

request reimbursement at the earliest possible date that the service provider may request reimbursement. This presumption may be rebutted only by demonstrating by clear and convincing evidence that it is unreasonable to assume that a service provider would incur such amount of expenses during the applicable time period. This presumption is not applicable to any reimbursement arrangement to which §1.409A-3(i)(1)(iv)(B) applies (certain medical reimbursement arrangements). In addition, this paragraph (b)(4) also applies to an arrangement providing a service provider a right to in-kind benefits from the service recipient, or a payment by the service recipient directly to the person providing the goods or services to the service provider.

(5) Split-dollar life insurance arrangements. For purposes of this section, if benefits for a service provider are provided under a nonqualified deferred compensation plan described in §1.409A-1(c)(2)(i)(F) (a split-dollar life insurance arrangement), the amount of the future payment to which the service provider is entitled is treated as the amount that would be includible in income under §1.61-22 or §1.7872-15 (as applicable) or, if those regulations are not applicable, the amount that would be includible in income under any other applicable guidance. For this purpose, the payment timing assumptions set forth in paragraph (b)(2)(vi) and (vii) of this section generally apply. However, in the case of an arrangement subject to §1.7872-15, to the extent the assumptions set forth in paragraph (b)(2)(vi) and (vii) of this section conflict with the provisions of §1.7872-15, the provisions of §1.7872-15 apply, and the conflicting assumptions set forth in paragraph (b)(2)(vi) and (vii) of this section do not apply. In either case, for purposes of determining the total amount deferred under the plan for the taxable year, the benefits under the split-dollar life insurance arrangement are included

only to the extent that the right to such benefits constitutes a right to deferred compensation under §1.409A-1(b).

(6) Stock rights. If a stock right has not been exercised during the service recipient's taxable year, and remains outstanding as of the last day of the service provider's taxable year for which the total amount deferred is being calculated, the total amount deferred under the stock right for such taxable year is the excess of the fair market value of the underlying stock on the last day of the service provider's taxable year (determined in accordance with §1.409A-1(b)(5)(iv)) over the sum of the stock right's exercise price plus any amount paid for the stock right. If a stock right has been exercised during the service provider's taxable year, the payment amount for purposes of calculating the total amount deferred for the taxable year under the stock right is the excess of the fair market value of the underlying stock (as determined in accordance with §1.409A-1(b)(5)(iv)) on the date of exercise over the sum of the exercise price of the stock right and any amount paid for the stock right.

(7) Anti-abuse provision. The Commissioner may disregard all or part of the rules of paragraphs (b)(2) through (b)(6) of this section or all or part of the plan's terms if the Commissioner determines based on all of the facts and circumstances that the plan terms have been established to eliminate or minimize the total amount deferred under the plan determined in accordance with the rules of paragraphs (b)(2) through (b)(6) of this section and if the rules of paragraphs (b)(2) through (b)(6) of this section were applied or such plan terms were given effect, the total amount deferred would not reasonably reflect the present value of the right. For example, if a plan provides that a deferred amount is payable upon a separation from service but also contains a

provision that the amount will be forfeited upon a separation from service occurring on the last day of the service provider's taxable year (so that the application of paragraph (b)(2)(vii)(A) of this section treating the service provider as separating from service on the last day of the taxable year for purposes of determining the timing of the payment in calculating the total amount deferred would result in a zero amount deferred), the latter provision will be disregarded.

(c) Additional 20 percent tax under section 409A(a)(1)(B)(i)(II). With respect to an amount required to be included in income under section 409A(a) for a taxable year, the amount is subject to an additional income tax equal to 20 percent of the amount required to be included in income under section 409A(a).

(d) Premium interest tax under section 409A(a)(1)(B)(i)(I)--(1) In general. With respect to an amount required to be included in income under section 409A(a) for a taxable year, the amount is subject to an additional income tax equal to the amount of interest at the underpayment rate plus one percentage point on the underpayments that would have occurred had the deferred compensation been includible in the service provider's gross income for the taxable year in which first deferred or, if later, the first taxable year in which such deferred compensation is not subject to a substantial risk of forfeiture. The amount required to be allocated to determine the additional tax described in this paragraph (d) is the amount required to be included in income under section 409A(a) for the taxable year, regardless of whether additional amounts were deferred under the plan in previous years.

(2) Identification of taxable year deferred amount was first deferred or vested--(i) Method of identification. The following method is applied for purposes of determining the

taxable year or years in which an amount required to be included in income under section 409A(a) was first deferred and not subject to a substantial risk of forfeiture.

(A) For each taxable year preceding the taxable year for which the deferred amount is includible in income (the current taxable year) in which the service provider had an amount deferred under the plan that was not subject to a substantial risk of forfeiture (vested), ending with the later of the first taxable year in which the service provider had no vested amount deferred or the first taxable year beginning after December 31, 2004, calculate the vested total amount deferred for such year. For each year, include any deferred amount that was previously included in income under paragraph (a)(3) of this section but has not been paid, but exclude any amount paid to (or on behalf of) the service provider during such taxable year.

(B) Identify any payments made under the plan to (or on behalf of) the service provider for each taxable year identified in paragraph (d)(2)(i)(A) of this section.

(C) Identify any deemed net investment losses or other net decreases in the amount deferred (other than as a result of a payment) applicable to amounts that are vested for the current taxable year and each preceding taxable year identified in paragraph (d)(2)(i)(A) of this section.

(D) Starting with the first taxable year during which there was a payment identified under paragraph (d)(2)(i)(B) of this section or a loss identified under paragraph (d)(2)(i)(C) of this section (or both), subtract the total payments and loss for such taxable year from the amount determined under paragraph (d)(2)(i)(A) of this section for the earliest taxable year before such year in which there is such an amount, and from the amount determined under paragraph (d)(2)(i)(A) of this section for each

subsequent taxable year ending before the taxable year in which the payment was made or the loss incurred. Do not reduce any taxable year-end balance below zero.

(E) Repeat this process for each subsequent taxable year during which there was a payment identified under paragraph (d)(2)(i)(B) of this section or a loss identified under paragraph (d)(2)(i)(C) of this section (or both).

(F) For each taxable year identified in paragraph (d)(2)(i)(A) of this section, determine the excess (if any) of the remaining amount deferred for the taxable year over the remaining amount deferred for the previous taxable year. Treat the amount deferred in taxable years beginning before January 1, 2005 as zero.

(G) Determine how much of the total amount deferred for the current taxable year was previously included in income in accordance with paragraph (a)(3) of this section.

(H) Subtract the amount determined in paragraph (d)(2)(i)(G) of this section from the excess amount determined in paragraph (d)(2)(i)(F) of this section for the earliest taxable year in which there is any such excess amount, but do not reduce the balance below zero. If the amount determined in paragraph (d)(2)(i)(G) of this section exceeds the amount determined in paragraph (d)(2)(i)(F) of this section for that earliest taxable year, subtract the excess from the amount determined in paragraph (d)(2)(i)(F) of this section for the next succeeding taxable year, but do not reduce the balance below zero. Repeat this process until the excess has been reduced to zero. The balance remaining with respect to each taxable year identified in paragraph (d)(2)(i)(A) of this section is the portion of the amount includible in income under section 409A(a) in the current taxable year that was first deferred and vested in that taxable year.

(ii) Examples. The following examples illustrate the provisions of paragraph (d)(2) of this section. In all of the following examples, the service provider is an individual taxpayer with a calendar year taxable year who elects to defer a portion of the bonus that would otherwise be payable to the service provider in each of Year 1 through Year 4. All amounts deferred are deferred under the same plan, and no amount deferred under the plan is ever subject to a substantial risk of forfeiture. The plan does not fail to meet the requirements of section 409A(a) in any year prior to Year 4, and no amounts deferred under the plan are otherwise includible in income until Year 4, except for payments actually made to the service provider. The service provider had no amount deferred under the plan prior to Year 1. The plan fails to meet the requirements of section 409A(a) in Year 4. The examples read as follows:

Example 1.

|                      | Year 1 | Year 2 | Year 3 | Year 4 |
|----------------------|--------|--------|--------|--------|
| Opening Total Amount | 0      | 110    | 275    | 495    |
| Bonus Deferral       | 100    | 150    | 200    | 250    |
| Net Gains (Losses)   | 10     | 15     | 20     | 25     |
| Payments             | 0      | 0      | 0      | 0      |
| Closing Total Amount | 110    | 275    | 495    | 770    |

(i) The amount required to be included in income under section 409A is 770. To calculate the premium interest tax, the 770 must be allocated to the year or years in which the amount was first deferred and vested.

(ii) Step A. Identification of vested total amount deferred excluding payments and including deferred amounts previously included in income.

| Year 1 | Year 2 | Year 3 |
|--------|--------|--------|
| 110    | 275    | 495    |

(iii) Step B. Identification of any payments for each year other than Year 4.

| Year 1 | Year 2 | Year 3 |
|--------|--------|--------|
| 0      | 0      | 0      |

(iv) Step C. Identification of any other decreases attributable to vested amounts.

| Year 1 | Year 2 | Year 3 | Year 4 |
|--------|--------|--------|--------|
| 0      | 0      | 0      | 0      |

(v) Steps D and E. Subtraction of payments and decreases from amounts deferred.

| Year 1    | Year 2    | Year 3    |
|-----------|-----------|-----------|
| 110       | 275       | 495       |
| <u>-0</u> | <u>-0</u> | <u>-0</u> |
| 110       | 275       | 495       |

(vi) Step F. Subtraction of previous year total from each year's total.

| Year 1    | Year 2      | Year 3      |
|-----------|-------------|-------------|
| 110       | 275         | 495         |
| <u>-0</u> | <u>-110</u> | <u>-275</u> |
| 110       | 165         | 220         |

(vii) Because no amount was previously included in income, Step G does not apply. Accordingly, the 770 is allocated such that 110 is treated as first deferred and vested in Year 1, 165 in Year 2, 220 in Year 3. The remainder (275) is treated as first deferred in Year 4, but is not required to be allocated for purposes of the premium interest tax because there is no hypothetical underpayment for such year.

Example 2.

|                      | Year 1 | Year 2 | Year 3 | Year 4 |
|----------------------|--------|--------|--------|--------|
| Opening Total Amount | 0      | 110    | 235    | 365    |
| Bonus Deferral       | 100    | 150    | 200    | 250    |
| Net Gains (Losses)   | 10     | (25)   | (30)   | 25     |
| Payments             | 0      | 0      | (40)   | (50)   |

|                      |     |     |     |     |
|----------------------|-----|-----|-----|-----|
| Closing Total Amount | 110 | 235 | 365 | 590 |
|----------------------|-----|-----|-----|-----|

(i) The amount that is includible in income under section 409A(a) for Year 4 is the closing total amount (590), plus the amounts paid during Year 4 that were includible in income (50) or 640. To calculate the premium interest tax, the 640 must be allocated to the year or years in which the amount was first deferred and vested.

(ii) Step A. Identification of vested total amount deferred excluding payments and including deferred amounts previously included in income.

| Year 1 | Year 2 | Year 3 |
|--------|--------|--------|
| 110    | 235    | 365    |

(iii) Step B. Identification of any payments for each year other than Year 4

| Year 1 | Year 2 | Year 3 |
|--------|--------|--------|
| 0      | 0      | (40)   |

(iv) Step C. Identification of any other decreases attributable to vested amounts

| Year 1 | Year 2 | Year 3 | Year 4 |
|--------|--------|--------|--------|
| 0      | (25)   | (30)   | 0      |

(v) Steps D and E. Subtraction of payments and decreases from amounts deferred

| Year 1             | Year 2            | Year 3            |
|--------------------|-------------------|-------------------|
| 110                | 235               | 365               |
| -25(Year 2)        | -40(Year 3)       |                   |
| -40(Year 3)        | -30(Year 3)       |                   |
| <u>-30(Year 3)</u> | <u>          </u> | <u>          </u> |
| 15                 | 165               | 365               |

(vi) Step F. Subtraction of previous year total from each year's total.

| Year 1    | Year 2     | Year 3      |
|-----------|------------|-------------|
| 15        | 165        | 365         |
| <u>-0</u> | <u>-15</u> | <u>-165</u> |
| 15        | 150        | 200         |

(vii) Because no amount was previously included in income, Step G does not apply. Accordingly, the 640 is allocated such that 15 is treated as first deferred and vested in Year 1, 150 in Year 2, and 200 in Year 3. The remaining amount includible in income under section 409A for Year 4 (275) is treated as first deferred in Year 4, but is not required to be allocated for purposes of the premium interest tax because there is no hypothetical underpayment for Year 4.

Example 3. (i) The facts are the same as in Example 2 except 125 was previously included in income under paragraph (a)(3) of this section. Accordingly, of the 590 closing total amount for Year 4 plus the 50 payment during Year 4, or 640, only 515 (640 – 125) must be included in income under section 409A(a). To calculate the premium interest tax, the 125 must be allocated to the year or years in which such amount was first deferred.

(ii) Step G. Allocation of amounts previously included in income.

| Year 1     | Year 2      | Year 3    |
|------------|-------------|-----------|
| 15         | 150         | 200       |
| <u>-15</u> | <u>-110</u> | <u>-0</u> |
| 0          | 40          | 200       |

(iii) Accordingly, for purposes of calculating the premium interest tax, the 125 previously included in income is allocated so that of the 515 includible in income under section 409A(a), 0 is treated as first deferred and vested in Year 1, 40 in Year 2, and 200 in Year 3.

(3) Calculation of hypothetical underpayment for the taxable year during which a deferred amount was first deferred and vested--(i) Calculation method. The hypothetical underpayment for a taxable year is determined by treating as an additional cash payment of compensation to the service provider for such taxable year, the amount determined pursuant to paragraph (d)(2) of this section to be the portion of the amount includible in income under section 409A(a) that was first deferred and vested during such taxable year. The hypothetical underpayment is calculated based on the service provider's taxable income, credits, filing status, and other tax information for the year, based on the service provider's original return filed for such year, as adjusted by any examination for such year or any amended return the service provider filed for such

year that was accepted by the Commissioner. The hypothetical underpayment must reflect the effect that such additional compensation would have had on the service provider's Federal income tax liability for such year, including the continued availability of any deductions taken, and the use of any carryovers such as carryover losses. For purposes of calculating a hypothetical underpayment in a subsequent year (whether or not a portion of the amount includible in income under section 409A(a) was first deferred and vested in the subsequent year), any changes to the service provider's Federal income tax liability for the subsequent year that would have occurred if the portion of the amount that was first deferred and vested during the previous taxable year had been included in the service provider's income for the previous year must be taken into account. Assumptions not based on the service provider's taxable income, credits, filing status, and other tax information for the year, based on the service provider's original return for such year, as adjusted by any examination for such year or any amended return the service provider filed for such year that was accepted by the Commissioner, may not be applied. For example, the service provider may not assume that some of the additional compensation would have been deferred under the terms of a qualified plan. If the service provider's Federal income tax liability for the taxable year in which an amount required to be included in income under section 409A(a) was first deferred and vested is adjusted (for example, by an amended return or IRS examination), and the adjustment affects the amount of the hypothetical underpayment, the service provider must recalculate the hypothetical underpayment and adjust the amount of premium interest tax due with respect to such inclusion in income under section 409A(a), as appropriate.

(ii) Examples. The following examples illustrate the provisions of paragraph (d)(3)(i) of this section. In all of the following examples, Employee N is an individual taxpayer with a calendar year taxable year. For the year 2020, Employee N has a total amount deferred of \$100,000 which is includible in income under section 409A(a). For purposes of determining the premium interest tax, assume that \$30,000 was first deferred and vested in 2018, \$35,000 was first deferred and vested in 2019, and \$35,000 was first deferred and vested in 2020. The first year that Employee N had a vested deferred amount under the plan was 2018. The examples read as follows:

Example 1. For the taxable years 2018 and 2019, Employee N has no carryover losses or other items a change in which could affect the adjusted gross income for a subsequent taxable year. Employee N determines the hypothetical underpayment for 2018 by assuming an additional cash compensation payment of \$30,000 for 2018, and determining the hypothetical underpayment of Federal income tax that would result. Employee N determines the hypothetical underpayment for 2019 by assuming an additional cash compensation payment of \$35,000 in 2019, and determining the hypothetical underpayment of Federal income tax for 2019 that would result. There is no hypothetical underpayment with respect to hypothetical income in 2020 because the tax payment would not have been due until 2021. Therefore, Employee N is not required to determine a hypothetical underpayment for 2020.

Example 2. The facts are the same as in Example 1, except that in 2018, Employee N had an excess charitable contribution the deduction of which was not permitted under section 170(b), and which was carried over to subsequent taxable years under section 170(d). For purposes of determining the hypothetical underpayment for 2018, Employee N uses the charitable contribution deduction that otherwise would have been available if the \$30,000 compensation payment had actually been made. Employee N must then calculate the hypothetical underpayment for all subsequent years in a manner that eliminates the portion of any carryovers of excess contributions under section 170(d) related to the charitable contribution in 2018 that would not have been available in such subsequent years as a result of having been deducted in 2018.

Example 3. The facts are the same as in Example 2, except that in 2021 the IRS examines Employee N's 2018 return and determines that Employee N had \$20,000 in unreported income for that year. In addition to paying the tax deficiency owed for 2018, Employee N must redetermine the hypothetical underpayment for 2018 and recalculate the premium interest tax owed for 2020.

(4) Calculation of hypothetical premium underpayment interest--(i) Calculation method. The amount of hypothetical premium underpayment interest is determined for any taxable year by applying the applicable rate of interest under section 6621 plus one percentage point to determine the underpayment interest under section 6601 that would be due for such underpayment as of the last day of the taxable year for which the amount deferred is includible in income under section 409A(a). The amount of additional income tax under paragraph (d)(2) of this section with respect to an amount required to be included in income under section 409A(a) is the sum of all of the hypothetical premium underpayment interest for all years in which there was determined a hypothetical underpayment.

(ii) Examples. The following examples illustrate the provisions of this paragraph (d)(4). In each of these examples, the service provider is an individual taxpayer with a calendar year taxable year. At all times the total amount deferred under the nonqualified deferred compensation plan is not subject to a substantial risk of forfeiture.

The examples read as follows:

Example 1. Employee O has a total amount deferred under a nonqualified deferred compensation plan for 2010 of \$100,000. The entire deferred amount was first deferred in 2006. For purposes of calculating the hypothetical premium underpayment interest tax, Employee O first must determine the hypothetical underpayment for taxable years 2006 through 2009 under the rules of paragraph (d)(3) of this section. Then Employee O must determine the underpayment interest under section 6601 that would have accrued, calculated using the applicable underpayment interest rate under section 6621 increased by one percentage point, applied through December 31, 2010. That amount is the premium interest tax that is due for 2010.

Example 2. Employee P has a total amount deferred under a nonqualified deferred compensation plan for 2010 of \$100,000. \$60,000 of that deferred amount was first deferred in 2006. \$30,000 of that amount was first deferred in 2008. \$10,000 of that amount was first deferred in 2010. For purposes of calculating the hypothetical premium underpayment interest tax, Employee P first must determine the hypothetical underpayment for taxable years 2006 through 2009 under the rules of paragraph (d)(3)

of this section applying \$60,000 of hypothetical additional compensation for 2006, and applying \$30,000 of hypothetical additional compensation for 2008. The \$10,000 of hypothetical additional compensation in 2010 would not result in a hypothetical underpayment because the Federal income tax applicable to that hypothetical additional compensation would not yet be due. Second, Employee P must determine the underpayment interest under section 6601 that would have accrued, calculated using the applicable underpayment interest rate under section 6621 increased by one percentage point, applied through December 31, 2010, for both the hypothetical underpayment occurring in 2006 and the hypothetical underpayment occurring in 2008. The sum of those two amounts is the premium interest tax that is due for 2010.

(e) Amounts includible in income under section 409A(b) [Reserved].

(f) Application of amounts included in income under section 409A to payments of amounts deferred--(1) In general. Section 409A(c) provides that any amount included in gross income under section 409A is not required to be included in gross income under any other provision of this chapter or any other rule of law later than the time provided in this section. An amount included in income under section 409A that has neither been paid in the taxable year the amount was included in income under section 409A nor served as the basis for a deduction under paragraph (g) of this section is allocated to the first payment of an amount deferred under the plan in any year subsequent to the year the amount was included in income under section 409A. To the extent the amount included in income under section 409A exceeds such payment, the excess is allocated to the next payment of an amount deferred under the plan. This process is repeated until the entire amount included in income under section 409A has been paid or the service provider has become entitled to a deduction under paragraph (g) of this section.

(2) Application of the plan aggregation rules. The plan aggregation rules of §1.409A-1(c)(2) apply to the allocation of amounts previously included in income under section 409A to payments made under the plan. Accordingly, references to an amount deferred under a plan, or a payment of an amount deferred under a plan, refer to an

amount deferred or a payment made under all arrangements in which a service provider participates that together are treated as a single plan under §1.409A-1(c)(2).

(3) Examples. The following examples illustrate the provisions of this section. In each of these examples, the service provider is an individual taxpayer with a calendar year taxable year. Each service provider has a total amount deferred under a nonqualified deferred compensation plan of \$0 for 2010, a total amount deferred under the plan of \$100,000 for 2011, a total amount deferred under the plan of \$250,000 for 2012, and a total amount deferred under the plan of \$400,000 for 2013. At all times the total amount deferred under the plan is not subject to a substantial risk of forfeiture. During 2011, the plan fails to comply with section 409A(a) and each service provider includes \$100,000 in income under section 409A. Except as otherwise provided in the following examples, the service provider does not receive any payments of amounts deferred under the plan. The examples read as follows:

Example 1. During 2012, Employee Q receives a \$10,000 payment under the plan. During 2013, Employee Q receives a \$150,000 payment under the plan. For 2012, \$10,000 of the \$100,000 included in income under section 409A(a) is allocated under paragraph (f)(1) of this section to the \$10,000 payment, so that no amount is includible in gross income as a result of such payment and Employee Q retains \$90,000 of amounts previously included in income under the plan to allocate to future plan payments. For 2013, the remaining \$90,000 included in income under section 409A(a) is allocated to the \$150,000 payment, so that only \$60,000 is includible in income as a result of such payment.

Example 2. During 2012, Employee R receives a \$10,000 payment under the plan. During 2014, Employee R receives a \$50,000 payment, equaling the entire amount deferred under the plan. For 2012, \$10,000 of the \$100,000 previously included in income is allocated pursuant to paragraph (f)(1) of this section to the \$10,000 payment, so that no amount is includible in gross income as a result of such payment. For 2014, \$50,000 of the \$90,000 remaining amount previously included in income is allocated pursuant to paragraph (f)(1) of this section to the \$50,000 payment, so that no amount is includible in gross income as a result of such payment. Provided that the requirements of paragraph (g) of this section are otherwise met, Employee R is entitled to a deduction for 2014 equal to the remaining amount (\$40,000) that was

previously included in income under section 409A(a) that has not been allocated to a payment under the plan.

(g) Forfeiture or other permanent loss of right to deferred compensation--(1)

Availability of deduction to the service provider. If a service provider has included a deferred amount in income under section 409A, but has not actually received payment of such deferred amount or otherwise allocated the amount included in income under paragraph (f) of this section, the service provider is entitled to a deduction for the taxable year in which the right to that amount of deferred compensation is permanently forfeited under the plan's terms or the right to the payment of the amount is otherwise permanently lost. The deduction to which the service provider is entitled equals the deferred amount included in income under section 409A in a previous year, less any portion of such deferred amount previously included in income under section 409A that was allocated under paragraph (f) of this section to amounts paid under the plan, including any deferred amount paid in the year the right to any remaining deferred compensation is permanently forfeited or otherwise lost. For this purpose, a mere diminution in the deferred amount under the plan due to deemed investment loss, actuarial reduction, or other decrease in the amount deferred is not treated as a permanent forfeiture or loss of the right if the service provider retains the right to an amount deferred under the plan (whether or not such right is subject to a substantial risk of forfeiture as defined in §1.409A-1(d)). In addition, a deferred amount is not treated as permanently forfeited or otherwise lost if the obligation to make the payment of such deferred amount is substituted for another deferred amount or obligation to make a payment in a future year. However, a deferred amount is treated as permanently lost if the service provider's right to receive the payment of the deferred amount becomes

wholly worthless during the taxable year. Whether the right to the payment of a deferred amount has become wholly worthless is determined based on all the facts and circumstances existing as of the last day of the relevant service provider taxable year.

(2) Application of the plan aggregation rules. For purposes of determining whether the right to a deferred amount is permanently forfeited or otherwise lost, the plan aggregation rules of §1.409A-1(c) apply. Accordingly, if the right to an identified deferred amount under a plan is permanently forfeited or otherwise lost, but an additional amount remains deferred under the plan, the service provider is not entitled to a deduction.

(3) Examples. The following examples illustrate the provisions of this paragraph (g). In each example, the service provider is an individual taxpayer who has a calendar year taxable year and the service recipient does not experience bankruptcy at any time or otherwise discharge any obligation to make a payment of a deferred amount, except as expressly provided in the example. The examples read as follows:

Example 1. For 2010, Employee S has a total amount deferred under an elective account balance plan of \$1,000,000. The plan fails to meet the requirements of section 409A(a) during 2010 and Employee S includes \$1,000,000 in income under section 409A(a) for the year 2010. In 2011, Employee S experiences investment losses but no payments before July 1, 2011, such that Employee S's account balance under the plan is \$500,000. On July 1, 2011, Employee S separates from service and receives a \$500,000 payment equal to the entire amount deferred under the plan, and retains no other right to deferred compensation under the plan (including all arrangements aggregated with the arrangement under which the payment was made). For 2011, Employee S is entitled to deduct \$500,000 (which is the amount Employee S previously included in income under section 409A(a) (\$1,000,000) less the amount actually received by Employee S (\$500,000)).

Example 2. For 2010, Employee T has a total amount deferred under an elective account balance plan of \$1,000,000. The plan fails to meet the requirements of section 409A(a) for 2010 and Employee T includes \$1,000,000 in income under section 409A(a) for 2010. For 2011, Employee T has a total amount deferred under the plan of \$500,000, due solely to the deemed investment losses attributable to Employee T's

account balance (with no payments being made during 2011). Because Employee T retains the right to an amount deferred under the plan, Employee T is not entitled to a deduction for 2011 as a result of the deemed investment losses.

Example 3. For 2010, Employee U has a total amount deferred under an elective account balance plan of \$1,000,000. The elective account balance plan consists of one arrangement providing for salary deferrals with an amount deferred for 2010 of \$600,000, and another arrangement providing for bonus deferrals with an amount deferred for 2010 of \$400,000. The plan fails to meet the requirements of section 409A(a) during 2010 and Employee U includes \$1,000,000 in income under section 409A(a) for 2010. On July 1, 2011, Employee U's account balance attributable to the salary deferral arrangement is \$500,000, the reduction of which is due solely to deemed investment losses in 2011 and not any payments. On July 1, 2011, Employee U is paid the \$500,000 equaling the entire account balance attributable to the salary deferral arrangement. On December 31, 2011, Employee U has an account balance attributable

to the bonus deferral arrangement equal to \$300,000. Because Employee U retains an amount deferred under the elective account balance plan, Employee U is not entitled to a deduction for 2011 as a result of the deemed investment losses.

(h) Effective/applicability date. The rules of this section apply to taxable years ending on or after the date of publication of the Treasury decision adopting these rules as final regulation in the **Federal Register**.

Linda E. Stiff,  
Deputy Commissioner for Services and Enforcement.

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