

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 2005-67, page 771.

Low-income housing credit; satisfactory bond; “bond factor” amounts for the period January through December 2005. This ruling provides the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period January through December 2005.

T.D. 9226, page 772.

Final regulations under section 864 of the Code relate to the application of the asset-use test to stock held by foreign insurance companies. The regulations provide that income from stock may, in some circumstances, be effectively connected income.

REG-158080-04, page 786.

Proposed regulations under new section 409A of the Code, added as part of the American Jobs Creation Act of 2004, provide certain rules relating to nonqualified deferred compensation plans, which generally are effective as of January 1, 2005. These regulations provide general guidance with respect to what arrangements are covered by section 409A, and the requirements that must be met under section 409A with respect to initial deferral elections, subsequent deferral elections and payments. A public hearing is scheduled for January 25, 2006.

ADMINISTRATIVE

REG-150088-02, page 774.

Proposed regulations under section 6320 of the Code relate to a taxpayer’s right to a hearing after the filing of a notice of federal tax lien (NFTL). The regulations make certain clarifying changes in the way collection due process hearings are con-

ducted and specify the period during which a taxpayer may request an equivalent hearing. The regulations affect taxpayers against whose property or rights to property the Service files an NFTL. A public hearing is scheduled for January 19, 2006.

REG-150091-02, page 780.

Proposed regulations under section 6330 of the Code relate to a taxpayer’s right to a hearing before or after levy. The regulations make certain clarifying changes in the way collection due process hearings are conducted and specify the period during which a taxpayer may request an equivalent hearing. The regulations affect taxpayers against whose property or rights to property the Service proposes to levy. A public hearing is scheduled for January 19, 2006.

Announcements of Disbarments and Suspensions begin on page 846.
Finding Lists begin on page ii.



The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by

applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are compiled semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations,

court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.

This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

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Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 42.—Low-Income Housing Credit

Low-income housing credit; satisfactory bond; “bond factor” amounts for the period January through December 2005. This ruling provides the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period January through December 2005.

Rev. Rul. 2005–67

In Rev. Rul. 90–60, 1990–2 C.B. 3, the Internal Revenue Service provided

guidance to taxpayers concerning the general methodology used by the Treasury Department in computing the bond factor amounts used in calculating the amount of bond considered satisfactory by the Secretary under § 42(j)(6) of the Internal Revenue Code. It further announced that the Secretary would publish in the Internal Revenue Bulletin a table of bond factor amounts for dispositions occurring during each calendar month.

Rev. Proc. 99–11, 1999–1 C.B. 275, established a collateral program as an alternative to providing a surety bond for taxpayers to avoid or defer recapture of the low-income housing tax credits under

§ 42(j)(6). Under this program, taxpayers may establish a Treasury Direct Account and pledge certain United States Treasury securities to the Internal Revenue Service as security.

This revenue ruling provides in Table 1 the bond factor amounts for calculating the amount of bond considered satisfactory under § 42(j)(6) or the amount of United States Treasury securities to pledge in a Treasury Direct Account under Rev. Proc. 99–11 for dispositions of qualified low-income buildings or interests therein during the period January through December 2005.

Table 1 Rev. Rul. 2005–67 Monthly Bond Factor Amounts for Dispositions Expressed As a Percentage of Total Credits											
	Calendar Year Building Placed in Service or, if Section 42(f)(1) Election Was Made, the Succeeding Calendar Year										
Month of Disposition	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Jan '05	14.99	27.92	39.03	48.55	56.77	56.71	56.86	57.15	57.52	58.00	58.83
Feb '05	14.99	27.92	39.03	48.55	56.77	56.59	56.74	57.04	57.41	57.89	58.72
Mar '05	14.99	27.92	39.03	48.55	56.77	56.47	56.63	56.93	57.30	57.79	58.61
Apr '05	15.85	29.52	41.27	51.33	60.03	60.18	60.95	61.89	62.92	64.10	65.66
May '05	15.85	29.52	41.27	51.33	60.03	60.05	60.83	61.77	62.80	63.98	65.54
Jun '05	15.85	29.52	41.27	51.33	60.03	59.93	60.71	61.65	62.69	63.87	65.42
Jul '05	15.85	29.52	41.27	51.33	60.03	59.81	60.59	61.54	62.57	63.76	65.32
Aug '05	15.85	29.52	41.27	51.33	60.03	59.70	60.48	61.42	62.46	63.65	65.21
Sep '05	15.85	29.52	41.27	51.33	60.03	59.58	60.36	61.31	62.36	63.55	65.11
Oct '05	16.68	31.06	43.42	54.01	63.16	63.18	64.65	66.33	68.14	70.14	72.58
Nov '05	16.68	31.06	43.42	54.01	63.16	63.06	64.54	66.21	68.02	70.02	72.47
Dec '05	16.68	31.06	43.42	54.01	63.16	62.94	64.42	66.10	67.91	69.92	72.36

Table 1 (cont'd)
Rev. Rul. 2005-67
Monthly Bond Factor Amounts for Dispositions Expressed
As a Percentage of Total Credits

Month of Disposition	Calendar Year Building Placed in Service or, if Section 42(f)(1) Election Was Made, the Succeeding Calendar Year									
	2002	2003	2004	2005						
Jan '05	59.92	61.22	62.49	62.68						
Feb '05	59.80	61.09	62.33	62.68						
Mar '05	59.69	60.97	62.19	62.68						
Apr '05	67.52	69.62	71.64	72.55						
May '05	67.40	69.48	71.49	72.55						
Jun '05	67.28	69.36	71.35	72.55						
Jul '05	67.17	69.24	71.23	72.55						
Aug '05	67.06	69.12	71.12	72.55						
Sep '05	66.96	69.02	71.02	72.55						
Oct '05	75.38	78.45	81.49	83.98						
Nov '05	75.27	78.34	81.38	83.98						
Dec '05	75.16	78.23	81.29	83.98						

For a list of bond factor amounts applicable to dispositions occurring during other calendar years, see: Rev. Rul. 98-3, 1998-1 C.B. 248; Rev. Rul. 2001-2, 2001-1 C.B. 255; Rev. Rul. 2001-53, 2001-2 C.B. 488; Rev. Rul. 2002-72, 2002-2 C.B. 759; Rev. Rul. 2003-117, 2003-2 C.B. 1051; and Rev. Rul. 2004-100, 2004-2 C.B. 718.

DRAFTING INFORMATION

The principal author of this revenue ruling is David McDonnell of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Mr. McDonnell at (202) 622-3040 (not a toll-free call).

Section 864.—Definitions and Special Rules

26 CFR 1.864-4: U.S. source income effectively connected with U.S. business.

T.D. 9226

**DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1**

Stock Held by Foreign Insurance Companies

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the determination of income of foreign insurance companies that is effectively connected with the conduct of a trade or business within the United States. The regulations provide that the exception to the asset-use test for stock shall not apply in determining whether the income, gain, or loss from portfolio stock held by foreign insurance companies constitutes effectively connected income.

DATES: *Effective Date:* These regulations are effective on October 3, 2005.

FOR FURTHER INFORMATION CONTACT: Sheila Ramaswamy, (202) 622-3870 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On June 25, 2004, a notice of proposed rulemaking (REG-117307-04, 2004-2 C.B. 39) was published in the **Federal Register** (69 FR 35543). No requests for a public hearing were received, and no public hearing was held. The IRS received one written comment in response to the notice of proposed rulemaking. After consideration of the comment, the proposed regulation is adopted without change.

Explanation of Provisions and Summary of Comments

This Treasury decision adopts the language of the proposed regulation without change.

The IRS received one comment in response to the proposed regulation. The commentator requested further clarification regarding what constitutes an insurance company for federal income tax purposes. The IRS believes the issue of what

constitutes an insurance company is outside the scope of this regulation, which solely relates to the application of the asset-use test to stock held by foreign insurance companies.

The commentator also expressed concern about the interaction of the proposed regulation with §1.864-5(a), which provides, generally, that foreign source income, such as a foreign-source dividend or gain, cannot constitute U.S. effectively connected income in circumstances in which a U.S.-source dividend or gain would not constitute U.S. effectively connected income. Accordingly, the commentator is concerned that the rule in the regulations will also expand the category of foreign-source dividends or gains that may constitute effectively connected income. That is true and the Treasury Department and the IRS believe this is the appropriate result.

The IRS invited comments whether the 10 percent threshold provided in the proposed regulation was an appropriate standard for determining whether stock is a portfolio investment. The commentator stated that it was possible for insurance companies to make a strategic investment in a corporation at a level below 10 percent of the vote or value of the corporation, such as by purchasing a special class of shares that conveyed the power to elect directors. The commentator recommended creating a rebuttable presumption of portfolio status.

We do not believe that treating the 10 percent threshold as a rebuttable presumption is appropriate. The 10 percent threshold provides a reasonable method for identifying portfolio stock held by a branch of a foreign life insurance company.

Special Analyses

It has been determined that this Treasury decision 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 these regulations do not impose a collection of information on small entities, the provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of this regulation is Sheila Ramaswamy, Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendment to the Regulations

Accordingly, 26 CFR part 1 is 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. In §1.864-4, paragraph (c)(2)(iii)(b) is revised to read as follows:

§1.864-4 U.S. source income effectively connected with U.S. business.

* * * * *

(c) * * *

(2) * * *

(iii) * * *

(b) Stock held by foreign insurance companies. This paragraph (c)(2)(iii) shall not apply to stock of a corporation (whether domestic or foreign) held by a foreign insurance company unless the foreign insurance company owns 10 percent or more of the total voting power or value of all classes of stock of such corporation. For purposes of this section, section 318(a) shall be applied in determining ownership, except that in applying section 318(a)(2)(C), the phrase “10 percent” is used instead of the phrase “50 percent.”

* * * * *

Mark E. Matthews,
*Deputy Commissioner for
Services and Enforcement.*

Approved August 9, 2005.

Eric Solomon,
*Acting Deputy Assistant Secretary
for Tax Policy.*

(Filed by the Office of the Federal Register on September 30, 2005, 8:45 a.m., and published in the issue of the Federal Register for October 3, 2005, 70 F.R. 57509)

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Miscellaneous Changes to Collection Due Process Procedures Relating to Notice and Opportunity for Hearing Upon Filing of Notice of Federal Tax Lien

REG-150088-02

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed amendments to the regulations relating to a taxpayer's right to a hearing under section 6320 of the Internal Revenue Code of 1986 after the filing of a notice of Federal tax lien (NFTL). The proposed regulations make certain clarifying changes in the way collection due process (CDP) hearings are held and specify the period during which a taxpayer may request an equivalent hearing. The proposed regulations affect taxpayers against whose property or rights to property the Internal Revenue Service (IRS) files a NFTL on or after January 19, 1999. This document also contains a notice of public hearing on these proposed regulations.

DATES: Written and electronic comments must be received by December 15, 2005. Outlines of topics to be discussed at the public hearing scheduled for 10 a.m. on January 19, 2006 must be received by December 29, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-150088-02), 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-150088-02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the

IRS Internet site at www.irs.gov/regs or via the Federal eRulemaking Portal at www.regulations.gov (indicate IRS and REG-150088-02). The public hearing will be held in the IRS Auditorium, Internal Revenue Building (7th Floor), 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, call Laurence K. Williams, 202-622-3600 (not a toll-free number); concerning submissions and/or to be placed on the building access list to attend the hearing, call Robin Jones, 202-622-7180 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Regulations on Procedure and Administration (26 CFR part 301) relating to the provision of notice under section 6320 of the Internal Revenue Code to taxpayers of a right to a CDP hearing (CDP Notice) after the IRS files a NFTL. Final regulations (T.D. 8979, 2002-1 C.B. 466) were published on January 18, 2002 in the **Federal Register** (67 FR 2558). The final regulations implemented certain changes made by section 3401 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Public Law 105-206, 112 Stat. 685) (RRA 1998), including the addition of section 6320 to the Internal Revenue Code. The final regulations affected taxpayers against whose property or rights to property the IRS files a NFTL.

Section 3401 of RRA 1998 also added section 6330 to the Internal Revenue Code. That statute provides for notice to taxpayers of a right to a hearing before or, in limited cases, after levy. A number of the provisions in section 6330 concerning the conduct and judicial review of a CDP hearing are incorporated by reference in section 6320. On January 18, 2002, final regulations (T.D. 8980, 2002-1 C.B. 477) under section 6330 were published in the **Federal Register** (67 FR 2549) along with the final regulations under section 6320.

Explanation of Provisions

A taxpayer is entitled to one CDP hearing with respect to the tax and tax period covered by a CDP Notice concerning a levy or a CDP Notice concerning the filing of a NFTL. The IRS Office of Appeals (Appeals) has conducted over 92,000 CDP hearings and more than 30,000 equivalent hearings since sections 6320 and 6330 became effective for collection actions initiated on and after January 19, 1999.

In general, the experience of the past six years with CDP hearings has demonstrated that there is a need for changes to allow Appeals to effectively and fairly handle the cases of taxpayers who raise issues of substance. Appeals has instituted many improvements in its processing of CDP cases and has conducted extensive training in an effort to provide careful, but timely, review of CDP cases, which currently are filed at a rate of approximately 2,450 per month. The proposed regulations, if adopted as final regulations, will increase efficiency without compromising the quality and fairness of review.

In many CDP cases, significant time is spent merely identifying the issues. Although the Form 12153 used to request a CDP hearing requires a taxpayer to state a reason or reasons for disagreeing with the NFTL filing, many taxpayers either do not supply that information, or raise new issues during the CDP hearing process not identified on the hearing request. Delays result while taxpayers provide new supporting documentation and Appeals personnel reconsider prior conclusions in light of the new information. Cases of other taxpayers pending in Appeals are delayed because other work must be constantly rescheduled.

Cases are also delayed when taxpayers propose collection alternatives for which they are not eligible. The IRS does not consider offers in compromise or installment agreements from taxpayers who have failed to file required returns as of the date the offer or the proposed installment agreement is submitted. See Publication 594, *What You Should Know About the IRS Collection Process* (Rev. 2-2004). Similarly, the IRS will not consider an offer in compromise from an in-business taxpayer unless the taxpayer has timely filed all re-

turns and timely made all Federal tax deposits for two consecutive quarters. See Form 656, “*Offer in Compromise* (Rev. 7-2004).” The resources of Appeals are ineffectively utilized arranging and conducting face-to-face conferences requested by non-compliant taxpayers whose only complaint is the rejection of an offer to compromise or installment agreement for which they are not eligible.

Frivolous cases also cause unnecessary delays. During fiscal year 2004, 5.4 percent of the 32,226 CDP and equivalent-hearing cases Appeals handled involved taxpayers who were non-filers or raised only frivolous issues. Cases raising frivolous issues, in particular, consume a disproportionately large amount of time, because Appeals personnel must often read lengthy, frivolous submissions in search of any substantive issue buried within. Delays also result when taxpayers use face-to-face conferences as a venue for frivolous oration and harassment of Appeals personnel.

The proposed regulations attempt to address these and other problems that have become apparent during the first six years of CDP practice. The proposed changes are aimed at creating a more focused procedure that will allow Appeals to continue to provide careful review of NFTL filings as the volume of cases increases.

A taxpayer must request a CDP hearing in writing. The current regulations require that a request for a CDP hearing include the taxpayer’s name, address, and daytime telephone number, and that the request be dated and signed by either the taxpayer or the taxpayer’s authorized representative. Section 301.6320-1(c)(2), Q&A-C1. A Form 12153, “*Request for a Collection Due Process Hearing*,” is included with the CDP Notice sent to the taxpayer pursuant to section 6320. The Form 12153 requests (1) the taxpayer’s name, address, daytime telephone number, and taxpayer identification number (SSN or EIN), (2) the type of tax involved, (3) the tax period at issue, (4) a statement that the taxpayer requests a hearing with Appeals concerning the filing of the NFTL, and (5) the reason or reasons why the taxpayer disagrees with the NFTL filing. Although taxpayers are encouraged to use a Form 12153 in requesting a CDP hearing, the current regulations do not require the use of Form 12153.

Section 301.6320-1(c)(2), A-C1, of the proposed regulations requires taxpayers to state their reasons for disagreement with the NFTL filing whether or not a Form 12153 is used to request a CDP hearing. In addition, a taxpayer who fails to sign a timely CDP hearing request because the request is made by a spouse or other unauthorized representative must affirm in writing that the request was originally submitted on the taxpayer’s behalf. Failure to provide the written affirmation within a reasonable time after a request from Appeals will result in the denial of a CDP hearing for that taxpayer.

A CDP hearing is to be conducted by an Appeals officer or employee who has had no “prior involvement” with respect to the tax for the tax periods to be covered by the hearing, unless the taxpayer waives this requirement. Section 301.6320-1(d)(2), A-D4 of the current regulations provides that “prior involvement” by an Appeals officer or employee includes participation or involvement in an Appeals hearing that the taxpayer may have had with respect to the tax and tax period shown on the CDP Notice, other than a CDP hearing held under either section 6320 or section 6330. It is important that “prior involvement” be construed in a manner that reasonably protects against predisposition but at the same time does not disqualify too broad a range of Appeals personnel. A broad standard of “prior involvement” would lead to uncertain application, could result in the disqualification of an entire Appeals office, many of which have small staffs, and could make it difficult to conduct the CDP hearing. Section 301.6320-1(d)(2), A-D4 of the proposed regulations provides that prior involvement exists only when the taxpayer, the tax liability and the tax period shown on the CDP Notice also were at issue in the prior non-CDP hearing or proceeding, and the Appeals officer or employee actually participated in the prior hearing or proceeding. Examples are provided in §301.6320-1(d)(3) of the proposed regulations. Section 301.6320-1(d)(2), A-D7, of the proposed regulations clarifies that a face-to-face conference is merely one aspect of a CDP hearing under section 6320 and is not by itself the entire CDP hearing.

A-D7 of the proposed regulations also provides that, in all cases, the Appeals officer or employee will review the tax-

payer’s request for a CDP hearing, the case file, other written communications from the taxpayer, and any notes of oral communications with the taxpayer or the taxpayer’s representative. If no face-to-face or telephonic conference is held, review of those documents will constitute the CDP hearing for purposes of section 6320(b).

A-D7 of the proposed regulations further clarifies that when a business taxpayer is offered an opportunity for a face-to-face conference it will be held at the Appeals office closest to the taxpayer’s principal place of business. The current regulations have been misinterpreted by some taxpayers as requiring the IRS to hold a face-to-face conference at the taxpayer’s principal place of business. Q&A-D8 of the proposed regulations is new. It describes specific circumstances in which Appeals will not hold a face-to-face conference with the taxpayer or the taxpayer’s representative because a conference will serve no useful purpose. The experience of Appeals is that although most taxpayers request face-to-face conferences, they are sometimes difficult to schedule on a date and at a time that is convenient for the taxpayer. In some of these cases, taxpayers or their representatives have used the scheduling of a face-to-face conference as a tactic to delay the IRS’s collection efforts. In other cases, taxpayers have requested a face-to-face conference merely to raise frivolous arguments concerning the Federal tax system or to request collection alternatives for which they do not qualify. Q&A-D8 of the proposed regulations provides that a face-to-face conference need not be offered if the taxpayer or the taxpayer’s representative raises only frivolous arguments concerning the Federal tax system. See the IRS Internet site, www.irs.gov/pub/irs-utl/friv_tax.pdf, for examples of frivolous arguments. A face-to-face conference also will not be granted if the taxpayer proposes collection alternatives that would not be available to other taxpayers in similar circumstances. A face-to-face conference need not be granted if the taxpayer does not provide in the written request for a CDP hearing, as perfected, the required information set forth in A-C1(ii)(E) of paragraph (c)(2) of the proposed regulations.

In addition, a face-to-face conference will not be held at the location closest to the taxpayer’s residence or principal place of business if all Appeals officers or

employees at that location are considered to have prior involvement as provided in A-D4. In this case, the taxpayer will be offered a hearing by telephone or correspondence, or some combination thereof. The taxpayer may be able to obtain a face-to-face conference at the Appeals office closest to the taxpayer's residence or principal place of business under these circumstances if the taxpayer waives the requirement of section 6320(b)(3) concerning impartiality of the Appeals officer or employee. Appeals will offer the taxpayer a face-to-face conference at another Appeals office if in the exercise of its discretion Appeals would have offered the taxpayer a face-to-face conference at the original location.

With the foregoing exceptions, it is anticipated that a face-to-face conference will ordinarily be offered with respect to any relevant issues or collection alternatives for which the taxpayer qualifies.

Sections 301.6320-1(e)(1) and 301.6320-1(e)(3), A-E2 and A-E7 have been changed to more closely follow the language of section 6330(c)(2)(B), made applicable to section 6320 by section 6320(c). These changes are necessary because these regulations have been misinterpreted as defining the underlying tax liability that may be considered at the CDP hearing under section 6330(c)(2)(B) to be the tax liability listed on the CDP Notice. The intent of the existing regulations, which refer to tax liability on the CDP Notice, is that taxpayers may only challenge taxes or tax periods listed on the CDP Notice, not to supply a substantive definition of underlying tax liability. Section 301.6320-1(e)(3), A-E6 has been amended to clarify that taxpayers who receive CDP hearings can only qualify for collection alternatives available generally to taxpayers in similar circumstances.

The experience of the past six years has revealed that many taxpayers raise an issue with Appeals but fail to furnish any documentation or evidence with respect to the issue despite being given a reasonable period to do so. For example, a taxpayer may request an installment agreement, but when an Appeals officer or employee requests financial data necessary to determine eligibility for the installment agreement, the taxpayer may not comply with the request. Or a taxpayer may dispute liability for a tax period by claim-

ing entitlement to deductions, but provide no substantiation for the deductions in response to requests from Appeals. Current §301.6320-1(f)(2), A-F5 provides that a taxpayer may not seek judicial review of an issue that he has not raised during the CDP hearing. A-F5 is revised to clarify that in order to obtain judicial review, a taxpayer must not only bring the issue to the attention of Appeals but must also submit, if requested, evidence with respect to that issue. Under revised A-F5, if the taxpayer does not provide Appeals any evidence with respect to the issue after being given a reasonable opportunity to submit such evidence, then he may not ask a court to consider the issue.

There has been some confusion about what documents Appeals should retain, and what notations the Appeals officer or employee conducting the hearing should make, in order to provide a judicially reviewable administrative record. A new Q&A-F6 has been added to specify the contents of the administrative record required for court review.

The IRS receives a number of tardy requests for CDP hearings. The changes to §301.6320-1(i)(2) explain how these requests will be treated. The proposed amendments to the regulations add a new Q&A-I1 to §301.6320-1(i)(2) to explain that a taxpayer must request an equivalent hearing in writing. A taxpayer may obtain an equivalent hearing if the 30-day period described in section 6320(a)(3) for requesting a CDP hearing has expired. Unlike an Appeals determination in a CDP hearing, the Appeals decision in an equivalent hearing is not reviewable in court. Under new Q&A-I1, the IRS is not required to treat a late-filed CDP request as a request for an equivalent hearing. Section 301.6320-1(c)(2), A-C7 has been amended to require that the taxpayer be notified of the right to an equivalent hearing in all cases in which a tardy request for a CDP hearing is received. It is expected that the IRS will either send the taxpayer a letter or orally inform the taxpayer that the CDP hearing request is untimely and ask if the taxpayer wishes to have an equivalent hearing. If the taxpayer elects to have an equivalent hearing, the IRS will treat the CDP hearing request as a request for an equivalent hearing without requiring the taxpayer to make an additional written request.

Current Q&A-I1 through I5 are renumbered Q&A-I2 through I6. The proposed regulations add Q&A-I7 to §301.6320-1(i)(2) to clarify that the period during which a taxpayer may obtain an equivalent hearing is not indefinite. The equivalent hearing procedure is not provided by statute but, consistent with the legislative history of RRA 1998, was adopted in order to accommodate taxpayers who failed timely to exercise their right to a CDP hearing. The equivalent hearing was meant to occur near the time a CDP hearing held pursuant to a timely request would have occurred, because it was meant to address the same matters that would have been addressed at a CDP hearing. The procedure was not meant to provide a hearing right that could be exercised months or years after the circumstances that precipitated the filing of the NFTL have passed. A hearing before Appeals at a later time may be obtained under the Collection Appeals Program. Therefore, proposed Q&A-I7 limits to one year the period during which a taxpayer may request an equivalent hearing. The period commences the day after the end of the five business day period following the filing of the NFTL, described in section 6320(a)(2).

Because the time for requesting an equivalent hearing will be limited, the proposed regulations add new Q&A-I8, Q&A-I9, Q&A-I10 and Q&A-I11 to §301.6320-1(i)(2) to provide the same rules governing mailing, delivery and determination of timeliness that apply to requests for CDP hearings. Unlike existing §301.6320-1(c)(2), A-C6, new A-I10 does not identify the officials to whom to send an equivalent hearing request if the CDP Notice does not specify where to send the request. Because the identity and the address of the person to whom the request should be sent may change in the future, taxpayers will be able to obtain more current information by calling the 1-800 number listed in A-I10. Section 301.6320-1(c)(2), A-C6 also has been revised in the proposed regulations to provide that taxpayers should call the 1-800 number to obtain the address to which the CDP hearing request should be sent.

The proposed regulations are effective the date 30 days after final regulations are published in the **Federal Register** with respect to requests for CDP hearings or

equivalent hearings made on or after the date 30 days after final regulations are published in the **Federal Register**.

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 also has 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 regulations do 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 Internal Revenue 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 electronic and written comments that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for January 19, 2006, at 10 a.m. in the IRS Auditorium, Internal Revenue Building (7th Floor), 1111 Constitution Avenue, NW, Washington, DC. 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 a visitor's name placed on the building access list to attend the hearing, see the FOR FURTHER INFORMATION CONTACT caption.

An outline of the topics to be discussed and the time to be devoted to each topic must be submitted by any person who wishes to present oral comments at the hearing. Outlines must be received by December 29, 2005.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. 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 requests to speak has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Laurence K. Williams, Office of Associate Chief Counsel, Procedure and Administration (Collection, Bankruptcy and Summonses Division).

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 301 is proposed to be amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read, in part, as follows:

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

Par. 2. Section 301.6320-1 is proposed to be amended as follows:

1. Paragraph (c)(2) A-C1, Q&A-C6 and A-C7 are revised.
2. Paragraph (d)(2) A-D4 and A-D7 are revised.
3. Paragraph (d)(2) Q&A-D8 is added.
4. Paragraph (d)(3) is added.
5. Paragraph (e)(1) is revised.
6. Paragraph (e)(3) A-E2, A-E6 and A-E7 are revised.
7. Paragraph (f)(2) A-F5 is revised
8. Paragraph (f)(2) Q&A-F6 is added.
9. Paragraph (i)(2) Q&A-I1 through Q&A-I5 are renumbered Q&A-I2 through Q&A-I6, a new paragraph (i)(2) Q&A-I1 and new paragraphs Q&A-I7 through Q&A-I11 are added.
10. Paragraph (j) is revised.

§301.6320-1 Notice and opportunity for hearing upon filing of notice of Federal tax lien.

* * * * *

(c) * * *

(2) * * *

A-C1. (i) The taxpayer must make a request in writing for a CDP hearing. The

request for a CDP hearing shall include the information specified in A-C1(ii) of this paragraph (c)(2). See A-D7 and A-D8 of paragraph (d)(2).

(ii) The written request for a CDP hearing must be dated and must include the following information:

(A) The taxpayer's name, address, daytime telephone number (if any), and taxpayer identification number (SSN or EIN).

(B) The type of tax involved.

(C) The tax period at issue.

(D) A statement that the taxpayer requests a hearing with Appeals concerning the filing of the NFTL.

(E) The reason or reasons why the taxpayer disagrees with the filing of the NFTL.

(F) The signature of the taxpayer or the taxpayer's authorized representative.

(iii) The taxpayer must perfect any timely written request for a CDP hearing that does not provide the required information set forth in A-C1(ii) of this paragraph within a reasonable period of time after a request from the IRS.

(iv) Taxpayers are encouraged to use a Form 12153, "Request for a Collection Due Process Hearing," in requesting a CDP hearing so that the request can be readily identified and forwarded to Appeals. Taxpayers may obtain a copy of Form 12153 by contacting the IRS office that issued the CDP Notice, by downloading a copy from the IRS Internet site, www.irs.gov/pub/irs-pdf/f12153.pdf, or by calling, toll-free, 1-800-829-3676.

(v) The taxpayer must affirm any timely written request for a CDP hearing which is signed or alleged to have been signed on the taxpayer's behalf by the taxpayer's spouse or other unauthorized representative by filing, within a reasonable period of time after a request from the IRS, a signed, written affirmation that the request was originally submitted on the taxpayer's behalf. If the affirmation is not filed within a reasonable period of time after a request, the CDP hearing request will be denied with respect to the non-signing taxpayer.

* * * * *

Q-C6. Where must the written request for a CDP hearing be sent?

A-C6. The written request for a CDP hearing must be sent, or hand delivered (if permitted), to the IRS office and address as directed on the CDP Notice. If the ad-

dress of that office does not appear on the CDP Notice, the taxpayer should obtain the address of the office to which the written request should be sent or hand delivered by calling, toll-free, 1-800-829-1040 and providing the taxpayer's identification number (SSN or TIN).

* * * * *

A-C7. If the taxpayer does not request a CDP hearing in writing within the 30-day period that commences on the day after the end of the five business day notification period, the taxpayer foregoes the right to a CDP hearing under section 6320 with respect to the unpaid tax and tax periods shown on the CDP Notice. If the request for CDP hearing is received after the 30-day period, the taxpayer will be notified of the untimely request and of the right to an equivalent hearing. See paragraph (i) of this section.

* * * * *

(d) * * *

(2) * * *

A-D4. Prior involvement by an Appeals officer or employee includes participation or involvement in an Appeals hearing (other than a CDP hearing held under either section 6320 or section 6330) that the taxpayer may have had with respect to the tax and tax period shown on the CDP Notice. Prior involvement exists only when the taxpayer, the tax liability and the tax period at issue in the CDP hearing also were at issue in the prior non-CDP hearing or proceeding, and the Appeals officer or employee actually participated in the prior hearing or proceeding.

* * * * *

A-D7. Except as provided in A-D8 of this paragraph (d)(2), a taxpayer who presents in the CDP hearing request relevant, non-frivolous reasons for disagreement with the NFTL filing will ordinarily be offered an opportunity for a face-to-face conference at the Appeals office closest to the taxpayer's residence. A business taxpayer will ordinarily be offered an opportunity for a face-to-face conference at the Appeals office closest to the taxpayer's principal place of business. If that is not satisfactory to the taxpayer, the taxpayer will be given an opportunity for a hearing by telephone or by correspondence. In all cases, the Appeals officer or employee will review the case file, which includes the taxpayer's request for a CDP hearing,

any other written communications from the taxpayer or the taxpayer's authorized representative, and any notes made by Appeals officers or employees of any oral communications with the taxpayer or the taxpayer's authorized representative. If no face-to-face or telephonic conference or correspondence hearing is held, review of those documents will constitute the CDP hearing for purposes of section 6320(b).

Q-D8. In what circumstances will a face-to-face CDP conference not be granted?

A-D8. A taxpayer is not entitled to a face-to-face CDP conference at a location other than as provided in A-D7 of this paragraph (d)(2) and this A-D8. If all Appeals officers or employees at the location provided for in A-D7 of this paragraph have had prior involvement with the taxpayer as provided in A-D4 of this paragraph, the taxpayer will not be offered a face-to-face meeting at that location, unless the taxpayer elects to waive the requirement of section 6320(b)(3). The taxpayer will be offered a face-to-face conference at another Appeals office if Appeals in the exercise of its discretion would have offered the taxpayer a face-to-face conference at the location provided in A-D7. A face-to-face CDP conference concerning a taxpayer's underlying liability will not be granted if the request for a hearing or other taxpayer communication indicates that the taxpayer wishes only to raise irrelevant or frivolous issues concerning that liability. A face-to-face CDP conference concerning a collection alternative, such as an installment agreement or an offer to compromise liability, will not be granted unless the alternative would be available to other taxpayers in similar circumstances. For example, because the IRS does not consider offers to compromise from taxpayers who have not filed required returns or have not made certain required deposits of tax, as set forth in Form 656, "Offer in Compromise," no face-to-face conference will be offered to a taxpayer who wishes to make an offer to compromise but has not fulfilled those obligations. A face-to-face conference need not be granted if the taxpayer does not provide the required information set forth in A-C1(ii)(E) of paragraph (c)(2). See also A-C1(iii) of paragraph (c)(2).

(3) *Examples.* The following examples illustrate the principles of this paragraph (d):

Example 1. Individual A timely requests a CDP hearing concerning a NFTL filed with respect to A's 1998 income tax liability. Appeals employee B previously conducted a CDP hearing regarding a proposed levy for the 1998 income tax liability assessed against individual A. Because employee B's only prior involvement with individual A's 1998 income tax liability was in connection with a section 6330 CDP hearing, employee B may conduct the CDP hearing under section 6320 involving the NFTL filed for the 1998 income tax liability.

Example 2. Individual C timely requests a CDP hearing concerning a NFTL filed with respect to C's 1998 income tax liability assessed against individual C. Appeals employee D previously conducted a Collection Appeals Program (CAP) hearing regarding a NFTL filed with respect to C's 1998 income tax liability. Because employee D's prior involvement with individual C's 1998 income tax liability was in connection with a non-CDP hearing, employee D may not conduct the CDP hearing under section 6320 unless individual C waives the requirement that the hearing will be conducted by an Appeals officer or employee who has had no prior involvement with respect to C's 1998 income tax liability.

Example 3. Same facts as in *Example 2*, except that the prior CAP hearing only involved individual C's 1997 income tax liability and employment tax liabilities for 1998 reported on Form 941. Employee D would not be considered to have prior involvement because the prior CAP hearing in which she participated did not involve individual C's 1998 income tax liability.

Example 4. Appeals employee F is assigned to a CDP hearing concerning a NFTL filed with respect to a trust fund recovery penalty (TFRP) assessed pursuant to section 6672 against individual E. Appeals employee F participated in a prior CAP hearing involving individual E's 1999 income tax liability, and participated in a CAP hearing involving the employment taxes of business entity X, which incurred the employment tax liability to which the TFRP assessed against individual E relates. Appeals employee F would not be considered to have prior involvement because the prior CAP hearings in which he participated did not involve the TFRP assessed against individual E.

Example 5. Appeals employee G is assigned to a CDP hearing concerning a NFTL filed with respect to a TFRP assessed pursuant to section 6672 against individual H. In preparing for the CDP hearing, Appeals employee G reviews the Appeals case file concerning the prior CAP hearing involving the TFRP assessed pursuant to section 6672 against individual H. Appeals employee G is not deemed to have participated in the previous CAP hearing involving the TFRP assessed against individual H by such review.

(e) *Matters considered at CDP hearing—(1) In general.* Appeals has the authority to determine the validity, sufficiency, and timeliness of any CDP Notice given by the IRS and of any request for a CDP hearing that is made by a taxpayer. Prior to issuance of a determination, Ap-

peals is required to obtain verification from the IRS office collecting the tax that the requirements of any applicable law or administrative procedure have been met. The taxpayer may raise any relevant issue relating to the unpaid tax at the hearing, including appropriate spousal defenses, challenges to the appropriateness of the NFTL filing, and offers of collection alternatives. The taxpayer also may raise challenges to the existence or amount of the underlying liability for any tax period specified on the CDP Notice if the taxpayer did not receive a statutory notice of deficiency for that tax liability or did not otherwise have an opportunity to dispute the tax liability. Finally, the taxpayer may not raise an issue that was raised and considered at a previous CDP hearing under section 6330 or in any other previous administrative or judicial proceeding if the taxpayer participated meaningfully in such hearing or proceeding. Taxpayers will be expected to provide all relevant information requested by Appeals, including financial statements, for its consideration of the facts and issues involved in the hearing.

* * * * *
(3) * * *

A-E2. A taxpayer is entitled to challenge the existence or amount of the underlying liability for any tax period specified on the CDP Notice if the taxpayer did not receive a statutory notice of deficiency for such liability or did not otherwise have an opportunity to dispute such liability. Receipt of a statutory notice of deficiency for this purpose means receipt in time to petition the Tax Court for a redetermination of the deficiency determined in the notice of deficiency. An opportunity to dispute the underlying liability includes a prior opportunity for a conference with Appeals that was offered either before or after the assessment of the liability.

* * * * *

A-E6. Collection alternatives include, for example, a proposal to withdraw the NFTL in circumstances that will facilitate the collection of the tax liability, an installment agreement, an offer to compromise, the posting of a bond, or the substitution of other assets. A collection alternative is not available unless the alternative would be available to other taxpayers in similar circumstances. For example,

the IRS does not consider an offer to compromise made by a taxpayer who, at the time of the CDP hearing, has not filed required returns or has not made certain required deposits of tax, as set forth in Form 656, "Offer in Compromise." The collection alternative of an offer to compromise would not be available to such a taxpayer in a CDP hearing.

* * * * *

A-E7. The taxpayer may raise appropriate spousal defenses, challenges to the appropriateness of the NFTL filing, and offers of collection alternatives. The existence or amount of the underlying liability for any tax period specified in the CDP Notice may be challenged only if the taxpayer did not already have an opportunity to dispute the tax liability. If the taxpayer previously received a CDP Notice under section 6330 with respect to the same tax and tax period and did not request a CDP hearing with respect to that earlier CDP Notice, the taxpayer has already had an opportunity to dispute the existence or amount of the underlying tax liability.

* * * * *

(f) * * *
(2) * * *

A-F5. In seeking Tax Court or district court review of a Notice of Determination, the taxpayer can only ask the court to consider an issue, including a challenge to the underlying tax liability, that was properly raised in the taxpayer's CDP hearing. An issue is not properly raised if the taxpayer fails to request consideration of the issue by Appeals, or if consideration is requested but the taxpayer fails to present to Appeals any evidence with respect to that issue after being given a reasonable opportunity to present such evidence.

Q-F6. What is the administrative record for purposes of court review?

A-F6. The case file, including written communications and information from the taxpayer or the taxpayer's authorized representative submitted in connection with the CDP hearing, notes made by an Appeals officer or employee of any oral communications with the taxpayer or the taxpayer's authorized representative and memoranda created by the Appeals officer or employee in connection with the CDP hearing, and any other documents or materials relied upon by the Appeals officer or employee in making the determination

under section 6330(c)(3), will constitute the record in any court review of the Notice of Determination issued by Appeals.

* * * * *

(i) * * *
(2) * * *

Q-I1. What must a taxpayer do to obtain an equivalent hearing?

A-I1. (i) A request for an equivalent hearing must be made in writing. A written request in any form that requests an equivalent hearing will be acceptable if it includes the information required in paragraph (ii) of this A-I1.

(ii) The request must be dated and must include the following information:

- (A) The taxpayer's name, address, daytime telephone number (if any), and taxpayer identification number (SSN or EIN).
- (B) The type of tax involved.
- (C) The tax period at issue.
- (D) A statement that the taxpayer is requesting an equivalent hearing with Appeals concerning the filing of the NFTL.
- (E) The reason or reasons why the taxpayer disagrees with the filing of the NFTL.

(F) The signature of the taxpayer or the taxpayer's authorized representative.

(iii) The taxpayer must perfect any timely written request for an equivalent hearing that does not provide the required information set forth in paragraph (ii) of this A-I1 within a reasonable period of time after a request from the IRS. If the requested information is not provided within a reasonable period of time, the taxpayer's equivalent hearing request will be denied.

(iv) The taxpayer must affirm any timely written request for an equivalent hearing that is signed or alleged to have been signed on the taxpayer's behalf by the taxpayer's spouse or other unauthorized representative, and that otherwise meets the requirements set forth in paragraph (ii) of this A-I1, by the taxpayer's spouse or any other representative, by filing, within a reasonable time after a request from the IRS, a signed written affirmation that the request was originally submitted on the taxpayer's behalf. If the affirmation is not filed within a reasonable period of time, the equivalent hearing request will be denied with respect to the non-signing taxpayer.

* * * * *

Q-17. When must a taxpayer request an equivalent hearing with respect to a CDP Notice issued under section 6320?

A-17. A taxpayer must submit a written request for an equivalent hearing within the one-year period commencing the day after the end of the five-business-day period following the filing of the NFTL. This period is slightly different from the period for submitting a written request for an equivalent hearing with respect to a CDP Notice issued under section 6330. For a CDP Notice issued under section 6330, a taxpayer must submit a written request for an equivalent hearing within the one-year period commencing the day after the date of the CDP Notice issued under section 6330.

Q-18. How will the timeliness of a taxpayer's written request for an equivalent hearing be determined?

A-18. The rules and regulations under section 7502 and section 7503 will apply to determine the timeliness of the taxpayer's request for an equivalent hearing, if properly transmitted and addressed as provided in A-I10 of this paragraph (i)(2).

Q-19. Is the one-year period within which a taxpayer must make a request for an equivalent hearing extended because the taxpayer resides outside the United States?

A-19. No. All taxpayers who want an equivalent hearing concerning the filing of the NFTL must request the hearing within the one-year period commencing the day after the end of the five-business-day period following the filing of the NFTL.

Q-I10. Where must the written request for an equivalent hearing be sent?

A-I10. The written request for an equivalent hearing must be sent, or hand delivered (if permitted), to the IRS office and address as directed on the CDP Notice. If the address of the issuing office does not appear on the CDP Notice, the taxpayer should obtain the address of the office to which the written request should be sent or hand delivered by calling, toll-free, 1-800-829-1040 and providing the taxpayer's identification number (SSN or EIN).

Q-I11. What will happen if the taxpayer does not request an equivalent hearing in writing within the one-year period commencing the day after the end of the five-business-day period following the filing of the NFTL?

A-I11. If the taxpayer does not request an equivalent hearing with Appeals within the one-year period commencing the day after the end of the five-business-day period following the filing of the NFTL, the taxpayer foregoes the right to an equivalent hearing with respect to the unpaid tax and tax periods shown on the CDP Notice. The taxpayer, however, may seek reconsideration by the IRS office collecting the tax, assistance from the National Taxpayer Advocate, or an administrative hearing before Appeals under its Collection Appeals Program or any successor program.

* * * * *

(j) *Effective date.* This section is applicable the date 30 days after final regulations are published in the **Federal Register** with respect to requests made for CDP hearings or equivalent hearings on or after the date 30 days after final regulations are published in the **Federal Register**.

Mark E. Matthews,
*Deputy Commissioner for
Services and Enforcement.*

(Filed by the Office of the Federal Register on September 15, 2005, 8:45 a.m., and published in the issue of the Federal Register for September 16, 2005, 70 F.R. 54681)

Notice of Proposed Rulemaking and Notice of Public Hearing

Miscellaneous Changes to Collection Due Process Procedures Relating to Notice and Opportunity for Hearing Prior to Levy

REG-150091-02

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed amendments to the regulations relating to a taxpayer's right to a hearing before or after levy under section 6330 of the Internal Revenue Code of 1986. The proposed regulations make certain clarifying changes in the way collection due process (CDP) hearings are held and specify the

period during which a taxpayer may request an equivalent hearing. The proposed regulations affect taxpayers against whose property or rights to property the Internal Revenue Service (IRS) intends to levy on or after January 19, 1999. This document also contains a notice of public hearing on these proposed regulations.

DATES: Written and electronic comments must be received by December 15, 2005. Outlines of topics to be discussed at the public hearing scheduled for 10 a.m. on January 19, 2006, must be received by December 29, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-150091-02), 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-150091-02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the IRS Internet site at www.irs.gov/regs or via the Federal eRulemaking Portal at www.regulations.gov (indicate IRS and REG-150091-02). The public hearing will be held in the IRS Auditorium, Internal Revenue Building (7th Floor), 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, call Laurence K. Williams, 202-622-3600 (not a toll-free number). Concerning submissions and/or to be placed on the building access list to attend the hearing, call Robin Jones, 202-622-7180 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Regulations on Procedure and Administration (26 CFR part 301) relating to the provision of notice under section 6330 of the Internal Revenue Code to taxpayers of a right to a CDP hearing (CDP Notice) before levy. Final regulations (T.D. 8980, 2002-1 C.B. 477) were published on January 18, 2002 in the **Federal Register** (67 FR 2549). The final

regulations implemented certain changes made by section 3401 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Public Law 105-206, 112 Stat. 685) (RRA 1998), including the addition of section 6330 to the Internal Revenue Code. The final regulations affected taxpayers against whose property or rights to property the IRS intends to levy.

Section 3401 of RRA 1998 also added section 6320 to the Internal Revenue Code. That statute provides for notice to taxpayers of a right to a hearing after the filing of a notice of Federal tax lien (NFTL). A number of the provisions in section 6330 concerning the conduct and judicial review of a CDP hearing are incorporated by reference in section 6320. On January 18, 2002, final regulations (T.D. 8979, 2002-1 C.B. 466) under section 6320 were published in the **Federal Register** (67 FR 2558) along with the final regulations under section 6330.

Explanation of Provisions

A taxpayer is entitled to one CDP hearing with respect to the tax and tax period covered by a CDP Notice concerning a levy or a CDP Notice concerning the filing of a NFTL. The IRS Office of Appeals (Appeals) has conducted over 92,000 CDP hearings and more than 30,000 equivalent hearings since sections 6320 and 6330 became effective for collection actions initiated on and after January 19, 1999.

In general, the experience of the past six years with CDP hearings has demonstrated that there is a need for changes to allow Appeals to effectively and fairly handle the cases of taxpayers who raise issues of substance. Appeals has instituted many improvements in its processing of CDP cases and has conducted extensive training in an effort to provide careful, but timely, review of CDP cases, which currently are filed at a rate of approximately 2,450 per month. The proposed regulations, if adopted as final regulations, will increase efficiency without compromising the quality and fairness of review.

In many CDP cases, significant time is spent merely identifying the issues. Although the Form 12153 used to request a CDP hearing requires a taxpayer to state a reason or reasons for disagreeing with the proposed levy, many taxpayers either do not supply that information, or raise new

issues during the CDP hearing process not identified on the hearing request. Delays result while taxpayers provide new supporting documentation and Appeals personnel reconsider prior conclusions in light of the new information. Cases of other taxpayers pending in Appeals are delayed because other work must be constantly rescheduled.

Cases are also delayed when taxpayers propose collection alternatives for which they are not eligible. The IRS does not consider offers in compromise or installment agreements from taxpayers who have failed to file required returns as of the date the offer or the proposed installment agreement is submitted. See Publication 594, *“What You Should Know About the IRS Collection Process (Rev. 2-2004).”* Similarly, the IRS will not consider an offer in compromise from an in-business taxpayer unless the taxpayer has timely filed all returns and timely made all Federal tax deposits for two consecutive quarters. See Form 656, *“Offer in Compromise (Rev. 7-2004).”* The resources of Appeals are ineffectively utilized arranging and conducting face-to-face conferences requested by non-compliant taxpayers whose only complaint is the rejection of an offer to compromise or installment agreement for which they are not eligible.

Frivolous cases also cause unnecessary delays. During fiscal year 2004, 5.4 percent of the 32,226 CDP and equivalent-hearing cases Appeals handled involved taxpayers who were non-filers or raised only frivolous issues. Cases raising frivolous issues, in particular, consume a disproportionately large amount of time, because Appeals personnel must often read lengthy, frivolous submissions in search of any substantive issue buried within. Delays also result when taxpayers use face-to-face conferences as a venue for frivolous oration and harassment of Appeals personnel.

The proposed regulations attempt to address these and other problems that have become apparent during the first six years of CDP practice. The proposed changes are aimed at creating a more focused procedure that will allow Appeals to continue to provide careful review of proposed levies as the volume of cases increases.

A taxpayer must request a CDP hearing in writing. The current regulations require that a request for a CDP hearing include

the taxpayer's name, address, and daytime telephone number, and that the request be dated and signed by either the taxpayer or the taxpayer's authorized representative. Section 301.6330-1(c)(2), Q&A-C1. A Form 12153, *“Request for a Collection Due Process Hearing,”* is included with the CDP Notice sent to the taxpayer pursuant to section 6330. The Form 12153 requests (1) the taxpayer's name, address, daytime telephone number, and taxpayer identification number (SSN or EIN), (2) the type of tax involved, (3) the tax period at issue, (4) a statement that the taxpayer requests a hearing with Appeals concerning the proposed levy, and (5) the reason or reasons why the taxpayer disagrees with the proposed levy. Although taxpayers are encouraged to use a Form 12153 in requesting a CDP hearing, the current regulations do not require the use of Form 12153.

Section 301.6330-1(c)(2), A-C1, of the proposed regulations requires taxpayers to state their reasons for disagreement with the proposed levy whether or not a Form 12153 is used to request a CDP hearing. In addition, a taxpayer who fails to sign a timely CDP hearing request because the request is made by a spouse or other unauthorized representative must affirm in writing that the request was originally submitted on the taxpayer's behalf. Failure to provide the written affirmation within a reasonable time after a request from Appeals will result in the denial of a CDP hearing for that taxpayer.

A CDP hearing is to be conducted by an Appeals officer or employee who has had no “prior involvement” with respect to the tax for the tax periods to be covered by the hearing, unless the taxpayer waives this requirement. Section 301.6330-1(d)(2), A-D4 of the current regulations provides that “prior involvement” by an Appeals officer or employee includes participation or involvement in an Appeals hearing that the taxpayer may have had with respect to the tax and tax period shown on the CDP Notice, other than a CDP hearing held under either section 6320 or section 6330. It is important that “prior involvement” be construed in a manner that reasonably protects against predisposition but at the same time does not disqualify too broad a range of Appeals personnel. A broad standard of “prior involvement” would lead to uncertain application, could result

in the disqualification of an entire Appeals office, many of which have small staffs, and could make it difficult to conduct the CDP hearing. Section 301.6330-1(d)(2), A-D4 of the proposed regulations provides that prior involvement exists only when the taxpayer, the tax liability and the tax period shown on the CDP Notice also were at issue in the prior non-CDP hearing or proceeding, and the Appeals officer or employee actually participated in the prior hearing or proceeding. Examples are provided in §301.6330-1(d)(3) of the proposed regulations.

Section 301.6330-1(d)(2), A-D7, of the proposed regulations clarifies that a face-to-face conference is merely one aspect of a CDP hearing under section 6330 and is not by itself the entire CDP hearing.

A-D7 of the proposed regulations also provides that, in all cases, the Appeals officer or employee will review the taxpayer's request for a CDP hearing, the case file, other written communications from the taxpayer, and any notes of oral communications with the taxpayer or the taxpayer's representative. If no face-to-face or telephonic conference is held, review of those documents will constitute the CDP hearing for purposes of section 6330(b).

A-D7 of the proposed regulations further clarifies that when a business taxpayer is offered an opportunity for a face-to-face conference it will be held at the Appeals office closest to the taxpayer's principal place of business. The current regulations have been misinterpreted by some taxpayers as requiring the IRS to hold a face-to-face conference at the taxpayer's principal place of business.

Q&A-D8 of the proposed regulations is new. It describes specific circumstances in which Appeals will not hold a face-to-face conference with the taxpayer or the taxpayer's representative because a conference will serve no useful purpose. The experience of Appeals is that although most taxpayers request face-to-face conferences, they are sometimes difficult to schedule on a date and at a time that is convenient for the taxpayer. In some of these cases, taxpayers or their representatives have used the scheduling of a face-to-face conference as a tactic to delay the IRS's collection efforts. In other cases, taxpayers have requested a face-to-face conference merely to raise frivolous arguments concerning the Fed-

eral tax system or to request collection alternatives for which they do not qualify. Q&A-D8 of the proposed regulations provides that a face-to-face conference need not be offered if the taxpayer or the taxpayer's representative raises only frivolous arguments concerning the Federal tax system. See the IRS Internet site, www.irs.gov/pub/irs-utl/friv_tax.pdf, for examples of frivolous arguments. A face-to-face conference also will not be granted if the taxpayer proposes collection alternatives that would not be available to other taxpayers in similar circumstances. A face-to-face conference need not be granted if the taxpayer does not provide in the written request for a CDP hearing, as perfected, the required information set forth in A-C1(ii)(E) of paragraph (c)(2) of the proposed regulations.

In addition, a face-to-face conference will not be held at the location closest to the taxpayer's residence or principal place of business if all Appeals officers or employees at that location are considered to have prior involvement as provided in A-D4. In this case, the taxpayer will be offered a hearing by telephone or correspondence, or some combination thereof. The taxpayer may be able to obtain a face-to-face conference at the Appeals office closest to the taxpayer's residence or principal place of business under these circumstances if the taxpayer waives the requirement of section 6330(b)(3) concerning impartiality of the Appeals officer or employee. Appeals will offer the taxpayer a face-to-face conference at another Appeals office if in the exercise of its discretion Appeals would have offered the taxpayer a face-to-face conference at the original location.

With the foregoing exceptions, it is anticipated that a face-to-face conference will ordinarily be offered with respect to any relevant issues or collection alternatives for which the taxpayer qualifies.

Sections 301.6330-1(e)(1) and 301.6330-1(e)(3), A-E2 and A-E7 have been changed to more closely follow the language of section 6330(c)(2)(B). These changes are necessary because these regulations have been misinterpreted as defining the underlying tax liability that may be considered at the CDP hearing under section 6330(c)(2)(B) to be the tax liability listed on the CDP Notice. The existing regulations, which refer to tax liability on

the CDP Notice, were intended merely to make clear that taxpayers may only challenge taxes or tax periods listed on the CDP Notice, not to supply a substantive definition of underlying tax liability. Section 301.6330-1(e)(3), A-E6 has been amended to clarify that taxpayers who receive CDP hearings can only qualify for collection alternatives available generally to taxpayers in similar circumstances.

The experience of the past six years has revealed that many taxpayers raise an issue with Appeals but fail to furnish any documentation or evidence with respect to the issue despite being given a reasonable period to do so. For example, a taxpayer may request an installment agreement, but when an Appeals officer or employee requests financial data necessary to determine eligibility for the installment agreement, the taxpayer may not comply with the request. Or a taxpayer may dispute liability for a tax period by claiming entitlement to deductions, but provide no substantiation for the deductions in response to requests from Appeals. Current §301.6330-1(f)(2), A-F5 provides that a taxpayer may not seek judicial review of an issue that he has not raised during the CDP hearing. A-F5 is revised to clarify that in order to obtain judicial review, a taxpayer must not only bring the issue to the attention of Appeals but must also submit, if requested, evidence with respect to that issue. Under revised A-F5, if the taxpayer does not provide Appeals any evidence with respect to the issue after being given a reasonable opportunity to submit such evidence, then he may not ask a court to consider the issue.

There has been some confusion about what documents Appeals should retain, and what notations the Appeals officer or employee conducting the hearing should make, in order to provide a judicially reviewable administrative record. A new Q&A-F6 has been added to specify the contents of the administrative record required for court review.

The IRS receives a number of tardy requests for CDP hearings. The changes to §301.6330-1(i)(2) explain how these requests will be treated. The proposed amendments to the regulations add a new Q&A-I1 to §301.6330-1(i)(2) to explain that a taxpayer must request an equivalent hearing in writing. A taxpayer may obtain an equivalent hearing if the 30-day

period described in section 6330(a)(3) for requesting a CDP hearing has expired. Unlike an Appeals determination in a CDP hearing, the Appeals decision in an equivalent hearing is not reviewable in court. Under new Q&A-I1, the IRS is not required to treat a late-filed CDP request as a request for an equivalent hearing. Section 301.6330-1(c)(2), A-C7 has been amended to require that the taxpayer be notified of the right to an equivalent hearing in all cases in which a tardy request for a CDP hearing is received. It is expected that the IRS will either send the taxpayer a letter or orally inform the taxpayer that the CDP hearing request is untimely and ask if the taxpayer wishes to have an equivalent hearing. If the taxpayer elects to have an equivalent hearing, the IRS will treat the CDP hearing request as a request for an equivalent hearing without requiring the taxpayer to make an additional written request.

Current Q&A-I1 through I5 are renumbered Q&A-I2 through I6. The proposed regulations add Q&A-I7 to §301.6330-1(i)(2) to clarify that the period during which a taxpayer may obtain an equivalent hearing is not indefinite. The equivalent hearing procedure is not provided by statute but, consistent with the legislative history of RRA 1998, was adopted in order to accommodate taxpayers who failed timely to exercise their right to a CDP hearing. The equivalent hearing was meant to occur near the time a CDP hearing held pursuant to a timely request would have occurred, because it was meant to address the same matters that would have been addressed at a CDP hearing. The procedure was not meant to provide a hearing right that could be exercised months or years after the circumstances that precipitated the proposed levy have passed. A hearing before Appeals at a later time may be obtained under the Collection Appeals Program. Therefore, proposed Q&A-I7 limits to one year the period during which a taxpayer may request an equivalent hearing. The period commences the day after the date of the CDP Notice issued under section 6330.

Because the time for requesting an equivalent hearing will be limited, the proposed regulations add new Q&A-I8, Q&A-I9, Q&A-I10 and Q&A-I11 to §301.6330-1(i)(2) to provide the same rules governing mailing, delivery and de-

termination of timeliness that apply to requests for CDP hearings. Unlike existing §301.6330-1(c)(2), A-C6, new A-I10 does not identify the officials to whom to send an equivalent hearing request if the CDP Notice does not specify where to send the request. Because the identity and the address of the person to whom the request should be sent may change in the future, taxpayers will be able to obtain more current information by calling the 1-800 number listed in A-I10. Section 301.6330-1(c)(2), A-C6 also has been revised in the proposed regulations to provide that taxpayers should call the 1-800 number to obtain the address to which the CDP hearing request should be sent.

The proposed regulations are effective the date 30 days after final regulations are published in the **Federal Register** with respect to requests for CDP hearings or equivalent hearings made on or after the date 30 days after final regulations are published in the **Federal Register**.

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 also has 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 regulations do 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 Internal Revenue 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 electronic and written comments that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for January 19, 2006, at 10 a.m. in the IRS Auditorium, Internal Revenue Building (7th Floor), 1111 Constitution Avenue, NW, Washington, DC. 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 a visitor's name placed on the building access list to attend the hearing, see the FOR FURTHER INFORMATION CONTACT caption.

An outline of the topics to be discussed and the time to be devoted to each topic must be submitted by any person who wishes to present oral comments at the hearing. Outlines must be received by December 29, 2005.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. 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 requests to speak has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Laurence K. Williams, Office of Associate Chief Counsel, Procedure and Administration (Collection, Bankruptcy and Summonses Division).

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 301 is proposed to be amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read, in part, as follows:

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

Par. 2. Section 301.6330-1 is proposed to be amended as follows:

1. Paragraph (c)(2) A-C1, Q&A-C6 and A-C7 are revised.

2. Paragraph (d)(2) A-D4 and A-D7 are revised.

3. Paragraph (d)(2) Q&A-D8 is added.

4. Paragraph (d)(3) is added.
5. Paragraph (e)(1) is revised
6. Paragraph (e)(3) A-E2, A-E6 and A-E7 are revised.
7. Paragraph (f)(2) A-F5 is revised.
8. Paragraph (f)(2) Q&A-F6 is added.
9. Paragraph (i)(2) Q&A-I1 through Q&A-I5 are renumbered Q&A-I2 through Q&A-I6, a new paragraph (i)(2) Q&A-I1 and new paragraphs Q&A-I7 through Q&A-I11 are added.
10. Paragraph (j) is revised.

§301.6330-1 Notice and opportunity for hearing prior to levy.

* * * * *

(c) * * *

(2) * * *

A-C1. (i) The taxpayer must make a request in writing for a CDP hearing. The request for a CDP hearing shall include the information specified in A-C1(ii) of this paragraph (c)(2). See A-D7 and A-D8 of paragraph (d)(2).

(ii) The written request for a CDP hearing must be dated and must include the following information:

(A) The taxpayer's name, address, daytime telephone number (if any), and taxpayer identification number (SSN or EIN).

(B) The type of tax involved.

(C) The tax period at issue.

(D) A statement that the taxpayer requests a hearing with Appeals concerning the proposed levy.

(E) The reason or reasons why the taxpayer disagrees with the proposed levy.

(F) The signature of the taxpayer or the taxpayer's authorized representative.

(iii) The taxpayer must perfect any timely written request for a CDP hearing that does not provide the required information set forth in A-C1(ii) of this paragraph within a reasonable period of time after a request from the IRS.

(iv) Taxpayers are encouraged to use a Form 12153, "Request for a Collection Due Process Hearing," in requesting a CDP hearing so that the request can be readily identified and forwarded to Appeals. Taxpayers may obtain a copy of Form 12153 by contacting the IRS office that issued the CDP Notice, by downloading a copy from the IRS Internet site, www.irs.gov/pub/irs-pdf/f12153.pdf, or by calling, toll-free, 1-800-829-3676.

(v) The taxpayer must affirm any timely written request for a CDP hearing which is signed or alleged to have been signed on the taxpayer's behalf by the taxpayer's spouse or other unauthorized representative by filing, within a reasonable time after a request from the IRS, a signed, written affirmation that the request was originally submitted on the taxpayer's behalf. If the affirmation is not filed within a reasonable period of time after a request, the CDP hearing request will be denied with respect to the non-signing taxpayer.

* * * * *

Q-C6. Where must the written request for a CDP hearing be sent?

A-C6. The written request for a CDP hearing must be sent, or hand delivered (if permitted), to the IRS office and address as directed on the CDP Notice. If the address of that office does not appear on the CDP Notice, the taxpayer should obtain the address of the office to which the written request should be sent or hand delivered by calling, toll-free, 1-800-829-1040 and providing the taxpayer's identification number (SSN or TIN).

* * * * *

A-C7. If the taxpayer does not request a CDP hearing in writing within the 30-day period that commences on the day after the date of the CDP Notice, the taxpayer foregoes the right to a CDP hearing under section 6330 with respect to the unpaid tax and tax periods shown on the CDP Notice. If the request for CDP hearing is received after the 30-day period, the taxpayer will be notified of the untimely request and of the right to an equivalent hearing. See paragraph (i) of this section.

* * * * *

(d) * * *

(2) * * *

A-D4. Prior involvement by an Appeals officer or employee includes participation or involvement in an Appeals hearing (other than a CDP hearing held under either section 6320 or section 6330) that the taxpayer may have had with respect to the tax and tax period shown on the CDP Notice. Prior involvement exists only when the taxpayer, the tax liability and the tax period at issue in the CDP hearing also were at issue in the prior non-CDP hearing or proceeding, and the Appeals officer or employee actually participated in the prior hearing or proceeding.

* * * * *

A-D7. Except as provided in A-D8 of this paragraph (d)(2), a taxpayer who presents in the CDP hearing request relevant, non-frivolous reasons for disagreement with the proposed levy will ordinarily be offered an opportunity for a face-to-face conference at the Appeals office closest to the taxpayer's residence. A business taxpayer will ordinarily be offered an opportunity for a face-to-face conference at the Appeals office closest to the taxpayer's principal place of business. If that is not satisfactory to the taxpayer, the taxpayer will be given an opportunity for a hearing by telephone or by correspondence. In all cases, the Appeals officer or employee will review the case file, which includes the taxpayer's request for a CDP hearing, any other written communications from the taxpayer or the taxpayer's authorized representative, and any notes made by Appeals officers or employees of any oral communications with the taxpayer or the taxpayer's authorized representative. If no face-to-face or telephonic conference is held, review of those documents will constitute the CDP hearing for purposes of section 6330(b).

Q-D8. In what circumstances will a face-to-face CDP conference not be granted?

A-D8. A taxpayer is not entitled to a face-to-face CDP conference at a location other than as provided in A-D7 of this paragraph (d)(2) and this A-D8. If all Appeals officers or employees at the location provided for in A-D7 of this paragraph have had prior involvement with the taxpayer as provided in A-D4 of this paragraph, the taxpayer will not be offered a face-to-face meeting at that location, unless the taxpayer elects to waive the requirement of section 6330(b)(3). The taxpayer will be offered a face-to-face conference at another Appeals office if Appeals in the exercise of its discretion would have offered the taxpayer a face-to-face conference at the location provided in A-D7. A face-to-face CDP conference concerning a taxpayer's underlying liability will not be granted if the request for a hearing or other taxpayer communication indicates that the taxpayer wishes only to raise irrelevant or frivolous issues concerning that liability. A face-to-face CDP conference concerning a collection alternative, such as an installment agreement or an offer to compro-

mise liability, will not be granted unless the alternative would be available to other taxpayers in similar circumstances. For example, because the IRS does not consider offers to compromise from taxpayers who have not filed required returns or have not made certain required deposits of tax, as set forth in Form 656, "Offer in Compromise," no face-to-face conference will be offered to a taxpayer who wishes to make an offer to compromise but has not fulfilled those obligations. A face-to-face conference need not be granted if the taxpayer does not provide the required information set forth in A-C1(ii)(E) of paragraph (c)(2). See also A-C1(iii) of paragraph C-2.

(3) *Examples.* The following examples illustrate the principles of this paragraph (d):

Example 1. Individual A timely requests a CDP hearing concerning a proposed levy for the 1998 income tax liability assessed against individual A. Appeals employee B previously conducted a CDP hearing regarding a NFTL filed with respect to A's 1998 income tax liability. Because employee B's only prior involvement with individual A's 1998 income tax liability was in connection with a section 6320 CDP hearing, employee B may conduct the CDP hearing under section 6330 involving the proposed levy for the 1998 income tax liability.

Example 2. Individual C timely requests a CDP hearing concerning a proposed levy for the 1998 income tax liability assessed against individual C. Appeals employee D previously conducted a Collection Appeals Program (CAP) hearing regarding a NFTL filed with respect to C's 1998 income tax liability. Because employee D's prior involvement with individual C's 1998 income tax liability was in connection with a non-CDP hearing, employee D may not conduct the CDP hearing under section 6330 unless individual C waives the requirement that the hearing will be conducted by an Appeals officer or employee who has had no prior involvement with respect to C's 1998 income tax liability.

Example 3. Same facts as in *Example 2*, except that the prior CAP hearing only involved individual C's 1997 income tax liability and employment tax liabilities for 1998 reported on Form 941. Employee D would not be considered to have prior involvement because the prior CAP hearing in which she participated did not involve individual C's 1998 income tax liability.

Example 4. Appeals employee F is assigned to a CDP hearing concerning a proposed levy for a trust fund recovery penalty (TFRP) assessed pursuant to section 6672 against individual E. Appeals employee F participated in a prior CAP hearing involving individual E's 1999 income tax liability, and participated in a CAP hearing involving the employment taxes of business entity X, which incurred the employment tax liability to which the TFRP assessed against individual E relates. Appeals employee F would not be considered to have prior involvement because the prior CAP hearings in which he participated did not di-

rectly involve the TFRP assessed against individual E.

Example 5. Appeals employee G is assigned to a CDP hearing concerning a proposed levy for a TFRP assessed pursuant to section 6672 against individual H. In preparing for the CDP hearing, Appeals employee G reviews the Appeals case file concerning the prior CAP hearing involving the TFRP assessed pursuant to section 6672 against individual H. Appeals employee G is not deemed to have participated in the previous CAP hearing involving the TFRP assessed against individual H by such review.

(e) *Matters considered at CDP hearing—(1) In general.* Appeals has the authority to determine the validity, sufficiency, and timeliness of any CDP Notice given by the IRS and of any request for a CDP hearing that is made by a taxpayer. Prior to issuance of a determination, Appeals is required to obtain verification from the IRS office collecting the tax that the requirements of any applicable law or administrative procedure have been met. The taxpayer may raise any relevant issue relating to the unpaid tax at the hearing, including appropriate spousal defenses, challenges to the appropriateness of the proposed levy, and offers of collection alternatives. The taxpayer also may raise challenges to the existence or amount of the underlying liability for any tax period specified on the CDP Notice if the taxpayer did not receive a statutory notice of deficiency for that tax liability or did not otherwise have an opportunity to dispute the tax liability. Finally, the taxpayer may not raise an issue that was raised and considered at a previous CDP hearing under section 6320 or in any other previous administrative or judicial proceeding if the taxpayer participated meaningfully in such hearing or proceeding. Taxpayers will be expected to provide all relevant information requested by Appeals, including financial statements, for its consideration of the facts and issues involved in the hearing.

* * * * *

(3) * * *

A-E2. A taxpayer is entitled to challenge the existence or amount of the underlying liability for any tax period specified on the CDP Notice if the taxpayer did not receive a statutory notice of deficiency for such liability or did not otherwise have an opportunity to dispute such liability. Receipt of a statutory notice of deficiency for this purpose means receipt in time to petition the Tax Court for a redetermination of

the deficiency determined in the notice of deficiency. An opportunity to dispute the underlying liability includes a prior opportunity for a conference with Appeals that was offered either before or after the assessment of the liability.

* * * * *

A-E6. Collection alternatives include, for example, a proposal to withhold the proposed levy or future collection action in circumstances that will facilitate the collection of the tax liability, an installment agreement, an offer to compromise, the posting of a bond, or the substitution of other assets. A collection alternative is not available unless the alternative would be available to other taxpayers in similar circumstances. For example, the IRS does not consider an offer to compromise made by a taxpayer who, at the time of the CDP hearing, has not filed required returns or has not made certain required deposits of tax, as set forth in Form 656, "Offer in Compromise." The collection alternative of an offer to compromise would not be available to such a taxpayer in a CDP hearing.

* * * * *

A-E7. The taxpayer may raise appropriate spousal defenses, challenges to the appropriateness of the proposed collection action, and offers of collection alternatives. The existence or amount of the underlying liability for any tax period specified in the CDP Notice may be challenged only if the taxpayer did not already have an opportunity to dispute the tax liability. If the taxpayer previously received a CDP Notice under section 6320 with respect to the same tax and tax period and did not request a CDP hearing with respect to that earlier CDP Notice, the taxpayer has already had an opportunity to dispute the existence or amount of the underlying tax liability.

* * * * *

(f) * * *

(2) * * *

A-F5. In seeking Tax Court or district court review of a Notice of Determination, the taxpayer can only ask the court to consider an issue, including a challenge to the underlying tax liability, that was properly raised in the taxpayer's CDP hearing. An issue is not properly raised if the taxpayer fails to request consideration of the issue

by Appeals, or if consideration is requested but the taxpayer fails to present to Appeals any evidence with respect to that issue after being given a reasonable opportunity to present such evidence.

Q-F6. What is the administrative record for purposes of court review?

A-F6. The case file, including written communications and information from the taxpayer or the taxpayer's authorized representative submitted in connection with the CDP hearing, notes made by an Appeals officer or employee of any oral communications with the taxpayer or the taxpayer's authorized representative and memoranda created by the Appeals officer or employee in connection with the CDP hearing, and any other documents or materials relied upon by the Appeals officer or employee in making the determination under section 6330(c)(3), will constitute the record in any court review of the Notice of Determination issued by Appeals.

- (i) * * *
- (2) * * *

Q-II. What must a taxpayer do to obtain an equivalent hearing?

A-II. (i) A request for an equivalent hearing must be made in writing. A written request in any form that requests an equivalent hearing will be acceptable if it includes the information required in paragraph (ii) of this A-II.

(ii) The request must be dated and must include the following information:

- (A) The taxpayer's name, address, daytime telephone number (if any), and taxpayer identification number (SSN or EIN).
- (B) The type of tax involved.
- (C) The tax period at issue.
- (D) A statement that the taxpayer is requesting an equivalent hearing with Appeals concerning the levy.

(E) The reason or reasons why the taxpayer disagrees with the proposed levy.

(F) The signature of the taxpayer or the taxpayer's authorized representative.

(iii) The taxpayer must perfect any timely written request for an equivalent hearing that does not provide the required information set forth in paragraph (ii) of this A-II within a reasonable period of time after a request from the IRS. If the requested information is not provided within a reasonable period of time, the taxpayer's equivalent hearing request will be denied.

(iv) The taxpayer must affirm any timely written request for an equivalent

hearing that is signed or alleged to have been signed on the taxpayer's behalf by the taxpayer's spouse or other unauthorized representative, and that otherwise meets the requirements set forth in paragraph (ii) of this A-II, by filing, within a reasonable time after a request from the IRS, a signed written affirmation that the request was originally submitted on the taxpayer's behalf. If the affirmation is not filed within a reasonable period of time, the equivalent hearing request will be denied with respect to the non-signing taxpayer.

* * * * *

Q-I7. When must a taxpayer request an equivalent hearing with respect to a CDP Notice issued under section 6330?

A-I7. A taxpayer must submit a written request for an equivalent hearing within the one-year period commencing the day after the date of the CDP Notice issued under section 6330. This period is slightly different from the period for submitting a written request for an equivalent hearing with respect to a CDP Notice issued under section 6320. For a CDP Notice issued under section 6320, a taxpayer must submit a written request for an equivalent hearing within the one-year period commencing the day after the end of the five-business-day period following the filing of the NFTL.

Q-I8. How will the timeliness of a taxpayer's written request for an equivalent hearing be determined?

A-I8. The rules and regulations under section 7502 and section 7503 will apply to determine the timeliness of the taxpayer's request for an equivalent hearing, if properly transmitted and addressed as provided in A-I10 of this paragraph (i)(2).

Q-I9. Is the one-year period within which a taxpayer must make a request for an equivalent hearing extended because the taxpayer resides outside the United States?

A-I9. No. All taxpayers who want an equivalent hearing must request the hearing within the one-year period commencing the day after the date of the CDP Notice issued under section 6330.

Q-I10. Where must the written request for an equivalent hearing be sent?

A-I10. The written request for an equivalent hearing must be sent, or hand delivered (if permitted), to the IRS office

and address as directed on the CDP Notice. If the address of the issuing office does not appear on the CDP Notice, the taxpayer should obtain the address of the office to which the written request should be sent or hand delivered by calling, toll-free, 1-800-829-1040 and providing the taxpayer's identification number (SSN or EIN).

Q-I11. What will happen if the taxpayer does not request an equivalent hearing in writing within the one-year period commencing the day after the date of the CDP Notice issued under section 6330?

A-I11. If the taxpayer does not request an equivalent hearing with Appeals within the one-year period commencing the day after the date of the CDP Notice issued under section 6330, the taxpayer foregoes the right to an equivalent hearing with respect to the unpaid tax and tax periods shown on the CDP Notice. The taxpayer, however, may seek reconsideration by the IRS office collecting the tax, assistance from the National Taxpayer Advocate, or an administrative hearing before Appeals under its Collection Appeals Program or any successor program.

* * * * *

(j) *Effective date.* This section is applicable the date 30 days after final regulations are published in the **Federal Register** with respect to requests made for CDP hearings or equivalent hearings on or after the date 30 days after final regulations are published in the **Federal Register**.

Mark E. Matthews,
*Deputy Commissioner for
Services and Enforcement.*

(Filed by the Office of the Federal Register on September 15, 2005, 8:45 a.m., and published in the issue of the Federal Register for September 16, 2005, 70 F.R. 54687)

Notice of Proposed Rulemaking and Notice of Public Hearing

Application of Section 409A to Nonqualified Deferred Compensation Plans

REG-158080-04

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations regarding the application of section 409A to nonqualified deferred compensation plans. The regulations affect service providers receiving amounts of deferred compensation, 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 January 3, 2006. Outlines of topics to be discussed at the public hearing scheduled for January 25, 2006, must be received by January 4, 2006.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-158080-04), 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-158080-04), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the IRS Internet site at www.irs.gov/regs or via the Federal eRulemaking Portal at www.regulations.gov (IRS REG-158080-04). 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, Richard A. Hurst at (202) 622-7116 (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 unless certain requirements are met, amounts deferred under a nonqualified deferred

compensation plan for all 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, where such arrangements are located outside of the United States or are restricted to the provision of benefits in connection with a decline in the financial health of the sponsor.

On December 20, 2004, the IRS issued Notice 2005-1, 2005-2 I.R.B. 274 (published as modified on January 6, 2005), setting forth initial guidance with respect to the application of section 409A, and supplying transition guidance in accordance with the terms of the statute. Notice 2005-1 requested comments on all aspects of the application of section 409A, including certain specified topics. Numerous comments were submitted and all were considered by the Treasury Department and the IRS in formulating these regulations. In general, these regulations incorporate the guidance provided in Notice 2005-1 and provide substantial additional guidance. For a discussion of the continued applicability of Notice 2005-1, see the **Effect on Other Documents** section of this preamble.

Explanation of Provisions

I. Definition of Nonqualified Deferred Compensation Plan

A. In general

Section 409A applies to amounts deferred under a nonqualified deferred compensation plan. For this purpose a nonqualified deferred compensation plan means any plan that provides for the deferral of compensation, with specified exceptions such as qualified retirement plans, tax-deferred annuities, simplified employee pensions, SIMPLEs and section 501(c)(18) trusts. In addition, section 409A does not apply to certain welfare benefit plans, including *bona fide* vacation leave, sick leave, compensatory time, disability pay, and death benefit plans.

In certain instances, these regulations cross reference the regulations under section 3121(v)(2), which provide a special timing rule under the Federal Insurance

Contributions Act (FICA) for nonqualified deferred compensation, as defined in section 3121(v)(2) and the regulations thereunder. However, unless explicitly cross-referenced in these regulations, the regulations under section 3121(v)(2) do not apply for purposes of section 409A and under no circumstances do these proposed regulations affect the application of section 3121(v)(2).

B. Section 457 plans

Section 409A does not apply to eligible deferred compensation plans under section 457(b). However, section 409A applies to nonqualified deferred compensation plans to which section 457(f) applies, separately and in addition to the requirements applicable to such plans under section 457(f). Section 409A(c) provides that nothing in section 409A prevents the inclusion of amounts in gross income under any other provision of the Code. Section 409A(c) further provides that any amount included in gross income under section 409A will not be required to be included in gross income under any other Code provision later than the time provided in section 409A. Accordingly, if in a taxable year an amount subject to section 409A (but not required to be included in income under section 409A) is required to be included in gross income under section 457(f), that amount must be included in gross income under section 457(f) for that taxable year. Correspondingly, if in a taxable year an amount that would otherwise be required to be included in gross income under section 457(f) has been included previously in gross income under section 409A, that amount will not be required to be included in gross income under section 457(f) for that taxable year.

These proposed regulations are intended solely as guidance with respect to the application of section 409A to such arrangements, and should not be relied upon with respect to the application of section 457(f). Thus, state and local government and tax exempt entities may not rely upon the definition of a deferral of compensation under §1.409A-1(b) of these proposed regulations in applying section 457(f). For example, for purposes of section 457(f), a deferral of compensation includes a stock option and an arrangement in which an employee or independent

contractor of a state or local government or tax-exempt entity earns the right to future payments for services, even if those amounts are paid immediately upon vesting and would qualify for the exclusion from the definition of deferred compensation under §1.409A-1(b)(4) or (5) of these proposed regulations. However, until further guidance is issued, state and local government and tax exempt entities may rely on the definitions of *bona fide* vacation leave, sick leave, compensatory time, disability pay, and death benefit plans for purposes of section 457(f) as applicable for purposes of applying section 409A and §1.409A-1(a)(5) of these proposed regulations to nonqualified deferred compensation plans under section 457(f).

C. Arrangements with independent contractors

Consistent with Notice 2005-1, Q&A-8, these regulations exclude from coverage under section 409A certain arrangements between service providers and service recipients. Under these regulations, amounts deferred in a taxable year with respect to a service provider using an accrual method of accounting for that year are not subject to section 409A. In addition, section 409A generally does not apply to amounts deferred pursuant to an arrangement between a service recipient and an unrelated independent contractor (other than a director of a corporation), if during the independent contractor's taxable year in which the amount is deferred, the independent contractor is providing significant services to each of two or more service recipients that are unrelated, both to each other and to the independent contractor. In response to comments, these regulations clarify that the determination is made based upon the independent contractor's taxable year in which the amount is deferred.

Commentators also requested clarification of the circumstances in which services to each service recipient will be deemed to be significant, as required for the exclusion. Determining whether services provided to a service recipient are significant generally will involve an examination of all relevant facts and circumstances. However, two clarifications have been provided. First, the analysis applies separately to each trade or business in which

the service provider is engaged. For example, a taxpayer providing computer programming services for one service recipient will not meet the exception if, as a separate trade or business, the taxpayer paints houses for another unrelated service recipient. To provide certainty to many independent contractors engaged in an active trade or business with multiple service recipients, a safe harbor has been provided under which an independent contractor with multiple unrelated service recipients, to whom the independent contractor also is not related, will be treated as providing significant services to more than one of those service recipients, if not more than 70 percent of the total revenue generated by the trade or business in the particular taxable year is derived from any particular service recipient (or group of related service recipients).

Commentators also requested clarification with respect to the application of section 409A to directors. As provided in these regulations, an individual will not be excluded from coverage under section 409A merely because the individual provides services as a director to two or more unrelated service recipients. However, the provisions of section 409A apply separately to arrangements between the service provider director and each service recipient. Accordingly, the inclusion of income due to a failure to meet the requirements of section 409A with respect to an arrangement to serve as a director of one service recipient will not cause an inclusion of income with respect to arrangements to serve as a director of an unrelated service recipient. In addition, the continuation of services as a director with one service recipient will not cause the termination of services as a director with an unrelated service recipient to fail to constitute a separation from service for purposes of section 409A, if the termination would otherwise qualify as a separation from service.

Commentators also requested clarification with respect to the application of the rule to directors who are also employees of the service recipient. In general, the provisions of section 409A will apply separately to the arrangements between the service recipient and the service provider for services as a director and the arrangements between the service recipient and the service provider for services as an employee. However, the distinction is not intended to

permit employee directors to limit the aggregation of arrangements in which the individual participates as an employee by labeling such arrangements as arrangements for services as a director. Accordingly, an arrangement with an employee director will be treated as an arrangement for services as a director only to the extent that another non-employee director defers compensation under the same, or a substantially similar, arrangement on similar terms. Moreover, the separate application of section 409A to arrangements for services as a director and arrangements for services as an employee does not extend to a service provider's services for the service recipient as an independent contractor in addition to the service provider's services as a director of the service recipient. Under those circumstances, both arrangements are treated as services provided as an independent contractor.

Commentators also requested clarification of the application of the exclusion to independent contractors who provide services to only one service recipient, when that service recipient itself has multiple clients. Specifically a commentator requested that the rule be applied on a look through basis, so that the independent contractor will be deemed to be providing services for multiple service recipients. The Treasury Department and the IRS do not believe that such a rule is appropriate. Where multiple persons have come together and formed an entity that is itself a service recipient of the independent contractor, the independent contractor is performing services for the single entity service recipient.

The Treasury Department and the IRS believe that where the service recipient is purchasing an independent contractor's management services, amounts deferred with respect to the independent contractor's performance of services should not be excluded from coverage under section 409A. Among the many objectives underlying the enactment of section 409A is to limit the ability of a service provider to retain the benefits of the deferral of compensation while having excessive control over the timing of the ultimate payment. Where the independent contractor is managing the service recipient, there is a significant potential for the independent contractor to have such influence or control over compensation matters so that categor-

ical exclusion from coverage under section 409A is not appropriate. Accordingly, the regulations provide that compensation arrangements between an independent contractor and a service recipient that involve the provision of management services are not excluded from coverage under section 409A, and in such cases, the service recipient is not treated as unrelated for purposes of determining whether arrangements with other service recipients are excluded from coverage under section 409A under the general rule addressing independent contractors providing services to multiple unrelated service recipients. For this purpose, management services include services involving actual or de facto direction or control of the financial or operational aspects of the client's trade or business, or investment advisory services that are integral to the trade or business of a service recipient whose primary trade or business involves the management of investments in entities other than the entities comprising the service recipient, such as a hedge fund or real estate investment trust.

II. *Definition of Nonqualified Deferred Compensation*

A. *In general*

Consistent with Notice 2005-1, Q&A-4, these regulations provide that a plan provides for the deferral of compensation only if, under the terms of the plan and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in gross income, and that, pursuant to the terms of the plan, is payable to (or on behalf of) the service provider in a later year. A legally binding right to compensation may exist even where the right is subject to conditions, including conditions that constitute a substantial risk of forfeiture. For example, an employee that in Year 1 is promised a bonus equal to a set percentage of employer profits, to be paid out in Year 3 if the employee has remained in employment through Year 3, has a legally binding right to the payment of the compensation, subject to the conditions being met. The right thus may be subject to a substantial risk of forfeiture, and accordingly be nonvested; however, the promise

constitutes a legally binding right subject to a condition.

In contrast, a service provider does not have a legally binding right to compensation if that compensation may be unilaterally reduced or eliminated by the service recipient or other person after the services creating the right to the compensation have been performed. Notice 2005-1, Q&A-4 provides that, if the facts and circumstances indicate that the discretion to reduce or eliminate the compensation is available or exercisable only upon a condition that is unlikely to occur, or the discretion to reduce or eliminate the compensation is unlikely to be exercised, a service provider will be considered to have a legally binding right to the compensation. Commentators criticized the provision as being difficult to apply, because the standard is too vague, requiring a subjective judgment as to whether the discretion is likely to be exercised. The intent of this provision was to eliminate the possibility of taxpayers avoiding the application of section 409A through the use of plan provisions providing negative discretion, where such provisions are not meaningful. In response to the comments, these regulations adopt a standard under which the negative discretion will be recognized unless it lacks substantive significance, or is available or exercisable only upon a condition. Thus, where a promise of compensation may be reduced or eliminated at the unfettered discretion of the service recipient, that promise generally will not result in a legally binding right to compensation. However, where the negative discretion lacks substantive significance, or the discretion is available or exercisable only upon a condition, the discretion will be ignored and the service provider will be treated as having a legally binding right. In addition, where the service provider has control over, or is related to, the person granted the discretion to reduce or eliminate the compensation, or has control over all or any portion of such person's compensation or benefits, the discretion also will be ignored and the service provider will be treated as having a legally binding right to the compensation.

B. *Short-term deferrals*

Notice 2005-1, Q&A-4(c), set forth an exception from coverage under section

409A under which certain arrangements, referred to as short-term deferrals, would not be treated as resulting in the deferral of compensation. Specifically, Notice 2005-1, Q&A-4 provided that until further guidance a deferral of compensation would not occur if, absent an election to otherwise defer the payment to a later period, at all times the terms of the plan require payment by, and an amount is actually or constructively received by the service provider by, the later of (i) the date that is 2½ months from the end of the service provider's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture, or (ii) the date that is 2½ months from the end of the service recipient's year in which the amount is no longer subject to a substantial risk of forfeiture. For these purposes, an amount that is never subject to a substantial risk of forfeiture is considered to be no longer subject to a substantial risk of forfeiture on the date the service provider first has a legally binding right to the amount. Under this rule, many multi-year bonus arrangements that require payments promptly after the amount vests would not be subject to section 409A.

The exception from coverage under section 409A for short-term deferrals set forth in Notice 2005-1, Q&A-4, has been incorporated into these proposed regulations. Commentators questioned whether a written provision in the arrangement requiring the payment to be made by the relevant deadline is necessary, or whether the customary practice of the service recipient is sufficient. These regulations do not require that the arrangement provide in writing that the payment must be made by the relevant deadline. Accordingly, where an arrangement does not otherwise defer compensation, an amount will qualify as a short-term deferral, and not be subject to section 409A, if the amount is actually paid out by the appropriate deadline. However, where an arrangement does not provide in writing that a payment must be paid by a specified date on or before the relevant deadline, and the payment is not made by the appropriate deadline (except due to unforeseeable administrative or solvency issues, as discussed below), the payment will result in automatic violation of section 409A due to the failure to specify the payment date or a permissible payment event. In addition, the rules permitting

the service recipient limited discretion to delay payments of amounts subject to section 409A (for example, where the service recipient reasonably anticipates that payment of the amount would not be deductible due to application of section 162(m), or where the service recipient reasonably anticipates that payment of the amount would violate a loan covenant or similar contractual provision) would not be available, because the arrangement would not have specified a payment date subject to the delay. In contrast, where an arrangement provides in writing that a payment must be made by a specified date on or before the relevant deadline, and the payment is not made by the appropriate deadline so that section 409A becomes applicable, the rules contained in these regulations generally permitting the payment to be made in the same calendar year as the fixed payment date become applicable. In addition, the rules permitting a plan to provide for a delay in the payment in certain circumstances and the relief applicable to disputed payments and refusals to pay would also be available. Accordingly, it will often be appropriate to include a date or year for payment even when it is intended that the payment will be made within the short-term deferral period.

The short-term deferral rule does not provide a method to avoid application of section 409A if the legally binding right creates a right to deferred compensation from the outset. For example, if a legally binding right to payment in Year 10 arises in Year 1, but the right is subject to a substantial risk of forfeiture through Year 3, paying the amount at the end of Year 3 would not result in the payment failing to be subject to section 409A, but rather generally would be an impermissible acceleration of the payment from the originally established right to payment in Year 10.

Commentators also questioned whether the 2½ month deadline for payment could be extended where the payment was not administratively practicable, or where the payment was made late due to error. These regulations provide that a payment made after the 2½ month deadline may continue to be treated as meeting the requirements of the exception from the definition of a deferral of compensation if the taxpayer establishes that it was impracticable, either administratively or economically, to avoid

the deferral of the receipt by a service provider of the payment beyond the applicable 2½ month period and that, as of the time the legally binding right to the amount arose, such impracticability was unforeseeable, and the payment is made as soon as practicable. Some commentators had asked for a rule permitting delays due to unintentional error to satisfy the standard for the exclusion. However, the exception is based upon the longstanding position set forth in §1.404(b)-1T, Q&A-2(b) regarding the timing of the deduction with respect to a payment under a nonqualified deferred compensation plan. Similar to the deduction rule, the exclusion from coverage under section 409A treats a payment made within the appropriate 2½ month period as made within such a short period following the date the substantial risk of forfeiture lapses that it may be treated as paid when earned (and not deferred to a subsequent period). Also similar to the rule governing the timing of deductions, the exclusion from coverage under section 409A permits only limited exceptions to the requirement that the amount actually be paid by the relevant deadline. Pending further study, the Treasury Department and the IRS believe that providing further flexibility with respect to meeting the deadline would create the potential for abuse and enforcement difficulty.

C. Stock options and stock appreciation rights

1. In general

The legislative history states that section 409A does not cover grants of stock options where the exercise price can never be less than the fair market value of the underlying stock at the date of grant (a non-discounted option). See H.R. Conf. Rep. No. 108-755, at 735 (2004). Thus an option with an exercise price that is or may be below the fair market value of the underlying stock at the date of grant (a discounted option) is subject to the requirements of section 409A. Consistent with the legislative history and with Notice 2005-1, Q&A-4, these regulations provide that a non-discounted stock option, that has no other feature for the deferral of compensation, generally is not covered by section 409A. However, a stock option granted with an exercise price below the fair mar-

ket value of the underlying shares of stock on the date of grant generally would be subject to section 409A except to the extent the terms of the option only permit exercise of the option during the short-term deferral period.

Commentators stressed that in many respects, a stock appreciation right can be the economic equivalent of a stock option, especially a stock option that allows the holder to exercise in a manner other than by the payment of cash (a cashless exercise feature). Accordingly, Notice 2005-1, Q&A-4 exempted from coverage certain non-discounted stock appreciation rights that most closely resembled stock options — stock appreciation rights settled in stock. The Treasury Department and the IRS were concerned that the manipulation of the purported stock valuation for purposes of determining whether the stock appreciation right was issued at a discount or settled at a premium could lead to a stock appreciation right being used to circumvent section 409A. Accordingly, the exception was limited to stock appreciation rights issued with respect to stock traded on an established securities market.

Commentators criticized the distinction between public corporations and non-public corporations, asserting that this distinction is not meaningful and unfairly discriminated against the latter corporations and placed such corporations at a severe competitive disadvantage. In addition, commentators questioned whether the distinction between stock-settled and cash-settled stock appreciation rights was relevant, where the amount of income generated would be identical.

In response to the comments, these regulations treat stock appreciation rights similarly to stock options, regardless of whether the stock appreciation right is settled in cash and regardless of whether the stock appreciation right is based upon service recipient stock that is not readily tradable on an established securities market. The Treasury Department and the IRS remain concerned that manipulation of stock valuations, and manipulation of the characteristics of the underlying stock, may lead to abuses with respect to stock options and stock appreciation rights (collectively referred to as stock rights). To that end, these regulations contain more detailed provisions with respect to the identification of service recipient stock

that may be subject to, or used to determine the amount payable under, stock rights excluded from the application of section 409A, and the valuation of such service recipient stock, discussed below.

2. *Definition of service recipient stock*

The legislative history of section 409A states that the exception from coverage under section 409A for certain nonstatutory stock options was intended to cover options granted on service recipient stock. H.R. Conf. Rep. No. 108-755, at 735 (2004). Section 409A(d)(6) provides that, for purposes of determining the identity of the service recipient under section 409A, aggregation rules similar to the rules in section 414(b) and (c) apply. Taxpayers requested that the definition of service recipient be expanded for purposes of the exception for stock rights to cover entities that would not otherwise be treated as part of the service recipient applying the rules under section 414(b) and (c). The Treasury Department and the IRS agree that the exclusion for nonstatutory stock rights was not meant to apply so narrowly. Accordingly, for purposes of the provisions excluding certain stock rights on service recipient stock, the stock right, or the plan or arrangement under which the stock right is granted, may provide that section 414(b) and (c) be applied by modifying the language and using "50 percent" instead of "80 percent" where appropriate, such that stock rights granted to employees of entities in which the issuing corporation owns a 50 percent interest generally will not be subject to section 409A.

Commentators also requested that the threshold be dropped below 50 percent to cover joint ventures and other similar arrangements, where the participating corporation does not have a majority interest. These regulations provide for such a lower threshold, allowing for the stock right, or the plan or arrangement under which the stock right is granted, to provide for the modification of the language and use of "20 percent" instead of "80 percent" in applying section 414(b) and (c), where the use of such stock with respect to stock rights is due to legitimate business criteria. For example, the use of such stock with respect to stock rights issued to employees of a joint venture that were former employees of a corporation with at

least a 20 percent interest in the joint venture generally would be due to legitimate business criteria, and accordingly would be treated as service recipient stock for purposes of determining whether the stock right was subject to section 409A. A designation by a service recipient to use either the 50 percent or the 20 percent threshold must be applied consistently to all compensatory stock rights, and any designation of a different permissible ownership threshold percentage may not be made effective until 12 months after the adoption of such change.

The increased ability to issue stock rights with respect to a related corporation for whom the service provider does not directly perform services could increase the potential for service recipients to exploit the exclusion for certain stock rights by establishing a corporation within the group of related corporations, the purpose of which is to serve as an investment vehicle for nonqualified deferred compensation. Accordingly, these regulations provide that other than with respect to service providers who are primarily engaged in providing services directly to such corporation, the term service recipient for purposes of the definition of service recipient stock does not include a corporation whose primary purpose is to serve as an investment vehicle with respect to the corporation's interest in entities other than the service recipient (including entities aggregated with the corporation under the definition of service recipient incorporating section 414(b) and (c)).

Commentators also questioned whether the exception for certain stock rights could apply where a service recipient provides a stock right with respect to preferred stock or a separate class of common stock. The Treasury Department and the IRS believe this exception was intended to cover stock rights with respect to service recipient stock the fair market value of which meaningfully relates to the potential future appreciation in the enterprise value of the corporation. The use of a separate class of common stock created for the purpose of compensating service providers, or the use of preferred stock with substantial characteristics of debt, could create an arrangement that more closely resembles traditional nonqualified deferred compensation arrangements rather than an interest in appreciation of

the value of the service recipient. An exception that excluded these arrangements from coverage under section 409A would undermine the effectiveness of the statute to govern nonqualified deferred compensation arrangements, contrary to the legislative intent. Accordingly, these regulations clarify that service recipient stock includes only common stock, and only the class of common stock that as of the date of grant has the highest aggregate value of any class of common stock of the corporation outstanding, or a class of common stock substantially similar to such class of stock (ignoring differences in voting rights). In addition, service recipient stock does not include any stock that provides a preference as to dividends or liquidation rights.

With respect to the foreign aspects of such arrangements, commentators requested clarification that service recipient stock may include American Depositary Receipts (ADRs). These regulations clarify that stock of the service recipient may include ADRs, provided that the stock to which the ADRs relate would otherwise qualify as service recipient stock.

Commentators also requested that certain equity appreciation rights issued by mutual companies, intended to mimic stock appreciation rights, be excluded from coverage under section 409A. These regulations expand the exclusion for stock appreciation rights to include equity appreciation rights with respect to mutual company units. A mutual company unit is defined as a specified percentage of the fair market value of the mutual company. For this purpose, a mutual company may value itself under the same provisions applicable to the valuation of stock of a corporation that is not readily tradable on an established securities market. The Treasury Department and the IRS request comments as to the practicability of this provision, and whether such a provision should be expanded to cover equity appreciation rights issued by other entities that do not have outstanding shares of stock.

3. *Valuation*

Notice 2005-1, Q&A-4(d)(ii) provides that for purposes of determining whether the requirements for exclusion of a nonstatutory stock option have been met, any reasonable valuation method may be used.

Commentators expressed concern that the standard was too vague, given the potential consequences of a failure to comply with the requirements of section 409A.

These regulations provide that with respect to service recipient stock that is readily tradable on an established securities market, a valuation of such stock may be based on the last sale before or the first sale after the grant, or the closing price on the trading day before or the trading day of the grant, or any other reasonable basis using actual transactions in such stock as reported by such market and consistently applied. Commentators pointed out that certain service recipients, generally corporations in certain foreign jurisdictions, would not be able to meet this requirement because the service recipient is subject to foreign laws requiring pricing based on an average over a period of time. To allow compliance with these requirements, these regulations further provide that service recipients (including U.S. service recipients) may set the exercise price based on an average of the price of the stock over a specified period provided such period occurs within the 30 days before and 30 days after the grant date, and provided further that the terms of the grant are irrevocably established before the beginning of the measurement period used to determine the exercise price.

Commentators asked for clarification of the definition of stock that is readily tradable on an established securities market. Specifically, commentators requested clarification of the scope of an established securities market, and whether that term includes over-the-counter markets and foreign markets. The regulations adopt the definition of an established securities market set forth in §1.897-1(m). Under that definition, over-the-counter markets generally are treated as established securities markets, as well as many foreign markets. However, the stock must also be readily tradable within such markets to qualify as stock readily tradable on an established securities market.

With respect to corporations whose stock is not readily tradable on an established securities market, these regulations provide that fair market value may be determined through the reasonable application of a reasonable valuation method. The regulations contain a description of the factors that will be taken into account

in determining whether a given valuation method is reasonable. In addition, in an effort to provide more certainty, certain presumptions with respect to the reasonableness of a valuation method have been set forth. Provided one such method is applied reasonably and used consistently, the valuation determined by applying such method will be presumed to equal the fair market value of the stock, and such presumption will be rebuttable only by a showing that the valuation is grossly unreasonable. A method will be treated as used consistently where the same method is used for all equity-based compensation granted to service providers by the service recipient, including for purposes of determining the amount due upon exercise or repurchase where the stock acquired is subject to an obligation of the service recipient to repurchase, or a put or call right providing for the potential repurchase by the service recipient, as applicable.

Commentators specifically requested clarification as to whether a valuation method based upon an appraisal will be treated as reasonable, and if so with respect to what period. These regulations provide that the use of an appraisal will be presumed reasonable if the appraisal satisfies the requirements of the Code with respect to the valuation of stock held in an employee stock ownership plan. If those requirements are satisfied, the valuation will be presumed reasonable for a one-year period commencing on the date as of which the appraisal values the stock.

Commentators also specifically requested clarification of whether a valuation method based on a nonlapse restriction addressed in §1.83-5(a) will be treated as reasonable. Under §1.83-5(a), in the case of property subject to a nonlapse restriction (as defined in §1.83-3(h)), the price determined under the formula price is considered to be the fair market value of the property unless established to the contrary by the Commissioner, and the burden of proof is on the Commissioner with respect to such value. If stock in a corporation is subject to a nonlapse restriction that requires the transferee to sell such stock only at a formula price based on book value, a reasonable multiple of earnings or a reasonable combination thereof, the price so determined ordinarily is regarded as determinative of the fair market

value of such property for purposes of section 83.

The Treasury Department and the IRS do not believe that this standard, in and of itself, is appropriate with respect to the application of section 409A. The Treasury Department and the IRS are not confident that a formula price determined pursuant to a nonlapse restriction will, in every case, adequately approximate the value of the underlying stock. The Treasury Department and the IRS are also concerned that such formula valuations, in the absence of other criteria, may be subject to manipulation or to the provision of predictable results that are inconsistent with a true equity appreciation right. Further, the Treasury Department and the IRS do not believe that the burden of proof with respect to valuation should be shifted to the Commissioner in all cases where such formulas have been utilized. Accordingly, the use of a valuation method based on a nonlapse restriction that meets the requirements of §1.83-5(a) does not by itself result in a presumption of reasonableness. However, where the method is used consistently for both compensatory and noncompensatory purposes in all transactions in which the service recipient is either the purchaser or seller of such stock, such that the nonlapse restriction formula acts as a substitute for the value of the underlying stock, the formula will qualify for the presumption that the valuation method is reasonable for purposes of section 409A. In addition, depending on the facts and circumstances of the individual case, the use of a nonlapse restriction to determine value may be reasonable, taking into account other relevant valuation criteria.

Commentators also expressed concern about the valuation of illiquid stock of certain start-up corporations. These commentators argued that the value of such stock is often highly speculative, rendering appraisals of limited value. Commentators also noted that such stock often is not subject to put rights or call rights that could be viewed as a nonlapse restriction. Given the illiquidity and speculative value, commentators argued that the risk that taxpayers would use rights on such shares as a device to pay deferred compensation is low. In response, these regulations propose additional conditions under which the valuation of illiquid stock in a start-up corporation will be presumed to be reason-

able. A valuation of an illiquid stock of a start-up corporation will be presumed reasonable if the valuation is made reasonably and in good faith and evidenced by a written report that takes into account the relevant factors prescribed for valuations generally under these regulations. For this purpose, illiquid stock of a start-up corporation refers to service recipient stock of a service recipient that is in the first 10 years of the active conduct of a trade or business and has no class of equity securities that are traded on an established securities market, where such stock is not subject to any put or call right or obligation of the service recipient or other person to purchase such stock (other than a right of first refusal upon an offer to purchase by a third party that is unrelated to the service recipient or service provider), provided that this rule does not apply to the valuation of any stock if the service recipient or service provider reasonably may anticipate, as of the time the valuation is applied, that the service recipient will undergo a change in control event or participate in a public offering of securities within the 12 months following the event to which the valuation is applied (for example, the grant date of an award). A valuation will not be treated as made reasonably and in good faith unless the valuation is performed by a person or persons with significant knowledge and experience or training in performing similar valuations.

As stated in the preamble to Notice 2005-1, the Treasury Department and the IRS are concerned about the treatment of stock rights where the service recipient is obligated to repurchase the stock acquired pursuant to the stock right, or the service provider retains a put or call right with respect to the stock. Where the service provider retains such a right, the ability to receive a purchase price that differs from the fair market value of the stock could be used to circumvent the application of section 409A. Accordingly, these regulations generally require that where someone is obligated to purchase the stock received upon the exercise of a stock right, or the stock is subject to a put or call right, the purchase price must also be set at fair market value, the determination of which is also subject to the consistency requirements for the methods used in determining fair market value.

4. *Modification*

Commentators asked under what conditions a modification, extension, or renewal of a stock right will be treated as a new grant. The treatment as a new grant is relevant because although the original grant may have been excluded from coverage under section 409A, if the new grant has an exercise price that is less than the fair market value of the underlying stock on the date of the new grant, the new grant would not qualify for the exclusion from coverage under section 409A. Accordingly, the regulations set forth rules governing the types of modifications, extensions or renewals that will result in treatment as a new grant. The regulations provide that the term *modification* means any change in the terms of the stock right that may provide the holder of the right with a direct or indirect reduction in the exercise price of the stock right, or an additional deferral feature, or an extension or renewal of the stock right, regardless of whether the holder in fact benefits from the change in terms. Under this definition, neither the addition of a provision permitting the transfer of the stock right nor a provision permitting the service provider to exchange the stock right for a cash amount equal to the amount that would be available if the stock right were exercised would be modifications of the stock right. In addition, these regulations explicitly provide that both a change in the terms of a stock right to allow for payment of the exercise price through the use of pre-owned stock, and a change in the terms of a stock right to facilitate the payment of employment taxes or required withholding taxes resulting from the exercise of the right, are not treated as modifications of the stock right for purposes of section 409A.

Generally, a change to the exercise price of the stock right (other than in connection with certain assumptions or substitutions of a stock right in connection with a corporate transaction or certain adjustments resulting from a stock split, stock dividend or similar change in capitalization) is treated as a modification, resulting in a new grant that may be excluded from section 409A if it satisfies the requirements in these regulations as of the new grant date. However, depending upon the facts and circumstances, a series

of repricings of the exercise price may indicate that the original right had a floating or adjustable exercise price and did not meet the requirements of the exclusion at the time of the original grant.

Generally, an extension granting the holder an additional period within which to exercise the stock right beyond the time originally prescribed will be treated as evidencing an additional deferral feature meaning that the stock right was subject to section 409A from the date of grant. Commentators stated that it is not uncommon upon a termination of employment to extend the exercise period for some brief period of time to allow the terminated employee a chance to exercise the stock right. In response, these regulations provide that it is not an extension of a stock right if the exercise period is extended to a date no later than the later of the fifteenth day of the third month following the date, or December 31 of the calendar year in which, the right would otherwise have expired if the stock right had not been extended, based on the terms of the stock right at the original grant date. The regulations further provide that it is not an extension of a stock right if at the time the stock right would otherwise expire, the stock right is subject to a restriction prohibiting the exercise of the stock right because such exercise would violate applicable securities laws and the expiration date of the stock right is extended to a date no later than 30 days after the restrictions on exercise are no longer required to avoid a violation of applicable securities laws.

These regulations also provide that if the requirements of §1.424-1 (providing rules under which an eligible corporation may, by reason of a corporate transaction, substitute a new statutory option for an outstanding statutory option or assume an old option without such substitution or assumption being considered a modification of the old option) would be met if the right were a statutory option, the substitution of a new right pursuant to a corporate transaction for an outstanding right or the assumption of an outstanding right will not be treated as the grant of a new right or a change in the form of payment for purposes of section 409A. Section 1.424-1 applies several requirements. Among them is the requirement under §1.424-1(a)(5)(ii) that the excess of the aggregate fair market value of the

shares subject to the new option over the exercise price immediately after the substitution must not exceed the excess of the fair market value of the shares subject to the old option over the exercise price immediately before the substitution. In addition, §1.424-1(a)(5)(iii) requires that on a share by share comparison, the ratio of the exercise price to the fair market value of the shares subject to the option immediately after the substitution not be more favorable than the ratio of the exercise price to the fair market value of the shares subject to the old option immediately before the substitution.

Commentators expressed concern that the use of the regulations contained in §1.424-1, and specifically the ratio test prescribed in §1.424-1(a)(5)(iii), would prove difficult to apply in circumstances where, to reduce dilution, the acquiring corporation wished to issue a smaller number of shares than the shares underlying the old option, but also wished to retain the entire aggregate difference between the fair market value of the shares and the exercise price that had been available to the service provider before the substitution. In response, Notice 2005-1, Q&A-4 and these regulations provide that the requirement of §1.424-1(a)(5)(iii) will be deemed to be satisfied if the ratio of the exercise price to the fair market value of the shares subject to the right immediately after the substitution or assumption is not greater than the ratio of the exercise price to the fair market value of the shares subject to the right immediately before the substitution or assumption. For example, if an employee had an option to purchase 25 shares for \$2 per share, and immediately prior to a substitution by reason of a corporate transaction the fair market value of a share was \$5, then the aggregate spread amount would be \$75 (25 shares multiplied by $(\$5 - \$2) = \$75$). The ratio of the exercise price to the fair market value would be $\$2/\$5 = .40$. As a part of the transaction, new employer wishes to substitute for the option an option to purchase 5 shares of new employer, when the shares have a fair market value of \$20 per share. To maintain the aggregate spread of \$75, the new grant has an exercise price of \$5 (5 shares multiplied by $(\$20 - \$5) = \$75$). The ratio of the exercise price to the fair market value immediately after the substitution is $\$5/\$20 = .25$, which is not

greater than the ratio immediately before the substitution. Provided that the other requirements of §1.424-1 were met, this substitution would not be considered a modification of the original stock option for purposes of section 409A.

One commentator asked for more flexible rules concerning adjustments to and substitutions of options following a spinoff or similar transaction because short-term trading activity in the period immediately following such a transaction frequently does not accurately reflect the relative long-term fair market values of the stock of the distributing and distributed corporations. To address this problem, the regulations provide that such adjustments or substitutions may be made based on market quotations as of a predetermined date not more than 60 days after the transaction, or based on an average of such market prices over a period of not more than 30 days ending not later than 60 days after the transaction.

These provisions addressing substitutions and assumptions of rights apply to stock appreciation rights, as well as stock options. However, the guidance provided in these regulations with respect to the assumption of stock appreciation right liabilities should not be interpreted as guidance with respect to issues raised under any other provision of the Code or common law tax doctrine.

D. *Restricted property*

Consistent with Notice 2005-1, Q&A-4(e), these regulations provide that if a service provider receives property from, or pursuant to, a plan maintained by a service recipient, there is no deferral of compensation merely because the value of the property is not includible in income in the year of receipt by reason of the property being nontransferable and subject to a substantial risk of forfeiture, or is includible in income solely due to a valid election under section 83(b). However, a plan under which a service provider obtains a legally binding right to receive property (whether or not the property is restricted property) in a future year may provide for the deferral of compensation and, accordingly, may constitute a non-qualified deferred compensation plan.

Commentators asked for clarification with respect to how this provision applies

to a promise to transfer restricted property in a subsequent tax year. Specifically, commentators questioned how section 409A would apply to a bonus program offering a choice between a payment in cash and a payment in substantially nonvested property. Because the promise grants the service recipient a legally binding right to receive property in a future year, this promise generally could not constitute property for section 83 purposes under §1.83-3(e), and could constitute deferred compensation for purposes of section 409A. However, the regulations provide that the vesting of substantially nonvested property subject to section 83 may be treated as a payment for purposes of section 409A, including for purposes of applying the short-term deferral rule. Accordingly, where the promise to transfer the substantially nonvested property and the right to retain the substantially nonvested property after the transfer are both subject to a substantial risk of forfeiture (as defined for purposes of section 409A), the arrangement generally would constitute a short-term deferral because the payment would occur simultaneously with the vesting of the right to the property. For example, where an employee participates in a two-year bonus program such that, if the employee continues in employment for two years, the employee is entitled to either the immediate payment of a \$10,000 cash bonus or the grant of restricted stock with a \$15,000 fair market value subject to a vesting requirement of three additional years of service, the arrangement generally would constitute a short-term deferral because under either alternative the payment would be received within the short-term deferral period.

E. *Arrangements between partnerships and partners*

The statute and legislative history to section 409A do not specifically address arrangements between partnerships and partners providing services to a partnership, and do not explicitly exclude such arrangements from the application of section 409A. The application of section 409A to such arrangements raises a number of issues, relating both to the scope of the arrangements subject to section 409A, and the coordination of the provisions of subchapter K and section 409A with respect

to those arrangements that are subject to section 409A. The Treasury Department and the IRS continue to analyze the issues raised in this area, and accordingly these regulations do not address arrangements between partnerships and partners. Notice 2005-1, Q&A-7 provides interim guidance regarding the application of section 409A to arrangements between partnerships and partners. Until further guidance is issued, taxpayers may continue to rely on Notice 2005-1, Q&A-7.

Commentators have asked whether section 409A applies to guaranteed payments for services described in section 707(c). Until further guidance is issued, section 409A will apply to guaranteed payments described in section 707(c) (and rights to receive such guaranteed payments in the future), only in cases where the guaranteed payment is for services and the partner providing services does not include the payment in income by the 15th day of the third month following the end of the taxable year of the partner in which the partner obtained a legally binding right to the guaranteed payment or, if later, the taxable year in which the right to the guaranteed payment is first no longer subject to a substantial risk of forfeiture.

The Treasury Department and the IRS continue to request comments with respect to the application of section 409A to arrangements between partnerships and partners.

F. Foreign arrangements

The regulations provide guidance with respect to the application of section 409A to various foreign arrangements. As an initial matter, the regulations provide that an arrangement does not provide for a deferral of compensation subject to section 409A where the compensation subject to the arrangement would not have been includible in gross income for Federal tax purposes if it had been paid to the service provider at the time that the legally binding right to the compensation first arose or, if later, the first time that the legally binding right was no longer subject to a substantial risk of forfeiture, if the service provider was a nonresident alien at such time. Accordingly, if, for example, a foreign citizen works outside the United States and then retires to the United States, the compensation deferred and vested while working in

the foreign country generally will not be subject to section 409A.

With respect to U.S. citizens or resident aliens working abroad, the regulations provide that an arrangement does not provide for a deferral of compensation subject to section 409A where the compensation subject to the arrangement would have constituted foreign earned income (within the meaning of section 911) paid to a qualified individual (as defined in section 911(d)(1)) and the amount of the compensation is less than or equal to the difference between the maximum section 911 exclusion amount and the amount actually excludible from gross income under section 911 for the taxable year for the individual. This hypothetical exclusion is applied at the time that the legally binding right to the compensation first exists or, if later, the time that the legally binding right is no longer subject to a substantial risk of forfeiture. Under section 911, a U.S. citizen or resident alien who resides in a foreign jurisdiction generally may exclude up to \$80,000 of foreign earned income (to be adjusted for inflation after 2007). For example, an individual with \$70,000 of foreign earned income excluded under section 911 in 2006 could also defer up to \$10,000 of additional compensation that would not be subject to section 409A, if the additional compensation would qualify as foreign earned income if paid to the individual in 2006. This exception to coverage under section 409A is intended to be applied on an annual basis, so that individuals will not be entitled to carry over any unused portion of the exclusion under section 911 to a future year. This exception also is not intended to modify the rules under section 911 or the regulations thereunder.

Similarly, these regulations also address deferrals of compensation income that would be excluded from gross income for Federal income tax purposes under section 893 (generally covering compensation paid to foreign workers of a foreign government or international organization working in the United States), section 872 (generally covering certain compensation earned by nonresident alien individuals), section 931 (generally covering certain compensation earned by *bona fide* residents of Guam, American Samoa, or the Northern Mariana Islands) and section 933 (generally covering certain compensation earned by *bona fide* residents of Puerto

Rico). The regulations provide that an arrangement does not provide for a deferral of compensation subject to section 409A where the compensation subject to the arrangement would have been excluded from gross income for Federal tax purposes under any of these sections, if the compensation had been paid to the service provider at the time that the legally binding right to the compensation first arose or, if later, the time that the legally binding right was no longer subject to a substantial risk of forfeiture.

The Treasury Department and the IRS understand that nonresident aliens may work for very limited periods in the United States. Many deferrals of the compensation earned by nonresident aliens for services rendered in the United States will not be covered by section 409A, because under an applicable treaty the amount of compensation deferred would not be includible in gross income for Federal tax purposes if paid at the time the legally binding right to the compensation deferred was no longer subject to a substantial risk of forfeiture. However, certain compensation earned in the United States by a nonresident alien might be includible in gross income under such circumstances, where there is no applicable treaty or where the treaty does not provide an exclusion. Where a nonresident alien defers such compensation earned in the United States under a foreign nonqualified deferred compensation plan — for example because the service in the United States is credited under the plan — the application of section 409A to the deferrals of the compensation subject to Federal income tax could be exceedingly burdensome in light of the relatively small amounts attributable to the service in the United States. Accordingly, these regulations adopt a *de minimis* exception, under which section 409A will not apply to an amount of compensation deferred under a foreign nonqualified deferred compensation plan for a given calendar year where the individual service provider is a nonresident alien for that calendar year and the amount deferred does not exceed \$10,000.

Commentators requested clarification of the application of section 409A to participation by U.S. citizens and resident aliens in foreign plans. In this context, it should be noted that under these regulations, transfers that are taxable under section 402(b) of the Code gener-

ally are not subject to section 409A. See §1.409A-1(b)(6) of these regulations and Notice 2005-1, Q&A-4. Such transfers may consist of contributions to an employees' trust, where the trust does not qualify under section 501(a). Many foreign plans that hold contributions in a trust will constitute funded plans. To the extent that a contribution to the trust is subject to inclusion in income for Federal tax purposes under section 402(b), such a contribution will not be subject to section 409A.

These regulations also provide that section 409A does not override treaty provisions that govern the U.S. Federal taxation of participation in particular foreign plans. Where a treaty provides that amounts contributed to a foreign plan by or on behalf of a service provider are not subject to U.S. Federal income tax, section 409A will not cause such amounts to be subject to inclusion in gross income.

Some commentators requested that any participation in a foreign plan be exempted from section 409A, or that only deferrals of U.S. source compensation income be subject to section 409A. However, with respect to U.S. citizens working abroad, and with respect to resident aliens in the United States, compensation income generally is subject to U.S. Federal income tax absent an applicable treaty provision. Accordingly, the provisions of section 409A generally are applicable to this type of deferred compensation. In addition, the Treasury Department and the IRS are concerned that providing a broad exception for foreign plans or foreign source income would create opportunities for U.S. citizens and resident aliens to avoid application of section 409A through participation in a foreign plan, or through reallocations of deferrals among U.S. source and foreign source income.

The regulations provide, however, that with respect to non-U.S. citizens who are not lawful permanent residents of the United States, amounts deferred under certain broad-based foreign retirement plans are not subject to section 409A. This exception is intended to allow a worker who is not a green card holder to continue to participate in a broad-based foreign retirement plan that does not comply with section 409A without incurring adverse tax consequences due solely to the worker earning some income in the United States

that is in some manner credited under the plan.

Commentators expressed concerns as to U.S. citizens and lawful permanent residents working abroad, and their ability to participate in broad-based plans of foreign employers. Generally, these workers' incomes are subject to Federal income tax, including section 409A. However, when U.S. citizens and lawful permanent residents work abroad for employers who sponsor broad-based foreign retirement plans providing relatively low levels of retirement benefits and such plans are nonelective, the worker's ability to control the timing of the income is limited. In such cases, the concerns with respect to the potential manipulation of the timing of compensation income addressed by section 409A are also limited, and do not outweigh the administrative burdens that would arise if a foreign employer's failure to amend these plans to be consistent with the provisions of section 409A would result in substantial adverse tax consequences to U.S. citizens and lawful permanent residents working abroad who are covered by such plans. Accordingly, an exception for foreign broad-based retirement plans also applies with respect to U.S. citizens and lawful permanent residents, but only with respect to nonelective deferrals of foreign earned income and only to the extent that the amount deferred in a given year does not exceed the amount of contributions or benefits that may be provided by a qualified plan under section 415 (calculated by treating the foreign source income as compensation for purposes of section 415).

Commentators also requested that certain types of payments, referred to as expatriate allowances, be exempted from coverage under section 409A. These payments were defined broadly to include many types of payments to U.S. citizens working abroad, intended to put the service providers in substantially the same economic position as the service providers would have been in had the services been provided in the United States. One very common arrangement involves payments intended to compensate the service provider for any differences in tax rates, often referred to as tax equalization plans. With respect to these plans, the Treasury Department and the IRS recognize that such payments often must be delayed be-

cause of the need to calculate foreign tax liabilities after the end of the year. In addition, where the amounts are limited to the amounts necessary to make up for difference in tax rates, the potential for abuse with respect to the timing of compensation income is not great, since the compensation will directly relate to taxes that the service provider has paid to a foreign jurisdiction. Accordingly, these regulations exempt tax equalization plans from coverage under section 409A provided that the payment is made no later than the end of the second calendar year beginning after the calendar year in which the individual's U.S. Federal income tax return is required to be filed (including extensions) for the year to which the tax equalization payment relates.

Other payments are not excluded from section 409A merely because they are denominated as expatriate allowances. The Treasury Department and the IRS believe that the rules provided in these regulations with respect to setting and meeting payment dates under a nonqualified deferred compensation plan will provide sufficient flexibility to permit arrangements involving expatriate allowances to satisfy the requirements of section 409A. For example, as discussed more fully below, these regulations generally provide that to meet the requirement that a payment be made upon a permissible payment event or a fixed date, the service recipient may make the payment by the later of the earliest date administratively practicable following, or December 31 of the calendar year in which occurs, the permissible payment event or fixed date. At the minimum, this should offer almost 12 months of flexibility with respect to a payment scheduled for January 1 of a calendar year. The Treasury Department and the IRS request comments, however, as to circumstances in which this flexibility will not be sufficient.

Commentators also requested a grace period during which arrangements with persons who have become resident aliens during a calendar year may be amended to comply with the requirements of section 409A. These regulations generally provide such relief. With respect to the initial year in which the service provider becomes a resident alien, the plan may be amended with respect to the service provider through the end of that year to comply with (or be excluded from cover-

age under) section 409A, including allowing the service provider the right to change the time and form of a payment. Provided that the election is made before the amount is paid or payable, initial deferral elections may also be made with respect to compensation related to services in that initial year, if the election is made by the end of the year or, if later, the 15th day of the third month after the service provider meets the requirements to be a resident alien. The relief generally does not extend further because a service recipient and service provider should reasonably anticipate the potential application of section 409A after the initial year in which the service provider attains the status of a resident alien. However, the Treasury Department and the IRS also recognize that there may be significant gaps between the years in which the service provider is treated as a resident alien. Accordingly, the grace period is available in a subsequent year, provided that the service provider has been a nonresident alien for at least five consecutive calendar years immediately preceding the year in which the service provider is again a resident alien.

Commentators also requested that amounts contributed or benefits paid under a foreign social security system that is the subject of a totalization agreement be exempted from coverage under section 409A. Totalization agreements refer to bilateral agreements between the United States and foreign jurisdictions intended to coordinate coverage under the Social Security system in the United States and similar systems of the foreign jurisdictions. These agreements are intended to minimize the potential for application of two different employment taxes, and correspondingly to coordinate the benefits under the two different social security systems. The Treasury Department and the IRS believe that section 409A was not intended to apply to benefits to which the service provider is entitled under the foreign jurisdiction social security system. Accordingly, these types of plans have been excluded from the definition of a nonqualified deferred compensation plan for purposes of section 409A. Similarly, for jurisdictions not covered by a totalization agreement, these regulations provide that amounts deferred under a government mandated social security system are not subject to section 409A.

G. Separation pay arrangements

1. In general

Many commentators requested clarification of the application of section 409A to plans or arrangements providing payments upon a termination of services, generally described as severance plans. Some commentators requested that all such arrangements be excluded from coverage under section 409A. However, section 409A(d)(1)(B) contains a list of welfare benefits that are specifically excluded from coverage under section 409A, including *bona fide* vacation leave, sick leave, compensatory time, disability pay and death benefit plans. Noticeably absent from this list is an exception for severance plans. This is particularly noteworthy because section 457(e)(11) contains the identical list of exclusions, with the one exception that the list of excluded plans under section 457(e)(11) includes severance pay plans, while the list of excluded plans under section 409A(d)(1)(B) does not. Therefore, it appears that Congress intended that severance payments could constitute deferred compensation under section 409A. To avoid confusion with other Code provisions, such as the specific exclusion from coverage under section 457(e)(11) for severance plans or the treatment of such arrangements under section 3121(v)(2), these regulations generally refer to such arrangements as separation pay arrangements.

With respect to payments available upon a voluntary termination of services, there is no substantive distinction between a plan labeled a severance plan or separation pay plan and a nonqualified deferred compensation plan that provides for payments upon a separation from service. If, as is often the case, the service recipient reserves the right to eliminate such arrangement at any time, the service provider may not have a legally binding right to the payment until payment actually occurs, or such other time as the service recipient's discretion to eliminate the right to the payments lapses. However, as provided in these regulations, where such negative discretion lacks substantive significance, or the person granted the discretion is controlled by, or related to, the service provider to whom the payment will be made, the service provider will be

considered to have a legally binding right to the compensation.

Commentators requested that the exclusion from coverage under section 409A contained in Notice 2005-1, Q&A-19(d) for payments during the calendar year 2005 to non-key employees pursuant to severance plans that are classified as welfare plans, rather than pension plans, in accordance with the Department of Labor regulations, be made a permanent exclusion. This approach generally would be consistent with the regulations under section 3121(v)(2) of the Code. However, the Department of Labor regulations reflect different concerns with respect to separation pay arrangements from the concerns addressed in section 409A. The Department of Labor regulations focus on whether an arrangement sufficiently resembles a retirement plan to require funding of the obligations under such a plan, or rather is a welfare plan that would not require funding. In contrast, section 409A focuses on the manipulation of the timing of inclusion of compensation income. Accordingly, these regulations do not categorically exclude these arrangements from coverage under section 409A, although a modified version of this exception has been provided, as discussed below.

Some commentators requested that the Treasury Department and the IRS adopt an exclusion for all amounts payable upon an involuntary separation. This request is based upon the position under certain other Code provisions, and stated in certain court cases, that payments to which an individual becomes entitled upon an involuntary separation from service do not constitute nonqualified deferred compensation. See *Kraft Foods North America v. U.S.*, 58 Fed. Cl. 507 (2003); §31.3121(v)(2)-1(b)(4)(iv). As discussed above, the statutory language and structure of section 409A strongly suggest that separation pay arrangements, including arrangements providing separation pay upon an involuntary separation, were meant to be covered by section 409A. Furthermore, the Treasury Department and the IRS believe that section 409A was not intended to be applied so narrowly. Section 409A addresses the manipulation of the timing of inclusion of compensation. Payments due to a separation from service, regardless of whether voluntary or involuntary,

constitute a payment of compensation. Accordingly, the ability to manipulate the timing of the inclusion of income related to the receipt of those amounts is within the scope of section 409A.

Much of the discussion above relates to predetermined arrangements, where the right to the payment upon an involuntary termination of services arises as part of an arrangement covering multiple service providers, often covering a service provider from the time the service provider begins performing services. Where the separation pay arrangement involves an agreement negotiated with a specific service provider at the time of the involuntary separation from service, commentators asked how deferral elections could be provided that would meet the requirement that the election be made in the year before the year in which the services were performed. Commentators pointed out that even if the service provider does not already participate in any involuntary separation pay arrangement, the rule in section 409A(a)(4)(B) that allows an initial deferral election to be made within 30 days of initial eligibility under a plan applies only with respect to services performed after the election. To address these concerns, these regulations provide that where separation pay due to an involuntary termination has been the subject of *bona fide*, arm's length negotiations, the election as to the time and form of payment may be made on or before the date the service provider obtains a legally binding right to the payment.

The Treasury Department and the IRS recognize that separation pay arrangements providing for short-term payments upon an involuntary separation from service are common arrangements, and that compliance with the provisions of section 409A may be burdensome. In addition, the Treasury Department and the IRS recognize that where both the amount of the payments and the time over which such payments may be made are limited, these arrangements create fewer concerns with respect to manipulation of the timing of compensation income. Accordingly, these regulations generally exempt such arrangements where the entire amount of payments does not exceed two times the service provider's annual compensation or, if less, two times the limit on annual compensation that may be taken into ac-

count for qualified plan purposes under section 401(a)(17) (\$210,000 for calendar year 2005), each for the calendar year before the year in which the service provider separates from service, and provided further that the arrangement requires that all payments be made by no later than the end of the second calendar year following the year in which the service provider terminates service. These limitations generally are consistent with the safe harbor under which severance plans may be treated as welfare plans under the applicable Department of Labor regulations, and should allow most of these arrangements to avoid coverage under section 409A.

The Treasury Department and the IRS further recognize that separation pay arrangements often occur in the context of a window program, where certain groups of service providers are identified as being subject to a separation from service, and the service recipient provides the identified service providers an incentive to voluntarily separate from service and obtain a benefit. Although technically these programs involve a voluntary separation from service, these regulations generally treat separations due to participation in a window arrangement the same as arrangements with respect to involuntary separations from service for purposes of the exceptions to coverage from section 409A.

These exclusions for separation pay are not intended to allow for rights to payments that would otherwise be deferred compensation subject to section 409A to avoid application of section 409A by being recharacterized as separation pay. Accordingly, the exclusions for separation pay do not apply to the extent the separation pay acts as a substitute for, or a replacement of, amounts that would otherwise be subject to section 409A. For example, a right to separation pay obtained in exchange for the relinquishment of a right to a payment of deferred compensation subject to section 409A will not be excluded from coverage under section 409A, but rather will be treated as a payment of the original amount of deferred compensation.

2. *Treatment as a separate plan*

Commentators have stated that arrangements involving payments due to an involuntary separation often operate sepa-

rately from more traditional types of non-qualified deferred compensation plans. In addition, especially in the case of agreements covering an individual, the involuntary separation pay agreement may involve many different types of payments that are of a much smaller magnitude than amounts deferred under other types of nonqualified deferred compensation plans. Commentators expressed concerns that inadvertent violations of section 409A with respect to these unique arrangements could lead to much larger amounts being included in income and subject to the additional tax under section 409A due to the aggregation of such involuntary separation pay arrangements with other arrangements under the definition of a plan. The Treasury Department and the IRS have concluded that a nonqualified deferred compensation plan providing separation pay due to an involuntary separation from service, or participation in a window program, should be treated as a separate type of plan from account balance plans, nonaccount balance plans, and other types of plans (generally equity-based compensation arrangements) in which the service provider may participate that do not provide separation pay due to an involuntary separation from service, or participation in a window program.

3. *Application of the short-term deferral rule to separation pay arrangements*

Many commentators asked for a clarification with respect to the application of the short-term deferral rule to separation pay arrangements. The right to a payment that will only be paid upon an involuntary termination of services generally would be viewed as a nonvested right. Accordingly, an involuntary separation pay arrangement may be structured to meet the requirements of the short-term deferral exception.

Some commentators also requested that arrangements involving rights to payments upon termination of services for good reason be treated as a right subject to a substantial risk of forfeiture. These arrangements are common, especially following a transaction resulting in a change in control of the service recipient. The Treasury Department and the IRS are not confident that amounts payable upon a voluntary separation from service, and amounts payable only upon a termination of services for good reason, always may be ad-

equately distinguished. Furthermore, even if the types of good reasons sufficient to constitute a substantial risk of forfeiture could be elucidated, the application of such a rule would involve intensive factual determinations, leaving taxpayers uncertain in their planning and creating a significant potential for abuse. Accordingly, the regulations do not treat the right to a payment upon a separation from service for good reason categorically as a right subject to a substantial risk of forfeiture. However, the Treasury Department and the IRS request comments as to what further guidance may be useful with respect to arrangements containing these types of provisions.

4. *Reimbursement arrangements*

Many commentators requested clarification with respect to the application of section 409A to reimbursement agreements, involving the service recipient reimbursing expenses of the terminated service provider. Because the promise to reimburse the former service provider is not contingent on the provision of any substantial services for the service provider, the right to the payment generally would not be treated as subject to a substantial risk of forfeiture. Accordingly, if the period in which expenses incurred will be reimbursed extends beyond the year in which the legally binding right arises, the right to the amount generally would constitute deferred compensation. The Treasury Department and the IRS recognize that reimbursement arrangements following a termination of services are common, and that requiring the service recipient to designate an amount at the time of the termination conflicts with the service recipient's desire to pay only amounts that the former service provider has actually incurred as an expense. However, a categorical exclusion for reimbursement arrangements is not tenable, because such an exclusion would allow for a limitless amount of deferred compensation to be paid without regard to the rules of section 409A, where such compensation took the form of the reimbursement of personal expenses (for example, reimbursements of home mortgage payments). These regulations provide that certain reimbursement arrangements related to a termination of services are not covered by section 409A, to the extent that the reimbursement ar-

range covers only expenses incurred and reimbursed before the end of the second calendar year following the calendar year in which the termination occurs. The types of reimbursement arrangements excluded include reimbursements that are otherwise excludible from gross income, reimbursements for expenses that the service provider can deduct under section 162 or section 167, as business expenses incurred in connection with the performance of services (ignoring any applicable limitation based on adjusted gross income), outplacement expenses, moving expenses, medical expenses, as well as any other types of payments that do not exceed \$5,000 in the aggregate during any given taxable year.

For purposes of this provision, reimbursement arrangements include the provision of in-kind benefits, or direct payments by the service recipient to the person providing the goods or services to the terminated service provider, if the provision of such in-kind benefits or direct payments would be treated as reimbursement arrangements if the service provider had paid for such in-kind benefits or such goods or services and received reimbursement from the service recipient.

H. *Split-dollar life insurance arrangements*

Commentators suggested that split-dollar life insurance arrangements should be excluded from the requirements of section 409A. However, the Treasury Department and the IRS believe that in applying the general definition of deferred compensation to split-dollar life insurance arrangements, the requirements of section 409A may apply to certain types of such arrangements (as described in §1.61-22). Split-dollar life insurance arrangements that provide only death benefits (as defined in these proposed regulations) to or for the benefit of the service provider may be excluded from coverage under section 409A under the exception from the definition of a nonqualified deferred compensation plan provided in these proposed regulations for death benefit plans. Also, split-dollar life insurance arrangements treated as loan arrangements under §1.7872-15 generally will not give rise to deferrals of compensation within the meaning of section 409A, provided that

there is no agreement under which the service recipient will forgive the related indebtedness and no obligation on the part of the service recipient to continue to make premium payments without charging the service provider a market interest rate on the funds advanced. However, policies structured under the endorsement method, where the service recipient is the owner of the policy but where the service provider obtains a legally binding right to compensation includible in income in a taxable year after the year in which a substantial risk of forfeiture (if any) lapses, may provide for a deferral of compensation. Just as a promise to transfer property in a future year may provide for a deferral of compensation (even though the transfer itself is subject to section 83), an endorsement method split-dollar life insurance arrangement that grants the service provider a legally binding right to a future transfer of interests in a policy owned by the service recipient may provide for a deferral of compensation subject to section 409A. For example, where a service recipient enters into an endorsement method split-dollar life insurance arrangement with respect to a service provider, and irrevocably promises to pay premiums in future years, the arrangement may provide for a deferral of compensation within the meaning of section 409A.

Commentators raised concerns about the impact of changes to a split-dollar life insurance arrangement to comply with section 409A, where the split-dollar life insurance arrangement was entered into on or before September 17, 2003, and is not otherwise subject to the regulations set forth in §1.61-22 (a grandfathered split-dollar life insurance arrangement). Pursuant to §1.61-22(j)(2), if a grandfathered split-dollar life insurance arrangement is materially modified after September 17, 2003, the arrangement is treated as a new arrangement entered into on the date of the modification. Commentators expressed concern that modifications necessary to comply with section 409A may cause the split-dollar life insurance arrangement to be treated as materially modified for purposes of §1.61-22(j)(2). Comments are requested as to the scope of changes that may be necessary to comply with, or avoid application of, section 409A, and under what conditions those changes should not

be treated as material modifications for purposes of §1.61-22(j)(2).

III. *Definition of Plan*

A. *Plan aggregation rules*

These regulations generally retain the plan aggregation rules set forth in Notice 2005-1, Q&A-9. Under the notice, all amounts deferred under an account balance plan are treated as deferred under a single plan, all amounts deferred under a nonaccount balance are treated as deferred under a single plan, and all amounts deferred under any other type of plan (generally equity-based compensation) are treated as deferred under a single plan. As discussed above, these regulations expand this rule so that all amounts deferred under certain separation pay arrangements are treated as a single plan. The purposes behind these aggregation rules are two-fold. First, because the provisions of section 409A are applied on an individual participant basis, rather than disqualifying the arrangement as to all participants, plan aggregation rules are necessary to implement the compliance incentives intended under the provision. Without such rules, multitudes of separate arrangements could be established for a single participant. Should the participant want access to an amount of cash, the participant would amend one or more of these separate arrangements and receive payments. The participant would argue that only those separate arrangements under which the amounts were paid failed to meet the requirements of section 409A and were subject to the income inclusion and additional tax, although in fact amounts were also available under the additional separate arrangements. Under that analysis, section 409A essentially would act as a 20 percent penalty required to receive a payment, similar to the haircut provisions that were intended to be prohibited by section 409A. The Treasury Department and the IRS do not believe that Congress intended that the consequences of section 409A could be limited in such a manner. However, the Treasury Department and the IRS also believe that complex plan aggregation rules, especially rules reliant on the particular facts and circumstances underlying each arrangement, would lead to unwarranted complexities and burdens

with respect to service recipient planning and IRS enforcement. Accordingly, these regulations adopt rules intended to be simple and relatively easy to administer that retain the integrity of the compliance incentives inherent in the statute.

Commentators asked whether an isolated violation of a term of an arrangement with respect to one participant will be treated as a violation of the same arrangement term with respect to other participants covered by the same arrangement. First, the terms of the arrangement with respect to each participant must be determined, based upon the rights the individual participant has under the plan. Generally, these rights will be determined based upon the written provisions applicable under a particular arrangement, as evidenced by a plan document, agreement, or some combination of documents that specify the terms of the contract under which the compensation is to be paid. However, where the terms of a plan or arrangement comply with section 409A, but the service recipient does not follow such terms, an individual participant's actual rights under the arrangement may be unclear. Where a violation of a provision is not an isolated incident, or involves a number of participants or an identifiable subgroup of participants under the arrangement, the violation may result in a finding that even with respect to a participant who did not directly benefit from the violation, the actual terms of the arrangement differ from the written terms of the arrangement. For example, if a plan document provides for installment payments upon a separation from service, but participants in the arrangement repeatedly are offered the opportunity to receive a lump sum payment, the facts and circumstances may indicate that the arrangement provides for an election of a lump sum payment for all participants.

An analogous analytical framework applies where the service recipient offers different benefits to separate participants in the same plan or arrangement. Under the terms of the overall arrangement, the service provider may grant many different types of rights, including some rights that would not be subject to the requirements of section 409A and some rights that would be subject to those requirements. With respect to the application of section 409A, a plan or arrangement is analyzed as consisting of the rights and benefits that have

actually been granted to a particular service provider. For example, with respect to an equity-based omnibus plan that permits the grant of discounted stock options that would be subject to the requirements of section 409A, as well as other types of stock options which would be excluded from coverage under section 409A, only those service providers actually granted the discounted stock options will be treated as having deferred an amount of compensation subject to section 409A, and then only with respect to the stock options subject to section 409A.

B. *Written plan requirement*

Although the statute does not explicitly state that a plan or arrangement must be in writing, the statute requires that a plan contain certain provisions in order to comply with section 409A. For example, section 409A(a)(2)(A) requires that a plan provide that compensation deferred under the plan may not be distributed earlier than certain specific events. Section 409A(a)(4)(B) requires that a plan provide certain restrictions with respect to initial deferral elections. Section 409A(a)(4)(C) requires that, if a plan permits under a subsequent election a delay in a payment or a change in the form of payment, the plan must require certain limits on the scope of such a delay or change. The clear implication of these provisions of section 409A is that the plan or arrangement must be set forth in writing and these regulations incorporate that requirement.

IV. *Definition of Substantial Risk of Forfeiture*

The scope of the definition of a substantial risk of forfeiture is central to the application of section 409A. In addition to the timing of the potential inclusion of income under section 409A, the existence of a substantial risk of forfeiture may also determine whether an amount is subject to section 409A or whether it qualifies for the exclusion under the short-term deferral rule. These regulations generally adopt the same definition as provided in Notice 2005-1, Q&A-10. This definition reflects the concerns of the Treasury Department and the IRS that the use of plan terms that purport to prescribe a substantial risk of forfeiture but, in fact, do not put the right to the payment at a substantial risk,

may be used to circumvent the application of section 409A in a manner inconsistent with the legislative intent. The definition of a substantial risk of forfeiture in these regulations contains certain restrictions. Certain amendments of an arrangement to extend a substantial risk of forfeiture will not be recognized. The ability to periodically extend, or roll, the risk of forfeiture is sufficiently suspect to question whether the parties ever intended that the right be subject to any true substantial risk, or rather whether the period is being extended through periods in which the service recipient can be reasonably assured that the forfeiture condition will not occur. Similarly, the risk that a right will be forfeited due to the violation of a noncompete agreement can be illusory, such as where the service provider has no intent to compete or to provide such services. In addition, a rational service provider normally would not agree to subject amounts that have already been earned, such as salary payments, to a condition that creates a real possibility of forfeiture, unless the service provider is offered a material inducement to do so, such as an additional amount of compensation. Accordingly, these provisions will not be treated as creating a substantial risk of forfeiture for purposes of section 409A.

V. Initial Deferral Election Rules

A. In general

Section 409A(a)(4)(B)(i) provides that in general, a plan must provide that compensation for services performed during a taxable year may be deferred at the participant's election only if the election to defer such compensation is made not later than the close of the preceding taxable year or at such other time as provided in regulations. The legislative history indicates that the taxable year to which the statute refers is the service provider's taxable year, as it indicates that the Secretary may issue guidance "providing coordination rules, as appropriate, regarding the timing of elections in the case when the fiscal year of the employer and the taxable year of the individual are different." H.R. Conf. Rep. No. 108-755, at 732 (2004). Accordingly, these regulations provide as a general rule that a service provider must make a deferral election in his or her taxable year be-

fore the year in which the services are performed. As discussed below, certain coordination rules for fiscal year employers have been provided.

An election to defer an amount includes an election both as to the time and form of the payment. An election is treated as made as of the date the election becomes irrevocable. Changes may be made to an initial deferral election, provided that the election becomes irrevocable (except to the extent the plan permits a subsequent deferral election consistent with these regulations) no later than the last date that such an election may be made. Commentators had questioned whether an evergreen deferral election, or a deferral election as to future compensation that remains in place unless the service provider changes the election, would be effective for purposes of section 409A. Such an election satisfies the initial deferral election requirements only if the election becomes irrevocable with respect to future compensation no later than the last permissible date an affirmative initial deferral election could have been made with respect to such compensation. For example, with respect to a salary deferral program under which an employee makes an initial deferral election to defer 10 percent of the salary earned during the subsequent calendar year, a plan may provide that the deferral election remains effective unless and until changed by the employee, provided that with respect to salary earned during any future taxable year, the election to defer 10 percent of such salary becomes irrevocable no later than the December 31 of the preceding calendar year.

B. Nonelective arrangements

Some commentators asked whether the initial deferral election rules apply to nonelective arrangements. The requirement that the election be made in the year before the services are performed is not applicable where the participant is not provided any election with respect to the amount deferred, or the time and form of the payment. However, as stated in the legislative history, "[t]he time and form of distribution must be specified at the time of initial deferral." H.R. Conf. Rep. No. 108-755, at 732 (2004). In addition, the application of the subsequent deferral rules becomes

problematic if the original time and form of deferred payment established by the service recipient is not viewed as an initial deferral election. Therefore, in order to avoid application of the initial deferral rules, a plan may not provide a service provider or service recipient with ongoing discretion as to the time and form of payment, but rather must set the time and form of payment no later than the time the service provider obtains a legally binding right to the compensation.

C. Performance-based compensation

Section 409A(a)(4)(B)(iii) provides that in the case of any performance-based compensation based on services performed over a period of at least 12 months, a participant's initial deferral election may be made no later than six months before the end of the period. The legislative history indicates that the performance-based compensation should be required to meet certain requirements similar to those under section 162(m), but not all requirements under that section. H.R. Conf. Rep. No. 108-755, at 732 (2004). An example in the legislative history, adopted in these regulations, is that the requirement of a determination by the compensation committee of the board of directors is not required.

Notice 2005-1 did not provide a definition of performance-based compensation. Rather, Notice 2005-1, Q&A-22 provided a definition of bonus compensation that, until further guidance was issued, could be used for purposes of applying the exception to the general rule regarding initial deferral elections.

Under these regulations, performance-based compensation is defined as compensation the payment of which or the amount of which is contingent on the satisfaction of preestablished organizational or individual performance criteria. Performance-based compensation does not include any amount or portion of any amount that will be paid either regardless of performance, or based upon a level of performance that is substantially certain to be met at the time the criteria are established.

Performance-based compensation generally may include payments based upon subjective performance criteria, provided that the subjective performance criteria relate to the performance of the partici-

pant service provider, a group of service providers that includes the participant service provider, or a business unit for which the participant service provider provides services (which may include the entire organization), and the determination that the subjective performance criteria have been met is not made by the service provider or a member of the service provider's family, or a person the service provider supervises or over whose compensation the service provider has any control.

Commentators requested that, similar to the provision contained in §1.162-27(e)(2) governing the requirements for establishing performance criteria for purposes of applying the deduction limitation under section 162(m), service recipients be allowed to establish performance criteria within 90 days of the commencement of a performance period of 12 months or more, rather than having to establish such criteria before the commencement of the period. These regulations adopt a similar provision with respect to the establishment of performance criteria for purposes of the exception under the deferral election rules, permitting the criteria to be established up to 90 days after the commencement of the period of service to which the criteria relates, provided that the outcome is not substantially certain at the time the criteria are established.

The legislative history indicates that to constitute performance-based compensation, the amount must be (1) variable and contingent on the satisfaction of preestablished organizational or individual performance criteria and (2) not readily ascertainable at the time of the election. H.R. Conf. Rep. No. 108-755, at 732 (2004). These regulations clarify that where the right to receive a specified amount is itself not substantially certain, the amount is not readily ascertainable as the amount paid could either be the specified amount or zero. Accordingly, these regulations provide that at the time of the initial deferral election, either the amount must not be readily ascertainable, or the right to the amount must not be substantially certain. So, for example, the right to a \$10,000 bonus that otherwise qualifies as performance-based compensation could be deferred by an employee up to six months before the end of the performance period, provided that at the time of

the deferral election the employee is not substantially certain to meet the criteria and receive the \$10,000 payment.

Under the definition of bonus compensation provided in Notice 2005-1, Q&A-22, bonus compensation does not include any amount or portion of any amount that is based solely on the value of, or appreciation in value of, the service recipient or the stock of the service recipient. Commentators criticized this limitation as inconsistent with the provisions of §1.162-27 governing application of the deduction limitation under section 162(m), and the legislative history to section 409A indicating that the definition of performance-based compensation for purposes of section 409A would be similar to that provided under section 162(m) and the regulations thereunder. These proposed regulations eliminate this limitation, so that performance-based compensation may be based solely upon an increase in the value of the service recipient, or the stock of the service recipient, after the date of grant or award. However, if an amount of compensation the service provider will receive pursuant to a grant or award is not based solely on an increase in the value of the stock after the grant or award (for example, in the case of restricted stock units or a stock right granted with an exercise price that is less than the fair market value of the stock as of the date of grant), and that other amount would not otherwise qualify as performance-based compensation, none of the compensation attributable to the grant or award is performance-based compensation. Nonetheless, an award of equity-based compensation may constitute performance-based compensation if entitlement to the compensation is subject to a condition that would cause a non-equity-based award to qualify as performance-based compensation, such as a performance-based vesting condition.

The Treasury Department and the IRS are concerned that the inclusion of such amounts in the definition of performance-based compensation could lead to a conclusion that an election to defer amounts payable under a stock right will necessarily comply with section 409A if the initial deferral election is made at least 6 months before the date of exercise. However, under these proposed regulations, a stock right with a deferral feature is subject to section 409A from the date of grant. To comply

with section 409A, the arrangement would be required to specify a permissible payment time and a form of payment. The requirement would not be met if, at some point during the term of the stock right, the stock right becomes immediately exercisable and the holder may decide whether and when to exercise the stock right. In addition, where a deferral feature is added to an existing stock right the stock right generally would violate section 409A because the stock right would have a deferral feature and would not have specified a permissible payment time or event.

D. First year of eligibility

Section 409A and these proposed regulations contain an exception to the general rule regarding initial deferral elections, under which a service provider newly eligible for participation in a plan may make a deferral election within the first 30 days of participation in the plan, provided that the election may only apply to compensation with respect to services performed after the election. These regulations further provide that for compensation that is earned based upon a specified performance period (for example, an annual bonus), where a deferral election is made in the first year of eligibility but after the beginning of the service period, the election is deemed to apply to compensation paid for service performed subsequent to the election if the election applies to the portion of the compensation that is no greater than the total amount of compensation for the performance period multiplied by the ratio of the number of days remaining in the performance period after the election over the total number of days in the performance period.

Commentators had requested that the plan aggregation rules not apply in determining whether a service provider is newly eligible for participation in a plan. The concern is that a mid-year promotion, or management reorganization or other corporate event may make the service provider eligible for an arrangement that is of the same type as an arrangement in which the service provider already participates. For example, an employee participating in a salary deferral account-balance plan may become eligible for a bonus and a bonus deferral arrangement that would also be an account-balance plan.

The Treasury Department and the IRS believe that the plan aggregation rules are necessary in this context. Without such a rule, service providers may attempt to take advantage of the new eligibility exception by establishing serial arrangements. For example, an employer may argue that a 2007 salary deferral program is a new program, and not a continuation of the 2006 salary deferral program. Commentators argue that standards should be provided comparing the terms of the two plans to distinguish new arrangements from those that are merely continuations of existing arrangements. However, such rules would by necessity be complicated and burdensome, generally relying on the facts and circumstances of the individual arrangements and resulting in administrative burden and uncertainties. Accordingly, these regulations retain the plan aggregation rules.

However, as discussed below, certain other initial deferral election rules have been provided that address many of the situations in which service recipients desire to grant service providers the opportunity to make initial deferral elections due to eligibility in new programs. For example, the rule governing initial deferral elections with respect to certain forfeitable rights discussed below allows initial deferral elections upon eligibility for many bonus programs and *ad hoc* equity-based compensation grants. The Treasury Department and the IRS request comments as to whether these rules adequately address the concerns raised with respect to the definition of plan for purposes of applying the initial eligibility exception.

E. Initial deferral election with respect to short-term deferrals

As discussed above, an amount that is paid by the 15th day of the third month following the end of the first taxable year in which the payment is no longer subject to a substantial risk of forfeiture generally will not constitute a deferral of compensation. Commentators asked how the deferral election rules apply to an election to defer such an amount. Generally, once the service provider has begun performing the services required to vest, no election to defer could be made that would meet the timing requirements for initial deferral elections. Commentators suggested that the

rules governing subsequent changes to the time and form of payment could be applied to elections to defer these amounts. The regulations provide that for purposes of an election to defer amounts that would not otherwise be subject to section 409A due to the short-term deferral rule, the date the substantial risk of forfeiture lapses is treated as the original time of payment established by an initial deferral election, and the form in which the payment would be made absent a deferral election is treated as the original form of payment established by an initial deferral election. Accordingly, the service provider may elect to defer the payment beyond the time at which the payment originally was scheduled to be made, in accordance with the rules governing subsequent changes in the time and form of payment. In general, this means that the service provider must make the election at least 12 months before the right to the payment vests, and must defer the payment for a period of not less than 5 years from the date the right to the payment could vest. Thus, no payment could be made within 5 years of the date the right to the payment vests (including upon a separation from service), except for instances of a change in control of the corporation, death, disability or an unforeseeable emergency. This would also mean that if the right to the payment actually vests within 12 months of the election, and the election is given effect so that the payment is not made within the short-term deferral period, the deferral of the payment would violate the requirements of section 409A.

For example, an employee may be entitled to the immediate payment of a bonus upon the occurrence of an initial public offering, where such a condition qualifies as a substantial risk of forfeiture so that the arrangement would constitute a short-term deferral. At some point after obtaining the right to the payment but before the initial public offering, the employee elects to defer any potential bonus payment to a date 5 years from the date of the initial public offering. To comply with the initial deferral election rules, that deferral election must not be given effect for 12 months. Accordingly, if the initial public offering occurred within 12 months of the deferral election, the payment must be made at the time of the initial public offering in accordance with the short-term deferral rules. If the payment is not made at such time, but

rather is made, for example, 5 years from the date of the initial public offering, the payment would be deemed deferred pursuant to an invalid initial deferral election effective before the required lapse of 12 months and the arrangement would violate section 409A.

F. Initial deferral election with respect to certain forfeitable rights

Commentators asked how the initial deferral election rules would apply with respect to grants of nonqualified deferred compensation that occur in the middle of a taxable year, especially where such grants were unforeseeable by the service provider. Under these circumstances, an initial deferral election could not be made by the service provider during the taxable year before the year in which the award was granted, unless the service recipient had the foresight to request such an election in the prior year. The Treasury Department and the IRS do not believe that a categorical exclusion from the initial deferral election rules is appropriate, because such a rule would encourage the characterization of all grants of nonqualified deferred compensation as occurring in the middle of the year and in large part render ineffective the initial deferral election rules set forth in section 409A. However, these regulations provide that where a grant of nonqualified deferred compensation is subject to a forfeiture condition requiring the continued performance of services for a period of at least 12 months, the initial deferral election may be made no later than 30 days after the date of grant, provided that the election is made at least 12 months in advance of the end of the service period. Under these circumstances, the election still must be made in all cases at least 12 months before the service provider has fully earned the amount of compensation, analogous to the general requirement that the election be made no later than the end of the year before the services are performed. The Treasury Department and the IRS believe that such a rule will provide a reasonable accommodation to service recipients granting certain *ad hoc* awards, such as restricted stock units, that often are subject to a requirement that the service provider continue to perform services for at least 12 months.

G. Initial deferral election with respect to fiscal year compensation

The legislative history to section 409A indicates that the Treasury Department and the IRS are to provide guidance coordinating the initial deferral election rules with respect to compensation paid by service recipients with fiscal years other than the calendar year. H.R. Conf. Rep. No. 108-755, at 732 (2004). These regulations provide such a rule, generally permitting an initial election to defer fiscal year compensation on or before the end of the fiscal year immediately preceding the first fiscal year in which any services are performed for which the compensation is paid. For these purposes, fiscal year compensation does not encompass all compensation paid by a fiscal year service recipient. Where the compensation is not specifically based upon the service recipient's fiscal year as the measurement period, the timing requirements applicable to an initial deferral election are unchanged. Accordingly, the rule applies to compensation based on service periods that are coextensive with one or more of the service recipient's consecutive fiscal years, where no amount of such compensation is payable during the service period. For example, a bonus based upon a service period of two consecutive fiscal years payable after the completion of the second fiscal year would be fiscal year compensation. In contrast, periodic salary payments or bonuses based on service periods other than the service recipient's fiscal year would not be fiscal year compensation, and the deferral of such amounts would be subject to the general rule.

H. Deferral elections with respect to commissions

Commentators requested clarification with respect to the application of section 409A to commissions. These regulations address commissions earned by a service provider where a substantial portion of the services provided by the service provider consists of the direct sale of a product or service to a customer, each payment of compensation by the service recipient to the service provider consists of a portion of the purchase price for the product or service (for example, 10 percent of the purchase price), or an amount calculated

solely by reference to the volume of sales (for example, \$100 per item sold), and each compensation payment is contingent upon the service recipient receiving payment from an unrelated customer for the product or services. In that case, the service provider is treated as having performed the services to which the commission compensation relates during the service provider's taxable year in which the unrelated customer renders payment for such goods or services. Accordingly, under the general initial deferral election rule an individual service provider could make an initial deferral election with respect to such compensation through December 31 of the calendar year preceding the year in which the customer renders the payment from which the commission is derived.

VI. Time and Form of Payment

A. In general

The regulations incorporate the statutory requirement that payments be made at a fixed date or under a fixed schedule, or upon any of five events: a separation from service, death, disability, change in the ownership or effective control of a corporation (to the extent provided by the Secretary), or unforeseeable emergency. As requested by commentators, these regulations provide guidance on what it means for a payment to be made upon one of these events. Where the time of payment is based upon the occurrence of a specified event (such as one of the five events listed above or upon the lapse of a substantial risk of forfeiture as discussed below), the plan must designate an objectively determinable date or year following the event upon which the payment is to be made. For example, the plan may designate the payment date as 30 days following a separation from service, or the first calendar year following a service provider's death. The Treasury Department and the IRS recognize that it may not be administratively feasible to make a payment upon the exact date or year designated. Furthermore, the Treasury Department and the IRS recognize that certain minimal delays that do not meaningfully affect the timing of the inclusion of income should not result in a violation of the requirements of section 409A. Accordingly, a payment will be treated as

made upon the designated date if the payment is made by the later of the first date it is administratively feasible to make such payment on or after the designated date, or the end of the calendar year containing the designated date (or the end of the calendar year if only a year is designated). This relaxation of the timing rules for administrative necessity is not intended to provide a method for the service provider to further defer the payment. Accordingly, any inability to make the payment that is caused by an action or inaction of the service provider, or any person related to, or under the control of, the service provider, will not be treated as causing the making of the payment to be administratively infeasible.

Once an event upon which a payment is to be made has occurred, the designated date generally is treated as the fixed date on which, or the fixed schedule under which, the payment is to be made (but not for purposes of the application of section 409A(a)(2)(B) generally requiring a six month delay in any payment upon a separation from service to a key employee of a corporation whose stock is traded on an established securities market). Accordingly, the recipient may change the time and form of payment after the event has occurred, provided that the change would otherwise be timely and permissible under these regulations. For example, a plan provides for payment of a lump sum on the third anniversary following a separation from service. A service provider has a separation from service on July 1, 2010. The July 1, 2013, payment date is now treated as the fixed date upon which the payment is to be made. Accordingly, the service provider generally could elect to defer the time and form of payment provided that the election were made on or before June 30, 2012, and deferred the payment to at least July 1, 2018. For a discussion of the application of the subsequent deferral rules when only a calendar year of payment is specified, see section VI.B of this preamble.

B. Specified time or fixed schedule of payments

Generally a plan will be deemed to provide for a specified time or fixed schedule of payments where, at the time of the deferral, the specific date upon which the

payment or payments will be made may be objectively determined. As requested by commentators, these regulations permit plans to specify simply the calendar year or years in which the payments are scheduled to be made, without specifying the particular date within such year on which the payment will be made. Although this provision would be consistent with the flexibility allowed with respect to meeting the specified time or fixed schedule of payments requirement, the provision must be coordinated with the subsequent deferral rules. Section 409A(a)(4)(C)(iii) requires that if a plan permits under a subsequent election a delay in a payment or a change in the form of payment with respect to a payment payable at a specified time or a fixed schedule, the plan must require that the election be made not less than 12 months prior to the date of the first scheduled payment. Application of such a provision requires a specific date for the first scheduled payment. For a plan that does not designate a specific date, but rather only the year in which the payment is to be made, the first scheduled payment is deemed to be scheduled to be paid as of January 1 of such year for this purpose.

Commentators asked whether a specified time or fixed schedule of payments could be determined based upon the date the service provider vests in the amount of deferred compensation, where the vesting is based upon the occurrence of an event. These regulations provide that a plan provides for payment at a specified time or fixed schedule of payments if the plan provides at the time of the deferral that the payment will be made at a date or dates that are objectively determinable based upon the date of the lapsing of a substantial risk of forfeiture, disregarding any acceleration of the vesting other than due to death or disability. So, for example, a plan that provides at the time the service provider obtains a legally binding right to the payment that the payment will be made in three installment payments, payable each December 31 following an initial public offering, where the condition that an initial public offering occur before the service provider is entitled to a payment constitutes a substantial risk of forfeiture, would satisfy the requirement that the plan provide for payments at a specified time or pursuant to a fixed schedule.

C. Separation from service

Section 409A(a)(2)(A)(i) provides that a plan may permit a payment to be made upon a separation from service as determined by the Secretary (except a payment to a specified employee, in which case the payment must be made subject to a six-month delay, discussed more fully below). These regulations provide guidance as to the circumstances under which service providers, including employees and independent contractors, will be treated as separating from service for purposes of section 409A. These rules are intended solely as guidance with respect to section 409A(a)(2)(A)(i), and should not be relied upon with respect to any other Code provisions, such as provisions with respect to distributions under qualified plans and provisions related to the service recipients' employment tax and information reporting obligations.

1. Employees

These regulations provide that an employee experiences a separation from service if the employee dies, retires, or otherwise has a termination of employment with the employer. However, the employment relationship is treated as continuing intact while the individual is on military leave, sick leave, or other *bona fide* leave of absence (such as temporary employment by the Government) if the period of such leave does not exceed six months, or if longer, so long as the individual's right to reemployment with the service recipient is provided either by statute or by contract. If the period of leave exceeds six months and the individual's right to reemployment is not provided either by statute or by contract, the employment relationship is deemed to terminate on the first date immediately following such six-month period.

Whether the employee has experienced a termination of employment is determined based on the facts and circumstances. The Treasury Department and the IRS do not intend for this standard to allow for the extension of deferrals through the use of consulting agreements or other devices under which the service provider technically agrees to perform services as demanded, but for which there is no intent that the service provider perform any

significant services. Accordingly, the regulations provide an anti-abuse rule stating that where an employee either actually or purportedly continues in the capacity as an employee, such as through the execution of an employment agreement under which the service provider agrees to be available to perform services if requested, but the facts and circumstances indicate that the employer and the service provider did not intend for the service provider to provide more than insignificant services for the employer, an employee will be treated as having a termination of employment and a separation from service. For these purposes, an employer and employee will be deemed to have intended for the employee to provide more than insignificant services if the employee provides services at an annual rate equal to at least 20 percent of the services rendered and the annual remuneration for such services is equal to at least 20 percent of the average remuneration earned during the immediately preceding three full calendar years of employment (or, if the employee was employed for less than three years, such lesser period).

In addition, the Treasury Department and the IRS do not intend for this standard to be circumvented to create a separation from service where the service provider continues to perform significant services for the service recipient. For these purposes, the regulations provide that where an employee continues to provide services to a previous employer in a capacity other than as an employee, a separation from service will be treated as not having occurred if the former employee provides services at an annual rate that is 50 percent or more of the services rendered, on average, during the final three full calendar years of employment (or, if less, such lesser period) and the annual remuneration for such services is 50 percent or more of the average annual remuneration earned during the immediately preceding three full calendar years of employment (or if less, such lesser period).

Commentators asked whether the previous positions of the Treasury Department and the IRS with respect to a separation from service for purposes of section 401(k), generally referred to as the same desk rule, would apply in these circumstances. Under that rule, in certain situations where the identity of the employee's employer changed, such as with respect to

a sale of substantially all of the assets of the original employer to a new employer who hired the employee, the employee would not be treated as having a separation from service where the duties and responsibilities of the employee had not materially changed. These regulations do not incorporate this standard.

Commentators had requested the ability to elect whether to apply the same desk rule in the case of a corporate transaction, such as a sale of substantially all of the assets of the original employer. The Treasury Department and the IRS do not believe that such a rule would be consistent with the provisions of section 409A, which generally restrict such control over the time and form of payment.

2. *Independent contractors*

The definition of a separation from service of an independent contractor in these proposed regulations generally is derived from the definition of severance from employment provided in §1.457-6(b)(2). Comments are requested with respect to any changes that may be necessary to address issues arising under section 409A.

3. *Delay for key employees*

Section 409A(a)(2)(B)(i) provides that payments upon a separation from service to a key employee of a corporation whose stock is publicly traded on an established securities market must be delayed at least six months following the separation from service. For these purposes, a key employee is defined in accordance with section 416(i), disregarding section 416(i)(5). Commentators asked for guidance on when a determination as to whether an individual is a key employee must be made. Section 416 relies upon plan year concepts, which generally are not relevant to the application of section 409A. In addition, the Treasury Department and the IRS wish to establish rules that minimize the administrative burden, while implementing the legislative intent. Accordingly, the regulations provide that the identification of key employees is based upon the 12-month period ending on an identification date chosen by the service recipient. Persons who meet the requirements of section 416(i)(1)(A)(i), (ii) or (iii) during that 12-month period

are considered key employees for the 12-month period commencing on the first day of the 4th month following the end of the 12-month period. For example, if an employer chose December 31 as an identification date, any key employees identified during the calendar year ending December 31 would be treated as specified employees for the 12-month period commencing the following April 1. In this manner, service recipients generally may know in advance whether the person to whom a payment is scheduled to be made will be subject to the provision. In addition, service recipients may choose an identification date other than December 31, provided that the date must be used consistently and provided that any change in the identification date may not be effective for a period of at least 12 months.

Some commentators had requested that certain types of payments, generally life annuities or longer-term installment payments, be excepted from the six-month delay requirement. The statutory language does not contemplate such an exception. Where an executive is aware that the source of funds to pay for his nonqualified deferred compensation are at significant risk, the executive may separate from service to obtain initial annuity or installment payments while such funds exist. Commentators argue that annuity payments or long-term installment payments generally would be less significant in amount. However, the Treasury Department and the IRS are not inclined to establish arbitrary limits, where such amounts may actually be quite significant due to the overall amount of the entire benefit, the number of installment payments, or the age of the participant, especially where the statutory language does not contemplate the creation of such an exception. Rather, the Treasury Department and the IRS believe that the provisions with respect to separation pay should provide service recipients the ability to provide reasonably significant amounts of benefits to terminating executives, that may respond to many of the concerns underlying the request to relax the six-month delay requirement.

To meet the six-month delay requirement, a plan may provide that any payment pursuant to a separation of service due within the six-month period is delayed until the end of the six-month period, or that each scheduled payment that becomes

payable pursuant to a separation from service is delayed six months, or a combination thereof. For example, a nonqualified deferred compensation plan of a corporation whose stock is publicly traded on an established securities market may provide that a participant is entitled to 60 monthly installment payments upon separation from service, payable commencing the first day of the first month following the date of separation from service. To comply with the requirement of a six-month delay for payments to key employees, the plan may provide that in the case of an affected participant, the aggregate amount of the first seven months of installments is paid at the beginning of the seventh month following the date of separation from service, or may provide that the commencement date of the 60 months of installment payments is the first day of the seventh month following the date of separation from service, or may provide for a combination of these provisions. A plan may be amended to specify or change the manner in which the delay will be implemented, provided that the amendment may not be effective for at least 12 months. Because the delay requirement applies only to certain public corporations, a corporation or other entity not covered by the requirement may have failed to include a provision in its plans at the time the corporation is contemplating becoming a public corporation. These regulations provide that where the stock of the service recipient is not publicly traded on an established securities market, a plan may be amended to specify or change the manner in which the delay will be implemented, effective immediately upon adoption of the amendment. A plan may provide a service provider an election as to the manner in which the six-month delay is to be implemented, provided that such election is subject to otherwise applicable deferral election rules.

D. *Death or disability*

As provided in section 409A(a)(2)(A)(ii) and (iii), these regulations state that the death or disability of the service provider are permissible payment events. The regulations incorporate the definition of disability provided in section 409A(a)(2)(C). These regulations clarify that a plan that provides for a payment

upon a disability need not provide for a payment upon all disabilities identified in section 409A(a)(2)(C), as long as any disability upon which a payment would be made is contained within the definition provided in section 409A(a)(2)(C). In addition, these regulations provide that a service recipient may rely upon a determination of the Social Security Administration with respect to the existence of a disability.

E. Change in ownership or effective control of the corporation

The provisions defining a change in ownership or effective control of a corporation remain substantially unchanged from Notice 2005-1, Q&As-11 through 14. These provisions are based largely upon the discussion in the legislative history, indicating that the guidance should provide a similar, but more restrictive, definition of a change in the ownership or effective control of a corporation as compared to the definition used for purposes of the golden parachute provisions of section 280G. H.R. Conf. Rep. No. 108-755, at 730 (2004). Accordingly, the provisions largely mirror the regulations under section 280G, though the percentage changes in ownership necessary to qualify as permissible payment events have increased. However, unlike the golden parachute provisions, a change in control event may occur that does not relate to the entire group of affiliated corporations. Rather, the relevant analysis for purposes of section 409A generally is whether the corporation for whom the service provider performed services at the time of the event, the corporation or corporations liable for the payment at the time of the event, or a corporate majority shareholder of one of these corporations, experienced a change in control event.

Commentators asked whether the provisions relating to the change in ownership or effective control of a corporation will be extended to non-corporate entities. Specifically, some commentators asked whether change in control provisions could be applied in the case of a partnership or other pass-through entity. Neither the statute nor the legislative history refers to a permissible distribution upon a change in ownership or effective control of any type of entity other than a corporation.

However, the Treasury Department and the IRS plan to issue regulations under section 409A(a)(3) that will allow an acceleration of payments upon a change in the ownership of a partnership or in the ownership of a substantial portion of the assets of the partnership. Until further guidance is issued, the section 409A rules regarding permissible distributions upon a change in the ownership of a corporation (as described in proposed §1.409A-3(g)(5)(v)) or a change in the ownership of a substantial portion of the assets of a corporation (as described in proposed §1.409A-3(g)(5)(vii)) may be applied by analogy to changes in the ownership of a partnership and changes in the ownership of a substantial portion of the assets of a partnership. For purposes of this paragraph, any references in proposed §1.409A-3(g)(5) to corporations, shareholders, and stock shall be treated as referring also to partnerships, partners, and partnership interests, respectively, and any reference to “majority shareholder” as applied by analogy to the owner of a partnership shall be treated as referring to a partner that (a) owns more than 50 percent of the capital and profits interests of such partnership, and (b) alone or together with others is vested with the continuing exclusive authority to make the management decisions necessary to conduct the business for which the partnership was formed. The Treasury Department and the IRS request comments with respect to the application of a change in control provision to partnerships and other non-corporate entities, as well as suggestions with respect to the formulation of which types of events should qualify and would be analogous to the corporate events described in the regulations.

Commentators also raised questions regarding the application of section 409A to earn-out provisions where an acquirer contracts to make an immediate payment at the closing of the transaction with additional amounts payable at a later date, subject to the satisfaction of specified conditions. In such situations, the later payments could create delays in payments of compensation calculated by reference to the value of target corporation shares. These regulations address this situation by providing that compensation payable pursuant to the purchase by the service recipient of service recipient stock or a stock right held by a

service provider, or payment of amounts of deferred compensation calculated by reference to the value of service recipient stock, may be treated as paid at a specified time or pursuant to a fixed schedule in conformity with the requirements of section 409A if paid on the same schedule and under the same terms and conditions as payments to shareholders generally pursuant to a change in the ownership of a corporation that qualifies as a change in control event or as payments to the service recipient pursuant to a change in the ownership of a substantial portion of a corporation’s assets that qualifies as a change in control event, and any amounts paid pursuant to such a schedule and such terms and conditions will not be treated as violating the initial or subsequent deferral election rules, to the extent that such amounts are paid not later than five years after the change in control event.

F. Unforeseeable emergency

The regulations contain provisions defining the types of circumstances that constitute an unforeseeable emergency, and the amounts that may be paid due to the unforeseeable emergency. Generally these provisions are derived directly from section 409A(a)(2)(B)(ii). Commentators requested that in the case of an unforeseeable emergency, a service provider be permitted to cancel future deferrals. This issue is discussed in this preamble at paragraph VII.D.

G. Multiple payment events

The regulations permit a plan to provide that payments may be made upon the earlier of, or the later of, two or more specified permissible payment events or times. In addition, the regulations provide that a different form of payment may be elected for each potential payment event. For example, a plan may provide that a service provider will receive an installment payment upon separation from service or, if earlier, a lump sum payment upon death. The application of the rules governing changes in time and form of payment and the anti-acceleration rules to amounts subject to multiple payment events, is discussed below.

H. *Delay in payment by the service recipient*

Commentators noted that for certain compelling reasons, a service recipient may be unwilling or unable to make a payment of an amount due under a nonqualified deferred compensation plan. These regulations generally provide that in the case of payments the deduction for which would be limited or eliminated by the application of section 162(m), payments that would violate securities laws, or payments that would violate loan covenants or other contractual terms to which the service recipient is a party, where such a violation would result in material harm to the service recipient, the plan may provide that the payment will be delayed. In addition, plans may be amended to add such provisions, but such an amendment cannot be effective for a period of at least 12 months. However, if a plan is amended to remove such a provision with respect to amounts deferred previously, the amendment will constitute an acceleration of the payment. In the case of amounts for which the deduction would be limited or reduced by the application of section 162(m), these regulations require that the payment be deferred either to a date in the first year in which the service recipient reasonably anticipates that a payment of such amount would not result in a limitation of a deduction with respect to the payment of such amount under section 162(m) or the year in which the service provider separates from service. In the case of amounts that would violate loan covenants or similar contracts, or would result in a violation of Federal securities laws or other applicable laws, the arrangement must provide that the payment will be made in the first calendar year in which the service recipient reasonably anticipates that the payment would not violate the loan contractual terms, the violation would not result in material harm to the service recipient, or the payment would not result in a violation of Federal securities law or other applicable laws. These regulations also provide that the Commissioner may prescribe through guidance published in the Internal Revenue Bulletin other circumstances in which a plan may provide for the delay of a payment of a deferred amount. The Treasury Department and the IRS specifically request comments as to what other

circumstances may be appropriate to include in such guidance.

I. *Disputed payments and refusals to pay*

In addition to situations in which a plan may delay payment due to certain business circumstances, commentators expressed concern about the possibility that a service recipient will refuse to pay deferred compensation when the payment is due, and whether such refusal to pay would result in taxation of the service provider under section 409A. Generally these situations will arise where either the obligation to make the payment, or the amount of the payment, is subject to dispute. But this situation may also arise where the service recipient simply refuses to pay. In either situation, these proposed regulations generally provide that the payment will be deemed to be made upon the date scheduled under the terms of the arrangement, provided that the service provider is acting in good faith and makes reasonable, good faith efforts to collect the amount. Factors relevant in determining whether a service provider is acting in good faith and making reasonable, good faith efforts to collect the amount include both the amount of the payment, or portion of a payment, in dispute, as well as the size of the disputed portion in relation to the entire payment. Although a payment may be delayed under this provision without violating section 409A because the service recipient refuses to make the payment, the payment may not be made subject to a subsequent deferral election because the payment was delayed. Rather, the payment must be made by the later of the end of the calendar year in which, or the 15th day of the third month following the date that, the service recipient and the service provider enter into a legally binding settlement of such dispute, the service recipient concedes that the full amount is payable, or the service recipient is required to make such payment pursuant to a final and nonappealable judgment or other binding decision. This paragraph is not intended to serve as a means of deferring payments without application of section 409A, by feigning a dispute or surreptitiously requesting that the service recipient refuse to pay the amount at the due date. Where the service provider is not acting in good faith, for example creating a dispute with no or tenuous basis, or

where the service provider is not making reasonable, good faith efforts to collect the amount, the failure to receive the payment at the date originally scheduled may result in a violation of the permissible payment requirements. Among the factors to be considered is the practice of the service recipient with respect to payments of nonqualified deferred compensation. In addition, these regulations provide that the service provider is treated as having requested that a payment not be made, rather than the service recipient having refused to make such payment, where the decision that the service recipient will not make the payment is made by the service provider, or any person or group of persons under the supervision of the service provider at the time the decision is made.

VII. *Anti-acceleration Provision*

A. *In general*

Under section 409A(a)(3), a payment of deferred compensation may not be accelerated except as provided in regulations by the Secretary. Certain permissible payment accelerations were listed in Notice 2005-1, Q&A-15, including payments necessary to comply with a domestic relations order, payments necessary to comply with certain conflict of interest rules, payments intended to pay employment taxes, and certain *de minimis* payments related to the participant's termination of his or her interest in the plan. All the permissible payment accelerations contained in Notice 2005-1, Q&A-15, are included in these regulations.

B. *Payments upon income inclusion under section 409A*

These regulations provide that a plan may permit the acceleration of the time or schedule of a payment to a service provider to pay the amount the service provider includes in income as a result of the plan failing to meet the requirements of section 409A. For this purpose, a service provider will be deemed to have included the amount in income if the amount is timely reported on a Form W-2, "Wage and Tax Statement", or Form 1099-MISC, "Miscellaneous Income", as appropriate.

C. Plan terminations

Some commentators requested that service recipients be allowed to retain the right to accelerate payments upon a termination of the arrangement, where the termination is at the discretion of the service recipient. A general ability of a service recipient to make such payments raises the potential for abuse, especially with respect to arrangements with individual service providers. Where a service provider retains sufficient influence to obtain a termination of the arrangement, the service recipient's discretion to terminate the plan in substance would mean that amounts deferred were available to the service provider upon demand. Such a condition would be inconsistent with the provisions of and legislative intent behind section 409A.

Some commentators requested that service recipients be permitted to terminate arrangements where the arrangements are broad-based, covering a significant number of service providers. Due to concerns about administrability and equity, the regulations do not adopt the suggestion.

Some commentators also suggested that service recipients be permitted to terminate arrangements due to *bona fide* business reasons. However, the Treasury Department and the IRS are not confident that such a standard could be applied on a consistent and coherent basis, leaving service recipients unable to plan with confidence and creating the potential for abuse. The Treasury Department and the IRS are considering further guidance establishing criteria or circumstances under which a plan could be terminated. For that purpose, these regulations provide authority to the Commissioner to establish such criteria or circumstances in generally applicable guidance published in the Internal Revenue Bulletin.

These proposed regulations provide three circumstances under which a plan may be terminated at the discretion of the service recipient in accordance with the terms of the plan. The first addresses a service recipient that wants to cease providing a certain category of nonqualified deferred compensation, such as account balance plans, entirely. A plan may be terminated provided that all arrangements of the same type (account balance plans, nonaccount balance plans, separation pay plans or

other arrangements) are terminated with respect to all participants, no payments other than those otherwise payable under the terms of the plan absent a termination of the plan are made within 12 months of the termination of the arrangement, all payments are made within 24 months of the termination of the arrangement, and the service recipient does not adopt a new arrangement that would be aggregated with any terminated arrangement under the plan aggregation rules at any time for a period of five years following the date of termination of the arrangement.

The remaining two exceptions relate to events that are both objectively determinable to have occurred-and so may be determined consistently-and are of such independent significance that they are unlikely to be related to any attempt to accelerate payments under a nonqualified deferred compensation plan in a manner inconsistent with the intent of the statute. These regulations provide that during the 12 months following a change in control of a corporation, the service recipient may elect to terminate a plan and make payments to the participants. In addition, a plan may provide that the plan terminates upon a corporate dissolution taxed under section 331, or with the approval of a bankruptcy court pursuant to 11 U.S.C. §503(b)(1)(A), provided that the amounts deferred under the plan are included in the participants' gross incomes by the latest of (i) the calendar year in which the plan termination occurs, (ii) the calendar year in which the amount is no longer subject to a substantial risk of forfeiture, or (iii) the first calendar year in which the payment is administratively practicable.

D. Terminations of deferral elections following an unforeseeable emergency or a hardship distribution

Commentators noted that although section 409A provides that a service provider may receive a payment upon an unforeseeable emergency, there is no provision explicitly permitting or requiring the service provider to halt all elective deferrals to receive such a payment. In addition, commentators noted that to receive a hardship distribution under a qualified plan with a qualified cash or deferred arrangement under section 401(k), a participant generally would be required pursuant to the regula-

tions under section 401(k) to halt any elective deferrals of compensation into a nonqualified deferred compensation plan. In response, these regulations provide that a plan may provide that a deferral election terminates if a service provider obtains a payment upon an unforeseeable emergency. Similarly, these regulations provide that a plan may provide that a deferral election is terminated if required for a service provider to obtain a hardship distribution under a qualified plan with a qualified cash or deferred arrangement under section 401(k). In each case, the deferral election must be terminated, and not merely suspended. A deferral election under the arrangement made after a termination of a deferral election due to a hardship distribution or an unforeseeable emergency will be treated as an initial deferral election.

E. Distributions to avoid a nonallocation year under section 409(p)

Commentators noted that in the case of an S corporation sponsoring an employee stock ownership plan, under certain conditions distributions from a nonqualified deferred compensation plan may be necessary to avoid a nonallocation year (within the meaning of section 409(p)(3)). These regulations provide rules under which such distributions may be made to avoid such a nonallocation year.

VIII. Subsequent Changes in the Time and Form of Payment

A. In general

Section 409A(a)(4)(C) and these regulations provide that, in the case of a plan that permits a service provider to make a subsequent election to delay a payment or to change the form of a payment (provided that any such payment is the subject of an initial deferral election), the following conditions must be met:

(1) The plan must require that such election not take effect until at least 12 months after the date on which the election is made,

(2) In the case of an election related to a payment other than a payment on account of death, disability or the occurrence of an unforeseeable emergency, the plan requires that the first payment with respect to which such election is made be deferred for a period of not less than 5 years from

the date such payment would otherwise have been made (the 5-year rule), and

(3) The plan requires that any election related to a payment at a specified time or pursuant to a fixed schedule may not be made less than 12 months prior to the date of the first scheduled payment.

B. Definition of payment

Commentators requested clarification whether the individual amounts paid in a defined stream of payments, such as installment payments, are treated as separate payments or as one payment. This affects the application of the rules governing subsequent deferral elections, particularly the 5-year rule.

These proposed regulations provide generally that each separately identified amount to which a service provider is entitled to payment under a plan on a determinable date is a separate payment. Accordingly, if an amount is separately identified as a payment, either because the right arises under a separate arrangement or because the arrangement identifies the amount as a separate payment, the amount will not be aggregated with other amounts for purposes of the rules relating to subsequent changes in the time and form of payment and the anti-acceleration rule. For example, an arrangement may provide that 50 percent of the benefit is paid as a lump sum at separation from service, and that the remainder of the benefit is paid as a lump sum at age 60, which would identify each amount as a separate payment. However, once a payment has been identified separately, the payment may only be aggregated with another payment if the aggregation would otherwise comply with the rules relating to subsequent changes in the time and form of payment and the anti-acceleration rule.

The Treasury Department and the IRS recognize that most taxpayers view the ability to elect installment payments as a choice of a single form of payment. Accordingly, the entitlement to a series of installment payments under a particular arrangement generally is treated as a single payment for purposes of the subsequent deferral rules. However, taxpayers could also view each individual payment in the series of payments as a separate payment. Accordingly, these regulations provide that an arrangement may specify that

a series of installment payments is to be treated as a series of separate payments.

An installment payment must be treated consistently both with respect to the rules governing subsequent changes in the time and form of payment, and with respect to the anti-acceleration rules. For example, if a 5-year installment payment is treated as a single payment and is scheduled to commence on July 1, 2010, then consistent with the 5-year rule a service provider generally could change the time and form of the payment to a lump sum payment on July 1, 2015, provided the other conditions related to a change in the time and form of payment were met. In contrast, if a 5-year installment payment is designated as five separate payments scheduled for the years 2010 through 2014, then the service provider could not change the time and form of the payment to a lump sum payment to be made on July 1, 2015, because the separate payments scheduled for the years 2011 through 2014 would not have been deferred at least 5 years. Rather, the service provider generally could change the time and form of payment to a lump sum payment only if the payment were scheduled to occur no earlier than 2019 (5 years after the last of the originally scheduled payments).

One exception to this rule is a life annuity, the entitlement to which is treated as a single payment. The Treasury Department and the IRS believe that taxpayers generally view an entitlement to a life annuity as a single form of payment, rather than a series of separate payments. In addition, treating a life annuity as a series of payments would lead to difficulty in applying the rules governing subsequent changes in the time and form of payment, because the aggregate amount of the payments and the duration of the payments are unknown, as their continuation depends on the continued life of the service provider or other individual. For example, if a single life annuity were treated as a series of separate payments, an election to change a form of payment to a lump sum payment could be made only if the lump sum payment were deferred to a date no earlier than five years after the death of the participant.

C. Application to multiple payment events

As discussed above, a plan may provide that a payment will be made upon the ear-

lier of, or the later of, multiple specified permissible payment events. In addition, a plan may provide for a different form of payment depending upon the payment event. For example, a plan may provide that a service provider is entitled to an annuity at age 65 or, if earlier, a lump sum payment upon separation from service.

The question then arises as to how the provisions governing changes in the time and form of payment and the anti-acceleration provision apply where there are multiple potential payment events, and possibly multiple forms of payment as well. The regulations provide that these provisions are to apply to each payment event separately. In the example above, these provisions would apply separately to the entitlement to the installment payment at age 65, and the entitlement to the lump sum payment at separation from service. Accordingly, the service provider generally would be able to delay the annuity payment date subject to the rules governing changes in the time and form of payment, while retaining a separate right to receive a lump sum payment at separation from service if that occurred at an earlier date. In other words, the 5-year rule would apply to the annuity payment date (delaying payment from age 65 to at least age 70) but not to the unchanged lump sum payment available upon separation from service before age 70.

Similarly, a plan may provide that an intervening event that is a permissible payment event under section 409A may override an existing payment schedule already in payment status. For example, a plan could provide that a participant would receive six installment payments commencing at separation from service, but also provide that if the participant died after the payments commenced, all remaining benefits would be paid in a lump sum.

An additional question arises where a new payment event, or a fixed time or fixed schedule of payments, is added to the plan. Generally, the addition of the payment event or date will be subject to the rules governing changes in the time and form of payment and the anti-acceleration rules. Accordingly, no fixed time of payment could be added that did not defer the payment at least five years from the date the fixed time was added. In addition, no payment due to any other added permissible event could be made within five years

of the addition of the event. For example, a service provider entitled to a payment only on January 1, 2050, could not make a subsequent deferral election to be paid on the later of January 1, 2050, or separation from service, but could make a subsequent deferral election to be paid at the later of separation from service or January 1, 2055.

IX. *Application of Rules to Nonqualified Deferred Compensation Plans Linked to Qualified Plans*

A. *In general*

Commentators raised many issues concerning the application of section 409A to nonqualified deferred compensation plans linked to qualified plans. These linked plans exist in a variety of formats, and are referred to under various labels such as excess plans, wrap plans, and supplemental employee retirement plans (SERPs). Typically the purpose of such plans is to replace the benefits that would have been provided under the qualified plan absent the application of certain limits contained in the Code (for example, section 415, section 401(a)(17) or section 402(g)). Often the amounts deferred under the nonqualified deferred compensation plan are established through an offset formula, where the amount deferred equals an amount determined under a formula, offset by any benefits credited under the qualified plan. Because of the close relationship between the qualified plan and the nonqualified deferred compensation plan, sponsor and participant actions under the qualified plan may affect the calculation or payment of the amounts deferred under the nonqualified deferred compensation plan. Commentators asked for guidance regarding the circumstances under which an action (or failure to act) under the qualified plan may be treated as violating section 409A, to the extent the action (or failure to act) also affects the amounts deferred under the nonqualified deferred compensation plan.

These proposed regulations generally adopt rules under which nonqualified deferred compensation plans linked to qualified plans may continue to operate, though certain changes may be required. The intent of these rules generally is to permit the qualified plan to be established, amended and operated under the rules governing

qualified plans, without causing the linked nonqualified deferred compensation plan to violate the rules of section 409A. However, the relief provided under certain rules to accommodate the linked plan structure is not intended to relax the rules generally with respect to all of the amounts deferred under the nonqualified deferred compensation plan, simply because a limited portion of the amounts deferred may be affected by actions under the qualified plan. Accordingly, in certain circumstances the relief provided relates solely to amounts deferred under the nonqualified deferred compensation plan that do not exceed the applicable limit on the qualified plan benefit for the taxable year.

B. *Actions that do not constitute deferral elections or accelerations*

Where amounts deferred under a nonqualified deferred compensation plan are linked to the benefits under a qualified plan, certain participant actions taken with respect to the benefit accrued under the qualified plan may affect the amounts deferred under the nonqualified deferred compensation plan. Where the amounts deferred under the nonqualified deferred compensation plan increase, the issue is whether the action taken with respect to the benefit accrued under the qualified plan constitutes a deferral election. Where the amounts deferred under the nonqualified deferred compensation plan decrease, the issue is whether the action taken with respect to the benefit accrued under the qualified plan constitutes an impermissible acceleration of a payment under the nonqualified deferred compensation plan.

With respect to the benefits provided under the qualified plan, these regulations provide generally that neither the amendment of the qualified plan to increase or decrease such benefits under the qualified plan nor the cessation of future accruals under the qualified plan is treated as a deferral election or an acceleration of a payment under the nonqualified deferred compensation plan. Similarly, the addition, removal, increase or reduction of a subsidized benefit or ancillary benefit under the qualified plan, or a participant election with respect to a subsidized benefit or ancillary benefit under the qualified plan, will not constitute either a deferral election or an acceleration of a payment under the

nonqualified deferred compensation, even where such action results in an increase or decrease in amounts deferred under the nonqualified deferred compensation plan.

Additional relief is provided with respect to nonqualified deferred compensation plans linked to defined contribution plans that include a 401(k) or similar cash or deferred arrangement. Specifically, the regulations provide that a service provider's action or inaction under a qualified plan that is subject to section 402(g), including an adjustment to a deferral election under such qualified plan, will not be treated as either a deferral election or an acceleration of a payment under the linked nonqualified deferred compensation plan, provided that for any given calendar year, the service provider's actions or inactions under the qualified plan do not result in an increase in the amounts deferred under all nonqualified deferred compensation plans in which the service provider participates in excess of the limit with respect to elective deferrals under section 402(g) in effect for the year in which such actions or inactions occur. The Treasury Department and the IRS intend for this provision to address common arrangements whereby the amounts deferred under the nonqualified deferred compensation plan are linked to amounts deferred under a 401(k) arrangement (often referred to as 401(k) wrap plans), but only to the extent the amount of affected deferrals under the nonqualified deferred compensation plan does not exceed the maximum amount that ever could have been electively deferred under the qualified plan.

Similar relief is provided with respect to plans involving matching contributions. The regulations provide that a service provider's action or inaction under a qualified plan with respect to elective deferrals or after-tax contributions by the service provider to the qualified plan that affects the amounts that are credited under a nonqualified deferred compensation arrangement as matching amounts or other amounts contingent on service provider elective deferrals or after-tax contributions will not be treated as either a deferral election or an acceleration of payment, provided that such matching or contingent amounts, as applicable, are either forfeited or never credited under the nonqualified deferred compensation arrangement in the absence of such service provider's elec-

tive deferral or after-tax contribution, and provided the service provider's actions or inactions under the qualified plan do not result in an increase or decrease in the amounts deferred under all nonqualified deferred compensation plans in which the service provider participates in excess of the limit with respect to elective deferrals under section 402(g) in effect for the year in which such actions or inactions occur. Although the section 402(g) limit applies to elective deferrals, rather than matching contributions, the Treasury Department and the IRS believe that matching contributions in excess of 100 percent of the elective deferrals of pre-tax contributions or after-tax contributions will be rare.

X. Statutory Effective Dates

A. Effective dates — earned and vested amounts

Consistent with Notice 2005-1, Q&A-16, these regulations provide that an amount is considered deferred before January 1, 2005, and thus is not subject to section 409A, if the service provider had a legally binding right to be paid the amount and the right to the amount was earned and vested as of December 31, 2004. For these purposes, a right to an amount is earned and vested only if the amount is not subject to either a substantial risk of forfeiture or a requirement to perform further services. Some commentators questioned the application of section 409A to contractual arrangements entered into before the enactment of the statute. However, the statutory effective date is tied to the date the amount is deferred and the legislative history states that for these purposes, "an amount is considered deferred before January 1, 2005, if the amount is earned and vested before such date." H.R. Conf. Rep. No. 108-755, at 737 (2004). Accordingly, these regulations are consistent with the legislative intent that deferred amounts that were not earned, or were not vested, as of December 31, 2004, are subject to the provisions of section 409A.

Clarification has been provided with respect to when a stock right or similar right to compensation will be treated as earned and vested. The issue arises because often a stock right terminates upon a separation from service. Taxpayers questioned whether this meant that the right had not

been earned and vested, because future services would be required to retain the right. These regulations clarify that a stock right or similar right will be treated as earned and vested by December 31, 2004, if on or before such date the right was either immediately exercisable for a payment of cash or substantially vested property, or was not forfeitable. Accordingly, stock options that on or before December 31, 2004, were immediately exercisable for substantially vested stock generally would not be subject to section 409A. In contrast, a non-statutory stock option that was immediately exercisable on or before December 31, 2004, but only for substantially non-vested stock, generally would be subject to section 409A.

B. Effective dates — calculation of grandfathered amount

For account balance plans and plans that are neither account balance plans nor nonaccount balance plans (generally equity-based compensation), these regulations generally retain the method of calculating the grandfathered amount set forth in Notice 2005-1, Q&A-17. Accordingly, for account balance plans the grandfathered amount generally will equal the vested account balance as of December 31, 2004, plus any earnings with respect to such amounts. For equity-based compensation, the grandfathered amount generally will equal the payment that would be available if the right were exercised on December 31, 2004, and any earnings with respect to such amount. For this purpose, the earnings generally would include the increase in the payment available due to appreciation in the underlying stock.

Commentators argued that the definition of the grandfathered amount contained in Notice 2005-1, Q&A-17 with respect to nonaccount balance plans was not sufficiently flexible to account for subsequent increases in benefits unrelated to any further performance of services or increases in compensation after December 31, 2004. For example, a participant's benefit may increase if the participant becomes eligible for a subsidized benefit at a specified age that the participant reaches after December 31, 2004. In response, these proposed regulations provide that for nonaccount balance plans, the grandfathered amount specifically equals the

present value as of December 31, 2004, of the amount to which the service provider would be entitled under the plan if the service provider voluntarily terminated services without cause on December 31, 2004, and received a payment of the benefits with the maximum value available from the plan on the earliest possible date allowed under the plan to receive a payment of benefits following the termination of services. Notwithstanding the foregoing, for any subsequent calendar year, the grandfathered amount may increase to equal the present value of the benefit the service provider actually becomes entitled to, determined under the terms of the plan (including applicable limits under the Code), as in effect on October 3, 2004, without regard to any further services rendered by the service provider after December 31, 2004, or any other events affecting the amount of or the entitlement to benefits (other than the participant's survival or a participant election under the terms of the plan with respect to the time or form of an available benefit).

Because separation pay plans with respect to involuntary terminations and window programs are now treated as separate plans, these regulations provide a rule for calculating the grandfathered amount under such plans. For these purposes, the principles used to calculate the grandfathered amounts under a nonaccount balance plan and an account balance plan are to be applied by analogy, depending upon the structure of the separation pay plan.

C. Material modifications

Commentators have pointed out that a grandfathered plan may become subject to section 409A upon any material modification, even if such modification occurs many years after 2004. Given the substantial amounts of compensation that are deferred under grandfathered plans, as well as the potential for these amounts to grow through accumulated grandfathered earnings, the consequences of such a modification could be significant. Commentators expressed concern that as long as these plans exist, there will be the potential for a change to the plan to mistakenly cause the plan to become subject to section 409A. In response, these regulations include a provision stating that to the extent a modification is rescinded before the earlier of

the date any additional right granted under the modification is exercised or the end of the calendar year in which the modification was made, the modification will not be treated as a material modification of the plan. For example, if a subsequent deferral feature is added that would allow participants to extend the time and form of payment of a grandfathered deferred amount, and if the right is removed before the earlier of the time the participant exercises the right or the end of the calendar year, then the modification will not be treated as a material modification of the plan. However, this provision is not intended to cover material modifications that are made with the knowledge that the modification will subject the amounts to section 409A, but are then rescinded.

Consistent with Notice 2005-1, Q&A-18(a), these regulations also provide that it is not a material modification to change a notional investment measure to, or to add, an investment measure that qualifies as a predetermined actual investment within the meaning of §31.3121(v)(2)-1(d)(2) of this chapter. Commentators requested similar flexibility with respect to investment measures reflecting reasonable rates of interest. These regulations provide such flexibility, generally adopting a modified version of the rules contained in §31.3121(v)(2)-1(d)(2) of this chapter. Under these regulations, it is not a material modification to change a notional investment measure to, or to add, an investment measure that qualifies as a predetermined actual investment within the meaning of §31.3121(v)(2)-1(d)(2) of this chapter or, for any given taxable year, reflects a reasonable rate of interest. For this purpose, if with respect to an amount deferred for a period, a plan provides for a fixed rate of interest to be credited, and the rate is to be reset under the plan at a specified future date that is not later than the end of the fifth calendar year that begins after the beginning of the period, the rate is reasonable at the beginning of the period, and the rate is not changed before the reset date, then the rate will be treated as reasonable in all future periods before the reset date. These proposed regulations also contain other clarifications of the application of the material modification rule.

XI. Transition Relief

A. In general

Until the effective date of these regulations, Notice 2005-1 generally remains in effect. Notice 2005-1, Q&As-18 through 23, provided transition relief that was limited to the 2005 calendar year. Commentators generally reacted favorably to the scope of the transition rules. The Treasury Department and the IRS intended for the transition rules to be generous during the calendar year 2005, both to enable taxpayers to familiarize themselves with the new provisions, and also to provide a period during which the Treasury Department and the IRS could develop regulations and taxpayers generally could be confident that either their plans were not in violation of section 409A, or could be corrected to avoid additional tax under the statute.

Because final regulations are not yet in place, the IRS and the Treasury Department are hereby extending through 2006 certain aspects of the transition relief provided for 2005 by Notice 2005-1. In addition, in response to questions, certain provisions of Notice 2005-1 are clarified below. However, because taxpayers will have had, by the end of 2005, over a year to implement the statute, certain other transition relief is not being extended through 2006.

B. Amendment and operation of plans adopted on or before December 31, 2006

Pursuant to Notice 2005-1, Q&A-19, a plan adopted on or before December 31, 2005, will not be treated as violating section 409A(a)(2), (3) or (4) only if the plan is operated in good faith compliance with the provisions of section 409A and Notice 2005-1 during the calendar year 2005, and the plan is amended on or before December 31, 2005, to conform to the provisions of section 409A with respect to amounts subject to section 409A. To allow time to finalize these regulations, and for practitioners to implement the final regulations, the deadline by which plan documents must be amended to comply with the provisions of section 409A and the regulations is hereby extended to December 31, 2006. Accordingly, in order to be treated as complying with section 409A(a)(2), (3) or (4), a plan adopted before December 31,

2006, must be amended on or before December 31, 2006, either to conform to the provisions of section 409A with respect to amounts subject to section 409A, or to provide a compensation arrangement that does not provide for a deferral of compensation for purposes of section 409A.

The good faith compliance period provided under Q&A-19 of Notice 2005-1 is also hereby extended through December 31, 2006. Accordingly, a plan adopted on or before December 31, 2006, will be treated as complying with section 409A(a)(2), (3) or (4) only if the plan is operated through December 31, 2006, in good faith compliance with the provisions of section 409A and Notice 2005-1. If any other guidance of general applicability under section 409A is published in the Internal Revenue Bulletin with an effective date prior to January 1, 2007, the plan must also comply with such published guidance as of its effective date. To the extent an issue is not addressed in Notice 2005-1 or such other published guidance, the plan must follow a good faith, reasonable interpretation of section 409A, and, to the extent not inconsistent therewith, the plan's terms.

These regulations are not proposed to become effective prior to January 1, 2007, and, accordingly, a plan is not required to comply with either these proposed regulations or the final regulations prior to January 1, 2007. However, compliance with either these proposed regulations or the final regulations will be good faith compliance with the statute. In general, these proposed regulations expand upon, and should be read consistently with, the provisions of Notice 2005-1. However, to the extent that a provision of either these proposed regulations or the final regulations is inconsistent with a provision of Notice 2005-1, the plan may comply with the provision of the proposed or final regulations in lieu of the corresponding provision of Notice 2005-1.

A plan will not be operating in good faith compliance if the plan sponsor exercises discretion under the terms of the plan, or a service provider exercises discretion with respect to that service provider's benefits, in a manner that causes the plan to fail to meet the requirements of section 409A. For example, if an employer retains the discretion under the terms of the plan to delay or extend payments under the plan

and exercises such discretion, the plan will not be considered to be operated in good faith compliance with section 409A with regard to any plan participant. However, an exercise of a right under the terms of the plan by a service provider solely with respect to that service provider's benefits under the plan, in a manner that causes the plan to fail to meet the requirements of section 409A, will not be considered to result in the plan failing to be operated in good faith compliance with respect to other participants. For example, the request for and receipt of an immediate payment permitted under the terms of the plan if the participant forfeits 20 percent of the participant's benefits (a haircut) will be considered a failure of the plan to meet the requirements of section 409A with respect to that service provider, but not with respect to all other service providers under the plan.

C. Change in payment elections or conditions on or before December 31, 2006

Notice 2005-1, Q&A-19(c) provided generally that with respect to amounts subject to section 409A, a plan could be amended to provide for new payment elections without violating the subsequent deferral and anti-acceleration rules, provided that the plan was amended and the participant made the election on or before December 31, 2005. The period during which a plan may be amended and a service provider may be permitted to change payment elections, without resulting in an impermissible subsequent deferral or acceleration, is hereby extended through December 31, 2006, except that a service provider cannot in 2006 change payment elections with respect to payments that the service provider would otherwise receive in 2006, or to cause payments to be made in 2006. Other provisions of the Internal Revenue Code and common law doctrines continue to apply to any such election.

Accordingly, with respect to amounts subject to section 409A and amounts that would be treated as a short-term deferral within the meaning of §1.409A-1(b)(4), a plan may provide, or be amended to provide, for new payment elections on or before December 31, 2006, with respect to both the time and form of payment of such amounts and the election will not be

treated as a change in the form and timing of a payment under section 409A(a)(4) or an acceleration of a payment under section 409A(a)(3), provided that the plan is so amended and the service provider makes any applicable election on or before December 31, 2006, and provided that the amendment and election applies only to amounts that would not otherwise be payable in 2006 and does not cause an amount to be paid in 2006 that would not otherwise be payable in such year. Similarly, an outstanding stock right that provides for a deferral of compensation subject to section 409A may be amended to provide for fixed payment terms consistent with section 409A, or to permit holders of such rights to elect fixed payment terms consistent with section 409A, and such amendment or election will not be treated as a change in the time and form of a payment under section 409A(a)(4) or an acceleration of a payment under section 409A(a)(3), provided that the option or right is so amended and any elections are made, on or before December 31, 2006.

D. Payments based upon an election under a qualified plan for periods ending on or before December 31, 2006

For calendar year 2005, Notice 2005-1 Q&A-23 provides relief for nonqualified deferred compensation plans where the time and form of payment is controlled by the time and form of payment elected by the service provider under a qualified plan. Commentators indicated that this is a common arrangement with respect to nonqualified deferred compensation plans providing benefits calculated in relation to benefits accrued under a defined benefit qualified plan. Generally, the provisions with respect to the election of a time and form of a payment with respect to a qualified plan benefit would not comply with the requirements of section 409A were the plan subject to section 409A. Accordingly, election provisions under a nonqualified plan that mirrored or depended upon an election under a qualified plan generally would not comply with section 409A. The Treasury Department and the IRS were concerned that service providers, service recipients and plan administrators would not have sufficient time to solicit, retain and process new elections from service providers to comply with section 409A in

2005. Accordingly, relief was provided in Notice 2005-1, Q&A-23, under which an election under a nonqualified deferred compensation plan that was controlled by an election under a qualified plan could continue in effect during the calendar year 2005.

Commentators requested that this relief be a permanent provision in the regulations. Although the Treasury Department and the IRS understand that such a provision would make the coordination of benefits under a qualified plan and benefits under a nonqualified deferred compensation plan calculated by reference to the qualified plan benefits easier to administer, the provisions of section 409A are not as flexible with respect to the timing of such elections as the qualified plan provisions. Given that the benefits under a nonqualified deferred compensation plan often dwarf the benefits provided under a qualified plan, the Treasury Department and the IRS do not believe that the importation of the more flexible qualified plan rules would be consistent with the legislative intent behind the enactment of section 409A. Accordingly, the transition relief has not been made permanent. However, because other transition relief granting a participant the ability to change a time and form of payment through the end of the calendar year 2006 would, in many instances, allow a participant to elect the same time and form of payment that had been elected under the qualified plan, the relief is hereby extended through the calendar year 2006.

Accordingly, for periods ending on or before December 31, 2006, an election as to the timing and form of a payment under a nonqualified deferred compensation plan that is controlled by a payment election made by the service provider or beneficiary of the service provider under a qualified plan will not violate section 409A, provided that the determination of the timing and form of the payment is made in accordance with the terms of the nonqualified deferred compensation plan as of October 3, 2004, that govern payments. For this purpose, a qualified plan means a retirement plan qualified under section 401(a). For example, where a nonqualified deferred compensation plan provides as of October 3, 2004, that the time and form of payment to a service provider or beneficiary will be the same time and

form of payment elected by the service provider or beneficiary under a related qualified plan, it will not be a violation of section 409A for the plan administrator to make or commence payments under the nonqualified deferred compensation plan on or after January 1, 2005, and on or before December 31, 2006, pursuant to the payment election under the related qualified plan. Notwithstanding the foregoing, other provisions of the Internal Revenue Code and common law tax doctrines continue to apply to any election as to the timing and form of a payment under a nonqualified deferred compensation plan.

E. Initial deferral elections

Notice 2005-1, Q&A-21 provides relief with respect to initial deferral elections, generally permitting initial deferral elections with respect to deferrals relating all or in part to services performed on or before December 31, 2005, to be made on or before March 15, 2005. No extension is provided with respect to this relief with respect to initial elections to defer compensation. The Treasury Department and the IRS believe that sufficient guidance has been provided so that timely elections may be solicited and received from plan participants. In combination with the extension of flexibility with respect to amending the time and form of payments, the Treasury Department and the IRS believe that participants should be sufficiently informed to make a decision with respect to deferral elections.

F. Cancellation of deferrals and termination of participation in a plan

Notice 2005-1, Q&A-20 provides a limited time during which a plan adopted before December 31, 2005, may provide a participant a right to terminate participation in the plan, or cancel an outstanding deferral election with regard to amounts subject to section 409A. Generally to qualify for this relief, if a plan amendment is necessary to permit the participant to terminate participation or cancel a deferral election, the plan amendment must be enacted and effective on or before December 31, 2005, and whether or not the plan is amended, the amount subject to the termination or cancellation must be includible in income of the participant in the calendar

year 2005 or, if later, in the taxable year in which the amounts are earned and vested.

The period during which a service provider may cancel a deferral election or terminate participation in the plan is not extended. This relief was intended as a temporary period during which service providers could decide whether to continue to participate in an arrangement subject to section 409A. The Treasury Department and the IRS believe that the statute and existing guidance provide sufficient information for service providers to determine by December 31, 2005, whether to continue to participate in a particular arrangement, and that the further extension of this relief, and the relaxation of constructive receipt rules it entails, is not appropriate.

A termination or cancellation pursuant to Notice 2005-1, Q&A-20 is treated as effective as of January 1, 2005, for purposes of section 409A, and may apply in whole or in part to one or more plans in which a service provider participates and to one or more outstanding deferral elections the service provider has made with regard to amounts subject to section 409A. The exercise of a stock option, stock appreciation right or similar equity appreciation right that provides for a deferral of compensation, on or before December 31, 2005, will be treated as a cancellation of a deferral.

G. Terminations of grandfathered plans

Notice 2005-1, Q&A-18(c) provides that amending an arrangement on or before December 31, 2005, to terminate the arrangement and distribute the amounts of deferred compensation thereunder will not be treated as a material modification, provided that all amounts deferred under the plan are included in income in the taxable year in which the termination occurs. For the same reasons discussed above with respect to the period during which plans may allow participants to terminate participation in a plan, the relief provided in Notice 2005-1, Q&A-18(c) is not extended.

To qualify for the relief provided in Notice 2005-1, Q&A-18(c), the amendment to the plan must result in the termination of the arrangement and the distribution of all amounts deferred under the arrangement in the taxable year of such termination. An amendment to a plan to provide a partic-

ipant a right to elect whether to terminate participation in the plan or to continue to defer amounts under the plan would not be covered by Q&A-18(c), and therefore would constitute a material modification of the plan. Accordingly, amounts that were not distributed pursuant to such an election and continued to be deferred under the plan would be subject to section 409A.

H. Substitutions of non-discounted stock options and stock appreciation rights for discounted stock options and stock appreciation rights

Notice 2005-1, Q&A-18(d) provides that it will not be a material modification to replace a stock option or stock appreciation right otherwise providing for a deferral of compensation under section 409A with a stock option or stock appreciation right that would not have constituted a deferral of compensation under section 409A if it had been granted upon the original date of grant of the replaced stock option or stock appreciation right, provided that the cancellation and reissuance occurs on or before December 31, 2005. The period during which the cancellation and reissuance may occur is extended until December 31, 2006, but only to the extent such cancellation and reissuance does not result in the cancellation of a deferral in exchange for cash or vested property in 2006. For example, a discounted option generally may be replaced through December 31, 2006, with an option that would not have provided for a deferral of compensation, although the exercise of such a discounted option in 2006 before the cancellation and replacement generally would result in a violation of section 409A.

Commentators pointed out that this relief could be interpreted as failing to cover discounted stock options or stock appreciation rights that were not earned and vested before January 1, 2005. Where replacement stock options or stock appreciation rights that would not constitute deferred compensation subject to section 409A are issued in accordance with the conditions set forth in Notice 2005-1, Q&A-18(d) and this preamble, such replacement stock options or stock appreciation rights will be treated for purposes of section 409A as if granted on the grant date of the original stock option or stock appreciation right.

For example, provided that the conditions of Notice 2005-1, Q&A-18(d) and this preamble are met, a discounted stock option granted in 2003 that was not earned and vested before January 1, 2005, may be replaced with a stock option with an exercise price that would not have been discounted as of the original 2003 grant date, and the substituted stock option will be treated for purposes of section 409A as granted on the original 2003 grant date. Accordingly, if the substituted stock option would not have been subject to section 409A had it been granted on the original 2003 grant date, the substituted stock option will not be subject to section 409A.

Commentators noted that some service recipients may wish to compensate the service provider for the lost discount. Commentators proposed three methods to provide such compensation. First, the service recipient may wish to pay the amount of the discount in 2005 in cash. As a cancellation of a deferral of compensation on or before December 31, 2005 pursuant to Notice 2005-1, Q&A-20(a), this payment would not be subject to section 409A. Note that as a payment due to the cancellation of a deferral, such a payment could not be made in 2006 as this relief has not been extended beyond December 31, 2005. Where the stock option remains nonvested during the year of the option substitution, the service recipient may wish to make the compensation for the lost discount also subject to a vesting requirement. In that case, commentators also proposed granting restricted stock with a fair market value equal to the lost discount, subject to a vesting schedule parallel to the vesting schedule of the substituted option. As a transfer of property subject to section 83 that becomes substantially vested after the year of substitution, this grant would not be subject to section 409A. Finally, commentators proposed establishing a separate plan, promising a payment of the lost discount (plus earnings) subject to a vesting schedule parallel to the vesting schedule of the substituted option. Provided the right to the payment becomes substantially vested in a future year and otherwise meets the requirement of the short-term deferral exception in these regulations, the right to this payment would not constitute deferred compensation subject to section 409A. Alternatively, such an arrangement could itself provide for de-

ferred compensation beyond the year of substantial vesting and be subject to the requirements of section 409A, but if such requirements are met, would not affect the exclusion of the amended stock option or stock appreciation right from the treatment as a deferral of compensation subject to section 409A.

XII. Calculation and Timing of Income Inclusion Amounts

To more rapidly issue guidance necessary to allow service recipients to comply with section 409A, the Treasury Department and the IRS have not included in these regulations guidance with respect to the calculation of the amounts of deferrals, or of the amounts of income inclusion upon the violation of the provisions of section 409A and these regulations, or the timing of the inclusion of income and related withholding obligations. The Treasury Department and the IRS anticipate that these topics will be addressed in subsequent guidance. The Treasury Department and the IRS request comments with respect to the calculation and timing of the income inclusion under section 409A, and specifically request comments in two areas.

First, section 409A generally requires that for any taxable year in which an amount is deferred under a plan that fails to meet certain requirements, all amounts deferred must be included in income. This provision generally treats earnings (whether actual or notional) as amounts deferred subject to the inclusion provision. Service providers may experience negative earnings in a calendar year, such that the amounts to which a service provider has a right in a particular year are less than the amounts to which a service provider had a right in a previous year, even where no actual payments have been made. The Treasury Department and the IRS request comments with respect to whether and how such negative earnings may be accounted for in determining the amount of deferrals and the amount of income inclusion for a given taxable year, particularly where continuing violations of section 409A extend to successive tax years.

Second, the Treasury Department and the IRS understand that a method of calculation of current deferrals and of amounts to be included in income is needed for

service recipients to meet their reporting and withholding obligations. Comments are requested as to what transitional relief may be appropriate depending upon when such future guidance is released. For interim guidance regarding the information reporting and wage withholding requirements applicable to deferrals of compensation within the meaning of section 409A, see Notice 2005-1, Q&A-24 through Q&A-38. Until further guidance is provided, taxpayers may rely on Notice 2005-1 regarding information reporting and wage withholding obligations.

XIII. Funding Arrangements

Section 409A(b)(1) provides certain tax consequences for the funding of deferrals of compensation in offshore trusts (or other arrangements determined by the Secretary) or pursuant to a change in the financial health of the employer. The consequences of such funding are generally consistent with a violation of section 409A with respect to funded amounts. The Treasury Department and the IRS intend to address these provisions in future guidance. Commentators have requested guidance with respect to when assets will be treated as set aside, especially with respect to service recipients that are, or include, foreign corporations. Comments are requested as to what types of arrangements, other than actual trusts, should be treated similarly to trusts. In addition, these proposed regulations provide guidance with respect to the types of arrangements that constitute deferred compensation subject to section 409A. Because the funding rules of section 409A(b) apply only to amounts set aside to fund deferred compensation subject to section 409A, many issues raised by commentators with respect to foreign arrangements and funding may be addressed or limited through the definition of deferred compensation contained in these proposed regulations.

Proposed Effective Date

These regulations are proposed to be generally applicable for taxable years beginning on or after January 1, 2007. As discussed, taxpayers may rely on these proposed regulations until the effective date of the final regulations.

Effect on Other Documents

These proposed regulations do not affect the applicability of other guidance issued with respect to section 409A, including Notice 2005-1, 2005-2 I.R.B. 274 (published as modified on January 6, 2005). However, upon the effective date of the final regulations, the Treasury Department and the IRS anticipate that Notice 2005-1 and certain other published guidance will become obsolete for periods after the effective date of the final regulations.

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 January 25, 2006, beginning at 10 a.m. in the Auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. 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 January 4, 2006. 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.

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Proposed Amendment to the Regulations

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

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

Par. 2. Sections 1.409A-1 through 1.409A-6 are added to read as follows:

§1.409A-1 Definitions and covered arrangements.

(a) *Nonqualified deferred compensation plan*—(1) *In general.* Except as otherwise provided in this paragraph (a), the term *nonqualified deferred compensation plan* means any plan (within the meaning of paragraph (c) of this section) that provides for the deferral of compensation (within the meaning of paragraph (b) of this section).

(2) *Qualified employer plans.* The term *nonqualified deferred compensation plan* does not include—

(i) Any plan described in section 401(a) that includes a trust exempt from tax under section 501(a);

(ii) Any annuity plan described in section 403(a);

(iii) Any annuity contract described in section 403(b);

(iv) Any simplified employee pension (within the meaning of section 408(k));

(v) Any simple retirement account (within the meaning of section 408(p);

(vi) Any arrangement under which an active participant makes deductible contributions to a trust described in section 501(c)(18);

(vii) Any eligible deferred compensation plan (within the meaning of section 457(b)); and

(viii) Any plan described in section 415(m).

(3) *Certain foreign plans*—(i) *Participation addressed by treaty.* With respect to an individual for a taxable year, the term *nonqualified deferred compensation plan* does not include any scheme, trust or arrangement maintained with respect to such individual, where contributions made by or on behalf of such individual to such scheme, trust or arrangement are excludable by such individual for Federal income tax purposes pursuant to any bilateral income tax convention to which the United States is a party.

(ii) *Participation by nonresident aliens and certain resident aliens.* With respect to an alien individual for a taxable year during which such individual is a nonresident alien or a resident alien classified as a resident alien solely under section 7701(b)(1)(A)(ii) (and not section 7701(b)(1)(A)(i)), the term *nonqualified deferred compensation plan* does not include any broad-based foreign retirement plan (within the meaning of paragraph (a)(3)(v) of this section) maintained by a person that is not a United States person.

(iii) *Participation by U.S. citizens and lawful permanent residents.* With respect to an individual for a given taxable year during which such individual is a U.S. citizen or a resident alien classified as a resident alien under section 7701(b)(1)(A)(i), and is not eligible to participate in a qualified employer plan described in paragraph (a)(2) of this section, the term *nonqualified deferred compensation plan* does not include a broad-based foreign retirement

plan (within the meaning of paragraph (a)(3)(v) of this section) maintained by a service recipient that is not a United States person, but only with respect to nonelective deferrals of foreign earned income (as defined in section 911(b)(1)) and only to the extent that the amounts deferred under such plan in such taxable year do not exceed the applicable limits under section 415(b) and (c) that would be applicable if such plan were a plan subject to section 415 and the foreign earned income of such individual were treated as compensation for purposes of applying section 415(b) and (c).

(iv) *Plans subject to a totalization agreement and similar plans.* The term *nonqualified deferred compensation plan* does not include any social security system of a jurisdiction to the extent that benefits provided under or contributions made to the system are subject to an agreement entered into pursuant to section 233 of the Social Security Act with any foreign jurisdiction. In addition, the term *nonqualified deferred compensation plan* does not include a social security system of a foreign jurisdiction to the extent that benefits are provided under or contributions are made to a government-mandated plan as part of that foreign jurisdiction's social security system.

(v) *Broad-based retirement plan.* For purposes of this paragraph (a)(3), the term *broad-based retirement plan* means a scheme, trust or arrangement that—

(A) Is written;

(B) In the case of an employer-maintained plan, is nondiscriminatory insofar as it (alone or in combination with other comparable plans) covers a wide range of employees, substantially all of whom are nonresident aliens or resident aliens classified as resident aliens solely under section 7701(b)(1)(A)(ii) (and not section 7701(b)(1)(A)(i)), including rank and file employees, and actually provides significant benefits for the range of covered employees;

(C) In the case of an employer-maintained plan, contains provisions that generally limit the employees' ability to use plan benefits for purposes other than retirement or restrict access to plan benefits prior to separation from service, such as restricting in-service distributions except in events similar to an unforeseeable emergency (as defined in §1.409A-3(g)(3)(i))

or hardship (as defined for purposes of section 401(k)(2)(B)(i)(IV)), and in all cases is subject to tax or plan provisions that discourage participants from using the assets for purposes other than retirement; and

(D) Provides for payment of a reasonable level of benefits at death, a stated age, or an event related to work status, and otherwise requires minimum distributions under rules designed to ensure that any death benefits provided to the participants' survivors are merely incidental to the retirement benefits provided to the participants.

(vi) *Participation by a nonresident alien — de minimis amounts.* With respect to a nonresident alien, the term *nonqualified deferred compensation plan* does not include any foreign plan maintained by a service recipient that is not a United States person for a taxable year, to the extent that the amounts deferred under the foreign plan based upon the nonresident alien's services performed in the United States (including compensation received due to services performed in the United States) do not exceed \$10,000 in the taxable year.

(4) *Section 457 plans.* A nonqualified deferred compensation plan under section 457(f) may constitute a nonqualified deferred compensation plan for purposes of this paragraph (a). The rules of section 409A apply to nonqualified deferred compensation plans separately and in addition to any requirements applicable to such plans under section 457(f). In addition, nonelective deferred compensation of nonemployees described in section 457(e)(12) and a grandfathered plan or arrangement described in §1.457-2(k)(4) may constitute a nonqualified deferred compensation plan for purposes of this paragraph (a). The term *nonqualified deferred compensation plan* does not include a length of service award to a *bona fide* volunteer under section 457(e)(11)(A)(ii).

(5) *Certain welfare benefits.* The term *nonqualified deferred compensation plan* does not include any *bona fide* vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. For these purposes, the term *disability pay* has the same meaning as provided in §31.3121(v)(2)-1(b)(4)(iv)(C) of this chapter, and the term *death benefit plan* refers to a plan providing death benefits as defined in §31.3121(v)(2)-1(b)(4)(iv)(C) of this chapter. The term *nonqualified deferred compensation plan* also does not

include any Archer Medical Savings Account as described in section 220, any Health Savings Account as described in section 223, or any other medical reimbursement arrangement, including a health reimbursement arrangement, that satisfies the requirements of section 105 and section 106.

(b) *Deferral of compensation—(1) In general.* Except as otherwise provided in paragraphs (b)(3) through (b)(9) of this section, a plan provides for the deferral of compensation if, under the terms of the plan and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in gross income, and that, pursuant to the terms of the plan, is payable to (or on behalf of) the service provider in a later year. A service provider does not have a legally binding right to compensation if that compensation may be reduced unilaterally or eliminated by the service recipient or other person after the services creating the right to the compensation have been performed. However, if the facts and circumstances indicate that the discretion to reduce or eliminate the compensation is available or exercisable only upon a condition, or the discretion to reduce or eliminate the compensation lacks substantive significance, a service provider will be considered to have a legally binding right to the compensation. Whether the negative discretion lacks substantive significance depends on the facts and circumstances of the particular arrangement. However, where the service provider to whom the compensation may be paid has effective control of the person retaining the discretion to reduce or eliminate the compensation, or has effective control over any portion of the compensation of the person retaining the discretion to reduce or eliminate the compensation, or is a member of the family (as defined in section 267(c)(4) applied as if the family of an individual includes the spouse of any member of the family) of the person retaining the discretion to reduce or eliminate the compensation, the discretion to reduce or eliminate the compensation will not be treated as having substantive significance. For this purpose, compensation is not considered subject to unilateral reduction or elimination merely because it may be reduced or eliminated by operation of

the objective terms of the plan, such as the application of an objective provision creating a substantial risk of forfeiture. Similarly, a service provider does not fail to have a legally binding right to compensation merely because the amount of compensation is determined under a formula that provides for benefits to be offset by benefits provided under a plan that is qualified under section 401(a), or because benefits are reduced due to actual or notional investment losses, or in a final average pay plan, subsequent decreases in compensation.

(2) *Earnings*. References to the deferral of compensation include references to earnings. When the right to earnings is specified under the terms of the arrangement, the legally binding right to earnings arises at the time of the deferral of the compensation to which the earnings relate. However, a plan may provide that the right to the earnings is treated separately from the right to the underlying compensation. For example, provided that the rules of section 409A are otherwise met, a plan may provide that earnings will be paid at a separate time or in a separate form from the payment of the underlying compensation. For the application of the deferral election rules to current payments of earnings and dividend equivalents, see §1.409A-2(a)(13).

(3) *Compensation payable pursuant to the service recipient's customary payment timing arrangement*. A deferral of compensation does not occur solely because compensation is paid after the last day of the service provider's taxable year pursuant to the timing arrangement under which the service recipient normally compensates service providers for services performed during a payroll period described in section 3401(b), or with respect to a non-employee service provider, a period not longer than the payroll period described in section 3401(b) or if no such payroll period exists, a period not longer than the earlier of the normal timing arrangement under which the service provider normally compensates non-employee service providers or 30 days after the end of the service provider's taxable year.

(4) *Short-term deferrals*—(i) *In general*. A deferral of compensation does not occur if, absent an election by the service provider (including an election under

§1.409A-2(a)(3)) to otherwise defer the payment of the compensation to a later period, an amount of compensation is actually or constructively received by the service provider by the later of the 15th day of the third month following the service provider's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture or the 15th day of the third month following the end of the service recipient's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture. In addition, the arrangement must not otherwise defer the payment to a later period. For example, an arrangement that deferred a payment until 5 years after the lapsing of a condition that constituted a substantial risk of forfeiture would constitute a deferral of compensation even if the amount were actually paid on the date the substantial risk of forfeiture lapsed. For these purposes, an amount that is never subject to a substantial risk of forfeiture is considered to be no longer subject to a substantial risk of forfeiture on the first date the service provider has a legally binding right to the amount. For example, an employer with a calendar year taxable year who on November 1, 2008, awards a bonus so that the employee is considered to have a legally binding right to the payment as of November 1, 2008, will not be considered to have provided for a deferral of compensation if, absent an election to otherwise defer the payment, the amount is paid or made available to the employee on or before March 15, 2009. An employer with a taxable year ending August 31 who on November 1, 2008, awards a bonus so that the employee is considered to have a legally binding right to the payment as of November 1, 2008, will not be considered to have provided for a deferral of compensation if, absent an election to otherwise defer the payment, the amount is paid or made available to the employee on or before November 15, 2009.

(ii) *Delayed payments due to unforeseeable events*. A payment that otherwise qualifies as a short-term deferral under paragraph (b)(4)(i) of this section but is made after the 15th day of the third month following the end of the relevant taxable year (the applicable 2½ month period) may continue to qualify as a short-term deferral if the taxpayer establishes that it was administratively impracticable to make the payment by the end of the ap-

plicable 2½ month period or that making the payment by the end of the applicable 2½ month period would have jeopardized the solvency of the service recipient, and, as of the date upon which the legally binding right to the compensation arose, such impracticability or insolvency was unforeseeable, and also the payment is made as soon as reasonably practicable. For example, an amount that would otherwise qualify as a short-term deferral except that the payment is made after the applicable 2½ month period may continue to qualify as a short-term deferral under this paragraph (b)(4) to the extent that the delay is caused either because the funds of the service recipient were not sufficient to make the payment before the end of the applicable 2½ month period without jeopardizing the solvency of the service recipient, or because it was not reasonably possible to determine by the end of the applicable 2½ month period whether payment of such amount was to be made, and the circumstance causing the delay was unforeseeable as of the date upon which the legally binding right to the compensation arose. Thus, the amount will not continue to qualify as a short-term deferral to the extent it was foreseeable, as of date upon which the legally binding right to the compensation arose, that the amount would not be paid within the applicable 2½ month period. For purposes of this paragraph (b)(4)(ii), an action or failure to act of the service provider or a person under the service provider's control, such as a failure to provide necessary information or documentation, is not an unforeseeable event.

(5) *Stock options, stock appreciation rights and other equity-based compensation*—(i) *Stock rights*—(A) *Nonstatutory stock options not providing for the deferral of compensation*. An option to purchase service recipient stock does not provide for a deferral of compensation if—

(1) The amount required to purchase stock under the option (the exercise price) may never be less than the fair market value of the underlying stock (disregarding lapse restrictions as defined in §1.83-3(i)) on the date the option is granted and the number of shares subject to the option is fixed on the original date of grant of the option;

(2) The transfer or exercise of the option is subject to taxation under section 83 and §1.83-7; and

(3) The option does not include any feature for the deferral of compensation other than the deferral of recognition of income until the later of exercise or disposition of the option under §1.83-7, or the time the stock acquired pursuant to the exercise of the option first becomes substantially vested (as defined in §1.83-3(b)).

(B) *Stock appreciation rights not providing for the deferral of compensation.* A right to compensation equal to the appreciation in value of a specified number of shares of stock of the service recipient occurring between the date of grant and the date of exercise of such right (a stock appreciation right) does not provide for a deferral of compensation if—

(1) Compensation payable under the stock appreciation right cannot be greater than the difference between the fair market value of the stock (disregarding lapse restrictions as defined in §1.83-3(i)) on the date of grant of the stock appreciation right and the fair market value of the stock (disregarding lapse restrictions as defined in §1.83-3(i)) on the date the stock appreciation right is exercised, with respect to a number of shares fixed on or before the date of grant of the right;

(2) The stock appreciation right exercise price may never be less than the fair market value of the underlying stock (disregarding lapse restrictions as defined in §1.83-3(i)) on the date the right is granted; and

(3) The stock appreciation right does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the stock appreciation right.

(C) *Stock rights that may provide for the deferral of compensation.* An option to purchase stock other than service recipient stock, or a stock appreciation right with respect to stock other than service recipient stock, generally will provide for the deferral of compensation within the meaning of this paragraph (b). If under the terms of an option to purchase service recipient stock (other than an incentive stock option described in section 422 or a stock option granted under an employee stock purchase plan described in section 423), the amount required to purchase the stock is or could become less than the fair market value of the stock (disregarding lapse restrictions as defined in §1.83-3(i)) on the date of grant, the grant of the option may provide for the

deferral of compensation within the meaning of this paragraph (b). If under the terms of a stock appreciation right with respect to service recipient stock, the compensation payable under the stock appreciation right is or could be any amount greater than, with respect to a predetermined number of shares, the difference between the stock value (disregarding lapse restrictions as defined in §1.83-3(i)) on the date of grant of the stock appreciation right and the stock value (disregarding lapse restrictions as defined in §1.83-3(i)) on the date the stock appreciation right is exercised, the grant of the stock appreciation right may provide for a deferral of compensation within the meaning of this paragraph (b).

(D) *Feature for the deferral of compensation.* To the extent a stock right grants the recipient a right other than to receive cash or stock on the date of exercise and such additional rights allow for the deferral of compensation, the entire arrangement (including the underlying stock right) provides for the deferral of compensation. For purposes of this paragraph (b)(5)(i), neither the right to receive substantially nonvested stock (as defined in §1.83-3(b)) upon the exercise of a stock right, nor the right to pay the exercise price with previously acquired shares, constitutes a feature for the deferral of compensation.

(E) *Rights to dividends declared.* For purposes of this paragraph (b)(5)(i), the right to receive, upon the exercise of a stock right, an amount equal to all or part of the dividends declared and paid on the number of shares underlying the stock right between the date of grant and the date of exercise of the stock right constitutes an offset to the exercise price of the stock option or an increase in the amount payable under the stock appreciation right (generally causing such stock rights to be subject to section 409A), unless the right to the dividends declared and paid on the number of shares underlying the stock right is explicitly set forth as a separate arrangement. If set forth as a separate arrangement, the arrangement may provide for deferred compensation for purposes of section 409A. However, the existence of a separate arrangement to receive such an amount that complies with the requirements of section 409A would not cause a stock right to fail to satisfy the requirements of the exclusion from the definition

of deferred compensation provided in paragraphs (b)(5)(i)(A) and (B) of this section.

(ii) *Statutory stock options.* The grant of an incentive stock option as described in section 422, or the grant of an option under an employee stock purchase plan described in section 423 (including the grant of an option with an exercise price discounted in accordance with section 423(b)(6) and the accompanying regulations), does not constitute a deferral of compensation. However, this paragraph (b)(5)(ii) does not apply to a modification, extension, or renewal of a statutory option that is treated as the grant of a new option that is not a statutory option. See §1.424-1(e). In such event, the option is treated as if it were a nonstatutory stock option at the date of the original grant, so that the modification, extension or renewal of the stock option that caused the stock option to be treated as the grant of a new option under §1.424-1(e) is treated as causing the option to be treated as the grant of a new option for purposes of this paragraph (b)(5) only if such modification, extension or renewal of the stock option would have been treated as resulting in the grant of a new option under paragraph (b)(5)(v) of this section.

(iii) *Stock of the service recipient—(A) In general.* Except as otherwise provided in paragraphs (b)(5)(iii)(B) and (C) of this section, for purposes of this section, stock of the service recipient means stock that, as of the date of grant, is common stock of a corporation that is a service recipient (including any member of a group of corporations or other entities treated as a single service recipient) that is readily tradable on an established securities market, or if none, that class of common stock of such corporation having the greatest aggregate value of common stock issued and outstanding of such corporation, or common stock with substantially similar rights to stock of such class (disregarding any difference in voting rights). However, under no circumstances does stock of the service recipient include stock that is preferred as to liquidation or dividend rights or that includes or is subject to a mandatory repurchase obligation or a put or call right that is not a lapse restriction as defined in §1.83-3(i) and is based on a measure other than the fair market value (disregarding lapse restrictions as defined in §1.83-3(i)) of the equity in-

terest in the corporation represented by the stock.

(B) *American depositary receipts*. For purposes of this section, an American depositary receipt or American depositary share may constitute service recipient stock, to the extent that the stock traded on a foreign securities market to which the American depositary receipt or American depositary share relates qualifies as service recipient stock.

(C) *Mutual company units*. For purposes of this section, mutual company units may constitute service recipient stock. For this purpose, the term *mutual company unit* means a fixed percentage of the overall value of a non-stock mutual company. For purposes of determining the value of the mutual company unit, the unit may be valued in accordance with the rules set forth in paragraph (b)(5)(iv)(B) of this section governing valuation of service recipient stock the shares of which are not traded on an established securities market, applied as if the mutual company were a stock corporation with one class of common stock and the number of shares of such stock determined according to the fixed percentage. For example, an appreciation right based on the appreciation of 10 mutual company units, where each unit is defined as 1 percent of the overall value of the mutual company, would be valued as if the appreciation right were based upon 10 shares of a corporation with 100 shares of common stock and no other class of stock, whose shares are not readily tradable on an established securities market.

(D) *Definition of service recipient—(1) In general*. For purposes of this paragraph (b)(5)(iii), the term *service recipient* generally has the same meaning as provided in paragraph (g) of this section, provided that a stock right, or the plan or arrangement under which the stock right is granted, may specify that in applying section 1563(a)(1), (2) and (3) for purposes of determining a controlled group of corporations under section 414(b), the language “at least 50 percent” is used instead of “at least 80 percent” each place it appears in section 1563(a)(1), (2) and (3), and in applying §1.414(c)-2 for purposes of determining trades or businesses (whether or not incorporated) that are under common control for purposes of section 414(c), the language “at least 50 percent” is used instead of “at least 80 percent” each place

it appears in §1.414(c)-2. In addition, where the use of such stock with respect to the grant of a stock right to such service provider is based upon legitimate business criteria, the term *service recipient* has the same meaning as provided in paragraph (g) of this section, provided that the stock right, or the plan or arrangement under which the stock right is granted, may specify that in applying sections 1563(a)(1), (2) and (3) for purposes of determining a controlled group of corporations under section 414(b), the language “at least 20 percent” is used instead of “at least 80 percent” at each place it appears in sections 1563(a)(1), (2) and (3), and in applying §1.414(c)-2 for purposes of determining trades or businesses (whether or not incorporated) that are under common control for purposes of section 414(c), the language “at least 20 percent” is used instead of “at least 80 percent” at each place it appears in §1.414(c)-2. For example, stock of a corporation participating in a joint venture involving an operating business, used with respect to stock rights granted to employees of the joint venture who are former employees of such corporation, generally will constitute use of such stock based upon legitimate business criteria, and therefore could constitute service recipient stock with respect to such employees if the corporation owns at least 20 percent of the joint venture and the other requirements of this paragraph (b)(5)(iii) are met. A designation by a service recipient to use the 50 percent or 20 percent thresholds described in this paragraph (b)(5)(iii)(D) must be applied consistently as to all compensatory stock rights for purposes of this paragraph (b)(5)(iii), and any designation of a different permissible ownership threshold percentage may not be made effective until 12 months after the adoption of such change.

(2) *Investment vehicles*. Notwithstanding the provisions of paragraph (b)(5)(iii)(D)(1) of this section, except as to a service provider providing services directly to such corporation, for purposes of this paragraph (b)(5) the term *service recipient* does not include any corporation whose primary purpose is to serve as an investment vehicle with respect to the corporation’s interest in entities other than the service recipient.

(3) *Substitutions and assumptions by reason of a corporate transaction*. If the

requirements of paragraph (b)(5)(v)(D) of this section are met such that the substitution of a new stock right pursuant to a corporate transaction for an outstanding stock right, or the assumption of an outstanding stock right pursuant to a corporate transaction, would not be treated as the grant of a new stock right or a change in the form of payment for purposes of section 409A, the stock underlying the stock right that is substituted or assumed will be treated as service recipient stock for purposes of applying this paragraph (b)(5) to the replacement stock rights. For example, where by reason of a spinoff transaction under which a subsidiary corporation is spun off from a distributing corporation, a distributing corporation employee’s stock option to purchase distributing corporation stock is replaced with a stock option to purchase distributing corporation stock and a stock option to purchase the spun off subsidiary corporation’s stock, and where such substitution is not treated as a modification of the original stock option pursuant to paragraph (b)(5)(v)(D) of this section, both the distributing corporation stock and the subsidiary corporation stock are treated as service recipient stock for purposes of applying this paragraph (b)(5) to the replacement stock options.

(E) *Stock rights granted on or before December 31, 2004*. Notwithstanding the requirements of paragraph (b)(5)(iii)(A) of this section, any class of common stock of the service recipient with respect to which stock rights were granted to service providers on or before December 31, 2004, is treated as service recipient stock for purposes of this paragraph (b)(5)(iii), but only with respect to stock rights granted on or before December 31, 2004.

(iv) *Determination of the fair market value of service recipient stock—(A) Stock readily tradable on an established securities market*. For purposes of (b)(5)(i) of this section, in the case of service recipient stock that is readily tradable on an established securities market, the fair market value of the stock may be determined based upon the last sale before or the first sale after the grant, the closing price on the trading day before or the trading day of the grant, or any other reasonable basis using actual transactions in such stock as reported by such market and consistently applied. The determination of fair market value also may be based upon an average

selling price during a specified period that is within 30 days before or 30 days after the grant, provided that the commitment to grant the stock right based on such valuation method must be irrevocable before the beginning of the specified period, and such valuation method must be used consistently for grants of stock rights under the same and substantially similar programs.

(B) *Stock not readily tradable on an established securities market*—(1) *In general.* For purposes of paragraph (b)(5)(i) of this section, in the case of service recipient stock that is not readily tradable on an established securities market, the fair market value of the stock as of a valuation date means a value determined by the reasonable application of a reasonable valuation method. The determination of whether a valuation method is reasonable, or whether an application of a valuation method is reasonable, is made based on the facts and circumstances as of the valuation date. Factors to be considered under a reasonable valuation method include, as applicable, the value of tangible and intangible assets of the corporation, the present value of future cash-flows of the corporation, the market value of stock or equity interests in similar corporations and other entities engaged in trades or businesses substantially similar to those engaged in by the corporation whose stock is to be valued, the value of which can be readily determined through objective means (such as through trading prices on an established securities market or an amount paid in an arm's length private transaction), and other relevant factors such as control premiums or discounts for lack of marketability and whether the valuation method is used for other purposes that have a material economic effect on the service recipient, its stockholders or its creditors. The use of a valuation method is not reasonable if such valuation method does not take into consideration in applying its methodology, all available information material to the value of the corporation. Similarly, the use of a value previously calculated under a valuation method is not reasonable as of a later date if such calculation fails to reflect information available after the date of the calculation that may materially affect the value of the corporation (for example, the resolution of material litigation or the issuance of a patent) or the value was calculated with respect to a date that is more

than 12 months earlier than the date for which the valuation is being used. The service recipient's consistent use of a valuation method to determine the value of its stock or assets for other purposes, including for purposes unrelated to compensation of service providers, is also a factor supporting the reasonableness of such valuation method.

(2) *Presumption of reasonableness.* For purposes of this paragraph (b)(5)(iv)(B), the consistent use of any of the following methods of valuation is presumed to result in a reasonable valuation, provided that the Commissioner may rebut such a presumption upon a showing that either the valuation method or the application of such method was grossly unreasonable:

(i) A valuation of a class of stock determined by an independent appraisal that meets the requirements of section 401(a)(28)(C) and the regulations thereunder as of a date that is no more than 12 months before the relevant transaction to which the valuation is applied (for example, the grant date of a stock option).

(ii) A valuation based upon a formula that, if used as part of a nonlapse restriction (as defined in §1.83-3(h)) with respect to the stock, would be considered to be the fair market value of the stock pursuant to §1.83-5, provided that such stock is valued in the same manner for purposes of any nonlapse restriction applicable to the transfer of any shares of such class of stock (or substantially similar class of stock), and all noncompensatory purposes requiring the valuation of such stock, including regulatory filings, loan covenants, issuances to and repurchases of stock from persons other than service providers, and other third-party arrangements, and such valuation method is used consistently for all such purposes, and provided further that this paragraph (b)(5)(iv)(B)(2)(ii) does not apply with respect to stock subject to a stock right payable in stock, where the stock acquired pursuant to the exercise of the stock right is transferable other than through the operation of a nonlapse restriction.

(iii) A valuation, made reasonably and in good faith and evidenced by a written report that takes into account the relevant factors described in paragraph (b)(5)(iv)(B)(1) of this section, of an illiquid stock of a start-up corporation. For this purpose, an illiquid stock of a start-up

corporation is service recipient stock of a service recipient corporation that has no trade or business that it or any predecessor to it has conducted for a period of 10 years or more and has no class of equity securities that are traded on an established securities market (as defined in paragraph (k) of this section), where such stock is not subject to any put or call right or obligation of the service recipient or other person to purchase such stock (other than a right of first refusal upon an offer to purchase by a third party that is unrelated to the service recipient or service provider and other than a right or obligation that constitutes a lapse restriction as defined in §1.83-3(i)), and provided that this paragraph (b)(5)(iv)(B)(2)(iii) does not apply to the valuation of any stock if the service recipient or service provider may reasonably anticipate, as of the time the valuation is applied, that the service recipient will undergo a change in control event as described in §1.409A-3(g)(5)(v) or §1.409A-3(g)(5)(vii) or make a public offering of securities within the 12 months following the event to which the valuation is applied (for example, the grant of a stock option or exercise of a stock appreciation right). For purposes of this paragraph (b)(5)(iv)(B)(2)(iii), a valuation will not be treated as made reasonably and in good faith unless the valuation is performed by a person or persons with significant knowledge and experience or training in performing similar valuations.

(3) *Consistent use of a method.* For purposes of paragraph (b)(5)(iv)(B)(2) of this section, the consistent use of a valuation method means the consistent use of the method for all equity-based compensation arrangements, including with respect to stock rights, for purposes of determining the exercise price, and with respect to stock appreciation rights not paid in stock, for purposes of determining the payment at the date of exercise, and for stock appreciation rights or stock options paid in stock subject to a put or call right providing for the potential repurchase by the service recipient, or other obligation of the service recipient or other person to purchase such stock, for purposes of determining the payment at the date of the purchase of such stock. Notwithstanding the foregoing, a service recipient may change the method prospectively for purposes of new grants of equity-based compensation, including stock

rights. In addition, where after the date of grant, but before the date of exercise, of the stock right, the service recipient stock to which the stock right relates becomes readily tradable on an established securities market, the service recipient must use the valuation method set forth in paragraph (b)(5)(iv)(A) of this section for purposes of determining the payment at the date of exercise or the purchase of the stock, as applicable.

(v) *Modifications, extensions, renewals, substitutions and assumptions of stock rights*—(A) *Treatment of modified stock right as a new grant.* Any modification of the terms of a stock right, other than an extension or renewal of the stock right, is considered the granting of a new stock right. The new stock right may or may not constitute a deferral of compensation under paragraph (b)(5)(i) of this section, determined at the date of grant of the new stock right. Where a stock right is extended or renewed, the stock right is treated as having had an additional deferral feature from the date of grant.

(B) *Modification in general.* The term *modification* means any change in the terms of the stock right (or change in the terms of the arrangement pursuant to which the stock right was granted or in the terms of any other agreement governing the stock right) that may provide the holder of the stock right with a direct or indirect reduction in the exercise price of the stock right, or an additional deferral feature, or an extension or renewal of the stock right, regardless of whether the holder in fact benefits from the change in terms. In contrast, a change in the terms of the stock right shortening the period during which the stock right is exercisable is not a modification. It is not a modification to add a feature providing the ability to tender previously acquired stock for the stock purchasable under the stock right, or to withhold or have withheld shares of stock to facilitate the payment of employment taxes or required withholding taxes resulting from the exercise of the stock right. In addition, it is not a modification for the grantor to exercise discretion specifically reserved under a stock right with respect to the transferability of the stock right.

(C) *Extensions and renewals.* An extension of a stock right refers to the granting to the holder of an additional period of time within which to exercise the stock right be-

yond the time originally prescribed, provided that it is not an extension if the exercise period of the stock right is extended to a date no later than the later of the 15th day of the third month following the date at which, or December 31 of the calendar year in which, the stock right would otherwise have expired if the stock right had not been extended, based on the terms of the stock right at the original grant date. For example, an option granted January 1, 2011, that expires upon the earlier of January 1, 2021, or 30 days after separation from service will not be considered to be modified if, upon the holder's separation from service on July 1, 2015, the term is extended to December 31, 2015. Notwithstanding the foregoing, it is not an extension of a stock right if the expiration of the stock right is tolled while the stock right is unexercisable because an exercise of the stock right would violate applicable securities laws, provided that the period during which the stock right may be exercised is not extended more than 30 days after the exercise of the stock right first would no longer violate applicable securities laws. A renewal of a stock right is the granting by the corporation of the same rights or privileges contained in the original stock right on the same terms and conditions.

(D) *Substitutions and assumptions of stock rights by reason of a corporate transaction.* If the requirements of §1.424-1 would be met if the stock right were a statutory option, the substitution of a new stock right pursuant to a corporate transaction for an outstanding stock right or the assumption of an outstanding stock right pursuant to a corporate transaction will not be treated as the grant of a new stock right or a change in the form of payment for purposes of section 409A. For purposes of the preceding sentence, the requirement of §1.424-1(a)(5)(iii) will be deemed to be satisfied if the ratio of the exercise price to the fair market value of the shares subject to the stock right immediately after the substitution or assumption is not greater than the ratio of the exercise price to the fair market value of the shares subject to the stock right immediately before the substitution or assumption. In the case of a transaction described in section 355 in which the stock of the distributing corporation and the stock distributed in the transaction are both readily tradable on an established securities market immedi-

ately after the transaction, for purposes of this paragraph (b)(5)(v), the requirements of §1.424-1(a)(5) may be satisfied by using market quotations for the stock of the distributing corporation and the stock distributed in the transaction as of a predetermined date not more than 60 days after the transaction or based on an average of such market prices over a predetermined period of not more than 30 days ending not later than 60 days after the transaction.

(E) *Acceleration of date when exercisable.* If a stock right is not immediately exercisable in full, a change in the terms of the right to accelerate the time at which the stock right (or any portion thereof) may be exercised is not a modification for purposes of this section. With respect to a stock right subject to section 409A, however, such an acceleration may constitute an impermissible acceleration of a payment date under §1.409A-3(h). Additionally, no modification occurs if a provision accelerating the time when a stock right may first be exercised is removed before the year in which it would otherwise be triggered.

(F) *Discretionary added benefits.* If a change to a stock right provides, either by its terms or in substance, that the holder may receive an additional benefit under the stock right at the future discretion of the grantor, and the addition of such benefit would constitute a modification, then the addition of such discretion is a modification at the time that the stock right is changed to provide such discretion.

(G) *Change in underlying stock increasing value.* A change in the terms of the stock subject to a stock right that increases the value of the stock is a modification of such stock right, except to the extent that a new stock right is substituted for such stock right by reason of the change in the terms of the stock in accordance with paragraph (b)(5)(v)(D) of this section.

(H) *Change in the number of shares purchasable.* If a stock right is amended solely to increase the number of shares subject to the stock right, the increase is not considered a modification of the stock right but is treated as the grant of a new additional stock right to which the additional shares are subject. Notwithstanding the previous sentence, if the exercise price and number of shares subject to a stock right are proportionally adjusted to

reflect a stock split (including a reverse stock split) or stock dividend, and the only effect of the stock split or stock dividend is to increase (or decrease) on a *pro rata* basis the number of shares owned by each shareholder of the class of stock subject to the stock right, then the stock right is not modified if it is proportionally adjusted to reflect the stock split or stock dividend and the aggregate exercise price of the stock right is not less than the aggregate exercise price before the stock split or stock dividend.

(I) *Rescission of changes.* Any change to the terms of a stock right (or change in the terms of the plan pursuant to which the stock right was granted or in the terms of any other agreement governing the right) that would inadvertently result in treatment as a modification under paragraph (b)(5)(v)(A) of this section is not considered a modification of the stock right to the extent the change in the terms of the stock right is rescinded by the earlier of the date the stock right is exercised or the last day of the calendar year during which such change occurred. Thus, for example, if the terms of a stock right are changed on March 1 to extend the exercise period and the change is rescinded on November 1, then if the stock right is not exercised before the change is rescinded, the stock right is not considered modified under paragraph (b)(5)(v)(A) of this section.

(J) *Successive modifications.* The rules of this paragraph (b)(5)(v) apply as well to successive modifications, including successive extensions or renewals.

(6) *Restricted Property*—(i) *In general.* If a service provider receives property from, or pursuant to, a plan maintained by a service recipient, there is no deferral of compensation merely because the value of the property is not includible in income in the year of receipt by reason of the property being substantially nonvested (as defined in §1.83-3(b)), or is includible in income solely due to a valid election under section 83(b). For purposes of this paragraph (b)(6)(i), a transfer of property includes the transfer of a beneficial interest in a trust or annuity plan, or a transfer to or from a trust or under an annuity plan, to the extent such a transfer is subject to section 83, section 402(b) or section 403(c).

(ii) *Promises to transfer property.* A plan under which a service provider ob-

tains a legally binding right to receive property (whether or not the property will be substantially nonvested (as defined in §1.83-3(b)) at the time of grant) in a future year may provide for the deferral of compensation and, accordingly, may constitute a nonqualified deferred compensation plan. The vesting of substantially nonvested property subject to section 83 may be treated as a payment for purposes of section 409A, including for purposes of applying the short-term deferral rules under paragraph (b)(4) of this section. Accordingly, where the promise to transfer the substantially nonvested property and the right to retain the substantially nonvested property are both subject to a substantial risk of forfeiture (as defined under paragraph (d) of this section), the arrangement generally would constitute a short-term deferral under paragraph (b)(4) of this section because the payment would occur simultaneously with the vesting of the right to the property. For example, where an employee participates in a two-year bonus program such that, if the employee continues in employment for two years, the employee is entitled to either the immediate payment of a \$10,000 cash bonus or the grant of restricted stock with a \$15,000 fair market value subject to a vesting requirement of three additional years of service, the arrangement generally would constitute a short-term deferral under paragraph (b)(4) of this section because under either alternative the payment would be received within the short-term deferral period.

(7) *Arrangements between partnerships and partners.* [Reserved.]

(8) *Certain foreign arrangements*—(i) *Arrangements with respect to compensation covered by treaty or other international agreement.* An arrangement with a service provider does not provide for a deferral of compensation for purposes of this paragraph (b) to the extent that the compensation under the arrangement would have been excluded from gross income for Federal income tax purposes under the provisions of any bilateral income tax convention or other bilateral or multilateral agreement to which the United States is a party if the compensation had been paid to the service provider at the time that the legally binding right to the compensation first arose or, if later, the time that the legally binding right was no

longer subject to a substantial risk of forfeiture.

(ii) *Arrangements with respect to certain other compensation.* An arrangement with a service provider does not provide for a deferral of compensation for purposes of this paragraph (b) to the extent that compensation under the arrangement would not have been includible in gross income for Federal tax purposes if it had been paid to the service provider at the time that the legally binding right to the compensation first arose or, if later, the time that the legally binding right was no longer subject to a substantial risk of forfeiture, due to one of the following—

(A) The service provider was a nonresident alien at such time and the compensation would not have been includible in gross income under section 872;

(B) The service provider was a qualified individual (as defined in section 911(d)(1)) at such time and the compensation would have been foreign earned income within the meaning of section 911(b)(1) if paid at such time, and the compensation would have been foreign earned income within the meaning of section 911(b)(1) that is less than the difference between the maximum exclusion amount under section 911(b)(2)(D) for such taxable year and the amount of foreign earned income actually excludible from gross income by such qualified individual for such taxable year under section 911(a)(1);

(C) The compensation would have been excludible from gross income under section 893; or

(D) The compensation would have been excludible from gross income under section 931 or section 933.

(iii) *Tax equalization arrangements.* Compensation paid under a tax equalization arrangement does not provide for a deferral of compensation, provided that any payment made under such arrangement is paid no later than the end of the second calendar year beginning after the calendar year in which the service provider's U.S. Federal income tax return is required to be filed (including extension) for the year to which the tax equalization payment relates. For purposes of this paragraph (b)(8)(iii), the term *tax equalization arrangement* refers to an arrangement that provides payments intended to compensate the service provider for the excess of the taxes actually imposed by a for-

eign jurisdiction on the compensation paid (other than the compensation under the tax equalization agreement) by the service recipient to the service provider over the taxes that would be imposed if the compensation were subject solely to United States Federal income tax, and provided that the payments made under such arrangement may not exceed such excess and the amount necessary to compensate for the additional taxes on the amounts paid under the arrangement.

(iv) *Additional foreign arrangements.* An arrangement with a service provider does not provide for a deferral of compensation for purposes of this paragraph (b) to the extent designated by the Commissioner in revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(v) *Earnings.* Earnings on compensation excluded from the definition of deferral of compensation pursuant to this paragraph (b)(8) are also not treated as a deferred compensation. However, amounts that would be recharacterized as deferred compensation under §31.3121(v)(2)-1(d)(2)(iii)(B) of this chapter (nonaccount balance plans), §31.3121(v)(2)-1(d)(2)(iii)(A) of this chapter (account balance plans), or similar principles with respect to plans that are neither nonaccount balance plans nor account balance plans, will not be treated as earnings for purposes of this paragraph (b)(8)(v).

(9) *Separation pay arrangements—(i) In general.* An arrangement that otherwise provides for a deferral of compensation under this paragraph (b) does not fail to provide a deferral of compensation merely because the right to payment of the compensation is conditioned upon a separation from service. However, see paragraphs (b)(9)(ii), (iii) and (iv) of this section for separation pay arrangements that do not provide for the deferral of compensation. Notwithstanding any other provision of this paragraph (b)(9), any payment or benefit, or entitlement to a payment or benefit, that acts as a substitute for, or replacement of, amounts deferred by the service recipient under a separate nonqualified deferred compensation plan constitutes a payment or a deferral of compensation under the separate nonqualified deferred compensation plan, and does not

constitute a payment or deferral of compensation under a separation pay arrangement.

(ii) *Collectively bargained separation pay arrangements.* A separation pay arrangement does not provide for a deferral of compensation if the arrangement is a collectively bargained separation pay arrangement that provides for separation pay upon an actual involuntary separation from service or pursuant to a window program. Only the portion of the separation pay arrangement attributable to employees covered by a collective bargaining agreement is considered to be provided under a collectively bargained separation pay arrangement. A collectively bargained separation pay arrangement is a separation pay arrangement that meets the following conditions:

(A) The separation pay arrangement is contained within an agreement that the Secretary of Labor determines to be a collective bargaining agreement.

(B) The separation pay provided by the collective bargaining agreement was the subject of arms-length negotiations between employee representatives and one or more employers, and the agreement between employee representatives and one or more employers satisfies section 7701(a)(46).

(C) The circumstances surrounding the agreement evidence good faith bargaining between adverse parties over the separation pay to be provided under the agreement.

(iii) *Separation pay plans due to involuntary separation from service or participation in a window program.* A separation pay plan that is not described in paragraph (b)(9)(ii) of this section and that provides for separation pay upon an actual involuntary separation from service or pursuant to a window program does not provide for a deferral of compensation if the plan provides that—

(A) The separation pay (other than amounts described in paragraph (b)(9)(iv) of this section) may not exceed two times the lesser of—

(I) The sum of the service provider's annual compensation (as defined in §1.415-2(d)) for services provided to the service recipient as an employee and the service provider's net earnings from self-employment (as defined in section 1402(a)) for services provided to the ser-

vice recipient as an independent contractor, each for the calendar year preceding the calendar year in which the service provider has a separation from service from such service recipient; or

(2) The maximum amount that may be taken into account under a qualified plan pursuant to section 401(a)(17) for such year; and

(B) The separation pay must be paid no later than December 31 of the second calendar year following the calendar year in which occurs the separation from service.

(iv) *Reimbursements and certain other separation payments—(A) In general.* To the extent a separation pay arrangement entitles a service provider to payment by the service recipient for a limited period of time of reimbursements that are otherwise excludible from gross income, of reimbursements for expenses that the service provider can deduct under section 162 or section 167 as business expenses incurred in connection with the performance of services (ignoring any applicable limitation based on adjusted gross income), or of reasonable outplacement expenses and reasonable moving expenses actually incurred by the service provider and directly related to the termination of services for the service recipient, such arrangement does not provide for a deferral of compensation. To the extent a separation pay arrangement (including an arrangement involving payments due to a voluntary separation from service) entitles a service provider to reimbursement by the service recipient for a limited period of time of payments of medical expenses incurred and paid by the service provider but not reimbursed and allowable as a deduction under section 213 (disregarding the requirement of section 213(a) that the deduction is available only to the extent that such expenses exceed 7.5 percent of adjusted gross income), such arrangement does not provide for a deferral of compensation.

(B) *In-kind benefits and direct service recipient payments.* A service provider's entitlement 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, will also be treated as not providing for a deferral of compensation for purposes of this paragraph (b), if a right to reimbursement by the service recipient for a payment for such benefits, goods or ser-

vices by the service provider would not be treated as providing for a deferral of compensation under this paragraph (b)(9)(iv).

(C) *De minimis payments.* In addition, if not otherwise excluded, to the extent a separation pay arrangement entitles a service provider to reimbursements or other payments or benefits that do not exceed \$5,000 in the aggregate, such arrangement does not provide for a deferral of compensation.

(D) *Limited period of time.* For purposes of paragraphs (b)(9)(iv)(A) and (B), a limited period of time refers to both the period during which applicable expenses may be incurred, and the period during which reimbursements must be paid, and may not extend beyond the December 31 of the second calendar year following the calendar year in which the separation from service occurred.

(v) *Window programs — definition.* The term *window program* refers to a program established by the service recipient to provide for separation pay in connection with a separation from service, for a limited period of time (no greater than one year), to service providers who separate from service during that period or to service providers who separate from service during that period under specified circumstances. A program will not be considered a window program if a service recipient establishes a pattern of repeatedly providing for similar separation pay in similar situations for substantially consecutive, limited periods of time. Whether the recurrence of these programs constitutes a pattern is determined based on the facts and circumstances. Although no one factor is determinative, relevant factors include whether the benefits are on account of a specific business event or condition, the degree to which the separation pay relates to the event or condition, and whether the event or condition is temporary or discrete or is a permanent aspect of the employer's business.

(c) *Plan*—(1) *In general.* The term *plan* includes any agreement, method or arrangement, including an agreement, method or arrangement that applies to one person or individual. A plan may be adopted unilaterally by the service recipient or may be negotiated or agreed to by the service recipient and one or more service providers or service provider representatives. An agreement, method or

arrangement may constitute a plan regardless of whether it is an employee benefit plan under section 3(3) of the Employee Retirement Income Security Act of 1974 (ERISA), as amended (29 U.S.C. 1002(3)). The requirements of section 409A are applied as if a separate plan or plans is maintained for each service provider.

(2) *Plan aggregation rules*—(i) *In general.* Except as provided in paragraph (c)(2)(ii) of this section, with respect to arrangements between a service provider and a service recipient—

(A) All amounts deferred with respect to that service provider under all account balance plans of the service recipient (as defined in §31.3121(v)(2)–1(c)(1)(ii)(A) of this chapter) other than a separation pay arrangement described in paragraph (c)(2)(i)(C) of this section are treated as deferred under a single plan;

(B) All amounts deferred with respect to that service provider under all nonaccount balance plans of the service recipient (as defined in §31.3121(v)(2)–1(c)(2)(i) of this chapter) other than a separation pay arrangement described in paragraph (c)(2)(i)(C) of this section are treated as deferred under a separate single plan;

(C) All amounts deferred with respect to that service provider under all separation pay arrangements (as defined in paragraph (m) of this section) of the service recipient due to an involuntary termination or participation in a window program are treated as deferred under a single plan; and

(D) All amounts deferred with respect to that service provider under all plans of the service recipient that are not described in paragraph (c)(2)(i)(A), (B) or (C) of this section (for example, discounted stock options, stock appreciation rights or other equity-based compensation described in §31.3121(v)(2)–1(b)(4)(ii) of this chapter) are treated as deferred under a separate single plan.

(ii) *Dual status.* Arrangements in which a service provider participates are not aggregated to the extent the service provider participates in one set of arrangements due to status as an employee of the service recipient (employee arrangements) and another set of arrangements due to status as an independent contractor of the service recipient (independent contractor arrangements). For example, where a service provider deferred amounts under an ar-

angement while providing services as an independent contractor, and then becomes eligible for and defers amounts under a separate arrangement after being hired as an employee, the two arrangements will not be aggregated for purposes of this paragraph (c)(2). Where an employee also serves as a director of the service recipient (or a similar position with respect to a non-corporate service recipient), the arrangements under which the employee participates as a director of the service recipient (director arrangements) are not aggregated with employee arrangements, provided that the director arrangements are substantially similar to arrangements provided to service providers providing services only as directors (or similar positions with respect to non-corporate service recipients). For example, an employee director who participates in an employee arrangement and a director arrangement generally may treat the two arrangements as separate plans, provided that the director arrangement is substantially similar to an arrangement providing benefits to a non-employee director. Director arrangements and independent contractor arrangements are aggregated for purposes of this paragraph (c)(2).

(3) *Establishment of arrangement*—(i) *In general.* To satisfy the requirements of section 409A, an arrangement must be established and maintained by a service recipient, in both form and operation, in accordance with the requirements of section 409A and these regulations. For purposes of this paragraph (c)(3), an arrangement is established on the latest of the date on which it is adopted, the date on which it is effective, and the date on which the material terms of the plan are set forth in writing. For purposes of this paragraph (c)(3)(i), an arrangement will be deemed to be set forth in writing if it is set forth in any other form that is approved by the Commissioner. The material terms of the arrangement include the amount (or the method or formula for determining the amount) of deferred compensation to be provided under the arrangement and the time when it will be paid. Notwithstanding the foregoing, an arrangement will be deemed to be established as of the date the participant obtains a legally binding right to deferred compensation, provided that the arrangement is otherwise established under the rules of this paragraph (c)(3)(i)

by the end of the calendar year in which the legally binding right arises, or with respect to an amount not payable in the year immediately following the year in which the legally binding right arises (the subsequent year), the 15th day of the third month of the subsequent year.

(ii) *Amendments to the arrangement.* In the case of an amendment that increases the amount deferred under an arrangement providing for the deferral of compensation, the arrangement is not considered established with respect to the additional amount deferred until the arrangement, as amended, is established in accordance with paragraph (c)(3)(i) of this section.

(iii) *Transition rule for written plan requirement.* For purposes of this section, an unwritten arrangement that was adopted and effective before December 31, 2006, is treated as established under this section as of the later of the date on which it was adopted or became effective, provided that the material terms of the arrangement are set forth in writing on or before December 31, 2006.

(iv) *Plan aggregation rules.* The plan aggregation rules of paragraph (c)(2)(i) of this section do not apply to the requirements of paragraphs (c)(3)(i) and (ii) of this section. Accordingly, an arrangement that fails to meet the requirements of section 409A solely due to a failure to meet the requirements of paragraph (c)(3)(i) or (ii) is not aggregated with other arrangements that meet such requirements.

(d) *Substantial risk of forfeiture—(1) In general.* Compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial. For purposes of this paragraph (d), a condition related to a purpose of the compensation must relate to the service provider's performance for the service recipient or the service recipient's business activities or organizational goals (for example, the attainment of a prescribed level of earnings, equity value or an initial public offering). Any addition of a substantial risk of forfeiture after the legally binding right to the compensation arises, or any extension of a period during which compensation is subject to a substantial risk of forfeiture, in either case whether elected by the

service provider, service recipient or other person (or by agreement of two or more of such persons), is disregarded for purposes of determining whether such compensation is subject to a substantial risk of forfeiture. An amount is not subject to a substantial risk of forfeiture merely because the right to the amount is conditioned, directly or indirectly, upon the refraining from performance of services. For purposes of section 409A, an amount will not be considered subject to a substantial risk of forfeiture beyond the date or time at which the recipient otherwise could have elected to receive the amount of compensation, unless the amount subject to a substantial risk of forfeiture (ignoring earnings) is materially greater than the amount the recipient otherwise could have elected to receive. For example, a salary deferral generally may not be made subject to a substantial risk of forfeiture. But, for example, where a bonus arrangement provides an election between a cash payment of a certain amount or restricted stock units with a materially greater value that will be forfeited absent continued services for a period of years, the right to the restricted stock units generally will be treated as subject to a substantial risk of forfeiture.

(2) *Stock rights.* A stock right will be treated as not subject to a substantial risk of forfeiture at the earlier of the first date the holder may exercise the stock right and receive cash or property that is substantially vested (as defined in §1.83-3(b)) or the first date that the stock right is not subject to a forfeiture condition that would constitute a substantial risk of forfeiture. Accordingly, a stock option that the service provider may exercise immediately and receive substantially vested stock will be treated as not subject to a substantial risk of forfeiture, even if the stock option automatically terminates upon the service provider's separation from service.

(3) *Enforcement of forfeiture condition—(i) In general.* In determining whether the possibility of forfeiture is substantial in the case of rights to compensation granted by a service recipient to a service provider that owns a significant amount of the total combined voting power or value of all classes of equity of the service recipient or of its parent, all relevant facts and circumstances will be taken into account in determining whether the probability of the service recipient

enforcing such condition is substantial, including—

(A) The service provider's relationship to other equity holders and the extent of their control, potential control and possible loss of control of the service recipient;

(B) The position of the service provider in the service recipient and the extent to which the service provider is subordinate to other service providers;

(C) The service provider's relationship to the officers and directors of the service recipient (or similar positions with respect to a noncorporate service recipient);

(D) The person or persons who must approve the service provider's discharge; and

(E) Past actions of the service recipient in enforcing the restrictions.

(ii) *Examples.* The following examples illustrate the rules of paragraph (d)(3)(i) of this section:

Example 1. A service provider would be considered as having deferred compensation subject to a substantial risk of forfeiture, but for the fact that the service provider owns 20 percent of the single class of stock in the transferor corporation. If the remaining 80 percent of the class of stock is owned by an unrelated individual (or members of such an individual's family) so that the possibility of the corporation enforcing a restriction on such rights is substantial, then such rights are subject to a substantial risk of forfeiture.

Example 2. A service provider would be considered as having deferred compensation subject to a substantial risk of forfeiture, but for the fact that the service provider who is president of the corporation, also owns 4 percent of the voting power of all the stock of a corporation. If the remaining stock is so diversely held by the public that the president, in effect, controls the corporation, then the possibility of the corporation enforcing a restriction on the right to deferred compensation of the president is not substantial, and such rights are not subject to a substantial risk of forfeiture.

(e) *Performance-based compensation—(1) In general.* The term *performance-based compensation* means compensation where the amount of, or entitlement to, the compensation is contingent on the satisfaction of preestablished organizational or individual performance criteria relating to a performance period of at least 12 consecutive months in which the service provider performs services. Organizational or individual performance criteria are considered preestablished if established in writing by not later than 90 days after the commencement of the period of service to which the criteria relates, provided that the outcome is substantially

uncertain at the time the criteria are established. Performance-based compensation may include payments based on performance criteria that are not approved by a compensation committee of the board of directors (or similar entity in the case of a non-corporate service recipient) or by the stockholders or members of the service recipient. Notwithstanding the foregoing, performance-based compensation does not include any amount or portion of any amount that will be paid either regardless of performance, or based upon a level of performance that is substantially certain to be met at the time the criteria is established. Except as provided in paragraph (e)(3) of this section, compensation is not performance-based compensation merely because the amount of such compensation is based on the value of, or increase in the value of, the service recipient or the stock of the service recipient.

(2) *Payments based upon subjective performance criteria.* The term *performance-based compensation* may include payments based upon subjective performance criteria, provided that—

(i) The subjective performance criteria relate to the performance of the participant service provider, a group of service providers that includes the participant service provider, or a business unit for which the participant service provider provides services (which may include the entire organization); and

(ii) The determination that any subjective performance criteria have been met is not made by the participant service provider or a family member of the participant service provider (as defined in section 267(c)(4) applied as if the family of an individual includes the spouse of any member of the family), or a person under the supervision of the participant service provider or such a family member, or where any amount of the compensation of the person making such determination is controlled in whole or in part by the service provider or such a family member.

(3) *Equity-based compensation.* Compensation is performance-based compensation if it is based solely on an increase in the value of the service recipient, or stock of the service recipient, after the date of a grant or award. If the amount of compensation the service provider will receive under a grant or award is not based solely on an increase in the value of the service

recipient, or stock of the service recipient, after the date of the grant or award (for example, a stock appreciation right granted with an exercise price that is less than the fair market value of the stock as of the date of grant), and that other amount would not otherwise qualify as performance-based compensation, the compensation attributable to the grant or award does not qualify as performance-based compensation. Notwithstanding the foregoing, an award of equity-based compensation may constitute performance-based compensation if entitlement to the compensation is subject to a condition that would cause the award to otherwise qualify as performance-based compensation, such as a performance-based vesting condition. The eligibility to defer compensation under an equity-based compensation award constitutes an additional deferral feature with respect to the award for purposes of the definition of a deferral of compensation under paragraph (b)(5) of this section.

(f) *Service provider*—(1) *In general.* The term *service provider* includes—

(i) An individual, corporation, subchapter S corporation or partnership;

(ii) A personal service corporation (as defined in section 269A(b)(1)), or a non-corporate entity that would be a personal service corporation if it were a corporation; or

(iii) A qualified personal service corporation (as defined in section 448(d)(2)), or a noncorporate entity that would be a qualified personal service corporation if it were a corporation.

(2) *Service providers using an accrual method of accounting.* Section 409A does not apply to a deferral under an arrangement between taxpayers if, for the taxable year in which the service provider taxpayer obtains a legally binding right to the compensation, the service provider uses an accrual method of accounting for Federal tax purposes.

(3) *Independent contractors*—(i) *In general.* Except as otherwise provided in paragraph (f)(3)(iv) of this section, section 409A does not apply to an amount deferred under an arrangement between a service provider and service recipient with respect to a particular trade or business in which the service provider participates, if during the service provider's taxable year in which the service provider obtains a

legally binding right to the payment of the amount deferred—

(A) The service provider is actively engaged in the trade or business of providing services, other than as an employee or as a director of a corporation;

(B) The service provider provides significant services to two or more service recipients to which the service provider is not related and that are not related to one another (as defined in paragraph (f)(3)(ii) of this section); and

(C) The service provider is not related to the service recipient, applying the definition of related person contained in paragraph (f)(3)(ii) of this section subject to the modification that the language “50 percent” is used instead of “20 percent” each place it appears in sections 267(b) and 707(b)(1).

(ii) *Related person.* For purposes of this paragraph (f)(3), a person is related to another person if the persons bear a relationship to each other that is specified in section 267(b) or 707(b)(1), subject to the modifications that the language “20 percent” is used instead of “50 percent” each place it appears in sections 267(b) and 707(b)(1), and section 267(c)(4) is applied as if the family of an individual includes the spouse of any member of the family; or the persons are engaged in trades or businesses under common control (within the meaning of section 52(a) and (b)). In addition, an individual is related to an entity if the individual is an officer of an entity that is a corporation, or holds a position substantially similar to an officer of a corporation with an entity that is not a corporation.

(iii) *Significant services.* Whether a service provider is providing significant services depends on the facts and circumstances of each case. However, for purposes of paragraph (f)(3)(i) of this section, a service provider who provides services to two or more service recipients to which the service provider is not related and that are not related to one another is deemed to be providing significant services to two or more of such service recipients for a given taxable year, if the revenues generated from the services provided to any service recipient or group of related service recipients during such taxable year do not exceed 70 percent of the total revenue generated by the service provider from the trade or business of providing such services.

(iv) *Management services.* A service provider is treated as related to a service recipient for purposes of paragraph (f)(3)(i) of this section if the service provider provides management services to the service recipient. For purposes of this paragraph (f)(3)(iv), the term *management services* means services that involve the actual or de facto direction or control of the financial or operational aspects of a trade or business of the service recipient, or investment advisory services provided to a service recipient whose primary trade or business includes the management of financial assets (including investments in real estate) for its own account, such as a hedge fund or a real estate investment trust.

(g) *Service recipient.* Except as otherwise specifically provided in these regulations, the term *service recipient* means the person for whom the services are performed and with respect to whom the legally binding right to compensation arises, and all persons with whom such person would be considered a single employer under section 414(b) (employees of a controlled group of corporations), and all persons with whom such person would be considered a single employer under section 414(c) (employees of partnerships, proprietorships, etc., under common control). For example, where the service provider is an employee, the service recipient generally is the employer. Notwithstanding the foregoing, section 409A applies to a plan that provides for the deferral of compensation, even though the payment of the compensation is not made by the person for whom services are performed.

(h) *Separation from service*—(1) *Employees*—(i) *In general.* An employee separates from service with the service recipient if the employee dies, retires, or otherwise has a termination of employment with the employer. However, for purposes of this paragraph (h)(1), the employment relationship is treated as continuing intact while the individual is on military leave, sick leave, or other *bona fide* leave of absence (such as temporary employment by the government) if the period of such leave does not exceed six months, or if longer, so long as the individual's right to reemployment with the service recipient is provided either by statute or by contract. If the period of leave exceeds six months and the individual's right to reemployment is not

provided either by statute or by contract, the employment relationship is deemed to terminate on the first date immediately following such six-month period.

(ii) *Termination of employment.* Whether a termination of employment has occurred is determined based on the facts and circumstances. Where an employee either actually or purportedly continues in the capacity as an employee, such as through the execution of an employment agreement under which the employee agrees to be available to perform services if requested, but the facts and circumstances indicate that the employer and the employee did not intend for the employee to provide more than insignificant services for the employer, an employee will be treated as having a separation from service for purposes of this paragraph (h)(1). For purposes of the preceding sentence, an employer and employee will not be treated as having intended for the employee to provide insignificant services where the employee continues to provide services as an employee at an annual rate that is at least equal to 20 percent of the services rendered, on average, during the immediately preceding three full calendar years of employment (or, if employed less than three years, such lesser period) and the annual remuneration for such services is at least equal to 20 percent of the average annual remuneration earned during the final three full calendar years of employment (or, if less, such lesser period). Where an employee continues to provide services to a previous employer in a capacity other than as an employee, a separation from service will not be deemed to have occurred for purposes of this paragraph (h)(1) if the former employee is providing services at an annual rate that is 50 percent or more of the services rendered, on average, during the immediately preceding three full calendar years of employment (or if employed less than three years, such lesser period) and the annual remuneration for such services is 50 percent or more of the annual remuneration earned during the final three full calendar years of employment (or if less, such lesser period). For purposes of this paragraph (h)(1)(ii), the annual rate of providing services is determined based upon the measurement used to determine the service provider's base compensation (for example, amounts of

time required to earn salary, hourly wages, or payments for specific projects).

(2) *Independent contractors*—(i) *In general.* An independent contractor is considered to have a separation from service with the service recipient upon the expiration of the contract (or in the case of more than one contract, all contracts) under which services are performed for the service recipient if the expiration constitutes a good-faith and complete termination of the contractual relationship. An expiration does not constitute a good faith and complete termination of the contractual relationship if the service recipient anticipates a renewal of a contractual relationship or the independent contractor becoming an employee. For this purpose, a service recipient is considered to anticipate the renewal of the contractual relationship with an independent contractor if it intends to contract again for the services provided under the expired contract, and neither the service recipient nor the independent contractor has eliminated the independent contractor as a possible provider of services under any such new contract. Further, a service recipient is considered to intend to contract again for the services provided under an expired contract if the service recipient's doing so is conditioned only upon incurring a need for the services, the availability of funds, or both.

(ii) *Special rule.* Notwithstanding paragraph (h)(2)(i) of this section, the plan is considered to satisfy the requirement described in §1.409A-3(a)(1) that amounts deferred under the plan may be paid or made available to the participant upon a separation from service with the service recipient if, with respect to amounts payable to a participant who is an independent contractor, a plan provides that—

(A) No amount will be paid to the participant before a date at least 12 months after the day on which the contract expires under which services are performed for the service recipient (or, in the case of more than one contract, all such contracts expire); and

(B) No amount payable to the participant on that date will be paid to the participant if, after the expiration of the contract (or contracts) and before that date, the participant performs services for the service recipient as an independent contractor or an employee.

(i) *Specified employee*—(1) *In general.* The term *specified employee* means a key employee (as defined in section 416(i) without regard to section 416(i)(5)) of a service recipient any stock of which is publicly traded on an established securities market or otherwise. For purposes of this paragraph (i)(1), an employee is a key employee if the employee meets the requirements of section 416(i)(1)(A)(i), (ii) or (iii) (applied in accordance with the regulations thereunder and disregarding section 416(i)(5)) at any time during the 12-month period ending on an identification date. If a person is a key employee as of an identification date, the person is treated as a specified employee for the 12-month period beginning on the first day of the fourth month following the identification date. A service recipient may designate any date in a calendar year as the identification date provided that a service recipient must use the same identification date with respect to all arrangements, and any change to the identification date may not be effective for a period of 12 months. If no identification date is designated, the identification date is December 31. The service recipient may designate an identification date through inclusion in each plan document or through a separate document, provided that the service recipient will not be treated as having designated an identification date on any date before the execution of the document containing the designation. Notwithstanding the foregoing, any designation of an identification date made on or before December 31, 2006, may be applied to any separation from service occurring on or after January 1, 2005. Whether any stock of a service recipient is publicly traded on an established securities market or otherwise must be determined as of the date of the employee's separation from service.

(2) *Spinoffs and mergers.* Where a new corporation or entity (new corporation) is established as part of a corporate division governed by section 355 from a corporation that is publicly traded on an established securities market or otherwise (old corporation), any employee of the new corporation who was a key employee of the old corporation immediately prior to the spinoff is a key employee of the new corporation until the end of the 12-month period beginning on the first day of the fourth month following the old corporation's last

identification date preceding the spinoff transaction. Where two corporations (pre-merger corporations) are merged or become part of the same controlled group of corporations so as to be treated as a single service recipient under paragraph (g) of this section, any employee of the merged corporation who was a key employee of either of the pre-merger corporations immediately before the merger is a key employee of the merged corporation until the first day of the fourth month after the identification date of the merged corporation next following the merger.

(3) *Nonresident alien employees.* For purposes of determining key employees, a service recipient generally must include all employees, including employees who are nonresident aliens. However, a plan may provide without causing an amount to be treated as an additional deferral as to any affected participant that for purposes of applying the six-month delay to specified employees, all employees that are nonresident aliens during the entire 12-month period ending with the relevant identification date are excluded for purposes of determining which employees meet the requirements of section 416(i)(1)(A)(i), (ii) or (iii) (applied in accordance with the regulations thereunder and disregarding section 416(i)(5)); provided that a service recipient must apply such exclusion with respect to all arrangements of the service recipient, and any change to include such nonresident alien employees may not be effective for a period of 12 months.

(j) *Nonresident alien*—(1) Except as provided in paragraph (j)(2) of this section, for purposes of this section the term *nonresident alien* means an individual who is—

(i) A nonresident alien within the meaning of section 7701(b)(1)(B); or

(ii) A dual resident taxpayer within the meaning of §301.7701(b)-7(a)(1) of this chapter with respect to any taxable year in which such individual is treated as a nonresident alien for purposes of computing the individual's U.S. income tax liability.

(2) The term *nonresident alien* does not include—

(i) A nonresident alien with respect to whom an election is in effect for the taxable year under section 6013(g) to be treated as a resident of the United States;

(ii) A former citizen or long-term resident (within the meaning of section

877(e)(2)) who expatriated after June 3, 2004, and has not complied with the requirements of section 7701(n); or

(iii) An individual who is treated as a citizen or resident of the United States for the taxable year under section 877(g).

(k) *Established securities market.* For purposes of section 409A and the regulations thereunder, the term *established securities market* means an established securities market within the meaning of §1.897-1(m).

(l) *Stock right.* For purposes of section 409A and these regulations, the term *stock right* means a stock option (other than an incentive stock option described in section 422 or an option granted pursuant to an employee stock purchase plan described in section 423) or a stock appreciation right.

(m) *Separation pay arrangement.* For purposes of section 409A and the regulations thereunder, the term *separation pay arrangement* means any arrangement that provides separation pay or, where an arrangement provides both amounts that are separation pay and that are not separation pay, that portion of the arrangement that provides separation pay. For purposes of this paragraph (m), the term *separation pay* means any amount of compensation where one of the conditions to the right to the payment is a separation from service, whether voluntary or involuntary, including payments in the form of reimbursements of expenses incurred, and the provision of other taxable benefits. Separation pay includes amounts payable due to a separation from service, regardless of whether payment is conditioned upon the execution of a release of claims, noncompetition or nondisclosure provisions, or other similar requirement. Notwithstanding the foregoing, any amount, or entitlement to any amount, that acts as a substitute for, or replacement of, amounts deferred by the service recipient under a separate nonqualified deferred compensation plan constitutes a payment of compensation or deferral of compensation under the separate nonqualified deferred compensation plan, and does not constitute separation pay.

§1.409A-2 *Deferral elections.*

(a) *Initial elections as to the time and form of payment*—(1) *In general.* An arrangement that is, or constitutes part of, a nonqualified deferred compensation

plan meets the requirements of section 409A(a)(4)(B) only if the arrangement provides that compensation for services performed during a service provider's taxable year (the service year) may be deferred at the service provider's election only if the election to defer such compensation is made and becomes irrevocable not later than the end of such period as may be permitted in this paragraph (a). An election will not be considered to be revocable merely because the service provider may make an election to change the time and form of payment pursuant to paragraph (b) of this section. Whether an arrangement provides a service provider an opportunity to elect the time or form of payment of compensation is determined based upon all the facts and circumstances surrounding the determination of the time and form of payment of the compensation. For purposes of this section, an election to defer includes an election as to the time of the payment, an election as to the form of the payment or an election as to both the time and the form of the payment, but does not include an election as to the medium of payment (for example, an election between a payment of cash or a payment of property). Except as otherwise provided in these regulations, an election will not be considered made until such election becomes irrevocable under the terms of the relevant arrangement. Thus, a plan may provide that an election to defer may be changed at any time prior to the last permissible date for making such an election. Where an arrangement provides the service provider a right to make an initial deferral election, and further provides that the election remains in effect until terminated or modified by the service provider, the election will be treated as made as of the date such election becomes irrevocable as to compensation for services performed during the relevant service year. For example, where an arrangement provides that a service provider's election to defer a set percentage will remain in effect until changed or revoked, but that as of each December 31 the election becomes irrevocable with respect to salary payable with respect to services performed in the immediately following year, the initial deferral election with respect to salary payable with respect to services performed in the immediately following year will be deemed to have

been made as of the December 31 upon which the election became irrevocable.

(2) *General rule.* An arrangement that is, or constitutes part of, a nonqualified deferred compensation plan meets the requirements of section 409A(a)(4)(B) if the plan provides that compensation for services performed during a service provider's taxable year (the service year) may be deferred at the service provider's election only if the election to defer such compensation is made not later than the close of the service provider's taxable year next preceding the service year.

(3) *Initial deferral election with respect to short-term deferrals.* With respect to a legally binding right to a payment of compensation in a subsequent taxable year that, absent a deferral election, would not be treated as a deferral of compensation pursuant to §1.409A-1(b)(4), an election to defer such compensation may be made in accordance with the requirements of paragraph (b) of this section, applied as if the amount were a deferral of compensation and the scheduled payment date for the amount were the date the substantial risk of forfeiture lapses. Notwithstanding the requirements of paragraph (b) of this section, such a deferral election may provide that the deferred amounts will be payable upon a change in control event (as defined in §1.409A-3(g)(5)) without regard to the 5-year additional deferral requirement.

(4) *Initial deferral election with respect to certain forfeitable rights.* With respect to a legally binding right to a payment in a subsequent year that is subject to a forfeiture condition requiring the service provider's continued services for a period of at least 12 months from the date the service provider obtains the legally binding right, an election to defer such compensation may be made on or before the 30th day after the service provider obtains the legally binding right to the compensation, provided that the election is made at least 12 months in advance of the earliest date at which the forfeiture condition could lapse.

(5) *Initial deferral election with respect to a service recipient with a fiscal year other than the calendar year.* In the case of a service recipient with a fiscal year other than the calendar year, a plan may provide that fiscal year compensation may be deferred at the service provider's election only if the election to defer such compensation is made not later than the close of

the service recipient's fiscal year next preceding the first fiscal year in which are performed any services for which such compensation is payable. For purposes of this paragraph (a)(5), the term *fiscal year compensation* means compensation relating to a period of service coextensive with one or more consecutive fiscal years of the service recipient, of which no amount is paid or payable during the service period. For example, fiscal year compensation generally would include a bonus based on a service period of the two consecutive fiscal years ending September 30, 2009, where the amount will be paid after the completion of the service period, but would not include either a bonus based on a calendar year service period or salary that would otherwise be paid during the service recipient's fiscal year.

(6) *First year of eligibility.* In the case of the first year in which a service provider becomes eligible to participate in a plan (as defined in §1.409A-1(c)), the service provider may make an initial deferral election within 30 days after the date the service provider becomes eligible to participate in such plan, with respect to compensation paid for services to be performed subsequent to the election. In the case of a plan that does not provide for service provider elections with respect to the time or form of a payment, the time and form of the payment must be specified on or before the date that is 30 days after the date the service provider becomes eligible to participate in such plan. For compensation that is earned based upon a specified performance period (for example, an annual bonus), where a deferral election is made in the first year of eligibility but after the beginning of the service period, the election will be deemed to apply to compensation paid for services performed subsequent to the election if the election applies to the portion of the compensation equal to the total amount of the compensation for the service period multiplied by the ratio of the number of days remaining in the performance period after the election over the total number of days in the performance period.

(7) *Performance-based compensation.* In the case of any performance-based compensation based upon a performance period of at least 12 months, provided that the service provider performed services continuously from a date no later than the date

upon which the performance criteria are established through a date no earlier than the date upon which the service provider makes an initial deferral election, an initial deferral election may be made with respect to such performance-based compensation no later than the date that is six months before the end of the performance period, provided that in no event may an election to defer performance-based compensation be made after such compensation has become both substantially certain to be paid and readily ascertainable.

(8) *Nonqualified deferred compensation arrangements linked to qualified plans.* With respect to an amount deferred under an arrangement that is, or constitutes part of, a nonqualified deferred compensation plan, where under the terms of the nonqualified deferred compensation arrangement the amount deferred under the plan is the amount determined under the formula under which benefits are determined under a qualified employer plan (as defined in §1.409A-1(a)(2)) applied without respect to one or more limitations applicable to qualified employer plans under the Internal Revenue Code or other applicable law, or is determined as an amount offset by some or all of the benefits provided under the qualified employer plan, the operation of the qualified employer plan with respect to changes in benefit limitations applicable to qualified employer plans under the Internal Revenue Code or other applicable law does not constitute a deferral election even if such operation results in an increase of amounts deferred under the nonqualified deferred compensation arrangement, provided that such operation does not otherwise result in a change in the time or form of a payment under the nonqualified deferred compensation plan. In addition, with respect to such a nonqualified deferred compensation arrangement, the following actions or failures to act will not constitute a deferral election under the nonqualified deferred compensation arrangement even if in accordance with the terms of the nonqualified deferred compensation arrangement, the actions or inactions result in an increase in the amounts deferred under the arrangement, provided that such actions or inactions do not otherwise affect the time or form of payment under the nonqualified deferred compensation plan:

(i) A service provider's action or inaction under the qualified plan with respect to whether to elect to receive a subsidized benefit or an ancillary benefit under the qualified plan.

(ii) The amendment of a qualified plan to add or remove a subsidized benefit or an ancillary benefit, or to freeze or limit future accruals of benefits under the qualified plan.

(iii) A service provider's action or inaction under a qualified plan subject to section 402(g), including an adjustment to a deferral election under the qualified plan subject to section 402(g), provided that for any given calendar year, the service provider's action or inaction does not result in an increase in the amounts deferred under all nonqualified deferred compensation arrangements in which the service provider participates in excess of the limit with respect to elective deferrals under section 402(g) in effect for the taxable year in which such action or inaction occurs.

(iv) A service provider's action or inaction under a qualified plan with respect to elective deferrals or after-tax contributions by the service provider to the qualified plan that affects the amounts that are credited under a nonqualified deferred compensation arrangement as matching amounts or other amounts contingent on service provider elective deferrals or after-tax contributions, provided that such matching or contingent amounts, as applicable, are either forfeited or never credited under the nonqualified deferred compensation arrangement in the absence of such service provider's elective deferral or after-tax contribution, and provided further that all of the service provider's actions or inactions do not result in an increase during such taxable year in the amounts deferred under all nonqualified deferred compensation arrangements in which the service provider participates in excess of the limit with respect to elective deferrals under section 402(g) in effect for the taxable year in which such action or inaction occurs. See paragraph (b)(6) of this section, *Example 12* and *Example 13*.

(9) *Separation pay.* In the case of separation pay (as defined in §1.409A-1(m)) due to an actual involuntary separation from service, where such separation pay is the subject of *bona fide*, arm's length negotiations, the initial deferral election may be

made at any time up to the time the service provider obtains a legally binding right to the payment. In the case of separation pay due to participation in a window program (as defined in §1.409A-1(b)(9)(v)), the initial deferral election may be made at any time up to the time the election to participate in the window program becomes irrevocable.

(10) *Commissions.* For purposes of this paragraph (a), in the case of commission compensation, a service provider earning such compensation is treated as providing the services to which such compensation relates only in the year in which the customer remits payment to the service recipient. For purposes of this paragraph (a)(10), the term *commission compensation* means compensation or portions of compensation earned by a service provider if a substantial portion of the services provided by such service provider to a service recipient consist of the direct sale of a product or service to a customer, the compensation paid by the service recipient to the service provider consists of either a portion of the purchase price for the product or service or an amount calculated solely by reference to the volume of sales, and payment of the compensation is contingent upon the service recipient receiving payment from an unrelated customer for the product or services. For this purpose, a customer is treated as an unrelated customer only if the customer is not related to either the service provider or the service recipient. A person is treated as related to another person if the person would be treated as related to the other person under §1.409A-1(f)(3)(ii) or the person would be treated as providing management services to the other person under §1.409A-1(f)(3)(iv).

(11) *Initial deferral elections with respect to compensation paid for final payroll period—(i) In general.* Unless an arrangement provides otherwise, compensation payable after the last day of the service provider's taxable year solely for services performed during the final payroll period described in section 3401(b) containing the last day of the service provider's taxable year or, with respect to a non-employee service provider, a period not longer than the payroll period described in section 3401(b), where such amount is payable pursuant to the timing arrangement under which the service recipient normally compensates service

providers for services performed during a payroll period described in section 3401(b), or with respect to a non-employee service provider, a period not longer than the payroll period described in section 3401(b), is treated as compensation for services performed in the subsequent taxable year. The preceding sentence does not apply to any compensation paid during such period for services performed during any period other than such final payroll period, such as a payment of an annual bonus. Any amendment of an arrangement after December 31, 2006, to add a provision providing for a differing treatment of such compensation may not be effective for 12 months from the date the amendment is executed and enacted.

(ii) *Transition rule.* For purposes of this paragraph (a)(11), an arrangement that was adopted and effective before December 31, 2006, whether written or unwritten, will be treated as designating such compensation for service performed in the taxable year in which the payroll period ends, unless otherwise set forth in writing before December 31, 2006.

(12) *Designation of time and form of payment with respect to a nonelective arrangement.* An arrangement that provides for a deferral of compensation for services performed during a service provider's taxable year that does not provide the service provider with an opportunity to elect the time of payment of such compensation must specify the time of payment no later than the time the service provider first has a legally binding right to the compensation. Similarly, an arrangement that provides for a deferral of compensation for services performed during a service provider's taxable year that does not provide the service provider with an opportunity to elect the form of payment of such compensation must specify the form of payment no later than the time the service provider first has a legally binding right to the compensation. Such designation shall be treated as an initial deferral election for purposes of this section.

(13) *Designation of time and form of payment with respect to earnings.* An arrangement that provides for actual or notional earnings to be credited on amounts of deferred compensation may specify, in accordance with the requirements of this paragraph (a), that such earnings will be paid by a date not later than the 15th day

of the third month following the calendar year for which the earnings are credited. To satisfy the requirements of this paragraph (a)(13), actual or notional earnings must be credited at least annually and the measure for such earnings must be either a specified, nondiscretionary interest rate (or a specified, nondiscretionary formula describing an interest rate such as, for example, the interest on a Treasury bond + 2 percent) or a predetermined actual investment within the meaning of §31.3121(v)(2)-1(d)(2) of this chapter. For these purposes, a right to dividend equivalents with respect to a specified number of shares of service recipient stock (as defined in §1.409A-1(b)(5)(iii)) may be treated as a right to actual or notional earnings on an amount of deferred compensation.

(b) *Subsequent changes in time and form of payment—(1) In general.* The requirements of section 409A(a)(4)(C) are met if, in the case of a plan that permits a subsequent election to delay a payment or to change the form of payment of an amount of deferred compensation, the following conditions are met:

(i) The plan requires that such election may not take effect until at least 12 months after the date on which the election is made.

(ii) In the case of an election related to a payment not described in §1.409A-3(a)(2) (payment on account of disability), §1.409A-3(a)(3) (payment on account of death) or §1.409A-3(a)(6) (payment on account of the occurrence of an unforeseeable emergency), the plan requires that the payment with respect to which such election is made be deferred for a period of not less than 5 years from the date such payment would otherwise have been paid (or in the case of a life annuity or installment payments treated as a single payment, 5 years from the date the first amount was scheduled to be paid).

(iii) The plan requires that any election related to a payment described in §1.409A-3(a)(4) (payment at a specified time or pursuant to a fixed schedule) may not be made less than 12 months prior to the date the payment is scheduled to be paid (or in the case of a life annuity or installment payments treated as a single payment, 12 months prior to the date the first amount was scheduled to be paid).

(2) *Definition of payments for purposes of subsequent changes in the time or form of payment—(i) In general.* Except as provided in paragraphs (b)(2)(ii) and (iii) of this section, the term *payment* refers to each separately identified amount to which a service provider is entitled to payment under a plan on a determinable date, and includes amounts applied for the benefit of the service provider. An amount is separately identified only if the amount may be objectively determined. For example, an amount identified as 10 percent of the account balance as of a specified payment date would be a separately identified amount. A payment includes the provision of any taxable benefit, including payment in cash or in kind. In addition, a payment includes, but is not limited to, the transfer, cancellation or reduction of an amount of deferred compensation in exchange for benefits under a welfare benefit plan, fringe benefit excludible under section 119 or section 132, or any other benefit that is excluded from gross income.

(ii) *Life annuities.* The entitlement to a life annuity is treated as the entitlement to a single payment. For purposes of this paragraph (b)(2)(ii), the term *life annuity* means a series of substantially equal periodic payments, payable not less frequently than annually, for the life (or life expectancy) of the service provider or the joint lives (or life expectancies) of the service provider and the service provider's designated beneficiary. A change in the form of a payment from one type of life annuity to another type of life annuity before any annuity payment has been made is not considered a change in the time and form of a payment, provided that the annuities are actuarially equivalent applying reasonable actuarial assumptions.

(iii) *Installment payments.* The entitlement to a series of installment payments that is not a life annuity is treated as the entitlement to a single payment, unless the arrangement provides at all times with respect to the amount deferred that the right to the series of installment payments is to be treated as a right to a series of separate payments. For purposes of this paragraph (b)(2)(iii), a series of installment payments refers to an entitlement to the payment of a series of substantially equal periodic amounts to be paid over a predetermined period of years, except to the extent any increase in the amount reflects reasonable

earnings through the date the amount is paid.

(iv) *Transition rule.* For purposes of this section, an arrangement that was adopted and effective before December 31, 2006, whether written or unwritten, that fails to make a designation as to whether the entitlement to a series of payments is to be treated as an entitlement to a series of separate payments under paragraph (b)(2)(iii) of this section is treated as having made such designation as of the later of the date on which the arrangement was adopted or became effective, provided that such designation is set forth in writing before December 31, 2006.

(3) *Coordination with prohibition against acceleration of payments.* For purposes of applying the prohibition against the acceleration of payments contained in §1.409A-3(h), the definition of payment is the same as the definition provided in paragraph (b)(2) of this section. However, even though a change in the form of a payment that results in a more rapid schedule for payments generally may not constitute an acceleration of a payment, the change in the form of payment must comply with the subsequent deferral rules. For example, although a change in form from a 10-year installment payment treated as a single payment to a lump-sum payment would not constitute an acceleration, the change in the form of the payment must still comply with the requirements of paragraph (b)(1) of this section, generally meaning that the election to change to a lump-sum payment could not be effective for 12 months and the lump-sum payment could not be made until at least 5 years after the date the installment payments were scheduled to commence.

(4) *Application to multiple payment events.* In the case of a plan that permits a payment upon each of a number of potential permissible payment events, such as the earlier of a fixed date or separation from service, the requirements of paragraph (b)(1) of this section are applied separately to each payment (as defined in paragraph (b)(2) of this section) due upon each payment event. Notwithstanding the foregoing, the addition of a permissible payment event to amounts previously deferred is subject to the rules of this paragraph (b) where the addition of the permissible payment event may result in a change in the time or form of payment

of the amount deferred. For application of the rules governing accelerations of payments to the addition of a permissible payment event to amounts deferred, see §1.409A-3.

(5) *Delay of payments under certain circumstances.* A plan may provide, or be amended to provide, that a payment will be delayed to a date after the designated payment date under any of the following circumstances, and the provision will not fail to meet the requirements of establishing a permissible payment event and the delay in the payment will not constitute a subsequent deferral election, provided that once such a provision is applicable to an amount of deferred compensation, any failure to apply such a provision or modification of the plan to remove such a provision will constitute an acceleration of any payment to which such provision applied:

(i) *Payments subject to section 162(m).* A plan may provide that a payment will be delayed where the service recipient reasonably anticipates that the service recipient's deduction with respect to such payment otherwise would be limited or eliminated by application of section 162(m); provided that the terms of the arrangement require the payment to be made either at the earliest date at which the service recipient reasonably anticipates that the deduction of the payment of the amount will not be limited or eliminated by application of section 162(m) or the calendar year in which the service provider separates from service.

(ii) *Payments that would violate a loan covenant or similar contractual requirement.* A plan may provide that a payment will be delayed where the service recipient reasonably anticipates that the making of the payment will violate a term of a loan agreement to which the service recipient is a party, or other similar contract to which the service recipient is a party, and such violation will cause material harm to the service recipient; provided that the terms of the arrangement require the payment to be made at the earliest date at which the service recipient reasonably anticipates that the making of the payment will not cause such violation, or such violation will not cause material harm to the service recipient, and provided that the facts and circumstances indicate that the service recipient entered into such loan agreement (including such covenant) or other similar con-

tract for legitimate business reasons, and not to avoid the restrictions on deferral elections and subsequent deferral elections under section 409A.

(iii) *Payments that would violate Federal securities laws or other applicable law.* A plan may provide that a payment will be delayed where the service recipient reasonably anticipates that the making of the payment will violate Federal securities laws or other applicable law; provided that the terms of the arrangement require the payment to be made at the earliest date at which the service recipient reasonably anticipates that the making of the payment will not cause such violation. For purposes of this paragraph (b)(5)(iii), the making of a payment that would cause inclusion in gross income or the application of any penalty provision or other provision of the Internal Revenue Code is not treated as a violation of applicable law.

(iv) *Other events and conditions.* A service recipient may delay a payment upon such other events and conditions as the Commissioner may prescribe in generally applicable guidance published in the Internal Revenue Bulletin.

(6) *Examples.* The following examples illustrate the application of the provisions of this section:

Example 1. Initial election to defer salary. Employee A is an individual employed by Employer X. Employer X sponsors an arrangement under which Employee A may elect to defer a percentage of Employee A's salary. Employee A has participated in the arrangement in prior years. To satisfy the requirements of this section with respect to salary earned in calendar year 2008, if Employee A elects to defer any amount of such salary, the deferral election (including an election as to the time and form of payment) must be made no later than December 31, 2007.

Example 2. Designation of time and form of payment where an initial deferral election is not provided. Employee A is an individual employed by Employer X. Employer X has a fiscal year ending September 30. On July 1, 2007, Employer X enters into a legally binding obligation to pay Employee A a \$10,000 bonus. The amount is not subject to a substantial risk of forfeiture. Employer X does not provide Employee A an election as to the time and form of payment. Unless the amount is paid in accordance with the short-term deferral rule of §1.409A-1(b)(4), to satisfy the requirements of this section, Employer X must specify the time and form of payment on or before July 1, 2007.

Example 3. Initial election to defer bonus payable based on services during calendar year. Employee A is an individual employed by Employer X. Employer X has a fiscal year ending September 30. Employee A participates in a bonus plan under which Employee A is entitled to a bonus for services performed during the calendar year that, absent an election by Em-

employee A, will be paid on March 15 of the following year. The amount is not subject to a substantial risk of forfeiture and does not qualify as performance based compensation. If Employee A elects to defer the payment of the bonus with respect to calendar year 2008, to satisfy the requirements of this paragraph, Employee A must elect the time and form of payment not later than December 31, 2007.

Example 4. Initial election to defer bonus payable based on services during fiscal year other than calendar year. Employee A is an individual employed by Employer X. Employer X has a fiscal year ending September 30. Employee A participates in a bonus plan under which Employee A is entitled to a bonus for services performed during Employer X's fiscal year that, absent an election by Employee A, will be paid on December 15 of the calendar year in which the fiscal year ends. The amount is not subject to a substantial risk of forfeiture and does not qualify as performance based compensation as described in §1.409A-1(e). The amount qualifies as fiscal year compensation. If Employee A elects to defer the payment of the amount related to the fiscal year ending September 30, 2008, to satisfy the requirements of this section Employee A must elect the time and form of payment not later than September 30, 2007.

Example 5. Initial election to defer bonus payable only if service provider completes at least 12 months of services after the election. Employee A is an individual employed by Employer X. Employer X has a calendar year fiscal year. On March 1, 2006, Employer X grants Employee A a \$10,000 bonus, payable on March 1, 2008, provided that Employee A continues performing services as an employee of Employer X through March 1, 2008. The amount does not qualify as performance-based compensation as described in §1.409A-1(e), and Employee A already participates in another account balance nonqualified deferred compensation plan. Employee A may make an initial deferral election on or before March 31, 2006 (within 30 days after obtaining a legally binding right), because at least 12 months of additional services are required after the date of election for the risk of forfeiture to lapse.

Example 6. Initial election to defer bonus that would otherwise constitute a short-term deferral. The same facts as Example 5, except that Employee A does not make an initial deferral election on or before March 31, 2006. Because the right to the compensation would not be treated as a deferral of compensation pursuant to §1.409A-1(b)(4) absent a deferral election (because the arrangement would be treated as a short-term deferral), Employee A may make an initial deferral election provided that the election may not become effective for 12 months and must defer the payment at least 5 years from March 1, 2008 (the first date the payment could become substantially vested). Accordingly, Employee A may make an election before March 1, 2007, provided that the election defers the payment to a date on or after March 1, 2013 (other than a payment due to death, disability, unforeseeable emergency, or a change in control event).

Example 7. Initial election to defer commissions. Employee A is an individual employed by Employer X. Employer X has a calendar year fiscal year. As part of Employee A's services for Employer X, Employee A sells refrigerators. Under the employment arrangement, Employee A is entitled to 10 percent

of the sales price of any refrigerator Employee A sells, payable only upon the receipt of payment from the customer who purchased the refrigerator. For purposes of the initial deferral rule, Employee A is treated as performing the services related to each refrigerator sale in the taxable year in which each customer pays for the refrigerator.

Example 8. Initial election to defer renewal commissions. The same facts as Example 7, except that Employee A also sells warranties related to the refrigerators sold. Under the warranty arrangement, refrigerator warranty customers are entitled in a future year to extend the warranty for an additional cost to be paid at the time of the extension. Under Employee A's arrangement with Employer X, Employee A is entitled to 10 percent of the amount paid for an extension of any warranty, payable upon the receipt of payment from the customer extending the warranty. For purposes of the initial deferral rule, Employee A is treated as performing the services related to the amount paid for the extension of the warranty in the taxable year in which the customer pays for the warranty extension.

Example 9. Initial election to defer negotiated separation pay. Employee A is an individual employed by Employer X. Under the terms of a separation pay arrangement, Employee A is entitled upon an involuntary separation from service to an amount equal to two weeks of pay for every year of service at Employer X. Employer X decides to terminate Employee A's employment involuntarily. As part of the process of terminating Employee A, Employer X enters into *bona fide*, arm's length negotiations with respect to the terms of Employee A's termination of employment. As part of the process, Employer X offers Employee A an amount that is in addition to any amounts to which Employee A is otherwise entitled, payable either as a lump sum payment at the end of three years or in three annual payments starting at the date of termination of employment. The election of the time and form of payment by Employee A may be made at any time before Employee A accepts the offer and obtains a legally binding right to the additional amount.

Example 10. Election of time and form of payments under a window program. Employee A is an individual employed by Employer X. Employer X establishes a window program, as defined in §1.409A-1(b)(9)(v). Individuals who elect to terminate employment under the window program are entitled to receive an amount equal to two weeks pay multiplied by every year of service with Employer X. The individuals participating in the window program may elect to receive the payment as either a lump sum payment payable on the first day of the month after making the election to participate in the window program, or as a payment of two equal annual installments on each January 1 of the first two years following the election to participate in the window program. Employee A is eligible to participate in the window program. Employee A may make the election as to the time and form of payment on or before the date Employee A's election to participate in the window program becomes irrevocable.

Example 11. Initial election to defer salary earned during final payroll period beginning in one calendar year and ending in the subsequent calendar year. Employee A performs services as an employee of Employer X. Employer X pays the salary of its

employees, including Employee A, on a bi-weekly basis. One bi-weekly payroll period runs from December 24, 2006, through January 6, 2007, with a scheduled payment date of January 13, 2001. Employer X sponsors, and Employee A participates in, a nonqualified deferred compensation arrangement under which Employee A may defer a specified percentage of his annual salary. The arrangement does not specify that any salary compensation paid for the payroll period in which falls January 1 is to be treated as compensation for services performed during the year preceding the year in which falls that January 1. For purposes of applying the initial deferral election rules, Employee A is deemed to have performed the services for the payroll period December 24, 2006, through January 6, 2007, during the calendar year 2007.

Example 12. Application of deferral election rules and anti-acceleration rules to a section 401(k) wrap plan. Employee A participates in a qualified retirement plan under section 401(a) with a qualified cash or deferred arrangement under section 401(k). Employee A also participates in a nonqualified deferred compensation arrangement. Under the terms of the nonqualified deferred compensation arrangement, Employee A elects, on or before December 31, to defer a specified percentage of his salary for the subsequent calendar year. Under the terms of the nonqualified deferred compensation arrangement and the qualified plan, as of the earliest date administratively practicable following the end of the year in which the salary is earned, the maximum amount that may be deferred under the qualified cash or deferred arrangement (not in excess of the amount specified under section 402(g) for the plan year) is credited to Employee A's account under the qualified plan, and Employee A's deferral under the nonqualified deferred compensation arrangement is reduced by a corresponding amount. The reduction has no effect on any other nonqualified deferred compensation arrangement in which Employee A participates. The reduction of Employee A's account under the nonqualified deferred compensation arrangement is not treated as an accelerated payment of deferred compensation for purposes of section 409A.

Example 13. Application of deferral election rules and anti-acceleration rules to a nonqualified deferred compensation arrangement linked to a qualified defined benefit plan. Employee A participates in a qualified retirement plan that is a defined benefit plan. Employee A also participates in a nonqualified deferred compensation arrangement, under which the benefit payable is calculated under a formula, with that benefit then reduced by any benefit which Employee A has accrued under the qualified retirement plan. In 2007, Employee A fails to elect a subsidized benefit under the qualified retirement plan, with the effect that the amounts payable under the nonqualified deferred compensation arrangement are increased relative to the lesser benefit payable under the qualified plan. Also, in 2007, Employer X amends the qualified retirement plan to increase benefits under the plan, resulting in a relative decrease in the amounts payable under the nonqualified deferred compensation arrangement relative to the greater benefit payable under the qualified plan. Neither of these actions constitute a deferral election or an acceleration of a payment under the nonqualified deferred compensation arrangement.

Example 14. Subsequent deferral election. Employee A participates in a nonqualified deferred compensation arrangement. Employee A elects to be paid in a lump sum payment at the earlier of age 65 or separation from service. Employee A anticipates that he will work after age 65, and wishes to defer payment to a later date. Provided that Employee A continues in employment and makes the election by his 64th birthday, Employee A may elect to receive a lump sum payment at the earlier of age 70 or separation from service.

Example 15. Grant of right to current payment of dividends paid with respect to restricted stock. Employer X grants Employee A stock that is not substantially vested for purposes of section 83, and Employee A does not make an election under section 83(b). As part of the restricted stock grant, Employee A receives the right to payments in an amount equal to the dividends payable with respect to the restricted stock. At the time Employer B grants Employee A the right to the dividend payments, the grant also specifies that each dividend payment will be made no later than the end of the calendar year in which the dividends are paid to shareholders of that class of stock or, if later, the 15th day of the third month following the date the dividends are paid to shareholders of that class of stock. The grant of the rights to dividend payments satisfies the requirement that deferred amounts be paid at a specified time or pursuant to a specified schedule.

Example 16. Subsequent deferral election rule — change in form of payment from lump sum payment to life annuity. Employee A participates in a nonqualified deferred compensation arrangement. Employee A elects to be paid in a lump sum payment at age 65. Employee A wishes to change the payment form to a life annuity. Provided that Employee A makes the election on or before his 64th birthday, Employee A may elect to receive a life annuity commencing at age 70.

Example 17. Subsequent deferral election rule — change in form of payment from life annuity to lump sum payment. Employee A participates in a nonqualified deferred compensation arrangement. Employee A elects to be paid in a life annuity at age 65. Employee A wishes to change the payment form to a lump sum payment. Provided that Employee A makes the election on or before his 64th birthday, Employee A may elect to receive a lump sum payment at age 70.

Example 18. Subsequent deferral election rule — installment payments designated as separate payments. Employee A participates in a nonqualified deferred compensation arrangement that provides for payment in a series of 5 equal annual amounts, each designated as a separate payment. The first payment is scheduled to be made on January 1, 2008. Provided that Employee A makes the election on or before January 1, 2007, Employee A may elect for the first payment to be made on January 1, 2013. If Employee A makes that election, the remaining payments may continue to be due upon January 1 of the four calendar years commencing on January 1, 2009.

Example 19. Subsequent deferral election rule — change in form of payment from installment payments to lump sum payment. Employee A participates in a nonqualified deferred compensation arrangement that provides for payment in a series of 5 equal annual amounts that are not designated as a series of

5 separate payments. The first amount is scheduled to be paid on January 1, 2008. Employee A wishes to receive the entire amount equal to the sum of all five of the amounts to be paid as a lump sum payment. Provided that Employee A makes the election on or before January 1, 2007, Employee A may elect to receive a lump sum payment on or after January 1, 2013.

Example 20. Subsequent deferral election rule — change in time of payment from payment at specified age to payment at later of specified age or separation from service. Employee A participates in a nonqualified deferred compensation arrangement that provides for a lump sum payment at age 65. Employee A wishes to add a payment provision such that the payment is payable upon the later of a predetermined age or separation from service. Provided that Employee A makes such election on or before his 64th birthday, Employee A may elect to receive a lump sum payment upon the later of age 70 or separation from service.

(c) *Special rules for certain resident aliens.* For the first calendar year in which an individual is classified as a resident alien, a nonqualified deferred compensation arrangement is deemed to meet the requirements of paragraph (a) of this section if, with respect to compensation payable for services performed during that first calendar year or with respect to compensation the right to which is subject to a substantial risk of forfeiture as of January 1 of that first calendar year, an initial deferral election is made by the end of such first calendar year, provided that the initial deferral election may not apply to amounts paid or first payable on or before the date of such initial deferral election. For any year subsequent to the first calendar year in which an individual is classified as a resident alien, this paragraph (c) does not apply, provided that a calendar year may again be treated as the first calendar year in which an individual is classified as a resident alien if such individual has not been classified as a resident alien for at least five consecutive calendar years immediately preceding the year in which the individual is again classified as a resident alien.

§1.409A-3 Permissible payments.

(a) *In general.* The requirements of this section are met only if the arrangement provides that an amount of deferred compensation may be paid only on account of one or more of the following:

(1) The service provider's separation from service (as defined in §1.409A-1(h)).

(2) The service provider becoming disabled (in accordance with paragraph (g)(4) of this section).

(3) The service provider's death.

(4) A time (or pursuant to a fixed schedule) specified under the plan (in accordance with paragraph (g)(1) of this section).

(5) A change in the ownership or effective control of the corporation, or in the ownership of a substantial portion of the assets of the corporation (in accordance with paragraph (g)(5) of this section).

(6) The occurrence of an unforeseeable emergency (in accordance with paragraph (g)(3) of this section).

(b) *Designation of payment upon a permissible payment event.* Except as otherwise specified in this section, an arrangement provides for the payment upon an event described in paragraph (a)(1), (2), (3), (5) or (6) of this section if the arrangement provides for a payment date that is objectively determinable at the time the event occurs (for example, 3 months following the date of initial disability or December 31 of the calendar year in which the disability first occurs). In addition, an arrangement may provide that a payment is to be made during an objectively determinable calendar year following the year in which the event occurs (for example, the calendar year following the year in which the service provider dies), provided that where no specific date within such calendar year is objectively determinable, the payment date is deemed to be January 1 of such calendar year for purposes of applying the subsequent deferral election rules of §1.409A-2(b). An arrangement may provide for payment upon the earliest or latest of more than one event, provided that each event is described in paragraphs (a)(1) through (6) of this section. An arrangement may also provide that a payment upon an event described in paragraph (a)(1), (2), (3), (5) or (6) of this section is to be made in accordance with a fixed schedule that is objectively determinable based on the date of the event, provided that the schedule must be fixed at the time the permissible payment event is designated, and any change in the fixed schedule will constitute a change in the time and form of payment. For example, an arrangement may provide that a service provider is entitled to three substantially equal payments payable

on each of the first three anniversaries of the date of the service provider's separation from service. In addition, an arrangement may provide that payments are to be made pursuant to a schedule of payments based upon objectively determinable calendar years following the year in which the event occurs, (for example, three substantially equal payments to be made during the three calendar years following the year in which the service provider dies), provided that where payment dates within such calendar years are not specified under the terms of the arrangement, the payment dates are deemed to be January 1 of such calendar years for purposes of applying the subsequent deferral election rules of §1.409A-2(b).

(c) *Designation of alternative specified dates or payment schedules based upon date of permissible event.* In general, in the case of an arrangement that provides that a payment upon an event described in paragraph (a)(1), (2), (3), (5) or (6) of this section is to be made on an objectively determinable date or year in accordance with paragraph (b) of this section, or in accordance with a fixed schedule that is objectively determinable based on the date of the event in accordance with paragraph (b) of this section, the objectively determined date or fixed schedule must apply consistently regardless of the date on which the specified event occurs. However, an arrangement may allow for an alternative payment schedule if the event occurs on or before one (but not more than one) specified date. For example, an arrangement may provide that a service provider will receive a lump sum payment of the service provider's entire benefit under the arrangement on the first day of the month following a separation from service before age 55, but will receive 5 substantially equal annual payments commencing on the first day of the month following a separation from service on or after age 55.

(d) *When a payment is treated as made upon the designated payment date.* Except as otherwise specified in this section, a payment is treated as made upon the date specified under the arrangement (including a date specified under paragraph (a)(4) of this section) if the payment is made at such date or a later date within the same calendar year or, if later, by the 15th day of the third calendar month following the date specified under the arrangement. If

calculation of the amount of the payment is not administratively practicable due to events beyond the control of the service provider (or service provider's estate), the payment will be treated as made upon the date specified under the arrangement if the payment is made during the first calendar year in which the payment is administratively practicable. Similarly, if the funds of the service recipient are not sufficient to make the payment at the date specified under the plan without jeopardizing the solvency of the service recipient, the payment will be treated as made upon the date specified under the arrangement if the payment is made during the first calendar year in which the funds of the service recipient are sufficient to make the payment without jeopardizing the solvency of the service recipient.

(e) *Disputed payments and refusals to pay.* If a payment is not made, in whole or in part, as of the date specified under the arrangement because the service recipient refuses to make such payment, the payment will be treated as made upon the date specified under the arrangement if the service provider accepts the portion (if any) of the payment that the service recipient is willing to make (unless such acceptance will result in a forfeiture of the claim to the remaining amount), makes prompt and reasonable, good faith efforts to collect the payment, and the payment is made during the first calendar year in which the service recipient and the service provider enter into a legally binding settlement of such dispute, the service recipient concedes that the amount is payable, or the service recipient is required to make such payment pursuant to a final and nonappealable judgment or other binding decision. For purposes of this paragraph (e), a service recipient is not treated as having refused to make a payment where pursuant to the terms of the plan the service provider is required to request payment, or otherwise provide information or take any other action, and the service provider has failed to take such action. In addition, for purposes of this paragraph (e), the service provider is deemed to have requested that a payment not be made, rather than the service recipient having refused to make such payment, where the service recipient's decision to refuse to make the payment is made by the service provider or a member of the service provider's family (as defined

in section 267(c)(4) applied as if the family of an individual includes the spouse of any member of the family), or any person or group of persons over whom the service provider or service provider's family member has effective control, or any person any portion of whose compensation is controlled by the service provider or service provider's family member.

(f) *Special rule for certain resident aliens.* An arrangement that is, or constitutes part of, a nonqualified deferred compensation plan is deemed to meet the requirements of this section with respect to any amount payable in the first calendar year in which a service provider is classified as a resident alien, and with respect to any amount payable in a subsequent calendar year if no later than the December 31 of the first calendar year in which the service provider is classified as a resident alien, the plan is amended as necessary so that the times and forms of payment of amounts payable in a subsequent year comply with the provisions of this section. For any year subsequent to the first calendar year in which an individual is classified as a resident alien, this paragraph (f) does not apply, provided that a calendar year may again be treated as the first calendar year in which an individual is classified as a resident alien if such individual has not been classified as a resident alien for at least five consecutive calendar years immediately preceding the year in which the service provider is again classified as a resident alien.

(g) *Definitions and special rules—(1) Specified time or fixed schedule.* Amounts are payable at a specified time or pursuant to a fixed schedule if objectively determinable amounts are payable at a date or dates that are objectively determinable at the time the amount is deferred. An amount is objectively determinable for this purpose if the amount is specifically identified or if the amount may be determined pursuant to a nondiscretionary formula (for example, 50 percent of an account balance). A specified time or fixed schedule also includes the designation of a calendar year or years that are objectively determinable at the time the amount is deferred, provided that for purposes of the application of the subsequent deferral rules contained in §1.409A-2(b), the specified time or fixed schedule of payments is deemed to refer to January 1 of the relevant

calendar year or years. An arrangement may provide that a payment upon the lapse of a substantial risk of forfeiture is to be made in accordance with a fixed schedule that is objectively determinable based on the date the substantial risk of forfeiture lapses (disregarding any acceleration of the lapsing of the substantial risk of forfeiture other than due to the occurrence of a condition applicable as of the date the legally binding right to the payment arose that itself would constitute a substantial risk of forfeiture), provided that the schedule must be fixed at the time the time and form of payment are designated, and any change in the fixed schedule will constitute a change in the time and form of payment. For example, an arrangement that provides for a bonus payment subject to the condition that the service provider complete three years of service, but provided further that such requirement of continued services would lapse upon the occurrence of an initial public offering that if applied alone would subject the right to the payment to a substantial risk of forfeiture, may provide that a service provider is entitled to substantially equal payments on each of the first three anniversaries of the date the substantial risk of forfeiture lapses (the earlier of three years of service or the date of an initial public offering).

(2) *Required delay in payment to a specified employee pursuant to a separation from service.* In the case of any specified employee (as defined in §1.409A-1(i)), the requirements of paragraph (a)(1) of this section permitting a payment upon a separation from service are satisfied only if payments may not be made before the date that is six months after the date of separation from service (or, if earlier, the date of death of the specified employee). The arrangement must provide the manner in which the six-month delay will be implemented in the case of a service provider who is a specified employee. For example, an arrangement may provide that payments to which a specified employee would otherwise be entitled during the first six months following the date of separation from service are accumulated and paid at another specified date or specified schedule, such as the first date of the seventh month following the date of separation from service. The arrangement may also provide that each installment payment to which a specified employee is

entitled upon a separation from service is delayed by six months. A service recipient may amend a plan at any time to change the method for applying the six-month delay, provided that the amendment may not be effective for a period of 12 months. Notwithstanding the foregoing, an amendment to a plan may be effective immediately in the case of a service recipient that amends the arrangement prior to the date upon which the service recipient's stock first becomes readily tradable on an established securities market. Notwithstanding the foregoing, this paragraph (g)(2) also does not apply to a payment made under the circumstances described in paragraph (h)(2)(i) (domestic relations order), (h)(2)(ii) (conflicts of interest), or (h)(2)(v) (payment of employment taxes) of this section.

(3) *Unforeseeable Emergency—(i) Definition.* For purposes of paragraph (a)(6) of this section, an unforeseeable emergency is a severe financial hardship of the service provider or beneficiary resulting from an illness or accident of the service provider or beneficiary, the service provider's or beneficiary's spouse, or the service provider's or beneficiary's dependent (as defined in section 152(a)); loss of the service provider's or beneficiary's property due to casualty (including the need to rebuild a home following damage to a home not otherwise covered by insurance, for example, as a result of a natural disaster); or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the service provider or beneficiary. For example, the imminent foreclosure of or eviction from the service provider's or beneficiary's primary residence may constitute an unforeseeable emergency. In addition, the need to pay for medical expenses, including non-refundable deductibles, as well as for the costs of prescription drug medication, may constitute an unforeseeable emergency. Finally, the need to pay for the funeral expenses of a spouse or a dependent (as defined in section 152(a)) may also constitute an unforeseeable emergency. Except as otherwise provided in this paragraph (g)(3)(i), the purchase of a home and the payment of college tuition are not unforeseeable emergencies. Whether a service provider or beneficiary is faced with an unforeseeable emergency permitting a distribution

under this paragraph is to be determined based on the relevant facts and circumstances of each case, but, in any case, a distribution on account of unforeseeable emergency may not be made to the extent that such emergency is or may be relieved through reimbursement or compensation from insurance or otherwise, by liquidation of the service provider's assets, to the extent the liquidation of such assets would not cause severe financial hardship, or by cessation of deferrals under the arrangement. An arrangement may provide for a payment upon any unforeseeable emergency, but does not have to provide for a payment upon all unforeseeable emergencies, provided that any event upon which a payment may be made qualifies as an unforeseeable emergency.

(ii) *Amount of payment permitted upon an unforeseeable emergency.* Distributions because of an unforeseeable emergency must be limited to the amount reasonably necessary to satisfy the emergency need (which may include amounts necessary to pay any Federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution). Determinations of amounts reasonably necessary to satisfy the emergency need must take into account any additional compensation that is available if the plan provides for cancellation of a deferral election upon a payment due to an unforeseeable emergency. See paragraph (h)(2)(vii) of this section. The payment may be made from any arrangement in which the service provider participates that provides for payment upon an unforeseeable emergency, provided that the arrangement under which the payment was made must be designated at the time of payment.

(4) *Disability—(i) In general.* For purposes of this section, a service provider is considered disabled if the service provider meets one of the following requirements:

(A) The service provider is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than 12 months.

(B) The service provider is, by reason of any medically determinable physical or mental impairment that can be expected to result in death or can be ex-

pected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than 3 months under an accident and health plan covering employees of the service provider's employer.

(ii) *Limited plan definition of disability.* An arrangement may provide for a payment upon any disability, and need not provide for a payment upon all disabilities, provided that any disability upon which a payment may be made under the arrangement complies with the provisions of this paragraph (g)(4).

(iii) *Determination of disability.* An arrangement may provide that a service provider will be deemed disabled if determined to be totally disabled by the Social Security Administration. An arrangement may also provide that a service provider will be deemed disabled if determined to be disabled in accordance with a disability insurance program, provided that the definition of disability applied under such disability insurance program complies with the requirements of this paragraph (g)(4).

(5) *Change in the ownership or effective control of a corporation, or a change in the ownership of a substantial portion of the assets of a corporation—(i) In general.* Pursuant to section 409A(a)(2)(A)(v), an arrangement may permit a payment upon the occurrence of a change in the ownership of the corporation (as defined in paragraph (g)(5)(v) of this section), a change in effective control of the corporation (as defined in paragraph (g)(5)(vi) of this section), or a change in the ownership of a substantial portion of the assets of the corporation (as defined in paragraph (g)(5)(vii) of this section) (collectively referred to as a change in control event). To qualify as a change in control event, the occurrence of the event must be objectively determinable and any requirement that any other person, such as a plan administrator or board of directors compensation committee, certify the occurrence of a change in control event must be strictly ministerial and not involve any discretionary authority. The arrangement may provide for a payment on any change in control event, and need not provide for a payment on all such events, provided that each event upon which a payment is provided qualifies as a change in control event. For rules regarding the ability of the service recipient to terminate the ar-

angement and pay amounts of deferred compensation upon a change in control event, see paragraph (h)(2)(viii)(B) of this section.

(ii) *Identification of relevant corporation—(A) In general.* To constitute a change in control event as to the service provider, the change in control event must relate to—

(1) The corporation for whom the service provider is performing services at the time of the change in control event;

(2) The corporation that is liable for the payment of the deferred compensation (or all corporations liable for the payment if more than one corporation is liable); or

(3) A corporation that is a majority shareholder of a corporation identified in paragraph (g)(5)(ii)(A)(1) or (2) of this section, or any corporation in a chain of corporations in which each corporation is a majority shareholder of another corporation in the chain, ending in a corporation identified in paragraph (g)(5)(ii)(A)(1) or (2) of this section.

(B) *Majority shareholder.* For purposes of this paragraph (g)(5)(ii), a majority shareholder is a shareholder owning more than 50 percent of the total fair market value and total voting power of such corporation.

(C) *Example.* The following example illustrates the rules of this paragraph (g)(5)(ii):

Example. Corporation A is a majority shareholder of Corporation B, which is a majority shareholder of Corporation C. A change in ownership of Corporation B constitutes a change in control event to service providers performing services for Corporation B or Corporation C, and to service providers for which Corporation B or Corporation C is solely liable for payments under the plan (for example, former employees), but is not a change in control event as to Corporation A or any other corporation of which Corporation A is a majority shareholder. Notwithstanding the foregoing, a sale of Corporation B may constitute an independent change in control event for Corporation A, Corporation B and Corporation C if the sale constitutes a change in the ownership of a substantial portion of Corporation A's assets (see paragraph (g)(5)(vii) of this section).

(iii) *Attribution of stock ownership.* For purposes of paragraph (g)(5) of this section, section 318(a) applies to determine stock ownership. Stock underlying a vested option is considered owned by the individual who holds the vested option (and the stock underlying an unvested option is not considered owned by the individual who holds the unvested option). For purposes of the preceding sentence,

however, if a vested option is exercisable for stock that is not substantially vested (as defined by §1.83-3(b) and (j)), the stock underlying the option is not treated as owned by the individual who holds the option.

(iv) *Special rule for certain delayed payments pursuant to a change in control event.* Compensation payable pursuant to the purchase by the service recipient of service recipient stock or a stock right held by a service provider, or payment of amounts of deferred compensation calculated by reference to the value of service recipient stock, may be treated as paid at a specified time or pursuant to a fixed schedule in conformity with the requirements of section 409A if paid on the same schedule and under the same terms and conditions as payments to shareholders generally pursuant to a change in control event described in paragraph (g)(5)(v) of this section (change in the ownership of a corporation) or as payments to the service recipient pursuant to a change in control event described in paragraph (g)(5)(vii) of this section (change in the ownership of a substantial portion of a corporation's assets), and any amounts paid pursuant to such a schedule and such terms and conditions will not be treated as violating the initial or subsequent deferral elections rules, to the extent that such amounts are paid not later than five years after the change in control event.

(v) *Change in the ownership of a corporation—(A) In general.* For purposes of section 409A, a change in the ownership of a corporation occurs on the date that any one person, or more than one person acting as a group (as defined in paragraph (g)(5)(v)(B) of this section), acquires ownership of stock of the corporation that, together with stock held by such person or group, constitutes more than 50 percent of the total fair market value or total voting power of the stock of such corporation. However, if any one person, or more than one person acting as a group, is considered to own more than 50 percent of the total fair market value or total voting power of the stock of a corporation, the acquisition of additional stock by the same person or persons is not considered to cause a change in the ownership of the corporation (or to cause a change in the effective control of the corporation (within the meaning of paragraph (g)(5)(vi) of this

section)). An increase in the percentage of stock owned by any one person, or persons acting as a group, as a result of a transaction in which the corporation acquires its stock in exchange for property will be treated as an acquisition of stock for purposes of this section. This section applies only when there is a transfer of stock of a corporation (or issuance of stock of a corporation) and stock in such corporation remains outstanding after the transaction (see paragraph (g)(5)(vii) of this section for rules regarding the transfer of assets of a corporation).

(B) *Persons acting as a group.* For purposes of paragraph (g)(5)(v)(A) of this section, persons will not be considered to be acting as a group solely because they purchase or own stock of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. If a person, including an entity, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation. See §1.280G-1, Q&A-27(d), *Example 4*.

(vi) *Change in the effective control of a corporation—(A) In general.* For purposes of section 409A, notwithstanding that a corporation has not undergone a change in ownership under paragraph (g)(5)(v) of this section, a change in the effective control of a corporation occurs only on the date that either—

(1) Any one person, or more than one person acting as a group (as determined under paragraph (g)(5)(v)(B) of this section), acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) ownership of stock of the corporation possessing 35 percent or more of the total voting power of the stock of such corporation; or

(2) A majority of members of the corporation's board of directors is replaced during any 12-month period by directors whose appointment or election is not en-

dorsed by a majority of the members of the corporation's board of directors prior to the date of the appointment or election, provided that for purposes of this paragraph (g)(5)(vi)(A) the term corporation refers solely to the relevant corporation identified in paragraph (g)(5)(ii) of this section, for which no other corporation is a majority shareholder for purposes of that paragraph (for example, if Corporation A is a publicly held corporation with no majority shareholder, and Corporation A is the majority shareholder of Corporation B, which is the majority shareholder of Corporation C, the term corporation for purposes of this paragraph (g)(5)(vi)(A)(2) would refer solely to Corporation A).

(B) *Multiple change in control events.* A change in effective control also may occur in any transaction in which either of the two corporations involved in the transaction has a change in control event under paragraphs (g)(5)(v) or (g)(5)(vii) of this section. Thus, for example, assume Corporation P transfers more than 40 percent of the total gross fair market value of its assets to Corporation O in exchange for 35 percent of O's stock. P has undergone a change in ownership of a substantial portion of its assets under paragraph (g)(5)(vii) of this section and O has a change in effective control under this paragraph (g)(5)(vi) of this section.

(C) *Acquisition of additional control.* If any one person, or more than one person acting as a group, is considered to effectively control a corporation (within the meaning of this paragraph (g)(5)(vi)), the acquisition of additional control of the corporation by the same person or persons is not considered to cause a change in the effective control of the corporation (or to cause a change in the ownership of the corporation within the meaning of paragraph (g)(5)(v) of this section).

(D) *Persons acting as a group.* Persons will not be considered to be acting as a group solely because they purchase or own stock of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. If a person, including an entity, owns stock in both corporations that enter into a merger, consol-

idation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only with respect to the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation. See §1.280G-1, Q&A-27(d), *Example 4*.

(vii) *Change in the ownership of a substantial portion of a corporation's assets—(A) In general.* Change in the ownership of a substantial portion of a corporation's assets. For purposes of section 409A, a change in the ownership of a substantial portion of a corporation's assets occurs on the date that any one person, or more than one person acting as a group (as determined in paragraph (g)(5)(v)(B) of this section), acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) assets from the corporation that have a total gross fair market value equal to or more than 40 percent of the total gross fair market value of all of the assets of the corporation immediately prior to such acquisition or acquisitions. For this purpose, gross fair market value means the value of the assets of the corporation, or the value of the assets being disposed of, determined without regard to any liabilities associated with such assets.

(B) *Transfers to a related person—(1)* There is no change in control event under this paragraph (g)(5)(vii) when there is a transfer to an entity that is controlled by the shareholders of the transferring corporation immediately after the transfer, as provided in this paragraph (g)(5)(vii)(B). A transfer of assets by a corporation is not treated as a change in the ownership of such assets if the assets are transferred to—

(i) A shareholder of the corporation (immediately before the asset transfer) in exchange for or with respect to its stock;

(ii) An entity, 50 percent or more of the total value or voting power of which is owned, directly or indirectly, by the corporation;

(iii) A person, or more than one person acting as a group, that owns, directly or indirectly, 50 percent or more of the total value or voting power of all the outstanding stock of the corporation; or

(iv) An entity, at least 50 percent of the total value or voting power of which is owned, directly or indirectly,

by a person described in paragraph (g)(5)(vii)(B)(I)(iii) of this section.

(2) For purposes of this paragraph (g)(5)(vii)(B) and except as otherwise provided, a person's status is determined immediately after the transfer of the assets. For example, a transfer to a corporation in which the transferor corporation has no ownership interest before the transaction, but which is a majority-owned subsidiary of the transferor corporation after the transaction is not treated as a change in the ownership of the assets of the transferor corporation.

(C) *Persons acting as a group.* Persons will not be considered to be acting as a group solely because they purchase assets of the same corporation at the same time. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of assets, or similar business transaction with the corporation. If a person, including an entity shareholder, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of assets, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only to the extent of the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation. See 1.280G-1, Q&A-27(d), *Example 4*.

(6) *Certain back-to-back arrangements—(i) In general.* Notwithstanding the generally applicable limitations on payments described under paragraph (a) of this section, an arrangement between a service recipient and a service provider that is also a service recipient (a service provider/service recipient) may provide for payment upon the occurrence of a payment event described in paragraph (a)(1), (2), (3), (5) or (6) of this section, where the time and form of payment is defined as the same time and form of payment provided under an arrangement subject to section 409A between the service provider/service recipient and a specified service provider to the service provider/service recipient, if the arrangement between the service provider/service recipient and the service recipient expressly provides for such time and form of payment and otherwise satisfies the requirements of section 409A.

(ii) *Example.* The provisions of this paragraph (g)(6) are illustrated by the following example:

Example. Company B (service provider/service recipient) provides services to Company C (service recipient). Employee A (service provider) provides services to Company B. Pursuant to a nonqualified deferred compensation plan meeting the requirements of section 409A, Employee A is entitled to a payment of deferred compensation upon a separation from service from Company B. Under an arrangement between Company B and Company C, Company C agrees to pay an amount of deferred compensation to Company B upon Employee A's separation from service from Company B, in accordance with the time and form of payment provided in the nonqualified deferred compensation plan between Employee A and Company B. Provided that the arrangement between Company B and Company C and the arrangement between Employee A and Company B otherwise comply with the requirements of section 409A, Company C's payment to Company B of the amount due upon the separation from service of Employee A from Company B may constitute a permissible payment event for purposes of paragraph (a) of this section.

(h) *Prohibition on acceleration of payments—(1) In general.* Except as provided in paragraph (h)(2) of this section, an arrangement that is, or constitutes part of, a nonqualified deferred compensation plan may not permit the acceleration of the time or schedule of any payment or amount scheduled to be paid pursuant to a payment under the arrangement. For purposes of this paragraph (h), an impermissible acceleration does not occur if payment is made in accordance with plan provisions or an election as to the time and form of payment in effect at the time of initial deferral (or added in accordance with the rules applicable to subsequent deferral elections under §1.409A-2(b)) pursuant to which payment is required to be made on an accelerated schedule as a result of an intervening event that is an event described in paragraph (a)(1), (2), (3), (5) or (6) of this section. For example, a plan may provide that a participant will receive six installment payments commencing at separation from service, and also provide that if the participant dies after such payments commence but before all payments have been made, all remaining amounts will be paid in a lump sum payment. Additionally, it is not an acceleration of the time or schedule of payment of a deferral of compensation if a service recipient waives or accelerates the satisfaction of a condition constituting a substantial risk of forfeiture applicable to such deferral of compensation, provided that the requirements of section

409A (including the requirement that the payment be made upon a permissible payment event) are otherwise satisfied with respect to such deferral of compensation. For example, if a nonqualified deferred compensation arrangement provides for a lump sum payment of the vested benefit upon separation from service, and the benefit vests under the plan only after 10 years of service, it is not a violation of the requirements of section 409A if the service recipient reduces the vesting requirement to 5 years of service, even if a service provider becomes vested as a result and receives a payment in connection with a separation from service before the service provider would have completed 10 years of service.

(2) *Exceptions—(i) Domestic relations order.* An arrangement may permit such acceleration of the time or schedule of a payment under the arrangement to an individual other than the service provider as may be necessary to fulfill a domestic relations order (as defined in section 414(p)(1)(B)).

(ii) *Conflicts of interest.* An arrangement may permit such acceleration of the time or schedule of a payment under the arrangement as may be necessary to comply with a certificate of divestiture (as defined in section 1043(b)(2)).

(iii) *Section 457 plans.* An arrangement subject to section 457(f) may permit an acceleration of the time or schedule of a payment to a service provider to pay Federal, state, local and foreign income taxes due upon a vesting event, provided that the amount of such payment is not more than an amount equal to the Federal, state, local and foreign income tax withholding that would have been remitted by the employer if there had been a payment of wages equal to the income includible by the service provider under section 457(f) at the time of the vesting.

(iv) *De minimis and specified amounts—(A) In general.* An arrangement that does not otherwise provide for mandatory lump sum payments of benefits that do not exceed a specified amount may be amended to permit the acceleration of the time or schedule of a payment to a service provider under the arrangement, provided that—

(I) The payment accompanies the termination of the entirety of the service provider's interest in the arrangement, and

all similar arrangements that would constitute a nonqualified deferred compensation plan under §1.409A-1(c);

(2) The payment is made on or before the later of December 31 of the calendar year in which occurs the service provider's separation from service from the service recipient, or the 15th day of the third month following the service provider's separation from service from the service recipient;

(3) The payment is not greater than \$10,000; and

(4) The participant is provided no election with respect to receipt of the lump sum payment.

(B) *Prospective deferrals.* An amendment described in paragraph (h)(2)(iv)(A) of this section may be made with respect to previously deferred amounts under the arrangement as well as amounts to be deferred in the future. In addition, a nonqualified deferred compensation arrangement that otherwise complies with section 409A may provide, or be amended with regard to future deferrals to provide, that, if a service provider's interest under the arrangement has a value below an amount specified by the plan at the time that amounts are payable under the plan, then the service provider's entire interest under the plan must be distributed as a lump sum payment. However, once such a payment feature applies to an amount deferred, any change or elimination of such feature is subject to the rules governing changes in the time and form of payment.

(v) *Payment of employment taxes.* An arrangement may permit the acceleration of the time or schedule of a payment to pay the Federal Insurance Contributions Act (FICA) tax imposed under section 3101, section 3121(a) and section 3121(v)(2), where applicable, on compensation deferred under the arrangement (the FICA Amount). Additionally, an arrangement may permit the acceleration of the time or schedule of a payment to pay the income tax at source on wages imposed under section 3401 or the corresponding withholding provisions of applicable state, local, or foreign tax laws as a result of the payment of the FICA Amount, and to pay the additional income tax at source on wages attributable to the pyramiding section 3401 wages and taxes. However, the total payment under this acceleration provision must not exceed the aggregate

of the FICA Amount, and the income tax withholding related to such FICA Amount.

(vi) *Payments upon income inclusion under section 409A.* An arrangement may permit the acceleration of the time or schedule of a payment to a service provider under the plan at any time the arrangement fails to meet the requirements of section 409A and these regulations. Such payment may not exceed the amount required to be included in income as a result of the failure to comply with the requirements of section 409A and the regulations.

(vii) *Cancellation of deferrals following an unforeseeable emergency or hardship distribution.* An arrangement may permit a cancellation of a service provider's deferral election due to an unforeseeable emergency or a hardship distribution pursuant to §1.401(k)-1(d)(3). The deferral election must be cancelled, and not postponed or otherwise delayed, such that any later deferral election will be subject to the provisions governing initial deferral elections. See §1.409A-2(a).

(viii) *Arrangement terminations.* An arrangement may permit an acceleration of the time and form of a payment where the right to the payment arises due to a termination of the arrangement in accordance with one of the following:

(A) The service recipient's discretion under the terms of the arrangement to terminate the arrangement within 12 months of a corporate dissolution taxed under section 331, or with the approval of a bankruptcy court pursuant to 11 U.S.C. §503(b)(1)(A), provided that the amounts deferred under the plan are included in the participants' gross incomes in the latest of—

(1) The calendar year in which the plan termination occurs;

(2) The calendar year in which the amount is no longer subject to a substantial risk of forfeiture; or

(3) The first calendar year in which the payment is administratively practicable.

(B) The service recipient's discretion under the terms of the arrangement to terminate the arrangement within the 30 days preceding or the 12 months following a change in control event (as defined in §1.409A-3(g)(5)(i)). For purposes of this paragraph (h)(2)(viii), an arrangement will be treated as terminated only if all substantially similar arrangements sponsored by the service recipient are terminated, so

that the participant in the arrangement and all participants under substantially similar arrangements are required to receive all amounts of compensation deferred under the terminated arrangements within 12 months of the date of termination of the arrangements.

(C) The service recipient's discretion under the terms of the arrangement to terminate the arrangement, provided that—

(1) All arrangements sponsored by the service recipient that would be aggregated with any terminated arrangement under §1.409A-1(c) if the same service provider participated in all of the arrangements are terminated;

(2) No payments other than payments that would be payable under the terms of the arrangements if the termination had not occurred are made within 12 months of the termination of the arrangements;

(3) All payments are made within 24 months of the termination of the arrangements; and

(4) The service recipient does not adopt a new arrangement that would be aggregated with any terminated arrangement under §1.409A-1(c) if the same service provider participated in both arrangements, at any time within five years following the date of termination of the arrangement.

(D) Such other events and conditions as the Commissioner may prescribe in generally applicable guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(ix) *Certain distributions to avoid a nonallocation year under section 409(p).* An arrangement may provide for an acceleration of payment to prevent the occurrence of a nonallocation year (within the meaning of section 409(p)(3)) in the plan year of the employee stock ownership plan next following the current plan year, provided that the amount distributed may not exceed 125 percent of the minimum amount of distribution necessary to avoid the occurrence of a nonallocation year. Solely for purposes of determining permissible distributions under this paragraph (h)(2)(ix), synthetic equity (within the meaning of section 409(p)(6)(C)) granted during the current employee stock ownership plan plan year is disregarded for purposes of determining whether the subsequent plan year would result in a nonallocation year.

(3) *Nonqualified deferred compensation arrangements linked to qualified plans.* With respect to amounts deferred under an arrangement that is, or constitutes part of, a nonqualified deferred compensation plan, where under the terms of the nonqualified deferred compensation arrangement the amount deferred under the plan is the amount determined under the formula determining benefits under a qualified employer plan (as defined in §1.409A-1(a)(2)) applied without respect to one or more limitations applicable to qualified employer plans under the Internal Revenue Code or other applicable law, or is determined as an amount offset by some or all of the benefits provided under the qualified employer plan, the operation of the qualified employer plan with respect to changes in benefit limitations applicable to qualified employer plans under the Internal Revenue Code or other applicable law, does not constitute an acceleration of a payment under the nonqualified deferred compensation arrangement regardless of whether such operation results in a decrease of amounts deferred under the nonqualified deferred compensation arrangement. In addition, with respect to such nonqualified deferred compensation arrangements, the following actions or failures to act will not constitute an acceleration of a payment under the nonqualified deferred compensation arrangement regardless of whether in accordance with the terms of the nonqualified deferred compensation arrangement, the actions or inactions result in a decrease in the amounts deferred under the arrangement:

(i) A service provider's action or inaction under the qualified employer plan with respect to whether to elect to receive a subsidized benefit or an ancillary benefit under the qualified employer plan.

(ii) The amendment of a qualified employer plan to increase benefits provided under the qualified plan, or to add or remove a subsidized benefit or an ancillary benefit.

(iii) A service provider's action or inaction with respect to an elective deferral election under a qualified employer plan subject to section 402(g), including an adjustment to a deferral election made during a calendar year, provided that for any given calendar year, the service provider's actions or inactions do not re-

sult in a decrease in the amounts deferred under all nonqualified deferred compensation plans in which the service provider participates in excess of an amount equal to the limit with respect to elective deferrals under section 402(g) in effect for the taxable year in which such action or inaction occurs.

(iv) A service provider's action or inaction under a qualified employer plan with respect to elective deferrals or after-tax contributions by the service provider to the qualified employer plan that affects the amounts that are credited under a nonqualified deferred compensation arrangement as matching amounts or other amounts contingent on service provider elective deferrals or after-tax contributions, provided that such matching or contingent amounts, as applicable, are either forfeited or never credited under the nonqualified deferred compensation arrangement in the absence of such service provider's elective deferral or after-tax contribution, and provided further that for any given calendar year, the service provider's actions and inactions do not result in a decrease in the amounts deferred under all nonqualified deferred compensation plans in which the service provider participates in excess of an amount equal to the limit with respect to elective deferrals under section 402(g) in effect for the taxable year in which such action or inaction occurs. See §1.409A-2(b)(6), *Example 12* and *Example 13*.

§1.409A-4 Calculation of income inclusion. [Reserved].

§1.409A-5 Funding. [Reserved].

§1.409A-6 Statutory effective dates.

(a) *Statutory effective dates—(1) In general.* Except as otherwise provided in this section, section 409A is effective with respect to amounts deferred in taxable years beginning after December 31, 2004, and amounts deferred in taxable years beginning before January 1, 2005, if the plan under which the deferral is made is materially modified after October 3, 2004. Section 409A is effective with respect to earnings on amounts deferred only to the extent that section 409A is effective with respect to the amounts deferred. Accordingly, section 409A is not effective with respect to earnings on amounts

deferred before January 1, 2005, unless section 409A is effective with respect to the amounts deferred.

(2) *Identification of date of deferral for statutory effective date purposes.* For purposes of determining whether section 409A is applicable with respect to an amount, the amount is considered deferred before January 1, 2005, if before January 1, 2005, the service provider had a legally binding right to be paid the amount, and the right to the amount was earned and vested. For purposes of this paragraph (a)(2), a right to an amount was earned and vested only if the amount was not subject to a substantial risk of forfeiture (as defined in §1.83-3(c)) or a requirement to perform further services. Amounts to which the service provider did not have a legally binding right before January 1, 2005 (for example because the service recipient retained discretion to reduce the amount), will not be considered deferred before January 1, 2005. In addition, amounts to which the service provider had a legally binding right before January 1, 2005, but the right to which was subject to a substantial risk of forfeiture or a requirement to perform further services after December 31, 2004, are not considered deferred before January 1, 2005, for purposes of the effective date. Notwithstanding the foregoing, an amount to which the service provider had a legally binding right before January 1, 2005, but for which the service provider was required to continue performing services to retain the right only through the completion of the payroll period (as defined in §1.409A-1(b)(3)) that includes December 31, 2004, is not treated as subject to a requirement to perform further services (or a substantial risk of forfeiture) for purposes of the effective date. For purposes of this paragraph (a)(2), a stock option, stock appreciation right or similar compensation that on or before December 31, 2004, was immediately exercisable for cash or substantially vested property (as defined in §1.83-3(b)) is treated as earned and vested, regardless of whether the right would terminate if the service provider ceased providing services for the service recipient.

(3) *Calculation of amount of compensation deferred for statutory effective date purposes—(i) Nonaccount balance plans.* The amount of compensation deferred before January 1, 2005, under a nonqual-

ified deferred compensation plan that is a nonaccount balance plan (as defined in §31.3121(v)(2)–1(c)(2)(i) of this chapter) equals the present value as of December 31, 2004, of the amount to which the service provider would be entitled under the plan if the service provider voluntarily terminated services without cause on December 31, 2004, and received a payment of the benefits with the maximum value available from the plan on the earliest possible date allowed under the plan to receive a payment of benefits following the termination of services. Notwithstanding the foregoing, for any subsequent calendar year, the grandfathered amount may increase to equal the present value of the benefit the service provider actually becomes entitled to, determined under the terms of the plan (including applicable limits under the Internal Revenue Code), as in effect on October 3, 2004, without regard to any further services rendered by the service provider after December 31, 2004, or any other events affecting the amount of or the entitlement to benefits (other than a participant election with respect to the time or form of an available benefit).

(ii) *Account balance plans.* The amount of compensation deferred before January 1, 2005, under a nonqualified deferred compensation plan that is an account balance plan (as defined in §31.3121(v)(2)–1(c)(1)(ii) of this chapter) equals the portion of the service provider's account balance as of December 31, 2004, the right to which is earned and vested (as defined in paragraph (a)(2) of this section) as of December 31, 2004.

(iii) *Equity-based compensation plans.* For purposes of determining the amounts deferred before January 1, 2005, under an equity-based compensation plan, the rules of paragraph (a)(3)(ii) of this section governing account balance plans are applied except that the account balance is deemed to be the amount of the payment available to the service provider on December 31, 2004 (or that would be available to the service provider if the right were immediately exercisable) the right to which is earned and vested (as defined in paragraph (a)(2) of this section) as of December 31, 2004. For this purpose, the payment available to the service provider excludes any exercise price or other amount that must be paid by the service provider.

(iv) *Earnings.* Earnings on amounts deferred under a plan before January 1, 2005, include only income (whether actual or notional) attributable to the amounts deferred under a plan as of December 31, 2004, or such income. For example, notional interest earned under the plan on amounts deferred in an account balance plan as of December 31, 2004, generally will be treated as earnings on amounts deferred under the plan before January 1, 2005. Similarly, an increase in the amount of payment available pursuant to a stock option, stock appreciation right or other equity-based compensation above the amount of payment available as of December 31, 2004, due to appreciation in the underlying stock after December 31, 2004, or accrual of other earnings such as dividends, is treated as earnings on the amount deferred. In the case of a nonaccount balance plan, earnings include the increase, due solely to the passage of time, in the present value of the future payments to which the service provider has obtained a legally binding right, the present value of which constituted the amounts deferred under the plan before January 1, 2005. Thus, for each year, there will be an increase (determined using the same interest rate used to determine the amounts deferred under the plan before January 1, 2005) resulting from the shortening of the discount period before the future payments are made, plus, if applicable, an increase in the present value resulting from the service provider's survivorship during the year. However, an increase in the potential benefits under a nonaccount balance plan due to, for example, an application of an increase in compensation after December 31, 2004, to a final average pay plan or subsequent eligibility for an early retirement subsidy, does not constitute earnings on the amounts deferred under the plan before January 1, 2005.

(v) *Definition of plan.* For purposes of this paragraph (a), the term *plan* has the same meaning provided in §1.409A–1(c), except that the provisions treating all nonaccount balance plans under which compensation is deferred as a single plan does not apply for purposes of the actuarial assumptions used in paragraph (a)(3)(ii) of this section. Accordingly, different reasonable actuarial assumptions may be used to calculate the amounts deferred by a service provider in two different ar-

rangements each of which constitutes a nonaccount balance plan.

(4) *Material modifications*—(i) *In general.* Except as otherwise provided, a modification of a plan is a material modification if a benefit or right existing as of October 3, 2004, is materially enhanced or a new material benefit or right is added, and such material enhancement or addition affects amounts earned and vested before January 1, 2005. Such material benefit enhancement or addition is a material modification whether it occurs pursuant to an amendment or the service recipient's exercise of discretion under the terms of the plan. For example, an amendment to a plan to add a provision that payments of deferred amounts earned and vested before January 1, 2005, may be allowed upon request if service providers are required to forfeit 20 percent of the amount of the payment (a haircut) would be a material modification to the plan. Similarly, a material modification would occur if a service recipient exercised discretion to accelerate vesting of a benefit under the plan to a date on or before December 31, 2004. However, it is not a material modification for a service recipient to exercise discretion over the time and manner of payment of a benefit to the extent such discretion is provided under the terms of the plan as of October 3, 2004. It is not a material modification for a service provider to exercise a right permitted under the plan as in effect on October 3, 2004. The amendment of a plan to bring the plan into compliance with the provisions of section 409A will not be treated as a material modification. However, a plan amendment or the exercise of discretion under the terms of the plan that materially enhances an existing benefit or right or adds a new material benefit or right will be considered a material modification even if the enhanced or added benefit would be permitted under section 409A. For example, the addition of a right to a payment upon an unforeseeable emergency of an amount earned and vested before January 1, 2005, would be considered a material modification. The reduction of an existing benefit is not a material modification. For example, the removal of a haircut provision generally would not constitute a material modification. The establishment of or contributions to a trust or other arrangement from which benefits under the plan are to be paid is not a material

modification of the plan, provided that the contribution to the trust or other arrangement would not otherwise cause an amount to be includible in the service provider's gross income.

(ii) *Adoptions of new arrangements.* It is presumed that the adoption of a new arrangement or the grant of an additional benefit under an existing arrangement after October 3, 2004, and before January 1, 2005, constitutes a material modification of a plan. However, the presumption may be rebutted by demonstrating that the adoption of the arrangement or grant of the additional benefit is consistent with the service recipient's historical compensation practices. For example, the presumption that the grant of a discounted stock option on November 1, 2004, is a material modification of a plan may be rebutted by demonstrating that the grant was consistent with the historic practice of granting substantially similar discounted stock options (both as to terms and amounts) each November for a significant number of years. Notwithstanding paragraph (a)(4)(i) and this paragraph (a)(4)(ii), the grant of an additional benefit under an existing arrangement that consists of a deferral of additional compensation not otherwise provided under the plan as of October 3, 2004, will be treated as a material modification of the plan only as to the additional deferral of compensation, if the plan explicitly identifies the additional deferral of compensation and provides that the additional deferral of compensation is subject to section 409A. Accordingly, amendments to conform a plan to the requirements of section 409A with respect to deferrals under a plan occurring after December 31, 2004, will not constitute a material modification of the plan with respect to amounts deferred that are earned and vested on or before December 31, 2004, provided that there is no concurrent material modification with respect to the amount of, or rights to, amounts deferred

that were earned and vested on or before December 31, 2004. Similarly, a grant of an additional benefit under a new arrangement adopted after October 3, 2004, and before January 1, 2005, will not be treated as a material modification of an existing plan to the extent that the new arrangement explicitly identifies additional deferrals of compensation and provides that the additional deferrals of compensation are subject to section 409A.

(iii) *Suspension or termination of a plan.* A cessation of deferrals under, or termination of, a plan, pursuant to the provisions of such plan, is not a material modification. Amending an arrangement to stop future deferrals thereunder is not a material modification of the arrangement or the plan. Amending an arrangement to provide participants an election whether to terminate participation in a plan constitutes a material modification of the plan.

(iv) *Changes to investment measures—account balance plans.* With respect to an account balance plan (as defined in §31.3121(v)(2)–1(c)(1)(ii) of this chapter), it is not a material modification to change a notional investment measure to, or to add to existing investment measures, an investment measure that qualifies as a predetermined actual investment within the meaning of §31.3121(v)(2)–1(d)(2) of this chapter or, for any given taxable year, reflects a reasonable rate of interest (determined in accordance with §31.3121(v)(2)–1(d)(2)(i)(C) of this chapter). For this purpose, if with respect to an amount deferred for a period, a plan provides for a fixed rate of interest to be credited, and the rate is to be reset under the plan at a specified future date that is not later than the end of the fifth calendar year that begins after the beginning of the period, the rate is reasonable at the beginning of the period, and the rate is not changed before the reset date, then the rate will be treated as reasonable in all future periods before the reset date.

(v) *Rescission of modifications.* Any modification to the terms of a plan that would inadvertently result in treatment as a material modification under this section is not considered a material modification of the plan to the extent the modification in the terms of the plan is rescinded by the earlier of a date before the right is exercised (if the change grants a discretionary right) or the last day of the calendar year during which such change occurred. Thus, for example, if a service recipient modifies the terms of a plan on March 1 to allow an election of a new change in the time or form of payment without realizing that such a change constituted a material modification that would subject the plan to the requirements of section 409A, and the modification is rescinded on November 1, then if no change in the time or form of payment has been made pursuant to the modification before November 1, the plan is not considered materially modified under this section.

(vi) *Definition of plan.* For purposes of this paragraph (a)(4), the term *plan* has the same meaning provided in §1.409A–1(c), except that the provision treating all account balance plans under which compensation is deferred as a single plan, all nonaccount balance plans under which compensation is deferred as a separate single plan, all separation pay arrangements due to an actual involuntary separation from service or participation in a window program as a separate single plan, and all other nonqualified deferred compensation plans as a separate single plan, does not apply.

(b) [Reserved].

Mark E. Matthews,
Deputy Commissioner for
Services and Enforcement.

(Filed by the Office of the Federal Register on September 29, 2005, 8:45 a.m., and published in the issue of the Federal Register for October 4, 2005, 70 F.R. 57929)

Announcement of Disciplinary Actions Involving Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries — Suspensions, Censures, Disbarments, and Resignations

Announcement 2005-76

Under Title 31, Code of Federal Regulations, Part 10, attorneys, certified public accountants, enrolled agents, and enrolled actuaries may not accept assistance from, or assist, any person who is under disbarment or suspension from practice before the Internal Revenue Service if the assistance relates to a matter constituting practice before the Internal Revenue Service and may not knowingly aid or abet another

person to practice before the Internal Revenue Service during a period of suspension, disbarment, or ineligibility of such other person.

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify persons to whom these restrictions apply, the Director, Office of Professional Responsibility, will announce in the Internal Revenue Bulletin

their names, their city and state, their professional designation, the effective date of disciplinary action, and the period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks.

Consent Suspensions From Practice Before the Internal Revenue Service

Under Title 31, Code of Federal Regulations, Part 10, an attorney, certified public accountant, enrolled agent, or enrolled actuary, in order to avoid the institution or conclusion of a proceeding for his or her disbarment or suspension from practice before the Internal Revenue Service,

may offer his or her consent to suspension from such practice. The Director, Office of Professional Responsibility, in his discretion, may suspend an attorney, certified public accountant, enrolled agent, or enrolled actuary in accordance with the consent offered.

The following individuals have been placed under consent suspension from practice before the Internal Revenue Service:

Name	Address	Designation	Date of Suspension
Reagan, John	Cortland, NY	CPA	Indefinite from June 24, 2005
Harris, Alexander W.	Chicago, IL	Attorney	July 1, 2005 to December 31, 2005
Belush, Glen J.	Monroe, CT	CPA	Indefinite from July 15, 2005
Lamont, Alice	Atlanta, GA	CPA	Indefinite from July 15, 2005
Morse, Kyle K.	Bedford, TX	CPA	Indefinite from July 22, 2005
Duggan Jr., Joseph A.	Jacksonville, OR	Enrolled Agent	Indefinite from August 1, 2005

Name	Address	Designation	Date of Suspension
Harper, Ivan	Brooklyn, NY	CPA	Indefinite from August 15, 2005
Bandy, Robert M.	Tyler, TX	Attorney	Indefinite from August 24, 2005
Peterson, Stanley	Springfield, PA	CPA	Indefinite from August 26, 2005
Shorten, Judy	Vacaville, CA	Enrolled Agent	Indefinite from September 1, 2005
Watkins, David E.	Shelbyville, IN	Enrolled Agent	Indefinite from September 1, 2005

Expedited Suspensions From Practice Before the Internal Revenue Service

Under Title 31, Code of Federal Regulations, Part 10, the Director, Office of Professional Responsibility, is authorized to immediately suspend from practice before the Internal Revenue Service any practitioner who, within five years from the date

the expedited proceeding is instituted (1) has had a license to practice as an attorney, certified public accountant, or actuary suspended or revoked for cause or (2) has been convicted of certain crimes.

The following individuals have been placed under suspension from practice before the Internal Revenue Service by virtue of the expedited proceeding provisions:

Name	Address	Designation	Date of Suspension
Leong, Thomas S.	Honolulu, HI	Attorney	Indefinite from July 11, 2005
Clark, Mark S.	Tucson, AZ	Attorney	Indefinite from July 11, 2005
Hudspeth, George E.	St. Louis, MO	Attorney	Indefinite from July 11, 2005
Dodd, Alan F.	Westborough, MA	Attorney	Indefinite from July 11, 2005
Crews, James F.	Tipton, MO	Attorney	Indefinite from July 11, 2005
Luparella, Joseph	Hoboken, NJ	CPA	Indefinite from July 13, 2005

Name	Address	Designation	Date of Suspension
Deutchman, Murray	Barnesville, MD	Attorney	Indefinite from July 13, 2005
Cozier, Clifford G.	Englewood, CO	Attorney	Indefinite from July 13, 2005
Segall, Steven M.	Denver, CO	Attorney	Indefinite from July 14, 2005
Richardson, Bruce	Reisterstown, MD	Attorney	Indefinite from July 15, 2005
Parsley, Jeffrey A.	Englewood, CO	Attorney	Indefinite from July 15, 2005
Wyrick, Richard L.	Hanford, CA	Attorney	Indefinite from July 15, 2005
Coates, Marsden S.	Baltimore, MD	Attorney	Indefinite from July 15, 2005
McCampbell, Daniel	Chico, CA	Attorney	Indefinite from July 15, 2005
Ralston, Ronald G.	Fairmount, GA	CPA	Indefinite from July 18, 2005
Friemann, Robert F.	Huntington Bay, NY	CPA	Indefinite from July 18, 2005
Friedman, Milton G.	Ft. Lauderdale, FL	CPA	July 25, 2005 to January 24, 2007
Acheampong, Robert	Columbus, OH	CPA	Indefinite from July 26, 2005
Elias, Robert F.	Canfield, OH	Attorney	Indefinite from July 27, 2005
Stover, Kathy A.	Topeka, KS	Attorney	Indefinite from July 29, 2005
Leffler, Fredric D.	Columbia, MD	Attorney	Indefinite from July 29, 2005

Name	Address	Designation	Date of Suspension
Harmon, Anthony N.	Batavia, IL	Attorney	Indefinite from July 29, 2005
Hames, David H.	Dallas, TX	CPA	Indefinite from August 2, 2005
Au, Ronald G.S.	Honolulu, HI	Attorney	Indefinite from August 9, 2005
Tilton Jr., George H.	Denver, CO	Attorney	Indefinite from August 12, 2005
Spalsbury Jr., Clark	Estes Park, CO	Attorney	Indefinite from August 12, 2005
Brockman, Louis R.	Dallas, TX	CPA	Indefinite from August 12, 2005
Hill, Richard B.	Kernersville, NC	CPA	Indefinite from August 12, 2005
Rosenberg, Jeffrey P.	Morgan Hill, CA	Attorney	Indefinite from August 12, 2005
Link, Robert A.	Waupaca, WI	CPA	Indefinite from August 15, 2005
Halcrow, David S.	Taft, CA	CPA	Indefinite from September 9, 2005
Lieber, Daniel M.	Edna, MO	Attorney	Indefinite from September 9, 2005
Kirchoff, William W.	Jefferson City, MO	Attorney	Indefinite from September 9, 2005
Lauby, Gregory C.	Lexington, NE	Attorney	Indefinite from September 9, 2005
Early, Michael J.	Newburyport, MA	Attorney	Indefinite from September 9, 2005
Mickiewicz, Robert	Dorchester, MA	Attorney	Indefinite from September 9, 2005
Conant, Jon F.	Gloucester, MA	Attorney	Indefinite from September 9, 2005

Name	Address	Designation	Date of Suspension
Pennington, Jill	Chevy Chase, MD	Attorney	Indefinite from September 9, 2005
Randolph, Robert E.	Denham Springs, LA	Attorney	Indefinite from September 9, 2005
Carillo, Donald	Chicago, IL	Attorney	Indefinite from September 9, 2005
Sloan Jr., Dewey	Sioux City, IA	Attorney	Indefinite from September 9, 2005
Vogel, Garrett	Dallas, TX	CPA	Indefinite from September 13, 2005
Becker, Joseph	Houston, TX	CPA	Indefinite from September 13, 2005
Winick, Robert M.	Sarasota, FL	Attorney	Indefinite from September 19, 2005
Hunsaker Jr., William	Golden, CO	Attorney	Indefinite from September 19, 2005
Wheatley, Jay D.	Boca Raton, FL	Attorney	Indefinite from September 19, 2005
Clark, Carroll A.	Mesa, AZ	Attorney	Indefinite from September 19, 2005

Suspensions From Practice Before the Internal Revenue Service After Notice and an Opportunity for a Proceeding

Under Title 31, Code of Federal Regulations, Part 10, after notice and an opportunity for a proceeding before an ad-

ministrative law judge, the following individuals have been placed under suspension

from practice before the Internal Revenue Service:

Name	Address	Designation	Effective Date
Sobel, Herbert L.	Elkins Park, PA	CPA	May 4, 2005 to February 3, 2007
Rubesh, Leland	Gillette, WY	CPA	August 1, 2005 to January 31, 2007

Name	Address	Designation	Effective Date
Gregory, Carolyn S.	Cathedral City, CA	Enrolled Agent	August 12, 2005 to November 11, 2007

Censure Issued by Consent

Under Title 31, Code of Federal Regulations, Part 10, in lieu of a proceeding being instituted or continued, an attorney, certified public accountant, enrolled agent,

or enrolled actuary, may offer his or her consent to the issuance of a censure. Censure is a public reprimand.

The following individuals have consented to the issuance of a Censure:

Name	Address	Designation	Date of Censure
Pugno, Thomas	Rockwood, MI	Enrolled Agent	June 29, 2005
Barrett, Richard	Tyler, TX	CPA	August 1, 2005
Kelly, Michael G.	Odessa, TX	Attorney	August 1, 2005
Volstad, Paul S.	Plymouth, MN	CPA	August 18, 2005
Quackenbush, Gary A.	San Diego, CA	Attorney	September 2, 2005
Flores, Fred A.	Laredo, TX	CPA	September 2, 2005
Velasquez, Felix	Laredo, TX	CPA	September 2, 2005

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A

and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance

of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.

ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.

PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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¹ A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2005–1 through 2005–26 is in Internal Revenue Bulletin 2005–26, dated June 27, 2005.

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¹ A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2005–1 through 2005–26 is in Internal Revenue Bulletin 2005–26, dated June 27, 2005.

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