

INTERNAL REVENUE BULLETIN



HIGHLIGHTS OF THIS ISSUE

Bulletin No. 2016-28
July 11, 2016

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

T.D. 9772, page 11.

The final regulations provide guidance under section 833(c)(5) for Blue Cross and Blue Shield organizations and certain other organizations to compute and apply the medical loss ratio and the consequences for not meeting the medical loss ratio threshold. The final regulations revise the 2014 final regulations to reflect the enactment of a technical correction to section 833(c)(5) by the Consolidated and Further Continuing Appropriations Act of 2015.

REG-147196-07, page 32.

Section 457 of the Internal Revenue Code applies to compensation deferred under plans established and maintained by State or local governments or other tax exempt organizations. The proposed regulations include rules for determining when amounts deferred under these plans are includible in income, the amounts that are includible in income, and the types of plans that are not subject to these rules. The proposed regulations would affect participants, beneficiaries, sponsors, and administrators of certain plans sponsored by State or local governments or tax-exempt organizations that provide for a deferral of compensation.

EMPLOYEE PLANS

REG-123854-12, page 15.

Section 409A(a) provides requirements on the deferral and payment of nonqualified deferred compensation. These proposed regulations amend various rules under the existing section 409A regulations (published May 2007) to address issues cited by commenters. These proposed regulations also withdraw the anti-abuse rule for nonvested deferred compensation at Prop. § 1.409A-4(a)(1)(ii)(B) (published December 2008), replacing it with a rule limiting the circumstances under which changes may be made to the payment of nonvested deferred amounts. REG-123854-12.

The IRS Mission

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

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

TD 9772

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Modification of Treatment of Certain Health Organizations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that provide guidance to Blue Cross and Blue Shield organizations, and certain other organizations, on computing and applying the medical loss ratio and the consequences for not meeting the medical loss ratio threshold. The final regulations reflect the enactment of a technical correction to section 833(c)(5) of the Internal Revenue Code by the Consolidated and Further Continuing Appropriations Act of 2015. The final regulations affect Blue Cross and Blue Shield organizations, and certain other organizations involved in providing health insurance.

DATES: *Effective Date:* These regulations are effective on June 22, 2016.

Applicability Date: For the date of applicability, see § 1.833-1(e).

FOR FUTURE INFORMATION

CONTACT: Rebecca L. Baxter, at (202) 317-6995 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This Treasury decision contains final regulations that amend 26 CFR part 1 under section 833 of the Internal Revenue Code (the Code). Section 833(a) provides that Blue Cross and Blue Shield organizations, and certain other organizations involved in providing health insurance as described in section 833(c), are entitled to: (1) treatment as stock insurance companies for purposes of sections 831 through

835 (related to taxation of non-life insurance companies generally); (2) a special deduction determined under section 833(b); and (3) computation of unearned premium reserves under section 832(b)(4) based on 100 percent, and not 80 percent, of unearned premiums for purposes of determining “insurance company taxable income” under section 832.

Section 833(c)(5) was added to the Code by section 9016 of the Patient Protection and Affordable Care Act (Public Law 111-148, 124 Stat. 119) (the Affordable Care Act), effective for taxable years beginning after December 31, 2009. Section 833(c)(5), as enacted by the Affordable Care Act, provided that section 833 did not apply to any organization unless the organization’s medical loss ratio (MLR) for the taxable year was at least 85 percent. For purposes of section 833, an organization’s MLR was its percentage of total premium revenue expended on reimbursement for clinical services provided to enrollees under its policies during such taxable year (as reported under section 2718 of the Public Health Service Act (42 U.S.C. 300gg-18)).

Section 2718 of the Public Health Service Act (PHSA) was added by section 1001 and amended by section 10101 of the Affordable Care Act. Section 2718 of the PHSA is administered by the Department of Health and Human Services. Section 2718(a) of the PHSA requires a health insurance issuer to submit a report for each plan year to the Secretary of the Department of Health and Human Services concerning the percentage of total premium revenue, after accounting for collections or receipts for risk adjustment and risk corridors and payments of reinsurance, that the issuer expends: (1) on reimbursement for clinical services provided to enrollees under such coverage; (2) for activities that improve health care quality; and (3) on all other non-claims costs, excluding federal and state taxes and licensing or regulatory fees.

Section 2718(b) of the PHSA requires that a health insurance issuer offering group or individual health insurance coverage, with respect to each plan year, pro-

vide an annual rebate to each enrollee under such coverage, on a pro rata basis, if the ratio of the amount of the premium revenue the issuer expends on costs for reimbursement for clinical services provided to enrollees under such coverage and for activities that improve health care quality to the total amount of premium revenue (excluding federal and state taxes and licensing or regulatory fees and after accounting for payments or receipts for risk adjustment, risk corridors, and reinsurance under sections 1341, 1342, and 1343 of the Affordable Care Act (42 U.S.C. 18061, 18062, and 18063)) for the plan year is less than a prescribed percentage. Section 2718(b)(1)(B)(ii) of the PHSA provides that beginning on January 1, 2014, the medical loss ratio computed under section 2718(b) of the PHSA shall be based on expenses and premium revenues for each of the previous three years of the plan.

The Department of Health and Human Services published in the **Federal Register** (75 FR 74864) an interim final rule under section 2718 of the PHSA on December 1, 2010, an interim final rule and final rule on December 7, 2011 (76 FR 76596 and 76574), and a final rule on May 16, 2012 (77 FR 28790). These rules implementing section 2718 of the PHSA are codified at 45 CFR part 158 (HHS Regulations).

On December 6, 2010, the Treasury Department and the IRS published Notice 2010-79 (2010-49 I.R.B. 809), which provided interim guidance and transitional relief to organizations under section 833(c)(5). The interim guidance applied to an organization’s first taxable year beginning after December 31, 2009.

The interim guidance provided that for purposes of determining whether an organization’s percentage of total premium revenue expended on reimbursement for clinical services provided to enrollees was at least 85 percent (and thus satisfied the requirement of section 833(c)(5)), organizations were required to use the definition of “reimbursement for clinical services provided to enrollees” set forth in the HHS Regulations. In addition, the interim guidance provided that for purposes of

determining whether the 85-percent requirement of section 833(c)(5) was satisfied, the IRS would not challenge the inclusion of amounts expended for “activities that improve health care quality” as described in the HHS Regulations.

Notice 2010–79 also stated that the consequences for an organization with an MLR of less than 85 percent (an insufficient MLR) were as follows: (1) the organization would not be taxable as a stock insurance company by reason of section 833(a)(1) (but may have been taxable as an insurance company if it otherwise met the requirements of section 831(c)); (2) the organization would not be allowed the special deduction set forth in section 833(b); and (3) the organization would only take into account 80 percent, rather than 100 percent, of its unearned premiums for purposes of computing premiums earned on insurance contracts under section 832(b)(4). However, Notice 2010–79 provided that solely for the first taxable year beginning after December 31, 2009, the IRS would not treat an organization as losing its status as a stock insurance company by reason of section 833(c)(5) provided the following conditions were met: (1) the organization was described in section 833(c) in the immediately preceding taxable year; (2) the organization would have been taxed as a stock insurance company for the current taxable year but for the enactment of section 833(c)(5); and (3) the organization would have met the requirements of section 831(c) to be taxed as an insurance company for the current taxable year but for its activities in the administration, adjustment, or settlement of claims under cost-plus or administrative services-only contracts.

On July 5, 2011, the Treasury Department and the IRS published Notice 2011–51 (2011–27 I.R.B. 36) extending the interim guidance and transitional relief provided in Notice 2010–79 to an organization’s first taxable year beginning after December 31, 2010. On June 11, 2012, the Treasury Department and the IRS published Notice 2012–37 (2012–24 I.R.B. 1014) extending the interim guidance and transitional relief provided in Notice 2010–79 and Notice 2011–51 through an organization’s first taxable year beginning after December 31, 2012.

On May 13, 2013, the Treasury Department and the IRS published in the **Federal Register** (78 FR 27873) a notice of proposed rulemaking (REG–126633–12) addressing the computation of an organization’s MLR for purposes of section 833(c)(5) and the consequences of non-application of section 833 if an organization had an insufficient MLR. The proposed regulations provided that the numerator of an organization’s MLR is the total premium revenue expended on “reimbursement for clinical services provided to enrollees” under its policies for the taxable year, but does not include amounts expended for “activities that improve health care quality.” In addition, the Treasury Department and the IRS concluded that, for administrative convenience and to be consistent with the MLR calculation under section 2718(b)(1)(B)(ii) of the PHSA, it was appropriate to compute the MLR for a taxable year under section 833(c)(5) using the same three-year period used under section 2718(b) of the PHSA. Therefore, the proposed regulations provided that amounts used for purposes of section 833(c)(5) for each taxable year should be determined based upon amounts reported under section 2718 of the PHSA for that taxable year and the two preceding taxable years, subject to the same adjustments that apply for purposes of the PHSA. The proposed regulations also provided that if an organization has an insufficient MLR, then section 833(a) does not apply to that organization.

On January 7, 2014, the Treasury Department and the IRS published in the **Federal Register** (79 FR 755) final regulations (TD 9651) adopting the provisions of the proposed regulations with certain modifications. These modifications included transition rules to phase in the same three-year period used under section 2718(b) of the PHSA to compute the MLR for a taxable year. Accordingly, the final regulations provide that for the first taxable year beginning after December 31, 2013, an organization’s MLR is computed on a one-year basis. For the first taxable year beginning after December 31, 2014, an organization’s MLR is computed on a two-year basis. Finally, for the first taxable year beginning after December 31, 2015, and for all succeeding taxable

years, the final regulations provide that an organization’s MLR is determined based on amounts reported under section 2718 of the PHSA for that taxable year and the two preceding taxable years, subject to the same adjustments that apply for purposes of section 2718 of the PHSA. The final regulations apply to taxable years beginning after December 31, 2013.

Congress subsequently passed the Consolidated and Further Continuing Appropriations Act, 2015 (Public Law 113–235, 128 Stat. 2130) (the Appropriations Act), which was signed into law by the President on December 16, 2014. Section 102 of Division N of the Appropriations Act made a technical correction to section 833(c)(5) (the Technical Correction). The Technical Correction provides that in calculating its MLR numerator, an organization includes both the cost of reimbursement for clinical services and amounts expended for activities that improve health care quality. In addition, the Technical Correction provides that the consequences for not meeting the MLR threshold are only that section 833(a)(2) and (3) do not apply. Therefore, an organization with an insufficient MLR is treated as if it were a stock insurance company under section 833(a)(1). The Technical Correction applies to taxable years beginning after December 31, 2009.

Explanation of Provisions

These final regulations restate § 1.833–1 of the Income Tax Regulations (26 CFR part 1) and incorporate the Technical Correction. As explained in this preamble, the Technical Correction, in effect, retroactively amended the rules in the existing final regulations to determine the MLR and the consequences of an insufficient MLR. In order to avoid any confusion caused by the effect of the Technical Correction on the existing final regulations, the Treasury Department and the IRS are publishing the existing final regulations, as revised by the Technical Correction, in their entirety in this Treasury decision.

1. *Determining the MLR*

Section 1.833–1 of the Income Tax Regulations generally provides that an organization’s MLR with respect to a

taxable year is the ratio, expressed as a percentage, of the organization's MLR numerator to its MLR denominator. Prior to the Technical Correction, the existing final regulations only included in the MLR numerator an organization's total premium revenue expended on reimbursement for clinical services provided to enrollees. Consistent with the Technical Correction, § 1.833-1(c)(1)(i) of these final regulations describes an organization's MLR numerator as the total premium revenue the organization expended on reimbursement for clinical services and activities that improve health care quality provided to enrollees under its policies for the taxable year. For purposes of section 833(c)(5), these final regulations define the term "activities that improve health care quality" to have the same meaning as the term has in section 2718 of the PHS Act and the regulations issued under that section (see 45 CFR 158.150). In addition, consistent with the Technical Correction, the transition rules for computation of the MLR in § 1.833-1(c)(2)(i) and (ii) of these final regulations include the premium revenue expended on activities that improve health care quality.

2. Consequences of an Insufficient MLR

Consistent with the Technical Correction, these final regulations provide that the consequences for an organization described in section 833(c) that has an MLR of less than 85 percent are the following: (1) the organization is not allowed the special deduction set forth in section 833(b); and (2) it must take into account 80 percent, rather than 100 percent, of its unearned premiums under section 832(b)(4). Unlike under the rule in the existing final regulations, an organization that has an MLR of less than 85 percent does not lose its eligibility to be treated as a stock insurance company under section 833(a)(1).

Effective/Applicability Date

These final regulations apply to taxable years beginning after December 31, 2016. However, taxpayers may rely on these final regulations for taxable years beginning after December 31, 2009.

Special Analyses

Certain IRS regulations, including this one, are exempt from the requirement of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (APA) (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.

The Treasury Department and the IRS have determined that section 553(b) of the APA does not apply to these regulations, including because good cause exists under section 553(b)(B) of the APA. Section 553(b)(B) provides that an agency is not required to publish a notice of proposed rulemaking in the **Federal Register** when the agency, for good cause, finds that notice and public comment thereon are impracticable, unnecessary, or contrary to the public interest. The Treasury Department and the IRS have determined that notice and public comment are unnecessary inasmuch as these revisions (1) merely incorporate the Technical Correction by adding or removing language in the existing final regulations and make nonsubstantive conforming changes to reflect the Technical Correction and (2) provide taxpayers with immediate guidance. For the same reason, a delayed effective date is not required pursuant to section 553(d)(3) of the APA. Pursuant to section 7805(f)(3) of the Code, these final regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comments on its impact on small businesses, and no comments were received.

Drafting Information

The principal author of these regulations is Rebecca L. Baxter, Office of Associate Chief Counsel (Financial Institutions & Products). However, other personnel from the Treasury Department and the IRS participated in their development.

Availability of IRS Documents

The IRS notices and Treasury decisions cited in this preamble are made available by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

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Adoption of Amendments 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. Section 1.833-1 is revised to read as follows:

§ 1.833-1 *Medical loss ratio under section 833(c)(5).*

(a) *In general.* Section 833(a)(2) and (3) do not apply to an organization unless the organization's medical loss ratio (MLR) for a taxable year is at least 85 percent. Paragraph (b) of this section provides definitions that apply for purposes of section 833(c)(5) and this section. Paragraph (c) of this section provides rules for computing an organization's MLR under section 833(c)(5). Paragraph (d) of this section addresses the treatment under section 833 of an organization that has an MLR of less than 85 percent. Paragraph (e) of this section provides the effective/applicability date.

(b) *Definitions.* The following definitions apply for purposes of section 833(c)(5) and this section.

(1) *Activities that improve health care quality.* The term *activities that improve health care quality* has the same meaning as that term has in section 300gg-18 of title 42, United States Code and the regulations issued under that section (see 45 CFR 158.150).

(2) *Reimbursement for clinical services.* The term *reimbursement for clinical services* has the same meaning as that term has in section 300gg-18 of title 42, United States Code and the regulations issued under that section (see 45 CFR 158.140).

(3) *Total premium revenue.* The term *total premium revenue* means the total amount of premium revenue (excluding federal and state taxes and licensing or regulatory fees and after accounting for payments or receipts for risk adjustment, risk corridors, and reinsurance under sections 1341, 1342, and 1343 of the Patient Protection and Affordable Care Act, Public Law 111–148 (124 Stat. 119 (2010)) (42 U.S.C. 18061, 18062, and 18063)) as those terms are used for purposes of section 300gg-18(b) of title 42, United States Code and the regulations issued under that section (see 45 CFR part 158).

(c) *Computation of MLR under section 833(c)(5)—(1) In general.* Starting with the first taxable year beginning after December 31, 2015, and for all succeeding taxable years, an organization's MLR with respect to a taxable year is the ratio, expressed as a percentage, of the MLR numerator, as described in paragraph (c)(1)(i) of this section, to the MLR denominator, as described in paragraph (c)(1)(ii) of this section.

(i) *MLR numerator.* The numerator of an organization's MLR is the total premium revenue expended on reimbursement for clinical services and activities that improve health care quality provided to enrollees under its policies for the taxable year, computed using a three-year period in the same manner as those expenses are computed for the plan year for purposes of section 300gg-18(b) of title 42, United States Code and regulations issued under that section (see 45 CFR part 158).

(ii) *MLR denominator.* The denominator of an organization's MLR is the organization's total premium revenue for the taxable year, computed using a three-year period in the same manner as the total

premium revenue is computed for the plan year for purposes of section 300gg-18(b) of title 42, United States Code and regulations issued under that section (see 45 CFR part 158).

(2) *Transition rules.* The transition rules in paragraphs (c)(2)(i) and (ii) of this section apply solely for the first taxable year beginning after December 31, 2013, and the first taxable year beginning after December 31, 2014.

(i) *First taxable year beginning after December 31, 2013.* For the first taxable year beginning after December 31, 2013, the numerator of an organization's MLR is the total premium revenue expended on reimbursement for clinical services and activities that improve health care quality provided to enrollees under its policies for the first taxable year beginning after December 31, 2013, and the denominator of an organization's MLR is the organization's total premium revenue for the first taxable year beginning after December 31, 2013.

(ii) *First taxable year beginning after December 31, 2014.* For the first taxable year beginning after December 31, 2014, the numerator of an organization's MLR is the sum of the total premium revenue expended on reimbursement for clinical services and activities that improve health care quality provided to enrollees under its policies for the first taxable year beginning after December 31, 2013, and for the first taxable year beginning after December 31, 2014, and the denominator of an organization's MLR is the sum of the organization's total premium revenue for the first taxable year beginning after December 31, 2013, and for the first taxable year beginning after December 31, 2014.

(d) *Failure to qualify under section 833(c)(5)—(1) In general.* If, for any tax-

able year, an organization's MLR is less than 85 percent, then beginning in that taxable year and for each subsequent taxable year for which the organization's MLR remains less than 85 percent, paragraphs (d)(1)(i) and (ii) of this section apply.

(i) *Special deduction.* The organization is not allowed the special deduction set forth in section 833(b).

(ii) *Premiums earned.* The organization must take into account 80 percent, rather than 100 percent, of its unearned premiums under section 832(b)(4) as it applies to other non-life insurance companies.

(2) *No material change.* An organization's loss of eligibility for the treatment provided by sections 833(a)(2) and (3) solely by reason of section 833(c)(5) will not be treated as a material change in the operations of such organization or in its structure for purposes of section 833(c)(2)(C).

(e) *Effective/applicability date.* This section applies to taxable years beginning after December 31, 2016. However, taxpayers may rely on this section for taxable years beginning after December 31, 2009.

John Dalrymple,
*Deputy Commissioner for
Services and Enforcement.*

Approved: May 18, 2016.

Mark J. Mazur,
*Assistant Secretary of
the Treasury (Tax Policy).*

(Filed by the Office of the Federal Register on June 21, 2016, 8:45 a.m., and published in the issue of the Federal Register for June 22, 2016, 81 F.R. 40518)

Part IV. Items of General Interest

Application of Section 409A to Nonqualified Deferred Compensation Plans

REG-123854-12

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Partial withdrawal of notice of proposed rulemaking; notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that would clarify or modify certain specific provisions of the final regulations under section 409A (TD 9321, 72 FR 19234). This document also withdraws a specific provision of the notice of proposed rulemaking (REG-148326-05) published in the *Federal Register* on December 8, 2008 (73 FR 74380) regarding the calculation of amounts includible in income under section 409A(a)(1) and replaces that provision with revised proposed regulations. These proposed regulations would affect participants, beneficiaries, sponsors, and administrators of nonqualified deferred compensation plans.

DATES: Comments and requests for a public hearing must be received by September 20, 2016.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-123854-12), 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-123854-12), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, 20224 or sent electronically, via the Federal Rulemaking Portal at www.regulations.gov (IRS REG-123854-12).

FOR FURTHER INFORMATION

CONTACT: Concerning these proposed regulations under section 409A, Gregory Burns at (202) 927-9639, concerning submission of comments and/or requests for a

hearing, Regina Johnson at (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 885 of the American Jobs Creation Act of 2004, Public Law 108-357 (118 Stat. 1418) (AJCA '04) added section 409A to the Internal Revenue Code (Code). Section 409A(a)(1)(A) generally provides that, if certain requirements are not met at any time during a taxable year, amounts deferred under a nonqualified deferred compensation plan for that year and all previous taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income.

On April 17, 2007 (72 FR 19234), the Treasury Department and the IRS issued final regulations under section 409A (TD 9321), which include §§ 1.409A-1, 1.409A-2, 1.409A-3, and 1.409A-6 (the final regulations). The final regulations define certain terms used in section 409A and in the final regulations, set forth the requirements for deferral elections and for the time and form of payments under nonqualified deferred compensation plans, and address certain other issues under section 409A.

On December 8, 2008 (73 FR 74380), the Treasury Department and the IRS issued additional proposed regulations under section 409A (REG-148326-05), which include proposed § 1.409A-4 (the proposed income inclusion regulations). The proposed income inclusion regulations provide guidance regarding the calculation of amounts includible in income under section 409A(a)(1) and the additional taxes imposed by section 409A with respect to service providers participating in certain nonqualified deferred compensation plans and other arrangements that do not comply with the requirements of section 409A(a).

Explanation of Provisions

I. Overview

The Treasury Department and the IRS have concluded that certain clarifications

and modifications to the final regulations and the proposed income inclusion regulations will help taxpayers comply with the requirements of section 409A. These proposed regulations address certain specific provisions of the final regulations and the proposed income inclusion regulations and are not intended to propose a general revision of, or broad changes to, the final regulations or the proposed income inclusion regulations. The narrow and specific purpose of these proposed regulations should be taken into account when submitting comments on these proposed regulations. As provided in the section of this preamble titled "Proposed Effective Dates," taxpayers may rely upon these proposed regulations immediately.

These proposed regulations:

(1) Clarify that the rules under section 409A apply to nonqualified deferred compensation plans separately and in addition to the rules under section 457A.

(2) Modify the short-term deferral rule to permit a delay in payments to avoid violating Federal securities laws or other applicable law.

(3) Clarify that a stock right that does not otherwise provide for a deferral of compensation will not be treated as providing for a deferral of compensation solely because the amount payable under the stock right upon an involuntary separation from service for cause, or the occurrence of a condition within the service provider's control, is based on a measure that is less than fair market value.

(4) Modify the definition of the term "eligible issuer of service recipient stock" to provide that it includes a corporation (or other entity) for which a person is reasonably expected to begin, and actually begins, providing services within 12 months after the grant date of a stock right.

(5) Clarify that certain separation pay plans that do not provide for a deferral of compensation may apply to a service provider who had no compensation from the service recipient during the year preceding the year in which a separation from service occurs.

(6) Provide that a plan under which a service provider has a right to payment or reimbursement of reasonable attorneys'

fees and other expenses incurred to pursue a bona fide legal claim against the service recipient with respect to the service relationship does not provide for a deferral of compensation.

(7) Modify the rules regarding recurring part-year compensation.

(8) Clarify that a stock purchase treated as a deemed asset sale under section 338 is not a sale or other disposition of assets for purposes of determining whether a service provider has a separation from service.

(9) Clarify that a service provider who ceases providing services as an employee and begins providing services as an independent contractor is treated as having a separation from service if, at the time of the change in employment status, the level of services reasonably anticipated to be provided after the change would result in a separation from service under the rules applicable to employees.

(10) Provide a rule that is generally applicable to determine when a “payment” has been made for purposes of section 409A.

(11) Modify the rules applicable to amounts payable following death.

(12) Clarify that the rules for transaction-based compensation apply to stock rights that do not provide for a deferral of compensation and statutory stock options.

(13) Provide that the addition of the death, disability, or unforeseeable emergency of a beneficiary who has become entitled to a payment due to a service provider’s death as a potentially earlier or intervening payment event will not violate the prohibition on the acceleration of payments.

(14) Modify the conflict of interest exception to the prohibition on the acceleration of payments to permit the payment of all types of deferred compensation (and not only certain types of foreign earned income) to comply with bona fide foreign ethics or conflicts of interest laws.

(15) Clarify the provision permitting payments upon the termination and liquidation of a plan in connection with bankruptcy.

(16) Clarify other rules permitting payments in connection with the termination and liquidation of a plan.

(17) Provide that a plan may accelerate the time of payment to comply with Federal debt collection laws.

(18) Clarify and modify § 1.409A–4(a)(1)(ii)(B) of the proposed income inclusion regulations regarding the treatment of deferred amounts subject to a substantial risk of forfeiture for purposes of calculating the amount includible in income under section 409A(a)(1).

(19) Clarify various provisions of the final regulations to recognize that a service provider can be an entity as well as an individual.

II. Deferral of Compensation

A. Section 457(f) and Section 457A Plans

Section 457(f) generally provides that compensation deferred under a plan of an eligible employer (as that term is defined under section 457) is included in gross income in the first taxable year in which there is no substantial risk of forfeiture of the rights to the compensation. The final regulations provide that a deferred compensation plan subject to section 457(f) may be a nonqualified deferred compensation plan for purposes of section 409A and that the rules of section 409A apply to deferred compensation plans separately and in addition to any requirements applicable to such plans under section 457(f).

Similarly, section 457A, which was enacted more than a year after publication of the final regulations, generally provides that any compensation deferred under a nonqualified deferred compensation plan of a nonqualified entity (as these terms are defined under section 457A) is includible in gross income when there is no substantial risk of forfeiture of the rights to the compensation. These proposed regulations clarify that a nonqualified deferred compensation plan under section 457A, like a deferred compensation plan under section 457(f), may be a nonqualified deferred compensation plan for purposes of section 409A and that the rules of section 409A apply to such a plan separately and

in addition to any requirements applicable to the plan under section 457A.

B. Short-term Deferral Rule

The final regulations provide that a deferral of compensation does not occur for purposes of section 409A under a plan with respect to any payment that is not a deferred payment¹ provided that the service provider actually or constructively receives the payment on or before the later of: (1) The 15th day of the third month following the end of the service provider’s first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture, or (2) the 15th day of the third month following the end of the service recipient’s first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture (the applicable 2½ month period). A payment that meets these requirements of the short-term deferral rule (described more fully in § 1.409A–1(b)(4)) is referred to as a short-term deferral and is generally exempt from the requirements applicable to plans that provide for a deferral of compensation.

The final regulations provide that a payment that otherwise qualifies as a short-term deferral, but is made after the applicable 2½ month period, may continue to qualify as a short-term deferral if the payment is delayed for one of three reasons: (1) The taxpayer establishes that it was administratively impracticable for the service recipient to make the payment by the end of the applicable 2½ month period; (2) making the payment by the end of the applicable 2½ month period would have jeopardized the service recipient’s ability to continue as a going concern; or (3) the service recipient reasonably anticipates that a deduction for the payment would not be permitted under section 162(m).

Similar exceptions apply under the general time and form of payment rules of section 409A. Under § 1.409A–3(d), a payment is treated as made on the date specified under the plan if the payment is delayed due to administrative impracticability or because making the payment

¹Under § 1.409A–1(b)(4)(i)(D), a payment is a deferred payment if it is made pursuant to a provision of a plan that provides for the payment to be made or completed on or after any date, or upon the occurrence of any event, that will or may occur later than the end of the applicable 2½ month period.

would jeopardize the ability of the service recipient to continue as a going concern. Under § 1.409A-2(b)(7), a payment may be delayed to a date after the payment date designated in a plan without failing to meet the requirements of section 409A(a) if the service recipient reasonably anticipates that a deduction for the payment would not be permitted under section 162(m) or if making the payment would violate Federal securities laws or other applicable law. Together, these rules generally permit payments under section 409A to be delayed due to administrative impracticability or because making the payment would jeopardize the ability of the service recipient to continue as a going concern, the payment would not be deductible under section 162(m), or making the payment would violate Federal securities laws or other applicable law.

Some commenters have suggested that the exception for payments that would violate Federal securities laws or other applicable law should also apply to payments that are intended to be short-term deferrals. These commenters have noted that the policy reasons for excusing a timely payment when the payment would violate Federal securities laws or other applicable law apply equally to the general time and form of payment rules under section 409A and the short-term deferral rule. In response to these comments, the Treasury Department and the IRS have determined that it is appropriate to extend this exception to the short-term deferral rule. Accordingly, these proposed regulations provide that a payment that otherwise qualifies as a short-term deferral, but is made after the end of the applicable 2½ month period, may still qualify as a short-term deferral if the service recipient reasonably anticipates that making the payment during the applicable 2½ month period will violate Federal securities laws or other applicable law and the payment is made as soon as reasonably practicable following the first date on which the service recipient anticipates or reasonably should anticipate that making the payment would not cause a violation. For this purpose, making a payment that would cause inclusion in gross income or the application of any penalty provision or other provision of the Code is not treated as a violation of applicable law.

C. Stock rights

1. Service Recipient Stock

The final regulations provide that certain stock options and stock appreciation rights (collectively, stock rights) granted with respect to service recipient stock do not provide for a deferral of compensation. The term “service recipient stock” means a class of stock that, as of the date of grant, is common stock for purposes of section 305 and the regulations thereunder of a corporation that is an eligible issuer of service recipient stock. For this purpose, service recipient stock does not include any stock that is subject to a mandatory repurchase obligation (other than a right of first refusal), or a permanent put or call right, if the stock price under such right or obligation is based on a measure other than the fair market value (disregarding lapse restrictions) of the equity interest in the corporation represented by the stock.

Commenters have noted that employers often want to deter employees from engaging in behavior that could be detrimental to the employer and have customarily reduced the amount that an employee receives under a stock rights arrangement if the employee is dismissed for cause or violates a noncompetition or nondisclosure agreement. These commenters have observed that this type of reduction is generally prohibited under the definition of service recipient stock in the final regulations but have argued that neither the statutory language nor the underlying policies of section 409A should prohibit a reduction under these circumstances. The Treasury Department and the IRS agree with these conclusions. Accordingly, these proposed regulations provide that a stock price will not be treated as based on a measure other than fair market value if the amount payable upon a service provider’s involuntary separation from service for cause, or the occurrence of a condition that is within the control of the service provider, such as the violation of a covenant not to compete or a covenant not to disclose certain information, is based on a measure that is less than fair market value.

2. Eligible Issuer of Service Recipient Stock

Under the final regulations, the term “eligible issuer of service recipient stock” means the corporation or other entity for which the service provider provides direct services on the date of grant of the stock right and certain affiliated corporations or entities. Some commenters have asserted that this definition of “eligible issuer of service recipient stock” hinders employment negotiations because it prevents service recipients from granting stock rights to service providers before they are employed by the service recipient. In response to these comments, these proposed regulations provide that, if it is reasonably anticipated that a person will begin providing services to a corporation or other entity within 12 months after the date of grant of a stock right, and the person actually begins providing services to the corporation or other entity within 12 months after the date of grant (or, if services do not begin within that period, the stock right is forfeited), the corporation or other entity will be an eligible issuer of service recipient stock.

D. Separation pay plans

Under the final regulations, separation pay plans that provide for payment only upon an involuntary separation from service or pursuant to a window program do not provide for a deferral of compensation to the extent that they meet certain requirements. One of these requirements is that the separation pay generally not exceed two times the lesser of (1) the service provider’s annualized compensation based upon the annual rate of pay for the service provider’s taxable year preceding the service provider’s taxable year in which the separation from service occurs, or (2) the limit under section 401(a)(17) for the year in which the service provider separates from service.

Some commenters have questioned whether this exception for separation pay plans is available for a service provider whose employment begins and ends during the same taxable year because the service provider was not employed by, and did not receive any compensation from, the service recipient for the taxable

year preceding the taxable year in which the separation from service occurs. These proposed regulations clarify that the separation pay plan exception is available for service providers whose employment begins and ends in the same taxable year. In that circumstance, these proposed regulations provide that the service provider's annualized compensation for the taxable year in which the service provider separates from service may be used for purposes of this separation pay plan exception if the service provider had no compensation from the service recipient in the taxable year preceding the year in which the service provider separates from service.

E. Employment-related legal fees and expenses

Under the final regulations, an arrangement does not provide for a deferral of compensation to the extent that it provides for amounts to be paid as settlements or awards resolving *bona fide* legal claims based on wrongful termination, employment discrimination, the Fair Labor Standards Act, or workers' compensation statutes, including claims under applicable Federal, state, local, or foreign laws, or for reimbursements or payments of reasonable attorneys' fees or other reasonable expenses incurred by the service provider related to such *bona fide* legal claims.

Commenters have requested guidance on the application of section 409A(a) to provisions commonly included in employment agreements that provide for the reimbursement of attorneys' fees in connection with employment-related disputes and have asserted that there is no reason to distinguish between arrangements that provide for payment of reasonable attorneys' fees and expenses for the types of legal claims currently specified in the final regulations and any other *bona fide* legal claim with respect to the service relationship between a service provider and a service recipient. In response to these comments, these proposed regulations provide that an arrangement does not provide for a deferral of compensation to the extent that it provides for the payment or reimbursement of a service provider's reasonable attorneys' fees and other expenses incurred to enforce a claim by the service

provider against the service recipient with respect to the service relationship.

F. Recurring Part-year Compensation

After publication of the final regulations, commenters have expressed concerns about the application of section 409A to recurring part-year compensation. The final regulations define recurring part-year compensation as compensation paid for services rendered in a position that the service recipient and service provider reasonably anticipate will continue on similar terms and conditions in subsequent years, and will require services to be provided during successive service periods each of which comprises less than 12 months and each of which begins in one taxable year of the service provider and ends in the next taxable year. For example, a teacher providing services during school years comprised of 10 consecutive months would have recurring part-year compensation. See § 1.409A-2(a)(14). In general, commenters have asserted that section 409A should not apply to this situation because the amount being deferred from one taxable year to a subsequent taxable year is typically only a small amount and because most service providers who receive recurring part-year compensation (typically teachers and other educational workers) view an election to annualize this compensation as a cash flow decision, rather than a tax-deferral opportunity.

In response, the Treasury Department and the IRS issued Notice 2008-62 (2008-29 IRB 130), which provides that arrangements involving recurring part-year compensation do not provide for a deferral of compensation for purposes of section 409A or section 457(f) if: (1) The arrangement does not defer payment of any of the recurring part-year compensation beyond the last day of the 13th month following the beginning of the service period, and (2) the arrangement does not defer from one taxable year to the next taxable year the payment of more than the applicable dollar amount under section 402(g)(1)(B) in effect for the calendar year in which the service period begins (\$18,000 for 2016). Notice 2008-62 also states that a conforming change is in-

tended be made to the final regulations to reflect these rules.

Commenters have expressed concerns that Notice 2008-62 would not adequately address some teaching positions, such as college and university faculty members. They have noted that, depending on several variables (such as the calendar month in which a service provider commences service or the length of the service period), the dollar limitation in the notice may result in adverse tax consequences to service providers with annual compensation as low as \$80,000. Commenters have further observed that some of these arrangements are nonelective, and therefore some service providers cannot opt out of a recurring part-year compensation arrangement. In recognition that service recipients in the field of education frequently structure their pay plans to include recurring part-year compensation and that the main purpose of this design is to provide uninterrupted cash flow for service providers who do not work for a portion of the year, these proposed regulations modify the recurring part-year compensation rule. These proposed regulations provide that a plan or arrangement under which a service provider receives recurring part-year compensation that is earned over a period of service does not provide for a deferral of compensation if the plan does not defer payment of any of the recurring part-year compensation to a date beyond the last day of the 13th month following the first day of the service period for which the recurring part-year compensation is paid, and the amount of the service provider's recurring part-year compensation (not merely the amount deferred) does not exceed the annual compensation limit under section 401(a)(17) (\$265,000 for 2016) for the calendar year in which the service period commences. A conforming change is being made for purposes of section 457(f) under proposed section 457(f) regulations (REG-147196-07) that are also published in the Proposed Rules section of this issue of the *Federal Register*.

III. Separation from Service Definition

A. Asset Purchase Transactions

The final regulations permit the seller and an unrelated buyer in an asset pur-

chase transaction to specify whether a person who is a service provider of the seller immediately before the transaction is treated as separating from service if the service provider provides services to the buyer after and as a result of the transaction. Commenters have asked whether this rule may be used with respect to a transaction that is treated as a deemed asset sale under section 338.

The provision of the final regulations giving buyers and sellers in asset transactions the discretion to treat employees as separating from service is based on the recognition that, while employees formally terminate employment with the seller and immediately recommence employment with the buyer in a typical asset transaction, the employees often experience no change in the type or level of services they provide. In a deemed asset sale under section 338, however, employees do not experience a termination of employment, formal or otherwise. Accordingly, the Treasury Department and the IRS have determined that it would be inconsistent with section 409A to permit the parties to a deemed asset sale to treat service providers as having separated from service upon the occurrence of the transaction. These proposed regulations affirm and make explicit that a stock purchase transaction that is treated as a deemed asset sale under section 338 is not a sale or other disposition of assets for purposes of this rule under section 409A.

B. Dual Status As Employee and Independent Contractor and Changes in Status from Employee to Independent Contractor (or Vice Versa)

The final regulations provide that an employee separates from service with an employer if the employee dies, retires, or otherwise has a termination of employment with the employer. Under the final regulations, a termination of employment generally occurs if the facts and circumstances indicate that the employer and employee reasonably anticipate that no further services would be performed after a certain date or that the level of bona fide services the employee would perform after that date (whether as an employee or as an independent contractor) would permanently decrease to no more than 20 per-

cent of the average level of bona fide services performed (whether as an employee or an independent contractor) over the immediately preceding 36-month period (or if the employee has been providing services to the employer for less than 36 months, the full period of services). The final regulations provide that an independent contractor separates from service with a service recipient upon the expiration of the contract (or, if applicable, all contracts) under which services are performed for the service recipient if the expiration is a good-faith and complete termination of the contractual relationship.

The final regulations also provide that if a service provider provides services both as an employee and an independent contractor of a service recipient, the service provider must separate from service both as an employee and as an independent contractor to be treated as having separated from service. The final regulations further provide that “[i]f a service provider ceases providing services as an independent contractor and begins providing services as an employee, or ceases providing services as an employee and begins providing services as an independent contractor, the service provider will not be considered to have a separation from service until the service provider has ceased providing services in both capacities.”

Some commenters have observed that the quoted sentence could be read to provide that a service provider who performs services for a service recipient as an employee, but who becomes an independent contractor for the same service recipient and whose anticipated level of services upon becoming an independent contractor are 20 percent or less than the average level of services performed during the immediately preceding 36-month period, would not have a separation from service because a complete termination of the contractual relationship with the service recipient has not occurred and, therefore, there is no separation from service as an independent contractor. Such a reading, however, would be inconsistent with the more specific rule that a service provider who is an employee separates from service if the employer and employee reasonably anticipate that the level of services to be performed after a certain date (whether

as an employee or as an independent contractor) would permanently decrease to no more than 20 percent of the average level of services performed (whether as an employee or an independent contractor) over the immediately preceding 36-month period. To avoid potential confusion, these proposed regulations delete the quoted sentence from the regulations.

However, if a service provider, who performs services for a service recipient as an employee, becomes an independent contractor for the same service recipient but does not have a separation from service when he or she becomes an independent contractor (because at that time it is not reasonably anticipated that the level of services that would be provided by the service provider in the future would decrease to no more than 20 percent of the average level of services performed over the immediately preceding 36-month period), the service provider will have a separation from service in the future when the service provider has a separation from service based on the rules that apply to independent contractors.

IV. References to a Payment Being Made

As discussed in section II.B of this preamble entitled “Short-term Deferral Rule,” the final regulations provide that a deferral of compensation does not occur under a plan if the service provider actually or constructively receives a payment that is not a deferred payment on or before the last day of the applicable 2½ month period. The final regulations further provide that, for this purpose, a payment is treated as actually or constructively received if the payment is includible in income, including if the payment is includible under the economic benefit doctrine, section 83, section 402(b), or section 457(f). Further, § 1.409A-2(b)(2) of the final regulations provides that, for purposes of subsequent changes in the time or form of payment, the term “payment” generally refers to each separately identified amount to which a service provider is entitled to payment under a plan on a determinable date. This section of the final regulations provides that a payment includes the provision of any taxable benefit, including cash or property. It also provides that 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 plan, a fringe benefit excludible from income, or any other benefit excludible from income. The final regulations, however, do not include a rule that is generally applicable for all purposes under section 409A to determine when a payment is made.

These proposed regulations add a generally applicable rule to determine when a payment has been made for all provisions of the regulations under section 409A. Under these proposed regulations, a payment is made, or the payment of an amount occurs, when any taxable benefit is actually or constructively received. Consistent with the final regulations, these proposed regulations provide that a payment includes a transfer of cash, any event that results in the inclusion of an amount in income under the economic benefit doctrine, a transfer of property includible in income under section 83, a contribution to a trust described in section 402(b) at the time includible in income under section 402(b), and the transfer or creation of a beneficial interest in a section 402(b) trust at the time includible in income under section 402(b). In addition, a payment is made upon the transfer, cancellation, or reduction of an amount of deferred compensation in exchange for benefits under a welfare plan, a non-taxable fringe benefit, or any other nontaxable benefit.

The final regulations generally provide that the inclusion of an amount in income under section 457(f)(1)(A) is treated as a payment under section 409A for purposes of the short-term deferral rule under § 1.409A-1(b)(4), but is generally not treated as a payment for other purposes under section 409A. Commenters, however, have observed that this treatment of income inclusion under section 457(f)(1)(A) is inconsistent with the rules under section 409A that generally treat the inclusion of any amount in income as a payment for all purposes under section 409A. These commenters have also noted

that a primary purpose of section 409A is to limit the ability of a service provider or service recipient to change the time at which deferred compensation is included in income after the time of payment is established and that the failure to treat income inclusion under section 457(f)(1)(A) as a payment would be inconsistent with this purpose. In response to these observations, these proposed regulations provide that the inclusion of an amount in income under section 457(f)(1)(A) is treated a payment for all purposes under section 409A.

Under this rule, if the plan provides for a deferral of compensation under section 409A: (1) Plan terms that specify the conditions to which the payment is subject and thus when a substantial risk of forfeiture lapses for purposes of section 457(f)(1)(A) (and, consequently, determine when an amount is includible in income) would be treated as plan terms providing for the payment of the amount includible in income, and (2) all rules under section 409A applicable to the payment of an amount would apply to the inclusion of an amount under section 457(f)(1)(A). A plan would not be a deferred compensation plan within the meaning of section 409A to the extent that the amounts payable under the plan are short-term deferrals under § 1.409A-1(b)(4). However, in certain limited circumstances, amounts includible in income under section 457(f)(1)(A) may not be short-term deferrals under § 1.409A-1(b)(4). For example, under the proposed section 457(f) regulations (REG-147196-07), which are also published in the Proposed Rules section of this issue of the *Federal Register*, in certain circumstances conditioning a payment upon compliance with a noncompetition agreement will result in the payment being subject to a substantial risk of forfeiture for purposes of section 457(f)(1)(A), but that payment would not be treated as subject to a substantial risk of forfeiture for purposes of section 409A. In such cases, the amount payable at the end of the term of the

noncompetition agreement upon compliance with the noncompete will be includible in income under section 457(f)(1)(A) only at the end of the term of the agreement under the section 457(f) regulations as proposed, but for purposes of section 409A will be deferred compensation (and not a short-term deferral), the payment of which is subject to the rules of section 409A.² See proposed § 1.457-12(e) (REG-147196-07); see also proposed § 1.457-12(a)(4) (REG-147196-07).

The Treasury Department and the IRS request comments on whether rules similar to those applicable to amounts included in income under section 457(f) should be adopted for amounts included in income under section 457A.

These proposed regulations also clarify that a transfer of property that is substantially nonvested (as defined under § 1.83-3(b)) to satisfy an obligation under a nonqualified deferred compensation plan is not a payment for purposes of section 409A unless the recipient makes an election under section 83(b) to include in income the fair market value of the property (disregarding lapse restrictions), less any amount paid for the property. These proposed regulations also make conforming clarifications to rules under § 1.409A-1(a)(4) regarding nonqualified deferred compensation plans subject to sections 457(f) and 457A, § 1.409A-1(b)(4) regarding the short-term deferral rule, and § 1.409A-2(b)(2) regarding the separate payment rule.

V. Permissible Payments

A. Death

The final regulations provide that an amount deferred under a nonqualified deferred compensation plan may be paid only at a specified time or upon an event set forth under the regulations. One of the permissible events upon which an amount may be paid is the service provider's death. The final regulations also provide that a payment is treated as made upon a date specified under the plan (including at

²There may also be instances in which a portion of an amount payable under an arrangement that is subject to section 457(f) is a short-term deferral for purposes of both section 409A and section 457(f)(1)(A), while another portion of the amount is a deferral of compensation for purposes of section 409A. For example, assume an arrangement subject to section 457(f) provides for payment of a specified dollar amount plus earnings upon separation from service, with vesting to occur when the service provider has completed three years of service. The specified dollar amount plus earnings to date is includible in income under section 457(f)(1)(A) when the service provider completes three years of service, and that amount will be a short-term deferral under section 409A if the service provider includes it in income at that time. The service provider's right to receive a payment of additional earnings accruing after the vesting date is a deferred compensation plan under section 409A.

the time a specified event occurs) if the payment is made on that date or on a later date within the same taxable year of the service provider or, if later, by the 15th day of the third calendar month following the date specified under the plan, provided that the service provider is not permitted, directly or indirectly, to designate the taxable year of the payment.

Some commenters have questioned whether these and other rules in the final regulations applicable to amounts payable upon the death of a service provider also apply in the case of the death of a beneficiary who has become entitled to the payment of an amount due to a service provider's death. These proposed regulations clarify that the rules applicable to amounts payable upon the death of a service provider also apply to amounts payable upon the death of a beneficiary.

Also, some commenters have indicated that the time periods for the payment of amounts following death often are not long enough to resolve certain issues related to the death (for example, confirming the death and completing probate). In view of the practical issues that often arise following a death, these proposed regulations provide that an amount payable following the death of a service provider, or following the death of a beneficiary who has become entitled to payment due to the service provider's death, that is to be paid at any time during the period beginning on the date of death and ending on December 31 of the first calendar year following the calendar year during which the death occurs is treated as timely paid if it is paid at any time during this period. A plan is not required to specify any particular date within this period as the payment date and may rely on this rule if the plan provides that an amount will be paid at some time during this period, including if the plan provides that payment will be made upon death without defining the period for payment following death in any other manner, and including if the plan provides that payment will be made on a date within this period determined in the discretion of the beneficiary. These proposed regulations further provide that a plan providing for the payment of an amount at any time during this specified period may be amended to provide for the payment of that amount (or the payment of that

amount may be made without amending the plan) at any other time during this period (including a time determined in the discretion of a beneficiary) without failing to meet the requirements of the deferral election provisions of § 1.409A-2 or the permissible payment provisions of § 1.409A-3, including the prohibition on the acceleration of payments under § 1.409A-3(j). For example, a plan that provides for a payment to be made during the first calendar year beginning after the death of a service provider may be amended to provide for the payment of the amount (or the payment may be made under the plan without such amendment) at any time during the period beginning on the date of death and ending on December 31 of the first calendar year following the calendar year during which the death occurs. For additional rules concerning payments due upon a beneficiary's death, see section VI.A of this preamble.

B. Certain Transaction-based Compensation

The final regulations provide special rules for payments of transaction-based compensation. Transaction-based compensation payments are payments related to certain types of changes in control that (1) occur because a service recipient purchases its stock held by a service provider or because the service recipient or a third party purchases a stock right held by a service provider, or (2) are calculated by reference to the value of service recipient stock. Under the final regulations, transaction-based compensation may be treated as paid at a designated date or pursuant to a payment schedule that complies with the requirements of section 409A(a) if it is paid on the same schedule and under the same terms and conditions as apply to payments to shareholders generally with respect to stock of the service recipient pursuant to the change in control. Likewise, transaction-based compensation meeting these requirements will not fail to meet the requirements of the initial or subsequent deferral election rules under section 409A if it is paid not later than five years after the change in control event. These proposed regulations clarify that the special payment rules for transaction-based compensation apply to a statutory

stock option or a stock right that did not otherwise provide for deferred compensation before the purchase or agreement to purchase the stock right. Accordingly, the purchase (or agreement to purchase) such a statutory stock option or stock right in a manner consistent with these rules does not result in the statutory stock option or stock right being treated as having provided for the deferral of compensation from the original grant date.

VI. Prohibition on Acceleration of Payments

A. Payments to Beneficiaries Upon Death, Disability, or Unforeseeable Emergency

Under the final regulations, a prohibited acceleration of a payment does not result from the addition of death, disability, or unforeseeable emergency as a potentially earlier alternative payment event for an amount previously deferred. However, under the final regulations, this exception applies only with respect to a service provider's death, disability, or unforeseeable emergency and does not apply with respect to the death, disability, or unforeseeable emergency of a beneficiary who has become entitled to a payment due to the service provider's death. These proposed regulations provide that this exception also applies to the payment of deferred amounts upon the death, disability, or unforeseeable emergency of a beneficiary who has become entitled to payment due to a service provider's death. These proposed regulations also clarify that a schedule of payments (including payments treated as a single payment) that has already commenced prior to a service provider's or a beneficiary's death, disability, or unforeseeable emergency may be accelerated upon the death, disability, or unforeseeable emergency.

B. Compliance With Bona Fide Foreign Ethics Laws or Conflicts of Interest Laws

Under the final regulations, a plan may provide for acceleration of the time or schedule of a payment, or a payment may be made under a plan, to the extent reasonably necessary to avoid the violation of a Federal, state, local, or foreign ethics

or conflicts of interest law. However, with respect to a foreign ethics or conflicts of interest law, this exception applies only to foreign earned income from sources within the foreign country that promulgated the law. Commenters have suggested that this provision should not be limited to foreign earned income because the requirements of foreign ethics or conflicts of interest laws may affect both the payment of foreign and United States earned income. These proposed regulations expand the scope of this provision to permit the acceleration of any nonqualified deferred compensation if the acceleration is reasonably necessary to comply with a *bona fide* foreign ethics or conflicts of interest law.

C. Plan Terminations and Liquidations

Under the final regulations, a plan may provide for the acceleration of a payment made pursuant to the termination and liquidation of a plan under certain circumstances. Specifically, a plan may provide for the acceleration of a payment if the plan is terminated and liquidated 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. section 503(b)(1)(A) if certain other conditions are satisfied. The citation to 11 U.S.C. section 503(b)(1)(A) is erroneous. These proposed regulations correct this provision by retaining the operative rule but deleting the section reference.

The final regulations also provide that a payment may be accelerated pursuant to a change in control event as described under § 1.409A-3(j)(4)(ix)(B) or in other circumstances provided certain requirements are satisfied, as described under § 1.409A-3(j)(4)(ix)(C). To terminate a plan pursuant to § 1.409A-3(j)(4)(ix)(C), the final regulations provide that the service recipient must terminate and liquidate all plans sponsored by the service recipient that would be aggregated with the terminated plan under the plan aggregation rules under § 1.409A-1(c) of the final regulations if the same service provider had deferrals of compensation under all such plans. The final regulations also provide that for three years following the date on which the service recipient took all necessary action to irrevocably termi-

nate and liquidate the plan the service recipient cannot adopt a new plan that would be aggregated with the terminated and liquidated plan if the same service provider participated in both plans. Some commenters have asked whether these rules mean that only the plans of a particular category in which a particular service provider actually participates must be terminated if a plan in which that service provider participates is terminated.

The plan aggregation rules under § 1.409A-1(c)(2) of the final regulations identify nine different types of nonqualified deferred compensation plans – account balance plans providing for elective deferrals, account balance plans that do not provide for elective deferrals, nonaccount balance plans, separation pay plans, plans providing for in-kind benefits or reimbursements, split-dollar plans, foreign earned income plans, stock right plans, and plans that are not any of the foregoing. All plans of the same type in which the same service provider participates are treated as a single plan. The rule set forth under § 1.409A-3(j)(4)(ix)(C) that requires the termination and liquidation of all plans sponsored by the service recipient that would be aggregated with the terminated plan “if the same service provider had deferrals of compensation” under all of those plans is intended to require the termination of all plans in the same plan category sponsored by the service recipient. The reference to the “same service provider” having deferrals of compensation under all of those plans refers to participation of a hypothetical service provider in all such plans, which would be required to aggregate all of the plans under the section 409A plan aggregation rules.

The Treasury Department and the IRS have concluded that the meaning of the plan termination rule under § 1.409A-3(j)(4)(ix)(C) is not ambiguous. However, to address the questions raised by commenters, these proposed regulations further clarify that the acceleration of a payment pursuant to this rule is permitted only if the service recipient terminates and liquidates all plans of the same category that the service recipient sponsors, and not merely all plans of the same category in which a particular service provider actually participates. These proposed regula-

tions also clarify that under this rule, for a period of three years following the termination and liquidation of a plan, the service recipient cannot adopt a new plan of the same category as the terminated and liquidated plan, regardless of which service providers participate in the plan.

D. Offset Provisions

The final regulations provide that the payment of an amount as a substitute for a payment of deferred compensation is generally treated as a payment of the deferred compensation. They also provide that when the payment of an amount results in an actual or potential reduction of, or current or future offset to, an amount of deferred compensation, the payment is a substitute for the deferred compensation. Further, the final regulations provide that if a service provider’s right to deferred compensation is made subject to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, attachment, or garnishment by the service provider’s creditors, the deferred compensation is treated as having been paid. Under certain circumstances, these provisions may result in an amount being paid (or treated as paid) before the payment date or event specified in the plan in violation of the prohibition on the acceleration of payments under section 409A. The final regulations, however, include a *de minimis* exception to these rules pursuant to which a plan may provide for the acceleration of the time or schedule of a payment, or a payment may be made under a plan, in satisfaction of a debt of the service provider if the debt is incurred in the ordinary course of the service relationship, the entire offset in any taxable year does not exceed \$5,000, and the offset is taken at the same time and in the same amount as the debt otherwise would have been due from the service provider.

Stakeholders have observed that the prohibition on offsets may conflict with certain laws regarding debt collection by the Federal government (for example, 31 U.S.C. sections 3711, *et. seq.*), and that the exception for small debts is insufficient to permit the enforcement of these laws. Because these laws would effectively prevent certain government entities from providing nonqualified deferred

compensation in a manner that complies with the requirements of section 409A(a) and because of the limited applicability of Federal debt collection laws, the Treasury Department and the IRS have determined that it is appropriate to expand the current exception to the prohibition on accelerated payments for certain offsets to permit a plan to provide for the acceleration of the time or schedule of a payment, or to make a payment, to the extent reasonably necessary to comply with Federal laws regarding debt collection.

VII. Amount Includible in Income under Section 409A

The proposed income inclusion regulations provide that the amount includible in income for a taxable year if a nonqualified deferred compensation plan fails to meet the requirements of section 409A(a) at any time during that taxable year equals the excess of (1) the total amount deferred under the plan for that taxable year, including any payments under the plan during that taxable year, over (2) the portion of that amount, if any, that is either subject to a substantial risk of forfeiture or has been previously included in income. The proposed income inclusion regulations, however, include an anti-abuse provision under § 1.409A-4(a)(1)(ii)(B), which provides that an amount otherwise subject to a substantial risk of forfeiture for purposes of determining the amount includible in income under a plan will be treated as not subject to a substantial risk of forfeiture for these purposes if the facts and circumstances indicate that a service recipient has a pattern or practice of permitting impermissible changes in the time or form of payment with respect to nonvested deferred amounts under one or more nonqualified deferred compensation plans and either (i) an impermissible change in the time or form of payment applies to the amount or (ii) the facts and circumstances indicate that the amount would be affected by the pattern or practice.

Although these rules permit the correction of certain plan provisions that fail to comply with the requirements of section 409A(a) while amounts are nonvested without including the amounts in income or incurring an additional tax, they were not intended to allow service recipients to

change time or form of payment provisions that otherwise meet the requirements of section 409A(a) in a manner that fails to comply with section 409A(a), and they were not intended to permit service recipients to create errors in nonqualified deferred compensation plans with respect to nonvested amounts with the intention of using those errors as a pretext for establishing or changing a time or form of payment in a manner that fails to comply with section 409A(a). Accordingly, these proposed regulations clarify and modify the anti-abuse rule under § 1.409A-4(a)(1)(ii)(B) of the proposed income inclusion regulations to preclude changes of this nature.

First, these proposed regulations clarify that a deferred amount that is otherwise subject to a substantial risk of forfeiture is treated as not subject to a substantial risk of forfeiture for a service provider's taxable year during which there is a change in a plan provision (including an initial deferral election provision) that is not otherwise permitted under section 409A and the final regulations and that affects the time or form of payment of the amount if there is no reasonable, good faith basis for concluding that the original provision failed to meet the requirements of section 409A(a) and that the change is necessary to bring the plan into compliance with the requirements of section 409A(a).

Second, these proposed regulations provide examples of the types of facts and circumstances that indicate whether a service recipient has a pattern or practice of permitting impermissible changes in the time or form of payment with respect to nonvested deferred amounts under one or more plans. If the service recipient has such a pattern or practice that would affect a nonvested deferred amount, that amount is treated as not subject to a substantial risk of forfeiture. The facts and circumstances include: Whether a service recipient has taken commercially reasonable measures to identify and correct substantially similar failures promptly upon discovery; whether substantially similar failures have occurred with respect to nonvested deferred amounts to a greater extent than with respect to vested deferred amounts; whether substantially similar failures occur more frequently with re-

spect to newly adopted plans; and whether substantially similar failures appear intentional, are numerous, or repeat common past failures that have since been corrected.

Third, these proposed regulations provide that, to the extent generally applicable guidance regarding the correction of section 409A failures prescribes a particular correction method (or methods) for a type of plan failure, that correction method (or one of the permissible correction methods) must be used if a service recipient chooses to correct that type of a failure with respect to a nonvested deferred amount. In addition, these proposed regulations provide that substantially similar failures affecting nonvested deferred amounts must be corrected in substantially the same manner.

A service recipient correcting a plan failure affecting a nonvested deferred amount is not required, solely with respect to the nonvested deferred amount, to comply with any requirement under generally applicable guidance regarding the correction of section 409A failures that is unrelated to the method for correcting the failure, such as general eligibility requirements, income inclusion, additional taxes, premium interest, or information reporting by the service recipient or service provider. Accordingly, a service recipient may amend a noncompliant plan term in a manner permitted under applicable correction guidance even though the failure may not have been eligible for correction under that guidance (for example, due to applicable timing requirements). In addition, the portion of the nonvested deferred amount that is affected by the correction is not subject to income inclusion, additional taxes, or applicable premium interest under section 409A(a)(1), and neither the service recipient nor the service provider is required to notify the IRS of the correction. For a description of the currently available corrections methods, see Notice 2008-113 (2008-51 IRB 1305), Notice 2010-6 (2010-3 IRB 275), and Notice 2010-80 (2010-51 IRB 853).

VIII. Individual and Entity Service Providers

Under the final regulations, the term service provider includes an individual, corporation, subchapter S corporation,

partnership, personal service corporation, noncorporate entity that would be a personal service corporation if it were a corporation, qualified personal service corporation, and noncorporate entity that would be a qualified personal service corporation if it were a corporation. These proposed regulations clarify §§ 1.409A-1(b)(5)(vi)(A), 1.409A-1(b)(5)(vi)(E), 1.409A-1(b)(5)(vi)(F), and 1.409A-3(i)(5)(iii) of the final regulations to reflect that a service provider can be an entity as well as an individual. These proposed regulations also clarify § 1.409A-1(b)(3) of the final regulations to correct an erroneous reference to “service provider” that should be “service recipient.”

Proposed Effective Dates

General Applicability Date for Amendments to Final Regulations

The provisions of these proposed regulations amending the final regulations are proposed to be applicable on or after the date on which they are published as final regulations in the *Federal Register*. For periods before this date, the existing final regulations and other applicable guidance apply (without regard to these proposed regulations). The applicability date for the existing final regulations in § 1.409A-6(b) is accordingly amended to reflect extension of certain transition relief through 2008 under Notice 2007-86, 2007-46 IRB 990. Taxpayers may, however, rely on these proposed regulations before they are published as final regulations, and until final regulations are published the IRS will not assert positions that are contrary to the positions set forth in these proposed regulations.

Certain provisions of these proposed amendments to the final regulations are not intended as substantive changes to the current requirements under section 409A. Accordingly, the Treasury Department and the IRS have concluded that the following positions may not properly be taken under the existing final regulations: (1) That the transfer of restricted stock for which no section 83(b) election is made or the transfer of a stock option that does not have a readily ascertainable fair market value would result in a payment under a plan; (2) that a contribution to a section 402(b) trust includible in income under section 402(b) to fund an ob-

ligation under a plan would not result in a payment under a plan; (3) that a stock purchase treated as a deemed asset sale under section 338 is a sale or other disposition of assets for purposes of determining when a service provider separates from service as a result of an asset purchase transaction; or (4) that the exception to the prohibition on acceleration of a payment upon a termination and liquidation of a plan pursuant to § 1.409A-3(j)(4)(ix)(C) applies if the service recipient terminates and liquidates only the plans of the same category in which a particular service provider participates, rather than all plans of the same category that the service recipient sponsors.

General Applicability Date for Amendments to Proposed Income Inclusion Regulations

The proposed income inclusion regulations are proposed to be applicable on or after the date on which they are published as final regulations in the *Federal Register*. Notice 2008-115 provides that, until the Treasury Department and the IRS issue further guidance, compliance with the provisions of the proposed income inclusion regulations with respect to the calculation of the amount includible in income under section 409A(a)(1) and the calculation of the additional taxes under section 409A(a)(1) will be treated as compliance with the requirements of section 409A(a), provided that the taxpayer complies with all of the provisions of the proposed regulations. Until the Treasury Department and the IRS issue further guidance, taxpayers may rely on the proposed income inclusion regulations, as modified by the amendment of § 1.409A-4(a)(1)(ii)(B) in these proposed regulations, for purposes of calculating the amount includible in income under section 409A(a)(1) (including the identification and treatment of deferred amounts subject to a substantial risk of forfeiture) and the calculation of the additional taxes under section 409A(a)(1), and the IRS will not assert positions with respect to periods before the date final regulations are published in the *Federal Register* that are contrary to the positions set forth in the proposed income inclusion regulations as amended by these proposed regulations.

Special Applicability Dates for Amendments to Recurring Part-Year Compensation Rules

The rules set forth in these proposed regulations regarding recurring part-year compensation are proposed to be applicable on and after the date on which these proposed regulations are published as final regulations in the *Federal Register*. However, taxpayers may rely on either the rules in these proposed regulations or the rules in Notice 2008-62 relating to recurring part-year compensation for the taxable year in which these proposed regulations are published as final regulations and all prior taxable years.

Effect on Other Documents

These proposed regulations do not affect the applicability of other guidance issued with respect to section 409A, including Notice 2008-115, except that, for the permitted reliance on the proposed income inclusion regulations, these proposed regulations withdraw § 1.409A-4(a)(1)(ii)(B) of the proposed income inclusion regulations and replace it with a new § 1.409A-4(a)(1)(ii)(B).

Statement of Availability of IRS Documents

IRS Revenue Procedures, Revenue Rulings notices, and other guidance cited in this document are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402, or by visiting the IRS website at <http://www.irs.gov>. (See § 601.601(d)(2)(ii)(b) of this chapter.)

Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact 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 proposed regulations. It is hereby certified that the collection of information in these proposed regulations would not have a significant

impact on a substantial number of small entities. This certification is based on the fact that these proposed regulations only provide guidance on how to satisfy existing collection of information requirements. Accordingly, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, these proposed regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the “AD-DRESSES” heading. The Treasury Department and the IRS request comments on all aspects of the rules proposed by these proposed regulations. All comments will be available at *www.regulations.gov* or upon request. A public hearing may be scheduled if requested by any person who timely submits comments. If a public hearing is scheduled, notice of the date, time and place for the hearing will be published in the *Federal Register*.

Drafting Information

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

* * * * *

Partial Withdrawal of Notice of Proposed Rulemaking

Accordingly, under the authority of 26 U.S.C. 7805, § 1.409A-4(a)(1)(ii)(B) of the notice of proposed rulemaking (REG-148326-05) that was published in the *Federal Register* on December 8, 2008 (73 FR 74380) is withdrawn.

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:
Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.409A-0 is amended by:

1. Revising the entry for § 1.409A-1 by adding paragraph (b)(13).
2. Redesignating paragraph (q) as paragraph (r), and revising paragraph (q) in § 1.409A-1.
3. Revising the entry to paragraph (d) in § 1.409A-3.
4. Revising the entry to (j)(4)(xiii) in § 1.409A-3.

The revisions and addition read as follows:

§ 1.409A-0 Table of contents.

* * * * *

§ 1.409A-1 Definitions and covered plans.

* * * * *

(b) * * *

(13) Recurring part-year compensation.

* * * * *

(q) References to a payment being made.

(r) Application of definitions and rules.

* * * * *

§ 1.409A-3 Permissible Payments.

* * * * *

(d) ***

(1) In general.

(2) Payments due following death.

* * * * *

(j) * * *

(4) * * *

(xiii) Certain offsets.

(A) De minimis offset.

(B) Compliance with Federal debt collection laws.

* * * * *

Par. 3. Section 1.409A-1 is amended by:

1. Revising paragraph (a)(4).
2. Revising the first sentence of paragraph (b)(1).
3. Revising paragraphs (b)(3) and (b)(4)(i)(B).
4. Revising paragraph (b)(4)(ii).

5. Adding a last sentence to paragraph (b)(5)(iii)(A).
6. Revising paragraph (b)(5)(iii)(E)(I).
7. Revising the first sentence of paragraph (b)(5)(vi)(A).
8. Revising paragraphs (b)(5)(vi)(E) and (b)(5)(vi)(F).
9. Revising paragraph (b)(9)(iii)(A).
10. Adding a last sentence to paragraph (b)(11).
11. Adding paragraph (b)(13).
12. Revising paragraphs (h)(4) and (h)(5).
13. Redesignating paragraph (q) as paragraph (r) and revising paragraphs (q) and (r).

The revisions and additions read as follows:

§ 1.409A-1 Definitions and covered plans.

* * * * *

(a) * * *

(4) Section 457(f) and section 457A plans. A deferred compensation plan under section 457(f) or a nonqualified deferred compensation plan under section 457A may be 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) or section 457A. In addition, nonelective deferred compensation of non-employees described in section 457(e)(12) and a grandfathered plan or arrangement described in § 1.457-2(k)(4) may be 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).

* * * * *

(b) * * *

(1) * * * Except as otherwise provided in paragraphs (b)(3) through (b)(13) 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, pursuant to the terms of the plan, is or may be payable to (or on

behalf of) the service provider in a later taxable year. * * *

* * * * *

(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 recipient normally compensates non-employee service providers or 30 days after the end of the service provider's taxable year.

(4) * * *

(i) * * *

(B) A payment is treated as actually or constructively received for purposes of this paragraph (b)(4) if it is made in accordance with the rules in § 1.409A-1(q).

* * * * *

(ii) *Certain delayed payments.* A payment that otherwise qualifies as a short-term deferral under paragraph (b)(4)(i) of this section but is made after the applicable 2½ month period may continue to qualify as a short-term deferral if the taxpayer establishes that it was administratively impracticable for the service recipient to make the payment by the end of the applicable 2½ month period and, as of the date upon which the legally binding right to the compensation arose, such impracticability was unforeseeable, or the taxpayer establishes that making the payment by the end of the applicable 2½ month period would have jeopardized the ability of the service recipient to continue as a going concern, and provided further that the payment is made as soon as administratively practicable or as soon as the payment would no longer have such effect. 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.

In addition, a payment that otherwise qualifies as a short-term deferral under paragraph (b)(4)(i) of this section but is made after the applicable 2½ month period may continue to qualify as a short-term deferral if the taxpayer establishes that the service recipient reasonably anticipated that the service recipient's deduction with respect to such payment otherwise would not be permitted by application of section 162(m), and, as of the date the legally binding right to the payment arose, a reasonable person would not have anticipated the application of section 162(m) at the time of the payment, and provided further that the payment is made as soon as reasonably practicable following the first date on which the service recipient anticipates or reasonably should anticipate that, if the payment were made on such date, the service recipient's deduction with respect to such payment would no longer be restricted due to the application of section 162(m). Further, a payment that otherwise qualifies as a short-term deferral under paragraph (b)(4)(i) of this section but is made after the applicable 2½ month period may continue to qualify as a short-term deferral if the taxpayer establishes that the service recipient reasonably anticipated that making the payment by the end of the applicable 2½ month period would have violated Federal securities laws or other applicable law, provided that the payment is made as soon as reasonably practicable following the first date on which the service recipient anticipates or reasonably should anticipate that making the payment would not cause such violation. 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. For additional rules applicable to certain transaction-based compensation, see § 1.409A-3(i)(5)(iv)(A).

* * * * *

(5) * * *

(iii) * * *

(A) * * * The stock price will not be treated as based on a measure other than the fair market value to the extent that the amount payable upon the service provider's involuntary separation from service for cause, or the occurrence of a condition

within the service provider's control such as noncompliance with a noncompetition or nondisclosure agreement (whether or not the condition is specified at the time the stock right is granted), is based on a measure that results in a payment of less than fair market value.

* * * * *

(E) *Eligible issuer of service recipient stock—(1) In general.* The term *eligible issuer of service recipient stock* means the corporation or other entity for which the service provider provides direct services on the date of grant of the stock right or a corporation or other entity for which it is reasonably anticipated that the service provider will begin providing direct services within 12 months after the date of grant, and any corporation or other entity (a related corporation or other entity) in a chain of corporations or other entities in which each corporation or other entity has a controlling interest in another corporation or other entity in the chain, ending with the corporation or other entity that has a controlling interest in the corporation or other entity for which the service provider provides direct services on the date of grant of the stock right or the corporation or other entity for which it is reasonably anticipated that the service provider will begin providing direct services within 12 months after the date of grant. If it is reasonably anticipated that a service provider will begin providing services for a corporation or other entity within 12 months after the date of grant, that corporation or other entity (or a related corporation or other entity) will be an eligible issuer of service recipient stock only if the services in fact commence within 12 months after the date of grant and the stock otherwise is service recipient stock at the time the services begin or, if services do not commence within that 12 month period, the right is forfeited. For this purpose, the term *controlling interest* has the same meaning as provided in § 1.414(c)-2(b)(2)(i), substituting the language "at least 50 percent" for "at least 80 percent" each place it appears in § 1.414(c)-2(b)(2)(i). In addition, if the use of such stock with respect to the grant of a stock right to a service provider is based upon legitimate business criteria, the term *controlling interest* has the same meaning as provided in § 1.414(c)-2(b)(2)(i),

substituting the language “at least 20 percent” for “at least 80 percent” each place it appears in § 1.414(c)–2(b)(2)(i). For purposes of determining ownership of an interest in an organization, the rules of §§ 1.414(c)–3 and 1.414(c)–4 apply. The determination of whether a grant is based on legitimate business criteria is based on the facts and circumstances, focusing primarily on whether there is a sufficient nexus between the service provider and the issuer of the stock right so that the grant serves a legitimate non-tax business purpose other than simply providing compensation to the service provider that is excluded from the requirements of section 409A. For example, when stock of a corporation that owns an interest in a joint venture involving an operating business is granted to service providers of the joint venture who are former service providers of such corporation, that use is generally based upon legitimate business criteria, and therefore could be service recipient stock with respect to such service providers if the corporation owns at least 20 percent of the joint venture and the other requirements of this paragraph (b)(5)(iii) are met. Similarly, the legitimate business criteria requirement generally would be met if the corporate venturer issued such a right to a service provider of the joint venture who it reasonably expected would become a service provider of the corporate venturer. However, if a service provider has no real nexus with a corporate venturer, such as generally happens when the corporate venturer is a passive investor in the service recipient joint venture, a stock right issued to the service provider on the investor corporation’s stock generally would not be based upon legitimate business criteria. Similarly, if a corporation holds only a minority interest in an entity that in turn holds a minority interest in the entity for which the service provider performs services, such that the corporation holds only an insubstantial indirect interest in the entity receiving the services, legitimate business criteria generally would not exist for issuing a stock right on the corporation’s stock to the service provider.

* * * * *

(vi) * * *

(A) * * * The term *option* means the right or privilege of a person to purchase

stock from a corporation by virtue of an offer of the corporation continuing for a stated period of time, whether or not irrevocable, to sell such stock at a price determined under paragraph (b)(5)(vi)(D) of this section, such person being under no obligation to purchase.

* * * * *

(E) *Exercise*. The term *exercise*, when used in reference to an option, means the act of acceptance by the holder of the option of the offer to sell contained in the option. In general, the time of exercise is the time when there is a sale or a contract to sell between the corporation and the holder. A promise to pay the exercise price is not an exercise of the option unless the holder of the option is subject to personal liability on such promise. An agreement or undertaking by the service provider to make payments under a stock purchase plan is not the exercise of an option to the extent the payments made remain subject to the withdrawal by or refund to the service provider.

(F) *Transfer*. The term *transfer*, when used in reference to the transfer to a person of a share of stock pursuant to the exercise of an option, means the transfer of ownership of such share, or the transfer of substantially all the rights of ownership. Such transfer must, within a reasonable time, be evidenced on the books of the corporation. A transfer may occur even if a share of stock is subject to a substantial risk of forfeiture or is not otherwise transferable immediately after the date of exercise. A transfer does not fail to occur merely because, under the terms of the arrangement, the person may not dispose of the share for a specified period of time, or the share is subject to a right of first refusal or a right to acquire the share at the share’s fair market value at the time of the sale.

* * * * *

(9) * * *

(iii) * * *

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

(J) The service provider’s annualized compensation based upon the annual rate of pay for services provided to the service recipient for the service provider’s taxable year preceding the taxable year in which

the service provider has a separation from service with such service recipient (or for the taxable year in which the service provider has a separation from service if the service provider had no compensation from the service recipient in the preceding taxable year), adjusted for any increase during that year that was expected to continue indefinitely if the service provider had not separated from service; or

(2) The maximum amount that may be taken into account under a qualified retirement plan pursuant to section 401(a)(17) for the calendar year in which the service provider has a separation from service.

* * * * *

(11) * * * In addition, a plan does not provide for a deferral of compensation for purposes of this paragraph (b) to the extent it provides for a payment of reasonable attorneys’ fees or other reasonable expenses incurred by the service provider to enforce any *bona fide* legal claim against the service recipient with respect to the service relationship between the service provider and the service recipient.

* * * * *

(13) *Recurring part-year compensation*. A plan in which a service provider participates that provides for the payment of recurring part-year compensation (as defined in § 1.409A–2(a)(14)), whether or not at the service provider’s election, does not provide for a deferral of compensation for purposes of this paragraph (b) if the plan does not defer payment of any of the recurring part-year compensation to a date beyond the last day of the 13th month following the first day of the service period for which the recurring part-year compensation is paid, and the amount of the service provider’s recurring part-year compensation does not exceed the annual compensation limit under section 401(a)(17) for the calendar year in which the service period commences.

* * * * *

(h) * * *

(4) *Asset purchase transactions*. If as part of a sale or other disposition of assets by one service recipient (seller) to an unrelated service recipient (buyer), a service provider of the seller would otherwise experience a separation from service with the seller, the seller and the buyer may retain the discretion to specify, and may specify, whether a service provider pro-

viding services to the seller immediately before the asset purchase transaction and providing services to the buyer after and as a result of the asset purchase transaction has experienced a separation from service for purposes of this paragraph (h), provided that the asset purchase transaction results from *bona fide*, arm's length negotiations, all service providers providing services to the seller immediately before the asset purchase transaction and providing services to the buyer after and as a result of the asset purchase transaction are treated consistently (regardless of position at the seller) for purposes of applying the provisions of any nonqualified deferred compensation plan, and such treatment is specified in writing no later than the closing date of the asset purchase transaction. For purposes of this paragraph (h)(4), references to a sale or other disposition of assets, or an asset purchase transaction, refer only to a transfer of substantial assets, such as a plant or division or substantially all of the assets of a trade or business, and do not refer to a stock purchase treated as a deemed asset sale under section 338. For purposes of this paragraph (h)(4), whether a service recipient is related to another service recipient is determined under the rules provided in paragraph (f)(2)(ii) of this section.

(5) *Dual status.* If a service provider provides services both as an employee of a service recipient and as an independent contractor of the service recipient, the service provider must separate from service both as an employee and as an independent contractor to be treated as having separated from service. Notwithstanding the foregoing, if a service provider provides services both as an employee of a service recipient and as a member of the board of directors of a corporate service recipient (or an analogous position with respect to a non-corporate service recipient), the services provided as a director are not taken into account in determining whether the service provider has a separation from service as an employee for purposes of a nonqualified deferred compensation plan in which the service provider participates as an employee that is not aggregated with any plan in which the service provider participates as a director under paragraph (c)(2)(ii) of this section. In addition, if a service provider provides

services both as an employee of a service recipient and as a member of the board of directors of a corporate service recipient (or an analogous position with respect to a non-corporate service recipient), the services provided as an employee are not taken into account in determining whether the service provider has a separation from service as a director for purposes of a nonqualified deferred compensation plan in which the service provider participates as a director that is not aggregated with any plan in which the service provider participates as an employee under paragraph (c)(2)(ii) of this section.

* * * * *

(q) *References to a payment being made.* A payment is made or an amount is paid or received when any taxable benefit is actually or constructively received, which includes a transfer of cash, a transfer of property includible in income under section 83, any other event that results in the inclusion in income under the economic benefit doctrine, a contribution to a trust described in section 402(b) at the time includible in income under section 402(b), a transfer or creation of a beneficial interest in a section 402(b) trust at the time includible in income under section 402(b), and the inclusion of an amount in income under 457(f)(1)(A). In addition, a payment is made or an amount is paid or received upon the transfer, cancellation, or reduction of an amount of deferred compensation in exchange for benefits under a welfare benefit plan, a fringe benefit excludible under section 119 or section 132, or any other benefit that is excludible from gross income. Notwithstanding the foregoing, the occurrence of any of the following events is not a payment:

(1) a grant of an option that does not have a readily ascertainable fair market value (as defined under § 1.83-7(b));

(2) a transfer of property (including an option that has a readily ascertainable fair market value) that is substantially nonvested (as defined under § 1.83-3(b)) with respect to which the service provider does not make a valid election under section 83(b); or

(3) a contribution to a trust described in section 402(b) or a transfer or creation of a beneficial interest in a section 402(b) trust unless and until the amount is includible in income under section 402(b).

(r) *Application of definitions and rules.* The definitions and rules set forth in paragraphs (a) through (q) of this section apply for purposes of section 409A, this section, and §§ 1.409A-2 through 1.409A-6.

Par. 4. Section 1.409A-2 is amended by revising paragraph (b)(2)(i) to read as follows:

§ 1.409A-2 *Deferral elections.*

* * * * *

(b) * * *

(2) *Definitions 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 under a nondiscretionary formula. For example, an amount identified as 10 percent of the account balance as of a specified payment date would be a separately identified amount. The determination of whether a payment is or has been made for purposes of this paragraph (b) is made in accordance with the rules in § 1.409A-1(q). For additional rules relating to the application of this paragraph (b) to amounts payable at a fixed time or pursuant to a fixed schedule, see § 1.409A-3(i)(1).

* * * * *

Par. 5. Section 1.409A-3 is amended by:

1. Revising paragraph (b).
2. Redesignating paragraph (d) as paragraph (d)(1) and revising the heading of paragraph (d)(1).
3. Adding paragraph (d)(2).
4. Revising paragraphs (i)(5)(iii) and (i)(5)(iv)(A).
5. Revising paragraphs (j)(1) and (j)(2).
6. Revising paragraph (j)(4)(iii)(B).
7. Revising paragraphs (j)(4)(ix)(A) and (j)(4)(ix)(C).
8. Revising paragraph (j)(4)(xiii).

The revisions and additions read as follows:

§ 1.409A-3 Permissible payments.

* * * * *

(b) *Designation of payment upon a permissible payment event.* Except as otherwise specified in this section, a plan provides for the payment upon an event described in paragraph (a)(1), (2), (3), (5), or (6) of this section if the plan provides the date of the event is the payment date, or specifies another payment date that is objectively determinable and nondiscretionary at the time the event occurs. A plan 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 schedule that is objectively determinable and nondiscretionary based on the date the event occurs and that would qualify as a fixed schedule under paragraph (i)(1) of this section if the payment event were instead a fixed date, provided that the schedule must be fixed at the time the permissible payment event is designated. In addition, a plan may provide that a payment, including a payment that is part of a schedule, is to be made during a designated taxable year of the service provider that is objectively determinable and nondiscretionary at the time the payment event occurs such as, for example, a schedule of three substantially equal payments payable during the first three taxable years following the taxable year in which a separation from service occurs. A plan may also provide that a payment, including a payment that is part of a schedule, is to be made during a designated period objectively determinable and nondiscretionary at the time the payment event occurs, but only if the designated period both begins and ends within one taxable year of the service provider or the designated period is not more than 90 days and the service provider does not have a right to designate the taxable year of the payment (other than an election that complies with the subsequent deferral election rules of § 1.409A-2(b)). However, in the case of a payment to be made following the death of the service provider or a beneficiary who has become entitled to payment due to the service provider's death, in addition to the permitted designated periods described in the previous sentence, the designated period may begin on the date of

death and end on December 31 of the first calendar year following the calendar year during which the death occurs, and the payment recipient may have the right to designate the taxable year of payment. If a plan provides for a period of more than one day following a payment event during which a payment may be made, such as permitting payment within 90 days following the date of the event, the payment date for purposes of the subsequent deferral rules under § 1.409A-2(b) is treated as the first possible date upon which a payment could be made under the terms of the plan. A plan may provide for payment upon the earliest or latest of more than one event or time, provided that each event or time is described in paragraphs (a)(1) through (6) of this section. For examples illustrating the provisions of this paragraph, see paragraph (i)(1)(vi) of this section.

* * * * *

(d) *When a payment is treated as made upon the designated payment date—(1) In general.* * * *

(2) *Payments due following death.* A payment specified to be made under the plan on any date within the period beginning on the date of the death of the service provider, or of a beneficiary who has become entitled to payment due to the service provider's death, and ending on December 31 of the first calendar year following the calendar year during which the death occurs (including a payment specified to be made upon death) is treated as made on the date specified under the plan if the payment is made on any date during this period, regardless of whether the payment recipient designates the taxable year of payment. Further, any change to the time or form of a payment that is specified to be made under the plan during this period to provide that the payment will be made on any other date during this period will not be treated as a subsequent deferral election for purposes of § 1.409A-2(b)(1) or an impermissible acceleration for purposes of § 1.409A-3(j)(1).

* * * * *

(i) * * *

(5) * * *

(iii) *Attribution of stock ownership.* For purposes of paragraph (i)(5) of this section, section 318(a) applies to determine

stock ownership. Stock underlying a vested option is considered owned by the person who holds the vested option (and the stock underlying a nonvested option is not considered owned by the person who holds the nonvested 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 person who holds the option.

* * * * *

(iv) *Special rules for certain delayed payments pursuant to a change in control event—(A) Certain transaction-based compensation.* Payments of compensation related to a change in control event described in paragraph (i)(5)(v) of this section (change in the ownership of a corporation) or paragraph (i)(5)(vii) of this section (change in the ownership of a substantial portion of a corporation's assets) that occur because a service recipient purchases its stock held by the service provider or because the service recipient or a third party purchases a stock right or a statutory stock option described in § 1.409A-1(b)(5)(ii) held by a service provider, or that are calculated by reference to the value of stock of the service recipient (collectively, transaction-based compensation), may be treated as paid on a designated date or pursuant to a payment schedule that complies with the requirements of section 409A if the transaction-based compensation is paid on the same schedule and under the same terms and conditions as apply to payments to shareholders generally with respect to stock of the service recipient pursuant to a change in control event described in paragraph (i)(5)(v) of this section (change in the ownership of a corporation) or as apply to payments to the service recipient pursuant to a change in control event described in paragraph (i)(5)(vii) of this section (change in the ownership of a substantial portion of a corporation's assets). In addition, to the extent that the transaction-based compensation is paid not later than five years after the change in control event, the payment of such compensation will not violate the initial or subsequent deferral election rules set out in § 1.409A-2(a) and (b) solely as a result of such transaction-based compensation being

paid pursuant to such schedule and terms and conditions. The payment or agreement to pay transaction-based compensation payable with respect to a stock right described in § 1.409A-1(b)(5)(i)(A) or (B) or a statutory stock option described in § 1.409A-1(b)(5)(ii) also will not cause the stock right or statutory stock option to be treated as having provided for the deferral of compensation from the original grant date solely as a result of the transaction-based compensation being paid on the same schedule and under the same terms and conditions as apply to payments to shareholders generally with respect to stock of the service recipient pursuant to the change in control event described in paragraph (i)(5)(v) of this section (change in the ownership of a corporation) or as apply to payments to the service recipient pursuant to the change in control event described in paragraph (i)(5)(vii) of this section (change in the ownership of a substantial portion of a corporation's assets) and the transaction-based compensation is paid not later than five years after the change in control event. If before and in connection with a change in control event described in paragraph (i)(5)(v) or (i)(5)(vii) of this section, transaction-based compensation that would otherwise be payable as a result of such event is made subject to a condition on payment that is a substantial risk of forfeiture (as defined in § 1.409A-1(d), without regard to the provisions of that section under which additions or extensions of forfeiture conditions are disregarded) and the transaction-based compensation is payable under the same terms and conditions as apply to payments made to shareholders generally with respect to stock of the service recipient pursuant to a change in control event described in paragraph (i)(5)(v) of this section or to payments to the service recipient pursuant to a change in control event described in paragraph (i)(5)(vii) of this section, for purposes of determining whether such transaction-based compensation is a short-term deferral the requirements of § 1.409A-1(b)(4) are applied as if the legally binding right to such transaction-based compensation arose on the date that it became subject to such substantial risk of forfeiture.

* * * * *

(j) *Prohibition on acceleration of payments*—(1) *In general*—Except as provided in paragraph (j)(4) of this section, 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 the terms of the plan, and no such accelerated payment may be made whether or not provided for under the terms of such plan. For purposes of determining whether a payment of deferred compensation has been made, the rules of paragraph (f) of this section (on substituted payments) apply. For purposes of this paragraph (j), 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 payment event that is an event described in paragraph (a)(1), (2), (3), (5) or (6) of this section. For such purpose, the intervening payment event may apply with respect to either the service provider or, following the service provider's death, a beneficiary who becomes entitled to payment due to the service provider's death (substituting such beneficiary for the service provider in the definitions of *disability* in paragraph (i)(4) of this section and *unforeseeable emergency* in paragraph (i)(3) of this section, as applicable). 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 plan 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 five 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. However, if the plan in this example had provided for a payment on a fixed date, rather than at separation from service, the date of payment could not be accelerated due to the accelerated vesting. For the definition of a payment for purposes of this paragraph (j), see § 1.409A-2(b)(5) (coordination of the subsequent deferral election rules with the prohibition on acceleration of payments). For other permissible payments, see § 1.409A-2(b)(2)(iii) (certain immediate payments of remaining installments) and paragraph (d) of this section (certain payments made no more than 30 days before the designated payment date).

(2) *Application to multiple payment events*. The addition of a permissible payment event, the deletion of a permissible payment event, or the substitution of one permissible payment event for another permissible payment event, results in an acceleration of a payment if the addition, deletion, or substitution could result in the payment being made on an earlier date than such payment would have been made absent such addition, deletion, or substitution. Notwithstanding the previous sentence, the addition of death, disability (as defined in paragraph (i)(4) of this section), or an unforeseeable emergency (as defined in paragraph (i)(3) of this section), as a potentially earlier alternative or intervening payment event to an amount previously deferred will not be treated as resulting in an acceleration of a payment, even if such addition results in the payment being paid at an earlier time than such payment would have been made absent the addition of the payment event. For such purpose, the earlier alternative or intervening payment event may apply with respect to either the service provider or, following the service provider's death, a beneficiary who becomes entitled to

payment due to the service provider's death (substituting such beneficiary for the service provider in the definitions of *disability* in paragraph (i)(4) of this section and *unforeseeable emergency* in paragraph (i)(3) of this section, as applicable). However, the addition of such a payment event as a potentially later alternative payment event generally is subject to the rules governing changes in the time and form of payment (see § 1.409A-2(b)).

* * * * *

(4) * * *

(iii) * * *

(B) *Compliance with ethics laws or conflicts of interest laws.* A plan may provide for acceleration of the time or schedule of a payment under the plan, or a payment may be made under a plan, to the extent reasonably necessary to avoid the violation of an applicable Federal, state, local, or *bona fide* foreign ethics law or conflicts of interest law (including under circumstances in which such payment is reasonably necessary to permit the service provider to participate in activities in the normal course of his or her position in which the service provider would otherwise not be able to participate under an applicable rule). A payment is reasonably necessary to avoid the violation of a Federal, state, local, or *bona fide* foreign ethics law or conflicts of interest law if the payment is a necessary part of a course of action that results in compliance with a Federal, state, local, or *bona fide* foreign ethics law or conflicts of interest law that would be violated absent such course of action, regardless of whether other actions would also result in compliance with the Federal, state, local, or *bona fide* foreign ethics law or conflicts of interest law.

* * * * *

(ix) * * *

(A) The service recipient's termination and liquidation of the plan within 12 months of a corporate dissolution taxed under section 331, or with the approval of a U.S. bankruptcy court, provided that the amounts deferred under the plan are included in the participants' gross incomes in the latest of the following years (or, if earlier, the taxable year in which the amount is actually or constructively received).

(I) The calendar year in which the plan termination and liquidation occurs;

(2) The first 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.

* * * * *

(C) The service recipient's termination and liquidation of the plan, provided that—

(I) The termination and liquidation does not occur proximate to a downturn in the financial health of the service recipient;

(2) The service recipient terminates and liquidates all agreements, methods, programs, and other arrangements sponsored by the service recipient that would be aggregated with any terminated and liquidated agreements, methods, programs, and other arrangements under § 1.409A-1(c) as if there were one service provider that had deferrals of compensation under every such agreement, method, program, and other arrangement sponsored by the service recipient (for example, all elective account balance plans that the service recipient sponsors);

(3) No payments in liquidation of the plan are made within 12 months of the date the service recipient takes all necessary action to irrevocably terminate and liquidate the plan other than payments that would be payable under the terms of the plan if the action to terminate and liquidate the plan had not occurred;

(4) All payments are made within 24 months of the date the service recipient takes all necessary action to irrevocably terminate and liquidate the plan; and

(5) The service recipient does not adopt any new agreement, method, program, or other arrangement described in paragraph (C)(2) of this subsection, at any time within three years following the date the service recipient takes all necessary action to irrevocably terminate and liquidate the plan.

* * * * *

(xiii) *Certain offsets*—(A) *De minimis offset.* A plan may provide for the acceleration of the time or schedule of a payment, or a payment may be made under such plan, as satisfaction of a debt of the service provider to the service recipient, if such debt is incurred in the ordinary course of the service relationship between the service recipient and the service pro-

vider, the entire amount of reduction in any of the service recipient's taxable years does not exceed \$5,000, and the reduction is made at the same time and in the same amount as the debt otherwise would have been due and collected from the service provider.

(B) *Compliance with Federal debt collection laws.* A plan may provide for the acceleration of the time or schedule of a payment, or a payment may be made under such plan, as satisfaction of a debt of the service provider to the service recipient, to the extent reasonably necessary to comply with 31 U.S.C. sections 3711 et. seq. or similar Federal nontax law regarding debt collection relating to claims of the Federal government. A payment is reasonably necessary to comply with such a Federal debt collection law if the payment is a necessary part of a course of action that results in compliance with the Federal debt collection law that would be violated absent such course of action, regardless of whether other actions would also result in compliance with the Federal debt collection law.

* * * * *

Par. 6. Section 1.409A-4 (REG-148326-05), as proposed at 73 FR 74380 (December 8, 2008), is proposed to be amended by revising paragraph (a)(1)(ii)(B) to read as follows:

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

* * * * *

(B) *Treatment of certain deferred amounts otherwise subject to a substantial risk of forfeiture*—For purposes of determining the amount includible in income under section 409A(a)(1) and paragraph (a)(1)(i) of this section, an amount deferred under a plan that is otherwise subject to a substantial risk of forfeiture for a taxable year is treated as not subject to a substantial risk of forfeiture for the taxable year, if during the taxable year any of the following occur:

(I) A change (including an initial deferral election) that is not authorized under § 1.409A-1, § 1.409A-2, or § 1.409A-3 is made to a provision of the plan providing for the time or form of payment of the deferred amount, if the service recipient has not made a reason-

able, good faith determination that, absent the change, the provision fails to comply with the requirements of section 409A(a).

(2) The service recipient has engaged in a pattern or practice of permitting substantially similar failures to comply with section 409A(a) under one or more non-qualified deferred compensation plans while amounts deferred under the plans are nonvested, and the facts and circumstances indicate that the deferred amount would be affected by the pattern or practice. Whether such a pattern or practice exists will depend on the facts and circumstances, including, but not limited to, whether the service recipient has taken commercially reasonable measures to identify and correct the substantially similar failures promptly upon discovery, whether the failures have affected non-vested deferred amounts with greater frequency than vested deferred amounts, whether the failures have occurred more frequently under newly adopted plans, and whether the failures appear intentional, are numerous, or repeat one or more similar past failures that were previously identified and corrected.

(3) The correction of a failure to comply with section 409A(a) affecting the deferred amount is not consistent with an applicable correction method (if one exists) set forth in applicable guidance issued by the Treasury Department and the IRS for correcting failures under section 409A(a), or the failure is not corrected in substantially the same manner as a substantially similar failure affecting a non-vested deferred amount under another plan sponsored by the service recipient. Solely with respect to the deferred amount, the requirements under applicable correction guidance with respect to eligibility, income inclusion, additional taxes, premium interest, and information reporting by the service recipient or service provider do not apply.

Par. 7. Section 1.409A-6 is amended by revising paragraph (b) to read as follows:

§ 1.409A-6 Application of section 409A and effective dates.

* * * * *

(b) *Regulatory applicability date.* Section 1.409A-0, § 1.409A-1, § 1.409A-2,

§ 1.409A-3 and this section, as amended, apply for taxable years beginning on or after publication of the Treasury decision adopting these rules as final regulations in the *Federal Register*. Section 1.409A-0, § 1.409A-1, § 1.409A-2, § 1.409A-3 and this section as they appeared in the April 2009 edition of 26 CFR part 1 apply for taxable years beginning on or after January 1, 2009 and before publication of the Treasury decision adopting these rules as final regulations in the *Federal Register*.

John Dalrymple
*Deputy Commissioner
for Services and Enforcement.*

(Filed by the Office of the Federal Register on June 21, 2016, 8:45 a.m., and published in the issue of the Federal Register for June 22, 2016, 81 F.R. 40569)

Deferred Compensation Plans of State and Local Governments and Tax- Exempt Entities

REG-147196-07

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations prescribing rules under section 457 of the Internal Revenue Code for the taxation of compensation deferred under plans established and maintained by State or local governments or other tax exempt organizations. These proposed regulations include rules for determining when amounts deferred under these plans are includible in income, the amounts that are includible in income, and the types of plans that are not subject to these rules. The proposed regulations would affect participants, beneficiaries, sponsors, and administrators of certain plans sponsored by State or local governments or tax-exempt organizations that provide for a deferral of compensation. This document also provides a notice of a public hearing on the proposed regulations.

DATES: Written or electronic comments on these proposed regulations must be received by September 20, 2016. Outline of topics to be discussed at the public hearing scheduled for October 18, 2016 at 10 a.m. must be received by September 20, 2016.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-147196-07), room 5203, Internal Revenue Service, P.O. 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-147196-07), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington DC, 20224 or sent electronically, via the Federal eRulemaking Portal at www.regulations.gov (IRS REG-147196-07). The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, N.W., Washington DC, 20224.

FOR FURTHER INFORMATION

CONTACT: Concerning the proposed regulations under section 457, Keith Kost at (202) 317-6799 or Cheryl Press at (202) 317-4148, concerning submission of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Regina Johnson at (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under section 457(a), (b), and (f) of the Internal Revenue Code (Code), as well as proposed regulations under section 457(e)(11), (e)(12), and (g)(4). Generally, if a deferred compensation plan of a State or local government or tax-exempt entity does not satisfy the requirements of section 457(b), (c), (d), and, in the case of a plan that is maintained by a State or local government, (g), compensation deferred under the plan will be included in income in accordance with section 457(f) unless the plan is not subject to section 457 or is treated as not providing for a deferral of compensation for purposes of section 457. Section 457(e) includes certain definitions

and special rules for purposes of section 457 and describes certain plans that either are not subject to section 457 or are treated as not providing for a deferral of compensation under section 457.¹

Section 457(a)(1) provides that any amount of compensation deferred under an eligible deferred compensation plan as defined in section 457(b) (an eligible plan), and any income attributable to the amounts so deferred, is includible in gross income only for the taxable year in which the compensation or other income is paid to the participant or beneficiary in the case of an eligible employer described in section 457(e)(1)(A) or is paid or otherwise made available to the participant or beneficiary in the case of an eligible employer described in section 457(e)(1)(B). An eligible employer described in section 457(e)(1)(A) means a State, a political subdivision of a State, or any agency or instrumentality of a State or political subdivision of a State (a governmental entity). An eligible employer described in section 457(e)(1)(B) means any organization other than a governmental entity that is exempt from tax under subtitle A (a tax-exempt entity).

Section 457(f)(1)(A) provides that, in the case of a plan of an eligible employer providing for a deferral of compensation, if the plan is not an eligible plan, the compensation is included in gross income when the rights to payment of the compensation are not subject to a substantial risk of forfeiture, as defined in section 457(f)(3)(B).² Section 457(f)(1)(B) provides that the tax treatment of any amount made available under the plan will be determined under section 72. Section 457(f)(2) provides that section 457(f)(1) does not apply to a plan that is described in section 401(a) or an annuity plan or contract described in section 403, the portion of any plan that consists of a transfer of property described in section 83, the

portion of a plan that consists of a trust described in section 402(b), a qualified governmental excess benefit arrangement described in section 415(m), or the portion of any applicable employment retention plan described in section 457(f)(4).

Section 457(e)(11) provides that certain plans are treated as not providing for a deferral of compensation. These plans include any bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plan, as well as any plan paying solely length of service awards to certain bona fide volunteers (or their beneficiaries) and certain voluntary early retirement incentive plans.³ Section 457(e)(12) provides that section 457 does not apply to certain nonelective deferred compensation of nonemployees.

On July 11, 2003, the Treasury Department and the IRS issued final regulations under section 457 (TD 9075) (68 FR 41230) (2003 final regulations). The 2003 final regulations provide guidance on deferred compensation plans of eligible employers, including eligible plans under section 457(b). The 2003 final regulations also reflect the changes made to section 457 by the Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2494), the Small Business Job Protection Act of 1996, Public Law 104-188 (110 Stat. 1755), the Taxpayer Relief Act of 1997, Public Law 105-34 (111 Stat. 788), the Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107-16 (115 Stat. 38), and the Job Creation and Worker Assistance Act of 2002, Public Law 107-147 (116 Stat. 21). The proposed amendments to the 2003 final regulations under section 457(a), (b), and (g) contained in this document include amendments to reflect subsequent statutory changes made to section 457. The following sections of this preamble provide a chronological description of the relevant changes made after the 2003 final

regulations were issued. (For a summary of the proposed changes to the 2003 final regulations, see the Explanation of Provisions section of this preamble.)

I. American Jobs Creation Act of 2004

Section 885 of the American Jobs Creation Act of 2004, Public Law 108-357 (118 Stat. 1418), added section 409A to the Code. Section 409A generally provides that, if at any time during a taxable year a nonqualified deferred compensation plan fails to meet the requirements of section 409A or is not operated in accordance with those requirements, all amounts deferred under the plan for the taxable year and all preceding taxable years are includible in gross income to the extent the amounts are not subject to a substantial risk of forfeiture and were not previously included in gross income.

On April 17, 2007, the Treasury Department and the IRS issued final regulations under section 409A (TD 9312) at 72 FR 19234 (final section 409A regulations). The final section 409A regulations provide guidance on the definition of certain terms and the types of plans covered under section 409A, permissible deferral elections under section 409A, and permissible payments under section 409A. The final section 409A regulations provide that a deferred compensation plan of a governmental entity or a tax-exempt entity that is subject to section 457(f) may constitute a nonqualified deferred compensation plan for purposes of section 409A and that the rules of section 409A apply separately and in addition to any requirements applicable to these plans under section 457(f).

On December 8, 2008, proposed regulations under section 409A were published in the **Federal Register** (73 FR 74380) (proposed section 409A regulations) that provide guidance on the calcu-

¹Plans described in certain statutes that are not incorporated into the Code are not subject to section 457. See sections 1107(c)(3)(B), 1107(c)(4), and 1107(c)(5) of the Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2494 (1986)), as amended, and sections 1101(e)(6), 6064(d)(2), and 6064(d)(3) of the Technical and Miscellaneous Revenue Act of 1988, Public Law 100-647 (102 Stat. 3342 (1988)).

²In Notice 2007-62 (2007-2 CB 331 (August 6, 2007)), the Treasury Department and the IRS announced the intent to issue guidance under section 457, including providing definitions of a bona fide severance pay plan under section 457(e)(11) and substantial risk of forfeiture under section 457(f)(3)(B). In response to comments received in response to a request in Notice 2007-62 (on subjects including but not limited to severance pay, covenants not to compete, and the definition of substantial risk of forfeiture), the rules in these proposed regulations have been modified from the proposals announced in that notice.

³Announcement 2000-1 (2000-1 CB 294 (January 1, 2000)), provides transitional guidance on the reporting requirements for certain broad-based, nonelective deferred compensation plans maintained by State or local governments. The announcement states that, pending the issuance of further guidance, a State or local government should not report amounts for any year before the year in which a participant or beneficiary is in actual or constructive receipt of those amounts if the amounts are provided under a plan that the State or local government has been treating as a bona fide severance pay plan under section 457(e)(11) for years before calendar year 1999. To be eligible for this transitional relief, the plan must satisfy certain requirements described in the announcement.

lation of amounts includible in income under section 409A(a) and the additional taxes imposed by that section with respect to arrangements that do not comply with the requirements of section 409A(a).

In Notice 2008–62 (2008–29 IRB 130 (July 21, 2008)), the Treasury Department and the IRS provided guidance under sections 409A and 457(f) regarding recurring part-year compensation. For this purpose, recurring part-year compensation is compensation paid for services rendered in a position that the employer and employee reasonably anticipate will continue under similar terms and conditions in subsequent years, and under which the employee will be required to provide services during successive service periods each of which comprises less than 12 months (for example, a teacher providing services during a school year comprised of 10 consecutive months) and each of which begins in one taxable year of the employee and ends in the next taxable year. Notice 2008–62 provides that an arrangement under which an employee or independent contractor receives recurring part-year compensation does not provide for the deferral of compensation for purposes of section 409A or for purposes of section 457(f) if (A) the arrangement does not defer payment of any of the recurring part-year compensation beyond the last day of the 13th month following the beginning of the service period, and (B) the arrangement does not defer from one taxable year to the next taxable year the payment of more than the applicable dollar amount under section 402(g)(1)(B) (\$18,000 for 2016). The notice provides that taxpayers may rely on this rule beginning in the first taxable year that includes July 1, 2008.

II. Pension Protection Act of 2006

The Pension Protection Act of 2006, Public Law 109–280 (120 Stat. 780) (PPA '06), permits a participant's designated beneficiary who is not a surviving spouse to roll over, in a direct trustee-to-

trustee transfer, distributions from an eligible plan maintained by a governmental entity (an eligible governmental plan) to an individual retirement account or annuity (IRA). Section 829 of PPA '06 added section 402(c)(11) to the Code, which provides that this type of transfer is treated as an eligible rollover distribution for purposes of section 402(c).

Section 845(b)(3) of PPA '06 added section 457(a)(3) to the Code, which provides an exclusion from gross income for amounts that are distributed from an eligible governmental plan to the extent provided in section 402(l). Section 402(l) provides that distributions from certain governmental retirement plans are excluded from the gross income of an eligible retired public safety officer to the extent the distributions do not exceed the amount paid by the retired officer for qualified health insurance premiums for the year, up to a maximum of \$3,000. See Notice 2007–7, part IV (2007–1 CB 395 (January 29, 2007)), as well as Notice 2007–99 (2007–2 CB 1243 (December 26, 2007)), for guidance on the application of section 402(l).

Section 1104(a)(1) of PPA '06 added section 457(e)(11)(D) to the Code, which treats applicable voluntary early retirement incentive plans as bona fide severance pay plans that do not provide for a deferral of compensation under section 457 with respect to payments or supplements that are an early retirement benefit, a retirement-type subsidy, or a social security supplement in coordination with a defined benefit pension plan. This treatment applies only to the extent the payments otherwise could have been provided under the defined benefit plan (determined as if section 411 applied to the defined benefit plan). Under section 457(e)(11)(D)(ii), an applicable voluntary early retirement incentive plan may be maintained only by a local educational agency or a tax-exempt education association.⁴

Section 1104(b)(1) of PPA '06 added section 457(f)(2)(F) to the Code, which provides that section 457(f)(1) does not apply to an applicable employment retention plan. Under section 457(f)(4), an applicable employment retention plan is a plan maintained by a local educational agency or a tax-exempt education association to pay additional compensation upon severance from employment for purposes of employee retention or rewarding employees to the extent that the benefits payable under the plan do not exceed twice the applicable annual dollar limit on deferrals in section 457(e)(15).⁵

III. Heroes Earnings Assistance and Relief Tax Act of 2008

Section 104(c) of the Heroes Earnings Assistance and Relief Tax Act of 2008, Public Law 110–245 (122 Stat. 1624) (HEART Act), amended section 457 to add section 457(g)(4) regarding benefits payable upon death during qualified active military service under the Uniformed Services Employment and Reemployment Rights Act of 1994, Public Law 103–353 (108 Stat. 3149). Section 457(g)(4) provides that an eligible governmental plan must meet the requirements of section 401(a)(37). Under section 401(a)(37), a plan is not treated as a qualified retirement plan unless the plan provides that, in the case of a participant who dies while performing qualified military service, the survivors of the participant are generally entitled to any additional benefits that would have been provided under the plan if the participant had resumed and then terminated employment on account of death. Section 105(b) of the HEART Act added section 414(u)(12) to the Code, which provides rules regarding (A) the treatment of differential wage payments as compensation and (B) the treatment of service in the uniformed services (as described in section 3401(h)(2)(A)) as a severance from employment for purposes of plan distribution requirements, including the

⁴A local education agency is defined in section 9101 of the Elementary and Secondary Education Act of 1965, Public Law 89–10 (79 Stat. 27), as a public board of education or other public authority legally constituted within a State for either administrative control or direction of, or to perform a service function for, public elementary schools or secondary schools in a city, county, township, school district, or other political subdivision of a State, or of or for a combination of school districts or counties that is recognized in a State as an administrative agency for its public elementary schools or secondary schools. A tax-exempt education association is an association that principally represents employees of one or more local education agencies and is an entity described in section 501(c)(5) or (6) that is exempt from tax under section 501(a).

⁵See also section 1104(c) of PPA '06, which amended section 3(2) of the Employee Retirement Income Security Act of 1974, Public Law 93–406 (88 Stat. 829) (ERISA), to provide that applicable voluntary early retirement incentive plans and applicable employment retention plans are treated as welfare plans (and not pension plans) for purposes of ERISA.

distribution requirements of section 457(d)(1)(A)(ii).

IV. *Small Business Jobs Act of 2010 and American Taxpayer Relief Act of 2012*

Section 2111 of the Small Business Jobs Act of 2010, Public Law 111-240 (124 Stat. 2504) (SBJA), amended section 402A of the Code to allow an eligible governmental plan to include a qualified Roth contribution program, effective for taxable years beginning after December 31, 2010. SBJA also amended section 402A to permit taxable in-plan rollovers to qualified Roth accounts under eligible governmental plans. Section 902 of the American Taxpayer Relief Act of 2012, Public Law 112-240 (126 Stat. 2313), expanded the types of amounts eligible for an in-plan Roth rollover. For guidance relating to in-plan rollovers to qualified Roth accounts, see Notice 2013-74 (2013-52 IRB 819 (December 23, 2013)) and Notice 2010-84 (2010-51 IRB 872 (July 19, 2010)).

Explanation of Provisions

I. *Overview*

These proposed regulations make certain changes to the 2003 final regulations under sections 457(a), 457(b), and 457(g) to reflect statutory changes to section 457 since the publication of those regulations. In addition, these proposed regulations provide guidance on certain issues under sections 457(e)(11) and 457(e)(12) that are not addressed in the 2003 final regulations and provide additional guidance under section 457(f). Consistent with the 2003 final regulations, although the rules under section 457 apply to plan participants and beneficiaries without regard to whether the related services are provided by an employee or independent contractor, these proposed regulations often use the terms employee and employer to describe a service provider and a service recipient, respectively, without regard to whether the service provider is an independent contractor.⁶

II. *Regulatory Amendments to Reflect Statutory Changes to Section 457*

A. *Qualified Roth contribution program*

Section 1.457-4 of the 2003 final regulations provides that annual deferrals to an eligible plan that satisfy certain requirements are excluded from the gross income of the participant in the year deferred or contributed and are not includable in gross income until paid to the participant, in the case of an eligible governmental plan, or until paid or otherwise made available to the participant, in the case of an eligible plan of a tax-exempt entity. These proposed regulations amend § 1.457-4(a) and (b) to reflect the change made by SBJA to allow an eligible governmental plan to include a qualified Roth contribution program, as defined in section 402A(c)(1), under which designated Roth contributions are included in income in the year of deferral. Consistent with section 402A(b)(2), these proposed regulations provide that contributions and withdrawals of a participant's designated Roth contributions must be credited and debited to a designated Roth account maintained for the participant, and that the plan must maintain a record of each participant's investment in the contract with respect to the account. In addition, the proposed regulations provide that no forfeitures may be allocated to a designated Roth account and that no contributions other than designated Roth contributions and rollover contributions described in section 402A(c)(3)(A) may be made to the account.

These proposed regulations also amend § 1.457-7(b)(1), which provides guidance regarding the circumstances under which amounts are included in income under an eligible governmental plan, to specify that qualified distributions from a designated Roth account are excluded from gross income.

B. *Certain distributions for qualified accident and health insurance premiums*

The proposed regulations amend the rules for the taxation of eligible governmental plan distributions under § 1.457-7(b) to reflect the change made by PPA '06 with

respect to certain amounts distributed to an eligible public safety officer. The proposed regulations provide that distributions from an eligible governmental plan meeting the requirements of section 402(1) are excluded from gross income and are not subject to the general rule providing that amounts deferred under an eligible governmental plan are includable in the gross income of a participant or beneficiary for the taxable year in which they are paid. For this purpose, see section 402(1) for rules regarding the extent to which this income exclusion applies to a distribution (including the dollar limitation on the exclusion) and section 402(1)(4)(C) for the meaning of the term public safety officer.

C. *Rules related to qualified military service*

The proposed regulations amend § 1.457-2(f) to implement the requirements of section 457(g)(4), which was added by the HEART Act and which provides that an eligible governmental plan must meet the requirements of section 401(a)(37) (providing that, in the case of a participant who dies while performing qualified military service, the survivors of the participant generally are entitled to any additional benefits that would have been provided under the plan if the participant had resumed and then terminated employment on account of death). In addition the proposed regulations amend § 1.457-6(b)(1) to provide a cross reference to the rules under section 414(u)(12)(B) (providing that leave for certain military service is treated as a severance from employment for purposes of the plan distribution restrictions that apply to eligible plans).

III. *Certain Plans That Are Not Subject to Section 457 or Are Not Treated as Providing for a Deferral of Compensation Under Section 457*

A. *In general*

Section 1.457-2(k) of the 2003 final regulations defines the term plan for purposes of section 457 to include any plan,

⁶Section 457(e)(2) provides that the performance of services for purposes of section 457 includes the performance of services as an independent contractor and that the person (or governmental entity) for whom these services are performed is treated as an employer.

agreement, method, program, or other arrangement, including an individual employment agreement, of an eligible employer under which the payment of compensation is deferred. Section 1.457-2(k) of the 2003 regulations also identifies certain plans that are not subject to section 457 (pursuant to section 457(e)(12) and (f)(2) and statutes not incorporated into the Code) and certain plans that are treated as not providing for a deferral of compensation for purposes of section 457 (pursuant to section 457(e)(11)). These proposed regulations amend the definition of plan for purposes of section 457 to remove from § 1.457-2(k) the provisions identifying plans that are not subject to section 457 and plans that are treated as not providing for a deferral of compensation for purposes of section 457, and move the provisions regarding most of these plans to § 1.457-11 of the proposed regulations. In addition, § 1.457-11 provides additional guidance on:

- bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, and death benefit plans, as described in section 457(e)(11)(A)(i), which are treated as not providing for a deferral of compensation for purposes of section 457; and
- plans paying solely length of service awards to bona fide volunteers (or their beneficiaries), as described in section 457(e)(11)(A)(ii), that also are treated as not providing for a deferral of compensation for purposes of section 457.⁷

The proposed regulations also provide guidance in a new § 1.457-12 on plans described in section 457(f)(2), to which section 457(f)(1) does not apply.

B. *Bona fide severance pay plans*

1. General Requirements

The proposed regulations provide that a plan must meet certain requirements to be a bona fide severance pay plan that is treated under section 457(e)(11)(A)(i) as not providing for the deferral of compensation (and therefore not subject to section 457). First, the benefits provided under the plan must be payable only upon a partic-

ipant's involuntary severance from employment or pursuant to a window program or voluntary early retirement incentive plan. Second, the amount payable under the plan with respect to a participant must not exceed two times the participant's annualized compensation based upon the annual rate of pay for services provided to the eligible employer for the calendar year preceding the calendar year in which the participant has a severance from employment (or the current calendar year if the participant had no compensation from the eligible employer in the preceding calendar year), adjusted for any increase in compensation during the year used to measure the rate of pay that was expected to continue indefinitely if the participant had not had a severance from employment. Third, pursuant to the written terms of the plan, the severance benefits must be paid no later than the last day of the second calendar year following the calendar year in which the severance from employment occurs. The rules in these proposed regulations for severance pay plans are similar to the rules for separation pay plans in § 1.409A-1(b)(9) of the final section 409A regulations.

2. Involuntary Severance from Employment

a. In general

The proposed regulations require that benefits under a bona fide severance pay plan be payable only upon an involuntary severance from employment or pursuant to a window or voluntary early retirement incentive program. For this purpose, an involuntary severance from employment is a severance from employment due to the eligible employer's independent exercise of its authority to terminate the participant's services, other than due to the participant's implicit or explicit request, if the participant is willing and able to continue to perform services. The determination of whether a severance from employment is involuntary is based on the relevant facts and circumstances. If a severance from employment is designated as an involuntary severance from employment, but the facts and circumstances indicate otherwise, the severance

from employment will not be treated as involuntary for purposes of section 457.

b. Severance from employment for good reason

The proposed regulations provide that an employee's voluntary severance from employment may be treated as an involuntary severance from employment for purposes of section 457 if the severance from employment is for good reason. A severance from employment is for good reason if it occurs under certain bona fide conditions that are pre-specified in writing under circumstances in which the avoidance of section 457 is not the primary purpose of the inclusion of these conditions in the plan or of the actions by the employer in connection with the satisfaction of those conditions. Notwithstanding the previous sentence, once the bona fide conditions have been established, the elimination of one or more of the conditions may result in the extension of a substantial risk of forfeiture, the recognition of which would be subject to the rules discussed in section III.E of this preamble.

To be treated as an involuntary severance from employment, a severance from employment for good reason must result from unilateral action taken by the eligible employer resulting in a material adverse change to the working relationship (such as a material reduction in the employee's duties, working conditions, or pay). Other factors that may be taken into account in determining whether a termination for good reason effectively constitutes an involuntary severance from employment include the following:

- whether the payments upon severance from employment for good reason are in the same amount and paid at the same time as payments conditioned upon an employer-initiated severance from employment without cause; and
- whether the employee is required to give notice to the employer of the material adverse change in conditions and provide the employer with an opportunity to remedy the adverse change.

The proposed regulations also provide a safe harbor under which a plan provid-

⁷See section 457(e)(11)(B) for special rules relating to length of service award plans.

ing for the payment of amounts upon a voluntary severance from employment under certain conditions, that are specified in writing by the time the legally binding right to the payment arises, will be treated as providing for a payment upon a severance from employment for good reason.

c. Window programs

The proposed regulations provide that the involuntary severance from employment requirement does not apply to window programs. The proposed regulations define the term window program to mean a program established by an employer to provide separation pay in connection with an impending severance from employment. To be a window program, the program must be offered for a limited period of time (typically no longer than 12 months), and the eligible employer must make the program available to employees who have a severance from employment during that period or who have a severance from employment during that period under specified circumstances. A program is not offered for a limited period of time (and, therefore, is not a window program) if there is a pattern of repeatedly providing similar programs. Whether the recurrence of programs constitutes a pattern of repeatedly providing similar programs is based on all of the relevant facts and circumstances, including whether the benefits are on account of a specific reduction in workforce (or other operational conditions), whether there is a relationship between the separation pay and an event or condition, and whether the event or condition is temporary and discrete or is a permanent aspect of the employer's operations.

d. Voluntary early retirement incentive plans

The proposed regulations also provide that the involuntary severance from employment requirement does not apply to an applicable voluntary early retirement incentive plan described in section 457(e)(11)(D)(ii). That section describes an applicable voluntary early retirement incentive plan as a bona fide severance pay plan for purposes of section 457 with respect to payments or supplements that

are made as an early retirement benefit, a retirement-type subsidy, or an early retirement benefit that is greater than a normal retirement benefit, as described in section 411(a)(9), and that are paid in coordination with a defined benefit pension plan that is qualified under section 401(a) and maintained by an eligible employer that is a governmental entity or a tax-exempt education association as described in section 457(e)(11)(D)(ii)(II). Section 457(e)(11)(D) provides that these payments or supplements are treated as provided under a bona fide severance pay plan only to the extent that they otherwise could have been provided under the defined benefit plan with which the applicable voluntary early retirement incentive plan is coordinated (determined as if the rules in section 411 applied to the defined benefit plan).

e. Transitional relief in Announcement 2000-1

Announcement 2000-1 provides transitional guidance on certain broad-based nonelective plans of State or local governments that were in existence before December 22, 1999, and were treated as bona fide severance pay plans for years before 1999. Under the announcement, an eligible employer that is a governmental entity is not required to report, including on Form W-2, "Wage and Tax Statement," or Form 1099-R "Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.," amounts payable under plans that meet certain requirements until the amounts are actually or constructively received. The rules described in these proposed regulations regarding bona fide severance pay plans, as modified when these proposed regulations are finalized and become applicable, will supersede the transitional guidance in Announcement 2000-1. See section V.B of this preamble for special applicability dates for governmental plans.

C. Bona fide death benefit plan

The proposed regulations provide that a bona fide death benefit plan, which is treated as not providing for the deferral of compensation pursuant to section 457(e)(11)(A)(i), is a plan providing for

death benefits as defined in § 31.3121(v)(2)-1(b)(4)(iv)(C) (relating to the application of the Federal Insurance Contributions Act to nonqualified deferred compensation). The proposed regulations further provide that benefits under a bona fide death benefit plan may be provided through insurance and that any lifetime benefits payable under the plan that may be includible in gross income will not be treated as including the value of any term life insurance coverage provided under the plan.

D. Bona fide disability pay plan

The proposed regulations provide that a bona fide disability pay plan, which is treated as not providing for the deferral of compensation pursuant to section 457(e)(11)(A)(i), is a plan that pays benefits only in the event of a participant's disability. For this purpose, the value of any taxable disability insurance coverage under the plan that is included in gross income is disregarded. These proposed regulations provide that a participant is disabled for this purpose if the participant meets any of the following three conditions:

- the participant is unable to engage in substantial gainful activity by reason of a medically determinable physical or mental impairment that can be expected to result in death or last for a continuous period of not less than 12 months;
- the participant is, by reason of any medically determinable physical or mental impairment that can be expected to result in death or last for a continuous period of not less than 12 months, receiving income replacement benefits for a continuous period of not less than three months under an accident or health plan covering employees of the eligible employer; or
- the participant is determined to be totally disabled by the Social Security Administration or the Railroad Retirement Board.

E. Bona fide sick leave and vacation leave plans

1. General Requirements

Under the proposed regulations, whether a sick or vacation leave plan is a

bona fide sick or vacation leave plan, and therefore treated as not providing for the deferral of compensation under section 457(e)(11)(A)(i), is determined based on the facts and circumstances. A sick or vacation leave plan is generally treated as bona fide, and not as a plan providing for the deferral of compensation, if the facts and circumstances demonstrate that the primary purpose of the plan is to provide employees with paid time off from work because of sickness, vacation, or other personal reasons. Factors used in determining whether a plan is a bona fide sick or vacation leave plan include the following:

- whether the amount of leave provided could reasonably be expected to be used by the employee in the normal course (and before the cessation of services);
- limits, if any, on the ability to exchange unused accumulated leave for cash or other benefits and any applicable accrual restrictions (for example, where permissible under applicable law, the use of forfeiture provisions often referred to as use-or-lose rules);
- the amount and frequency of any in-service distributions of cash or other benefits offered in exchange for accumulated and unused leave;
- whether the payment of unused sick or vacation leave is made promptly upon severance from employment (or, instead, is paid over a period of time after severance from employment); and
- whether the sick leave, vacation leave, or combined sick and vacation leave offered under the plan is broadly applicable or is available only to certain employees.

2. Delegation of Authority to Commissioner

The Treasury Department and the IRS recognize that eligible employers sponsor a wide variety of sick and vacation leave plans and that additional rules on more specific arrangements or features of these plans may be beneficial. Accordingly, the proposed regulations provide that the Commissioner may issue additional rules regarding bona fide sick or vacation leave

plans in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin, as the Commissioner determines to be necessary or appropriate.

F. Constructive receipt

Bona fide sick or vacation leave plans (and certain other plans) are treated as not providing for the deferral of compensation for purposes of section 457, and the general federal tax principles for determining the timing and amount of income inclusion, including the constructive receipt rules of section 451, apply to these plans. See §§ 1.451-1 and 1.451-2 for rules regarding constructive receipt of income.

IV. Ineligible Plans Under Section 457(f)

A. Tax treatment of amounts deferred under section 457(f)

Consistent with section 457(f)(1)(A), the proposed regulations provide that if a plan of an eligible employer provides for a deferral of compensation for the benefit of a participant or beneficiary and the plan is not an eligible plan (an ineligible plan), the compensation deferred under the plan is includible in the gross income of the participant or beneficiary under section 457(f)(1)(A) on the date (referred to in this preamble and the proposed regulations as the applicable date) that is the later of the date the participant or beneficiary obtains a legally binding right to the compensation or, if the compensation is subject to a substantial risk of forfeiture at that time, the date the substantial risk of forfeiture lapses. Generally, the amount of the compensation deferred under the plan that is includible in gross income on the applicable date is the present value, as of that date, of the amount of compensation deferred. For this purpose, the amount of compensation deferred under a plan as of an applicable date includes any earnings as of that date on amounts deferred under the plan.

Consistent with section 457(f)(1)(B), the proposed regulations provide that any earnings credited thereafter on compensation that was included in gross income

under section 457(f)(1)(A) are includible in the gross income of a participant or beneficiary when paid or made available to the participant or beneficiary and are taxable under section 72. For purposes of section 72, the participant (or beneficiary) is treated as having an investment in the contract equal to the amount actually included in gross income on the applicable date.

Consistent with section 457(f)(2), the proposed regulations provide that section 457(f)(1) does not apply to a qualified plan described in section 401(a), an annuity plan or contract described in section 403, the portion of a plan that consists of a trust to which section 402(b) applies, a qualified governmental excess benefit arrangement described in section 415(m), the portion of a plan that consists of a transfer of property to which section 83 applies, or the portion of an applicable employment retention plan described in section 457(f)(4) with respect to any participant.

B. Calculation of the present value of compensation deferred under an ineligible plan

1. Overview

The proposed regulations provide general rules for determining the present value of compensation deferred under an ineligible plan. The proposed regulations also include specific rules for determining the present value of compensation deferred under ineligible plans that are account balance plans. The rules for determining present value in the proposed regulations are similar to the rules for determining present value in the proposed section 409A regulations.⁸

The Treasury Department and the IRS expect that these regulations will be finalized after the proposed section 409A regulations are finalized and that these proposed regulations, when finalized, will adopt many provisions of § 1.409A-4 for ease of administration. Accordingly, these proposed regulations include cross references to certain provisions of § 1.409A-4 as currently proposed, including rules for

⁸One difference between these proposed regulations and the proposed section 409A regulations is that income inclusion under section 457(f) and § 1.457-12(a)(2), and the present value calculation under these proposed regulations, is determined as of the applicable date, whereas income inclusion under section 409A, and the present value calculation under the proposed § 1.409A-4, is determined as of the end of the service provider's taxable year.

determining present value under certain specific types of plans, such as reimbursement and in-kind benefit arrangements⁹ and split-dollar life insurance arrangements,¹⁰ and rules regarding the treatment of payment restrictions and alternative times and forms of a future payment. The Treasury Department and the IRS request comments on whether it is appropriate to provide any additional exceptions from the application of the rules currently described in the proposed section 409A regulations to amounts includible in income under section 457(f), to account for the different manners in which the two provisions apply to an amount deferred.

2. Present Value of Compensation Deferred Under an Account Balance Plan

The proposed regulations provide specific rules for calculating the present value of compensation deferred under an ineligible plan that is an account balance plan (as defined in § 31.3121(v)(2)–1(c)(1)(ii) and (iii)).¹¹ Provided that the account balance is determined using a predetermined actual investment or a reasonable rate of interest, the present value of an amount payable under an account balance plan as of an applicable date is generally the amount credited to the account, which includes both the principal and any earnings or losses through the applicable date. If the account balance is not determined using a predetermined actual investment or a reasonable rate of interest, the present value of compensation deferred under the plan as of an applicable date is equal to the amount credited to the participant's account as of that date, plus the present value of the excess (if any) of the earnings to be credited under the plan after the applicable date and through the projected payment date over the earnings that would be credited during that period using a reasonable rate of interest. If the present value of compensation deferred under the plan is not determined and is not taken into account by the taxpayer in this manner, the present value of the compensation

deferred under the plan as of the applicable date will be treated as equal to the amount credited to the participant's account as of that date, plus the present value of the excess (if any) of the earnings to be credited under the plan through the projected payment date over the earnings that would be credited using the applicable Federal rate. The proposed regulations also provide that if the amount of earnings or losses credited under an account balance plan is based on the greater of the earnings on two or more investments or interest rates, then the amount included in income on the applicable date is the sum of the amount credited to the participant's account as of the applicable date and the present value (determined as described in section IV.B.3 of this preamble) of the right to future earnings.

3. Present Value of Compensation Deferred Under a Plan That Is Not an Account Balance Plan

a. Reasonable actuarial assumptions

The proposed regulations also set forth rules for calculating the present value of compensation deferred under an ineligible plan that is not an account balance plan. Under the proposed regulations, the present value of an amount deferred under such a plan as of an applicable date is the value, as of that date, of the right to receive payment of the compensation in the future, taking into account the time value of money and the probability that the payment will be made. Any actuarial assumptions used to calculate the present value of the compensation deferred must be reasonable as of the applicable date, determined based on all of the relevant facts and circumstances. For this purpose, taking into account the probability that a participant might die before receiving certain benefits is a reasonable actuarial assumption only if the plan provides that the benefits will be forfeited upon death. Discounts based on the probability that payments will not be made due to the unfunded status of the plan, the risk that the

eligible employer or another party may be unwilling or unable to pay, the possibility of future plan amendments or changes in law, and other similar contingencies are not permitted for purposes of determining present value under the proposed regulations.

b. Treatment of severance from employment

If the present value of an amount depends on the time when a severance from employment occurs and the severance from employment has not occurred by the applicable date, then, for purposes of determining the present value of the amount, the severance from employment generally may be treated as occurring on any date on or before the fifth anniversary of the applicable date, unless, as of the applicable date, it would be unreasonable to use such an assumption. For example, if the applicable date occurs in 2017 and the employer knows on the applicable date that the severance from employment will occur in 2018, it would be unreasonable to use a date after the expected severance from employment date to determine the present value of the compensation.

c. Treatment of payments based on formula amounts

Some ineligible plans may provide that all or part of the amount payable under the plan is determined by reference to one or more factors that are indeterminable on the applicable date. For example, an amount payable may be dependent on a participant's final average compensation and total years of service. These proposed regulations refer to such an amount as a formula amount. The proposed regulations provide that the determination of the present value of a formula amount under an ineligible plan must be based on reasonable, good faith assumptions with respect to any contingencies as to the amount of the payment, with the assumptions based on all the facts and circumstances existing on the applicable date.

⁹A reimbursement or in-kind benefit arrangement is an arrangement in which benefits for a participant are provided under a nonqualified deferred compensation arrangement described in § 1.409A–1(c)(2)(i)(E).

¹⁰A split-dollar insurance arrangement is an arrangement in which benefits for a participant are provided under a nonqualified deferred compensation plan described in § 1.409A–1(c)(2)(i)(F).

¹¹The rules in these regulations, however, do not apply with respect to Federal Insurance Contributions Act and Federal Unemployment Tax Act taxation liability under sections 3121(v)(2) and 3306(r)(2), respectively, and the regulations thereunder.

The proposed regulations also provide that, if only a portion of the compensation deferred under the plan consists of a formula amount, the amount payable with respect to that portion is determined under the rules applicable to formula amounts, and the remaining balance is determined under the rules applicable to amounts that are not formula amounts.

d. Unreasonable actuarial assumptions

If the Commissioner determines that the actuarial assumptions used by an employer in determining present value are not reasonable, the proposed regulations provide that the Commissioner will determine the present value of the compensation deferred using actuarial assumptions and methods that the Commissioner determines to be reasonable based on all of the facts and circumstances.

4. Loss Deduction Rules

The proposed regulations contain rules similar to the loss deduction rules in the proposed section 409A regulations. Under the rules in these proposed regulations, if a participant includes an amount of deferred compensation in income under section 457(f)(1)(A), but the compensation that is subsequently paid or made available is less than the amount included in income because the participant has forfeited or lost some or all of the compensation due to death or some other reason (for example, due to investment performance), the participant is entitled to a deduction for the taxable year in which any remaining right to the amount is permanently forfeited under the plan's terms or otherwise permanently lost. The deduction allowed for the taxable year in which the permanent forfeiture or loss occurs is equal to the amount previously included in income under section 457(f)(1)(A), less the total amount of compensation that is actually paid or made available under the plan that constitutes a return of investment in the contract. In the case of an employee, the available deduction generally would be treated as a miscellaneous itemized deduction, subject to the deduction

limitations applicable to such expenses under sections 67 and 68.¹²

5. Examples Illustrating the Present Value Rules

The proposed regulations include several examples illustrating the application of the present value rules to the more common types of plans providing for the deferral of compensation under section 457(f). The regulations do not illustrate the application of these valuation rules to plans that are more unusual for employees of governmental and tax-exempt entities, such as compensatory options to acquire stock or other property. The amount includible in income on the applicable date under these less common types of plans would be determined under the general rules for plans that are not account balance plans.

C. Definition of deferral of compensation

1. In General

The proposed regulations define the term deferral of compensation for purposes of determining whether section 457(f) applies to an arrangement because it provides for a deferral of compensation. In general, a plan provides for a deferral of compensation if a participant has a legally binding right during a taxable year to compensation that, pursuant to the terms of the plan, is or may be payable in a later taxable year. However, the proposed regulations generally provide that a participant does not have a legally binding right to compensation to the extent that it may be unilaterally reduced or eliminated by the employer after the services creating the right have been performed.

Whether a plan provides for a deferral of compensation is generally based on the terms of the plan and the relevant facts and circumstances at the time that the participant obtains a legally binding right to the compensation, or, if later, when a plan is amended to convert a right that does not provide for a deferral of compensation into a right that does provide for a deferral of compensation. For example, if

a plan providing retiree health care does not initially provide for a deferral of compensation but is later amended to provide the ability to receive future cash payments instead of health benefits, it may become a plan that provides for the deferral of compensation at the time of the amendment.

Under the proposed regulations, an amount of compensation deferred under a plan that provides for the deferral of compensation does not cease to be an amount subject to section 457(f) by reason of any change to the plan that would recharacterize the right to the amount as a right that does not provide for the deferral of compensation. In addition, any change under the plan that results in an exchange of an amount deferred under the plan for some other right or benefit that would otherwise be excluded from the participants' gross income does not affect the characterization of the plan as one that provides for a deferral of compensation. Thus, for example, if a plan that provides for a deferral of compensation is amended to provide health benefits instead of cash, it will retain its character as a plan that provides for a deferral of compensation.

2. Short-term Deferrals

The proposed regulations provide that a deferral of compensation does not occur with respect to any amount that would be a short-term deferral under § 1.409A-1(b)(4), substituting the definition of a substantial risk of forfeiture provided under these proposed regulations for the definition under § 1.409A-1(d). Accordingly, a deferral of compensation does not occur with respect to any payment that is not a deferred payment, provided that the participant actually or constructively receives the payment on or before the last day of the applicable 2 1/2 month period. For this purpose, the applicable 2 1/2 month period is the period ending on the later of the 15th day of the third month following the end of the first calendar year in which the right to the payment is no longer subject to a substantial risk of forfeiture or the 15th day of the third month following the end of the eligible employer's first taxable year in which the right to the

¹²Section 1341 would not be applicable to this type of loss because inclusion of an amount in income as a result of section 457(f) would not constitute receipt of an amount to which it appeared that the taxpayer had an unrestricted right in the taxable year of inclusion.

payment is no longer subject to a substantial risk of forfeiture.

Because there is considerable overlap between the definition of substantial risk of forfeiture for purposes of section 457(f) and the definition of substantial risk of forfeiture for purposes of section 409A, in many cases amounts that, under this rule, are not deferred compensation subject to section 457(f) are also not deferred compensation subject to section 409A. For example, if an arrangement provides for the payment of a bonus on or before March 15 of the year following the calendar year in which the right to the bonus is no longer subject to a substantial risk of forfeiture (within the meaning of both these proposed regulations and § 1.409A-1(d)) and the bonus is paid on or before that March 15, the arrangement would not be a plan providing for a deferral of compensation to which section 457(f) (or section 409A) applies. For circumstances in which a payment under a plan made after that March 15 may still qualify as a short-term deferral for purposes of sections 409A and 457(f) (due to incorporation of the section 409A regulatory provisions into these proposed regulations under section 457(f)), see § 1.409A-1(b)(4)(ii).

3. Recurring Part-Year Compensation

After issuance of the final section 409A regulations, commenters expressed concerns about the application of section 409A to situations involving certain recurring part-year compensation. For this purpose, recurring part-year compensation is compensation paid for services rendered in a position that the employer and employee reasonably anticipate will continue under similar terms and conditions in subsequent years, and under which the employee will be required to provide services during successive service periods each of which comprises less than 12 months (for example, a teacher providing services during a school year comprised of 10 consecutive months) and each of which begins in one taxable year of the employee and ends in the next taxable year. In general, commenters asserted that section 409A should not apply to situations involving recurring part-year compensation because the

amount being deferred from one taxable year to the next taxable year is typically small and because most taxpayers view that type of arrangement as a method of managing cash flow, rather than a tax-deferral opportunity.

In response to these comments, Notice 2008-62 provided that an arrangement under which an employee or independent contractor receives recurring part-year compensation does not provide for the deferral of compensation for purposes of section 409A or for purposes of section 457(f) if (i) the arrangement does not defer payment of any of the recurring part-year compensation beyond the last day of the 13th month following the beginning of the service period, and (ii) the arrangement does not defer from one taxable year to the next taxable year the payment of more than the applicable dollar amount under section 402(g)(1)(B) (\$18,000 for 2016).

Some commenters, however, subsequently expressed concerns that Notice 2008-62 does not adequately address some teaching positions, such as those of college and university faculty members. They asserted that, depending on several variables (such as the month in which the service period begins), the dollar limitation in the notice could result in adverse tax consequences to teachers with academic year compensation as low as \$80,000. Commenters further observed that some of these arrangements are non-elective and, therefore, some employees cannot opt out of a recurring part-year compensation arrangement. Some commenters also contended that the rules set forth in the notice were difficult to apply.

To simplify the rule set forth in Notice 2008-62, and recognizing that educational employers frequently structure their pay plans to include recurring part-year compensation and that the main purpose of this design is to achieve an even cash flow for employees who do not work for a portion of the year, these proposed regulations modify the recurring part-year compensation rule for purposes of section 457(f). The proposed regulations provide that a plan or arrangement under which an employee receives recurring part-year compensation that is earned over a period

of service does not provide for the deferral of compensation if the plan or arrangement does not defer payment of any of the recurring part-year compensation to a date beyond the last day of the 13th month following the first day of the service period for which the recurring part-year compensation is paid, and the amount of the recurring part-year compensation (not merely the amount deferred) does not exceed the annual compensation limit under section 401(a)(17) (\$265,000 for 2016) for the calendar year in which the service period commences. A conforming change is included in proposed regulations under section 409A that are also published in the Proposed Rules section of this issue of the **Federal Register**.

D. Interaction of section 457 with section 409A

The proposed regulations also address the interaction of the rules under section 457(f) and section 409A. Section 409A(c) provides that nothing in section 409A is to be construed to prevent the inclusion of amounts in gross income under any other provision of chapter 1 of subtitle A of the Code (Normal taxes and surtaxes) or any other rule of law earlier than the time provided in section 409A. In addition, it provides that any amount included in gross income under section 409A is not required to be included in gross income under any other provision of chapter 1 of subtitle A or any other rule of law later than the time provided in section 409A. The proposed regulations provide that the rules under section 457(f) apply to plans separately and in addition to the requirements under section 409A.¹³ Thus, a deferred compensation plan of an eligible employer that is subject to section 457(f) may also be a nonqualified deferred compensation plan that is subject to section 409A. Section 1.457-12(d)(5)(iii) of the proposed regulations provides an example of the interaction of sections 409A and 457(f), and it is intended that this example will also be included in § 1.409A-4 when those currently proposed regulations are finalized.

¹³See also § 1.409A-1(a)(4).

E. Rules relating to substantial risk of forfeiture

The proposed regulations provide rules regarding the conditions that constitute a substantial risk of forfeiture for purposes of section 457(f). As discussed in section IV.A of this preamble, an amount to which an employee has a legally binding right under an ineligible plan is generally includible in gross income on the later of the date the employee obtains the legally binding right to the compensation or, if the compensation is subject to a substantial risk of forfeiture, the date the substantial risk of forfeiture lapses. The proposed regulations provide that an amount is generally subject to a substantial risk of forfeiture for this purpose only if entitlement to that amount is conditioned on the future performance of substantial services, or upon the occurrence of a condition that is related to a purpose of the compensation if the possibility of forfeiture is substantial. A special rule applies to determine whether initial deferrals of current compensation may be treated as subject to a substantial risk of forfeiture and whether a substantial risk of forfeiture can be extended. For this purpose, current compensation refers to compensation that is payable on a current basis such as salary, commissions, and certain bonuses, and does not include compensation that is deferred compensation.

Whether an amount is conditioned on the future performance of substantial services is based on all of the relevant facts and circumstances, such as whether the hours required to be performed during the relevant period are substantial in relation to the amount of compensation. A condition is related to a purpose of the compensation only if the condition relates to the employee's performance of services for the employer or to the employer's tax exempt or governmental activities, as applicable, or organizational goals. A substantial risk of forfeiture exists based on a condition related to the purpose of the compensation only if the likelihood that the forfeiture event will occur is substantial. Also, an amount is not subject to a substantial risk of forfeiture if the facts and circumstances indicate that the forfeiture condition is unlikely to be enforced. Factors considered for purposes of deter-

mining the likelihood that the forfeiture will be enforced include, but are not limited to, the past practices of the employer, the level of control or influence of the employee with respect to the organization and the individual(s) who would be responsible for enforcing the forfeiture, and the enforceability of the provisions under applicable law.

Under these proposed regulations, if a plan provides that entitlement to an amount is conditioned on an involuntary severance from employment without cause, the right is subject to a substantial risk of forfeiture if the possibility of forfeiture is substantial. For this purpose, a voluntary severance from employment that would be treated as an involuntary severance from employment under a bona fide severance pay plan for purposes of section 457(e)(11)(A)(i) (that is, a severance from employment for good reason) is also treated as an involuntary severance from employment without cause. See section III.B.2 of this preamble for a discussion of circumstances under which a severance from employment for good reason may be treated as an involuntary severance from employment for purposes of section 457(e)(11)(A)(i).

The proposed regulations provide that compensation is not considered to be subject to a substantial risk of forfeiture merely because it would be forfeited if the employee accepts a position with a competing employer unless certain conditions are satisfied. First, the right to the compensation must be expressly conditioned on the employee refraining from the performance of future services pursuant to a written agreement that is enforceable under applicable law. Second, the employer must consistently make reasonable efforts to verify compliance with all of the noncompetition agreements to which it is a party (including the noncompetition agreement at issue). Third, at the time the noncompetition agreement becomes binding, the facts and circumstances must show that the employer has a substantial and bona fide interest in preventing the employee from performing the prohibited services and that the employee has a bona fide interest in engaging, and an ability to engage, in the prohibited services. The proposed regulations identify several factors that are relevant for this purpose.

Additional conditions apply with respect to the ability to treat initial deferrals of current compensation as being subject to a substantial risk of forfeiture. Similarly, an attempt to extend the period covered by a risk of forfeiture, often referred to as a rolling risk of forfeiture, is generally disregarded under the proposed regulations unless certain conditions are met.

Specifically, the proposed regulations permit initial deferrals of current compensation to be subject to a substantial risk of forfeiture and also allow an existing risk of forfeiture to be extended only if all of the following requirements are met. First, the present value of the amount to be paid upon the lapse of the substantial risk of forfeiture (as extended, if applicable) must be materially greater than the amount the employee otherwise would be paid in the absence of the substantial risk of forfeiture (or absence of the extension). The proposed regulations provide that an amount is materially greater for this purpose only if the present value of the amount to be paid upon the lapse of the substantial risk of forfeiture, measured as of the date the amount would have otherwise been paid (or in the case of an extension of the risk of forfeiture, the date that the substantial risk of forfeiture would have lapsed without regard to the extension), is more than 125 percent of the amount the participant otherwise would have received on that date in the absence of the new or extended substantial risk of forfeiture. (No implication is intended that this standard would also apply for purposes of § 1.409A-1(d)(1).)

Second, the initial or extended substantial risk of forfeiture must be based upon the future performance of substantial services or adherence to an agreement not to compete. It may not be based solely on the occurrence of a condition related to the purpose of the transfer (for example, a performance goal for the organization), though that type of condition may be combined with a sufficient service condition.

Third, the period for which substantial future services must be performed may not be less than two years (absent an intervening event such as death, disability, or involuntary severance from employment).

Fourth, the agreement subjecting the amount to a substantial risk of forfeiture must be made in writing before the begin-

ning of the calendar year in which any services giving rise to the compensation are performed in the case of initial deferrals of current compensation or at least 90 days before the date on which an existing substantial risk of forfeiture would have lapsed in the absence of an extension. Special rules apply to new employees. The proposed regulations do not extend these special rules for new employees to employees who are newly eligible to participate in a plan. The Treasury Department and the IRS request comments on whether special provisions for newly eligible employees are needed in the context of arrangements subject to section 457(f), and if so whether the rules under §§ 1.409A-1(c)(2) and 1.409A-2(a)(7) would be a useful basis for similar rules under section 457(f) and how an aggregated single plan (versus multiple plans) should be defined for this purpose to ensure that the rules are not subject to manipulation.

V. Proposed Applicability Dates

A. General applicability date

Generally, these regulations are proposed to apply to compensation deferred under a plan for calendar years beginning after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**, including deferred amounts to which the legally binding right arose during prior calendar years that were not previously included in income during one or more prior calendar years. No implication is intended regarding application of the law before these proposed regulations become applicable. Taxpayers may rely on these proposed regulations until the applicability date.

B. Special applicability dates

These regulations are proposed to include three special applicability dates for specific provisions. First, in the case of a plan that is maintained pursuant to one or more collective bargaining agreements that have been ratified and are in effect on the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**, these regulations would not apply to compensation deferred under the plan before the earlier of (1) the date on which the last of

the collective bargaining agreements terminates (determined without regard to any extension thereof after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**, or (2) the date that is three years after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Second, for all plans, with respect to the rules regarding recurring part-year compensation for periods before the applicability date of these regulations, taxpayers may rely on either the rules set forth in these proposed regulations or the rules set forth in Notice 2008-62.

Third, to the extent that legislation is required to amend a governmental plan, the proposed regulations would apply only to compensation deferred under the plan in calendar years beginning on or after the close of the second regular legislative session of the legislative body with the authority to amend the plan that begins after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact 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 Code, this notice of proposed rulemaking has been 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 the 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 as prescribed in this preamble under the “ADDRESSES” heading. The Treas-

ury Department and the IRS request comments on all aspects of the proposed rules, including whether special transition rules are needed for plans established before the proposed applicability dates of these regulations (including sick and vacation leave or severance pay plans that may be treated as providing deferred compensation subject to section 457, but that, under the proposed regulations, may be treated as providing deferred compensation subject to section 457(f), whether additional exceptions are appropriate to the general application of the rules currently described in the proposed section 409A regulations to determine the amounts includible in income under section 457(f), and whether special provisions for newly eligible employees are needed in the context of arrangements subject to section 457(f) (and if so whether the rules under §§ 1.409A-1(c)(2) and 1.409A-2(a)(7) would be a useful basis for similar rules under section 457(f)). All comments submitted by the public will be available at www.regulations.gov or upon request.

A public hearing has been scheduled for October 18, 2016, beginning at 10 a.m. in the Auditorium, Internal Revenue Service, 1111 Constitution Avenue, N.W., 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 by September 20, 2016 and an outline of the topics to be discussed and the amount of time to be devoted to each topic (a signed original and eight (8) copies) by September 20, 2016. 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.

Statement of Availability of IRS Documents

For copies of recently issued revenue procedures, revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin, please visit the IRS website at <http://www.irs.gov> or contact the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Drafting Information

The principal author of the proposed regulations is Keith R. Kost, Office of Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the Treasury Department and the IRS participated in their development.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.457-1 is revised to read as follows:

§ 1.457-1 General overview of section 457.

Section 457 provides rules for non-qualified deferred compensation plans established by eligible employers as defined under § 1.457-2(d). Eligible employers may establish either deferred compensation plans that are eligible plans that meet the requirements of section 457(b) and §§ 1.457-3 through 1.457-10, or deferred compensation plans that do not meet the requirements of section 457(b) and §§ 1.457-3 through 1.457-10 (and therefore are ineligible plans which are generally subject to federal income tax treatment under section 457(f) and § 1.457-12(a)). Plans described in § 1.457-11 are not subject to section 457 or are treated as not providing for a deferral of compensation for purposes of section 457 (and, accordingly, the rules under §§ 1.457-3

through 1.457-10 and § 1.457-12(a) do not apply to these plans).

Par. 3. Section 1.457-2 is amended by:

1. Revising the introductory text.
2. Revising the second sentence of paragraph (f).
3. Revising the last sentence of paragraph (i).
4. Revising paragraph (k).

The revisions read as follows:

§ 1.457-2 Definitions.

This section sets forth the definitions that are used under §§ 1.457-1 through 1.457-12.

* * * * *

(f) * * * An eligible governmental plan is an eligible plan that is established and maintained by a State as defined in paragraph (l) of this section and that meets the requirements of section 401(a)(37). * * *

* * * * *

(i) * * * Solely for purposes of section 457 and §§ 1.457-2 through 1.457-12, the term *nonelective employer contribution* includes employer contributions that would be described in section 401(m) if they were contributions to a qualified plan.

* * * * *

(k) *Plan*. *Plan* includes any agreement, method, program, or other arrangement (including an individual employment agreement) under which the payment of compensation for services rendered to an eligible employer is deferred (whether by salary reduction, nonelective employer contribution, or otherwise). However, the plans described in § 1.457-11 are either not subject to section 457 or are treated as not providing for a deferral of compensation for purposes of section 457, even if the payment of compensation is deferred under the plan.

* * * * *

Par. 4. Section 1.457-4 is amended by:

1. Revising paragraphs (a), (b), and the last sentence of (e)(1).
2. Removing the language “§ 1.457-11” wherever it appears in paragraphs (e)(1), (e)(2), (e)(3), and (e)(5) *Example 1* and adding the language “§ 1.457-12” in its place.

The revisions read as follows:

§ 1.457-4 Annual deferrals, deferral limitations, and deferral agreements under eligible plans.

(a) *Taxation of annual deferrals*. With the exception of designated Roth contributions (which are not excludable from gross income), annual deferrals that satisfy the requirements of paragraphs (b) and (c) of this section are excluded from the gross income of a participant in the year deferred or contributed and are not includible in gross income until paid to the participant in the case of an eligible governmental plan, or until paid or otherwise made available to the participant in the case of an eligible plan of a tax-exempt entity. See § 1.457-7.

(b) *Agreement for deferral*—(1) *In general*. To be an eligible plan, the plan must provide that compensation for any calendar month may be deferred by salary reduction only if an agreement providing for the deferral has been entered into before the first day of the month in which the compensation to be deferred under the agreement would otherwise be paid or made available, and any modification or revocation of such an agreement may not become effective before the first day of the month following the month in which the modification or revocation occurs. However, a new employee may defer compensation in the first calendar month of employment if an agreement providing for the deferral is entered into on or before the first day the participant performs services for the eligible employer. An eligible plan may provide that if a participant enters into an agreement providing for deferral by salary reduction under the plan, the agreement will remain in effect until the participant revokes or alters the terms of the agreement. Nonelective employer contributions to an eligible plan are not subject to the timing rules for salary reduction agreements described in this paragraph (b)(1).

(2) *Designated Roth contributions in plans maintained by eligible governmental employers*—(i) *Elections*. An election by a participant to make a designated Roth contribution (as defined in section 402A(c)(1)) to an eligible governmental plan in lieu of all or a portion of the amount that the participant could elect to contribute to the plan on a pre-tax basis

must be irrevocably designated as an elective deferral that is not excludable from gross income in accordance with the timing rules under paragraph (b)(1) of this section. Designated Roth contributions are treated the same as pre-tax contributions for purposes of §§ 1.457-1 through 1.457-10, except as otherwise specifically provided in those sections.

(ii) *Separate accounting.* Contributions and withdrawals of a participant's designated Roth contributions must be credited and debited to a designated Roth account maintained for the participant, and the plan must maintain a record of the participant's investment in the contract (that is, designated Roth contributions that have not been distributed) with respect to the participant's designated Roth account. In addition, gains, losses, and other credits or charges must be separately allocated on a reasonable and consistent basis to the designated Roth account and other accounts under the plan. However, forfeitures may not be allocated to the designated Roth account, and no contributions other than designated Roth contributions and rollover contributions described in section 402A(c)(3)(B) may be allocated to such account. The separate accounting requirement described in this paragraph applies to a plan at the time a designated Roth contribution is contributed to the plan and continues to apply until all designated Roth contributions (and the earnings attributable thereto) are distributed from the plan. See A-13 of § 1.402A-1 for additional requirements for separate accounting.

* * * * *
(e) * * *

(1) * * * Thus, an excess deferral is includible in gross income when deferred or, if later, when the excess deferral first ceases to be subject to a substantial risk of forfeiture, under the rules described in § 1.457-12(e).

* * * * *

Par. 5. Section 1.457-6 is amended by revising the first sentence of paragraph (b)(1) to read as follows:

§ 1.457-6 Timing of distributions under eligible plans.

* * * * *
(b) * * *

(1) * * * An employee has a severance from employment with the eligible employer if the employee dies, retires, or otherwise has a severance from employment (including as described in section 414(u)(12)(B)) with the eligible employer.* * *

* * * * *

Par. 6. Section 1.457-7 is amended by revising paragraph (b)(1), redesignating paragraph (b)(4) as (b)(5), and adding a new paragraph (b)(4) to read as follows:

§ 1.457-7 Taxation of Distributions under Eligible Plans.

* * * * *
(b) * * *

(1) *Amounts included in gross income in year paid under an eligible governmental plan.* Except as provided in paragraphs (b)(2), (3), and (4) of this section (or in § 1.457-10(c) relating to payments to a spouse or former spouse pursuant to a qualified domestic relations order), amounts deferred under an eligible governmental plan are includible in the gross income of a participant or beneficiary for the taxable year in which paid to the participant or beneficiary under the plan. Distributions from designated Roth accounts are excludable from gross income to the extent provided in section 402A and § § 1.402A-1 and 1.402A-2.

* * * * *

(4) *Certain amounts from an eligible governmental plan not in excess of the amount paid for qualified health insurance premiums.* Amounts paid to a participant who is an eligible retired public safety officer from an eligible governmental plan are excludible from gross income to the extent provided in section 402(l).

* * * * *

Par. 7. Section 1.457-9 is amended by revising the third sentence of paragraph (a) and the last sentence of paragraph (b) to read as follows:

§ 1.457-9 Effect on eligible plans when not administered in accordance with eligibility requirements.

(a) * * * If a plan ceases to be an eligible governmental plan, amounts subsequently deferred by participants are includible in gross income when deferred,

or, if later, when the amounts deferred first cease to be subject to a substantial risk of forfeiture, under the rules described in § 1.457-12(e). * * *

(b) * * * See § 1.457-12 for rules regarding the treatment of an ineligible plan.

§ 1.457-10 [Amended]

Par. 8. Section 1.457-10 is amended by removing the language “§ 1.457-11” wherever it appears in paragraphs (a)(2)(i), (a)(3) *Example 2* (ii), (c)(2) *Example 1* (ii) and *Example 2* (ii) and adding the language “§ 1.457-12” in its place.

§§ 1.457-11 and 1.457-12
[Redesignated as §§ 1.457-12 and 1.457-13]

Par. 9. Redesignate §§ 1.457-11 and 1.457-12 as §§ 1.457-12 and 1.457-13, respectively.

Par. 10. Add a new § 1.457-11 to read as follows:

§ 1.457-11 Exclusions and exceptions for certain plans.

(a) *In general.* The plans described in paragraphs (b) and (c) of this section either are not subject to section 457 or are treated as not providing for a deferral of compensation for purposes of section 457, and, accordingly, the provisions of §§ 1.457-3 through 1.457-10 and 1.457-12(a) do not apply to these plans.

(b) *Plans not subject to section 457.* The following plans are not subject to section 457:

(1) Any plan satisfying the conditions in section 1107(c)(4) of the Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2494) (TRA '86) (relating to certain plans for State judges);

(2) Any of the following plans (to which specific transitional statutory exclusions apply):

(i) A plan of a tax-exempt entity in existence prior to January 1, 1987, if the conditions of section 1107(c)(3)(B) of the TRA '86, as amended by section 1011(e)(6) of the Technical and Miscellaneous Revenue Act of 1988, Public Law 100-647 (102 Stat. 3342) (TAMRA), are satisfied (see § 1.457-2(b)(4) for a differ-

ent rule that may apply to the annual deferrals permitted under this type of plan);

(ii) A collectively bargained nonelective deferred compensation plan in effect on December 31, 1987, if the conditions of section 6064(d)(2) of TAMRA are satisfied;

(iii) Amounts deferred under plans described in section 6064(d)(3) of TAMRA (relating to amounts deferred under certain nonelective deferred compensation plans in effect before 1989); and

(iv) Any plan satisfying the conditions in section 1107(c)(4) and (5) of TRA '86 (relating to certain plans for certain individuals with respect to which the IRS issued guidance before 1977); and

(3) Any plan described in section 457(e)(12) that provides only nonelective deferred compensation attributable to services not performed as an employee (for example, a plan providing nonelective deferred compensation attributable to services performed by independent contractors). For this purpose, deferred compensation is nonelective only if all individuals, other than those who have not satisfied any applicable initial service requirement, with the same relationship to the payor are covered under the same plan with no individual variations or options under the plan.

(c) *Plans treated as not providing for a deferral of compensation.* The following plans are treated as not providing for a deferral of compensation for purposes of section 457, §§ 1.457-1 through 1.457-10, and § 1.457-12:

(1) A bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plan, as described in section 457(e)(11)(A)(i) (see paragraph (d) of this section for the definition of a bona fide severance pay plan, paragraph (e) of this section for the definitions of a bona fide death benefit plan and a bona fide disability pay plan, and paragraph (f) of this section for the requirements for a bona fide sick or vacation leave plan); and

(2) A plan described in section 457(e)(11)(A)(ii) paying solely length of service awards that are based on service accrued after December 31, 1996, to bona fide volunteers (and their beneficiaries) on account of qualified services performed by those volunteers.

(d) *Definition of bona fide severance pay plan—(1) In general.* A bona fide severance pay plan is an arrangement that meets the following requirements:

(i) Except as provided in paragraph (d)(3) of this section, benefits are payable only upon involuntary severance from employment, as defined in paragraph (d)(2) of this section (see § 1.457-6(b) for the meaning of severance from employment);

(ii) The amount payable does not exceed two times the participant's annualized compensation based upon the annual rate of pay for services provided to the eligible employer for the calendar year preceding the calendar year in which the participant has a severance from employment with the eligible employer (or the current calendar year if the participant had no compensation for services provided to the eligible employer in the preceding calendar year), adjusted for any increase during the year used to measure the rate of pay that was expected to continue indefinitely if the participant had not had a severance from employment; and

(iii) The entire severance benefit must be paid to the participant no later than the last day of the second calendar year following the calendar year in which the severance from employment occurs, pursuant to a requirement contained in a written plan document.

(2) *Involuntary severance from employment—(i) In general.* For purposes of paragraph (d)(1)(i) of this section, an *involuntary severance from employment* means a severance from employment due to the independent exercise of the eligible employer's unilateral authority to terminate the participant's services, other than due to the participant's implicit or explicit request, if the participant was willing and able to continue performing services. An involuntary severance from employment may include an eligible employer's failure to renew a contract at the time the contract expires, provided that the employee was willing and able to execute a new contract providing terms and conditions substantially similar to those in the expiring contract and to continue providing such services. The determination of whether a severance from employment is involuntary is based on all the facts and circumstances without regard to any character-

ization of the reason for the payment by the employer or participant.

(ii) *Severance from employment for good reason—(A) In general.* Notwithstanding paragraph (d)(2)(i) of this section, a participant's voluntary severance from employment will be treated as an involuntary severance from employment, for purposes of paragraph (d)(1)(i) of this section, if the severance occurs under certain bona fide conditions that are pre-specified in writing (referred to herein as a severance from employment for good reason), provided that the avoidance of the requirements of section 457 is not the primary purpose of the inclusion of the conditions or of the actions by the employer in connection with the satisfaction of the conditions, and a voluntary severance from employment under such conditions effectively constitutes an involuntary severance from employment. Notwithstanding the previous sentence, once the bona fide conditions have been established, the elimination of one or more of the conditions may result in the extension of a substantial risk of forfeiture, the recognition of which would be subject to the rules discussed in § 1.457-12(e)(2).

(B) *Material negative change required.* A severance from employment for good reason will be treated as an involuntary severance from employment only if the relevant facts and circumstances demonstrate that it was the result of unilateral employer action that caused a material negative change to the participant's relationship with the eligible employer. Some factors that may provide evidence of such a material negative change include a material reduction in the duties to be performed, a material negative change in the conditions under which the duties are to be performed, or a material reduction in the compensation to be received for performing such services. Other factors to be considered in determining whether a severance from employment due to good reason will be treated as an involuntary severance from employment include the extent to which the payments upon a severance from employment for good reason are in the same amount and made at the same time and in the same form as payments that would be made upon an actual involuntary severance from employment, and whether the employee is required to

give the employer notice of the existence of the condition that would result in the treatment of a severance from employment as being for good reason and a reasonable opportunity to remedy the condition.

(C) *Safe harbor.* The requirements of paragraph (d)(2)(ii)(B) of this section are deemed to be satisfied if a severance from employment occurs under the conditions described in paragraph (d)(2)(ii)(C)(I) of this section, those conditions are specified in writing by the time the legally binding right to the payment arises, and the plan also satisfies the requirements in paragraphs (d)(2)(ii)(C)(2) and (3) of this section.

(I) The severance from employment occurs during a limited period of time not to exceed two years following the initial existence of one or more of the following conditions arising without the consent of the participant:

(i) A material diminution in the participant's base compensation;

(ii) A material diminution in the participant's authority, duties, or responsibilities;

(iii) A material diminution in the authority, duties, or responsibilities of the supervisor to whom the participant is required to report, including a requirement that a participant report to a corporate officer or employee instead of reporting directly to the board of directors (or similar governing body) of an organization;

(iv) A material diminution in the budget over which the participant retains authority;

(v) A material change in the geographic location at which the participant must perform services; or

(vi) Any other action or inaction that constitutes a material breach by the eligible employer of the agreement under which the participant provides services.

(2) The amount, time, and form of payment upon the severance from employment is substantially the same as the amount, time, and form of payment that would have been made upon an actual involuntary severance from employment, to the extent such right to payment exists.

(3) The participant is required to provide notice to the eligible employer of the existence of the applicable condition(s) described in paragraph (d)(2)(ii)(C)(I) of

this section within a period not to exceed 90 days after the initial existence of the condition(s), upon the notice of which, the employer must be provided a period of at least 30 days during which it may remedy the condition(s) and not be required to pay the amount.

(3) *Window programs.* The requirement in paragraph (d)(1)(i) of this section that benefits be payable only upon involuntary severance from employment does not apply to a bona fide severance pay plan that provides benefits upon a severance from employment pursuant to a window program. For this purpose, a *window program* means a program established by an employer to provide separation pay in connection with an impending severance from employment, if the program is made available by the employer for a limited period of time (typically no longer than 12 months) to participants who have a severance from employment during that period or to participants who have a severance from employment during that period under specified circumstances. A program is not considered a window program for purposes of this paragraph if it is part of a pattern of multiple similar programs that, if offered as a single program, would not be a window program under this paragraph. Whether multiple programs constitute a pattern of similar programs is determined based on the relevant facts and circumstances. Although no one factor is determinative, relevant factors include whether the benefits are on account of a specific reduction in workforce (or some other entity-related operational condition), the degree to which the separation pay relates to an event or condition, and whether the event or condition is temporary or discrete or is a permanent aspect of the employer's practices.

(4) *Voluntary early retirement incentive plans*—(i) *In general.* Notwithstanding paragraph (d)(1) of this section, an applicable voluntary early retirement incentive plan (as defined in section 457(e)(11)(D)(ii)) is treated as a bona fide severance pay plan for purposes of this section with respect to payments or supplements made as an early retirement benefit, a retirement-type subsidy, or an early retirement benefit described in the last sentence of section 411(a)(9), if the payments or supplements are made in coordi-

nation with a defined benefit pension plan that is qualified under section 401(a) maintained by an eligible employer described in section 457(e)(1)(A) or by an education association described in section 457(e)(11)(D)(ii)(II). See section 1104(d)(4) of the Pension Protection Act of 2006, Public Law 109–280 (120 Stat. 780), regarding the application of the Internal Revenue Code and certain other laws to any plan, arrangement, or conduct to which section 457(e)(11)(D) does not apply.

(ii) *Definitions.* The definitions in § 1.411(d)–3(g)(6)(i) and (iv) apply for purposes of determining whether payments or supplements are an early retirement benefit or a retirement-type subsidy, and the definition in § 1.411(a)–7(c)(4) applies for purposes of determining whether payments or supplements are an early retirement benefit described in the last sentence of section 411(a)(9).

(e) *Bona fide death benefit or disability pay plans*—(1) *Bona fide death benefit plan.* For purposes of section 457(e)(11)(A)(i) and this section, a *bona fide death benefit plan* is a plan providing death benefits as defined in § 31.3121(v)(2)–1(b)(4)(iv)(C) of this chapter, provided that, for purposes of this paragraph (e)(1), the death benefits may be provided through insurance and the lifetime benefits payable under the plan are not treated as including the value of any term life insurance coverage provided under the plan that is includible in gross income.

(2) *Bona fide disability pay plan.* For purposes of section 457(e)(11)(A)(i) and this section, a *bona fide disability pay plan* is a plan that pays benefits (whether or not insured) only in the event that a participant is disabled, provided that, for purposes of this paragraph (e)(2), the value of any disability insurance coverage provided under the plan that is included in gross income is disregarded. For this purpose, a participant is considered disabled only if the participant meets one of the following conditions:

(i) The participant 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 last for a

continuous period of not less than 12 months;

(ii) The participant is, by reason of any medically determinable physical or mental impairment that can be expected to result in death or last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than three months under an accident and health plan covering employees of the eligible employer; or

(iii) The participant is determined to be totally disabled by the Social Security Administration or Railroad Retirement Board.

(f) *Bona fide sick and vacation leave plans*—(1) *In general.* For purposes of section 457(e)(11)(A)(i) and this section, the determination of whether a sick or vacation leave plan is a bona fide sick or vacation leave plan is made based on the relevant facts and circumstances. In general, a plan is treated as a bona fide sick or vacation leave plan, and not an arrangement to defer compensation, if the facts and circumstances demonstrate that the primary purpose of the plan is to provide participants with paid time off from work because of sickness, vacation, or other personal reasons. Factors used in determining whether a plan is a bona fide sick or vacation leave plan include whether the amount of leave provided could reasonably be expected to be used in the normal course by an employee (before the employee ceases to provide services to the eligible employer) absent unusual circumstances, the ability to exchange unused accumulated leave for cash or other benefits (including nontaxable benefits and the use of leave to postpone the date of termination of employment), the applicable restraints (if any) on the ability to accumulate unused leave and carry it forward to subsequent years in circumstances in which the accumulated leave may be exchanged for cash or other benefits, the amount and frequency of any in-service distributions of cash or other benefits offered in exchange for accumulated and unused leave, whether any payment of unused leave is made promptly upon severance from employment (or instead is paid over a period after severance from employment), and whether the program (or a particular feature of the program) is

available only to a limited number of employees.

(2) *Delegation of authority to Commissioner.* The Commissioner may provide additional rules regarding the requirements of a bona fide sick or vacation leave plan under section 457, in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(b) of this chapter), as the Commissioner determines to be necessary or appropriate.

Par. 11. Newly-designated § 1.457-12 is revised to read as follows:

§ 1.457-12 Tax treatment of participants if plan is not an eligible plan.

(a) *Tax treatment of an ineligible plan under section 457(f)*—(1) *In general.* Pursuant to section 457(f)(1), if an eligible employer provides for a deferral of compensation under an ineligible plan, amounts will be included in income in accordance with paragraphs (a)(2) through (4) of this section, except as otherwise provided in this paragraph (a) or paragraph (b) of this section. See § 1.457-11 for plans that are not subject to section 457 or are not treated as providing for a deferral of compensation for purposes of section 457.

(2) *Income inclusion.* The present value of compensation deferred under an ineligible plan is includible in the gross income of a participant or beneficiary under section 457(f) on the applicable date. For this purpose, the applicable date is the later of the first date on which there is a legally binding right to the compensation or, if the compensation is subject to a substantial risk of forfeiture, the first date on which the substantial risk of forfeiture (within the meaning of section 457(f)(3)(B) and paragraph (e) of this section) lapses. Paragraph (c) of this section provides rules for determining the present value of the compensation deferred under the plan, including a requirement that the amount of compensation deferred under an ineligible plan as of an applicable date includes any earnings on the compensation as of that date.

(3) *Treatment of earnings after income inclusion.* Earnings credited on compensation deferred under an ineligible plan after the date on which the compensation

is includible in gross income under section 457(f)(1) pursuant to paragraph (a)(2) of this section are includible in the gross income of a participant or beneficiary when paid or made available to the participant or beneficiary.

(4) *Income inclusion when compensation is paid or made available.* Amounts paid or made available to a participant or beneficiary under an ineligible plan are includible in the gross income of the participant or beneficiary under section 72, relating to annuities. For this purpose, an amount is paid or made available if there is actual or constructive receipt (within the meaning of § 1.451-2) of any taxable or nontaxable benefit, including a transfer of cash, a transfer of property includible in income under section 83, any other event that results in the inclusion in income under the economic benefit doctrine, a contribution to (or transfer or creation of a beneficial interest in) a trust described in section 402(b) at a time when contributions to the trust are includible in income under section 402(b), or inclusion of an amount in income under section 457A. An amount is also paid or made available for this purpose if there is a transfer, cancellation, or reduction of an amount of deferred compensation in exchange for benefits under a welfare benefit plan, a fringe benefit excludible under section 119 or section 132, or any other benefit that is excludible from gross income.

(5) *Investment in the contract.* For purposes of applying section 72 to amounts that are paid or made available as described in paragraph (a)(4) of this section, a participant is treated as having an investment in the contract to the extent that compensation has been included in gross income by the participant in accordance with paragraph (a)(2) of this section. An amount is treated as included in income for a taxable year only to the extent that the amount was properly includible in income and the participant actually included the amount in income (including on an original or amended federal income tax return or as a result of an IRS examination or a final decision of a court of competent jurisdiction).

(b) *Exceptions*—(1) *In general.* Section 457(f)(1) and paragraph (a) of this section do not apply to a plan or a portion of a plan described in this paragraph (b).

The determination of whether a plan or a portion of a plan is described in this paragraph (b) is made as of the date on which the legally binding right to an amount arises. However, a plan or portion of a plan will cease to be a plan that is described in this paragraph (b) on the first date that it no longer meets the requirements described in this paragraph (b).

(2) *Certain retirement plans.* Annuity plans and contracts described in section 403 and plans described in section 401(a) are not subject to the provisions of section 457(f)(1) and paragraph (a) of this section.

(3) *Section 402(b) trusts—(i) Section 402(b).* The portion of a plan that consists of a trust to which section 402(b) applies is not subject to the provisions of section 457(f)(1) and paragraph (a) of this section.

(ii) *Example.* The provisions of this paragraph (b)(3) are illustrated in the following example:

Example. (i) *Facts.* On October 1, 2017, an eligible employer establishes an ineligible plan covering only one participant (a highly compensated employee under section 414(q)) under which the participant obtains an unconditional right to be paid \$150,000 (plus interest at a specified reasonable rate) on October 1, 2021. As part of the plan, the employer simultaneously establishes a trust described in section 402(b) in the United States for the sole benefit of the participant. Under the terms of the plan and trust, the assets of the trust are also payable to the participant on October 1, 2021, and the amount that the employer is otherwise obligated to pay under the plan will be reduced (offset) by the amount paid to the participant from the trust. Section 402(b)(4) applies to the trust, and the trust has assets of \$98,000 on October 1, 2017 and \$100,000 on December 31, 2017.

(ii) *Conclusion.* Section 457(f) and this section apply only to the portion of the plan that is not funded through the section 402(b) trust. Thus, the participant has income under section 457(f) equal to the present value of the portion of the compensation deferred under the plan that is not funded through the section 402(b) trust on the date on which there is a legally binding right to the compensation (October 1, 2017). This present value is equal to \$52,000 (\$150,000 - \$98,000), which is included in the participant's gross income on October 1, 2017. The participant must also include \$100,000 in gross income on December 31, 2017 pursuant to section 402(b)(4)(A).

(4) *Qualified governmental excess benefit arrangements under section 415(m).* A qualified governmental excess benefit arrangement described in section 415(m) is not subject to the provisions of section 457(f)(1) and paragraph (a) of this section.

(5) *Nonqualified annuities under section 403(c)—(i) Section 403(c) annuities.*

The portion of a plan in which premiums are paid by an employer for an annuity contract to which section 403(c) applies is not subject to the provisions of section 457(f)(1) and paragraph (a) of this section.

(ii) *Examples.* The provisions of this paragraph (b)(5) are illustrated by the following examples:

Example 1. (i) *Facts.* A tax-exempt entity pays a premium for an annuity contract (described in section 403(c)) for the benefit of a participant. The annuity contract has a value of \$135,000, and the participant is substantially vested (as defined in § 1.83-3(b)) at the time the premium is paid. The participant includes the full value (\$135,000) in income under section 403(c) in the year the employer pays the premium.

(ii) *Conclusion.* Although the participant has a legally binding right to payments under the annuity contract that will be made in a subsequent taxable year, the participant's interest in the annuity contract is not subject to section 457(f)(1) and paragraph (a) of this section.

Example 2. (i) *Facts.* The facts are the same as in *Example 1* of this paragraph (b)(5), except the participant's rights in the annuity contract are not substantially vested (as defined in § 1.83-3(b)) at the time the premium is paid and do not become substantially vested until a future taxable year. The participant does not include the full value of the contract in income under section 403(c) in the year the employer pays the premium.

(ii) *Conclusion.* Neither the payment of the premium nor the participant's interest in the annuity contract is subject to section 457(f)(1) or paragraph (a) of this section.

(6) *Transfer of property under section 83—(i) Section 83.* The portion of a plan that consists of a transfer of property to which section 83 applies is not subject to the provisions of section 457(f)(1) and paragraph (a) of this section. Specifically, section 457(f)(1) and paragraph (a) of this section do not apply if, on or before the first date on which compensation deferred under a plan is not subject to a substantial risk of forfeiture (within the meaning of section 457(f)(3)(B) and paragraph (e) of this section), the amount is paid through a transfer of property described in section 83. However, section 457(f)(1) and paragraph (a) of this section do apply if the first date on which compensation deferred under a plan is not subject to a substantial risk of forfeiture (as defined in section 457(f)(3)(B) and paragraph (e) of this section) precedes the date on which the amount is paid through a transfer of property described in section 83. If deferred compensation payable in property is includible in gross income under section 457(f)(1)(A), then, as provided in section

72, the amount includible in gross income when that property is later transferred or made available to the participant or beneficiary is the excess of the value of the property at that time over the amount previously included in gross income under section 457(f)(1)(A).

(ii) *Examples.* The provisions of this paragraph (b)(6) are illustrated by the following examples:

Example 1. (i) *Facts.* On December 1, 2017, an eligible employer agrees to transfer property that is substantially vested (within the meaning of § 1.83-3(b)) and has a fair market value equal to a specified dollar amount, to a participant on January 15, 2020. The participant's rights under the agreement are not subject to a substantial risk of forfeiture (within the meaning of section 457(f)(3)(B) and paragraph (e) of this section).

(ii) *Conclusion.* Because there is no substantial risk of forfeiture (within the meaning of section 457(f)(3)(B) and paragraph (e) of this section) with respect to the agreement to transfer property in 2020, the present value of the amount on the applicable date (December 1, 2017) is includible in the participant's gross income under section 457(f)(1)(A). Under paragraph (a)(4) of this section, when the substantially vested property is transferred to the participant on January 15, 2020, the amount includible in the participant's gross income is equal to the excess of the fair market value of the property on that date over the amount that was included in gross income for 2017.

Example 2. (i) *Facts.* Under a bonus plan, an eligible employer agrees in 2021 to transfer property that is substantially nonvested (within the meaning of § 1.83-3(b)) to Participants A and B in 2023 if they are continuously employed by the eligible employer through the date of the transfer (which condition constitutes a substantial risk of forfeiture within the meaning of section 457(f)(3)(B) and paragraph (e) of this section). In 2023, the eligible employer transfers the property to Participants A and B, subject to a substantial risk of forfeiture (within the meaning of § 1.83-3(c)), that lapses in 2025. Participant A makes a timely election to include the fair market value of the property in gross income under section 83(b). Participant B does not make this election.

(ii) *Conclusion.* The compensation deferred for both Participants A and B is not subject to section 457(f)(1) or paragraph (a) of this section because section 83 applies to the transfer of property on or before the date on which the property is not subject to a substantial risk of forfeiture (within the meaning of section 457(f)(3)(B) and paragraph (e) of this section). Because of the section 83(b) election, Participant A includes the fair market value of the property (disregarding lapse restrictions) in gross income for 2023 under section 83(b)(1). Participant B includes the value of the property in gross income when the substantial risk of forfeiture lapses in 2025 under section 83(a).

(7) *Applicable employment retention plan.* The portion of a plan that is an applicable employment retention plan as

described in section 457(f)(4) with respect to any participant is not subject to the provisions of section 457(f)(1) and paragraph (a) of this section. See also section 1104(d)(4) of the Pension Protection Act of 2006, Public Law 109–280 (120 Stat. 780), regarding the application of the Internal Revenue Code and certain other laws to any plan, arrangement, or conduct to which section 457(f)(2)(F) does not apply.

(c) *Amount included in income*—(1) *Calculation of present value*—(i) *In general*. Except as otherwise provided in this paragraph (c), the present value of compensation deferred under an ineligible plan as of an applicable date equals the present value of the future payments to which the participant has a legally binding right (as described in paragraph (d) of this section). For this purpose, present value is determined in accordance with the provisions of this paragraph (c)(1)(i) by multiplying the amount of a payment (or the amount of each payment in a series of payments) by the probability that any condition or conditions on which the payment is contingent will be satisfied and discounting the amount using an assumed rate of interest to reflect the time value of money.

(ii) *Actuarial assumptions*—(A) *In general*—(1) *Reasonable actuarial assumptions*. For purposes of paragraph (c)(1)(i) of this section, present value is determined using actuarial assumptions and methods that, based on all of the facts and circumstances, are reasonable as of the applicable date, including an interest rate that is reasonable as of that date and other assumptions necessary to determine the present value (without regard to whether the present value of the compensation deferred under the plan is reasonably ascertainable as described in § 31.3121(v)(2)–1(e)(4)(i)(B) of this chapter).

(2) *Probability of death before the payment of benefits*. For purposes of paragraph (c)(1)(i) of this section, the probability that a participant will die before a payment is made is permitted to be taken into account only to the extent that the payment is forfeitable upon death.

(3) *Probability that the payment will not be made*. For purposes of paragraph (c)(1)(i) of this section, the probability

that payments will not be made (or will be reduced) because of the unfunded status of a plan, the risk associated with any deemed or actual investment of compensation deferred under the plan, the risk that the eligible employer or another party will be unwilling or unable to pay, the possibility of future plan amendments, the possibility of a future change in the law, or similar risks or contingencies are not taken into account.

(B) *Payments made in foreign currency*. The rules in § 1.409A–4(b)(2)(i) apply for purposes of determining the treatment of payments in foreign currency.

(C) *Treatment of payment triggers based upon events*—(1) *In general*. Except as provided in paragraph (c)(1)(ii)(C)(2) of this section, the rules in § 1.409A–4(b)(2)(vii) apply for purposes of determining the treatment of payment triggers based upon events.

(2) *Treatment of severance from employment*. If the date on which a payment will be made depends on the date the participant has a severance from employment (as described in § 1.457–6(b)) and the participant has not had a severance from employment by the applicable date, then for purposes of paragraph (c)(1)(ii)(A)(1) of this section, the severance from employment may be treated as occurring on any date that is not later than the fifth anniversary of the applicable date, unless this assumption would be unreasonable under the facts and circumstances.

(iii) *Unreasonable assumptions*. If any actuarial assumption or method used to determine the present value of compensation deferred under the plan is not reasonable, as determined by the Commissioner, then the Commissioner will determine the present value using actuarial assumptions and methods that the Commissioner determines to be reasonable, including the AFR and the applicable mortality table under section 417(e)(3)(B) as of the applicable date. For purposes of this section, AFR means the mid-term applicable federal rate (as defined pursuant to section 1274(d)) for January 1 of the relevant calendar year, compounded annually.

(iv) *Account balance plans*—(A) *In general*. To the extent benefits are provided under an account balance plan, as

defined in § 31.3121(v)(2)–1(c)(1)(ii) and (iii) of this chapter, to which earnings (or losses, if applicable) are credited at least annually, the present value of compensation deferred under the plan as of an applicable date is the amount credited to the participant's account, including both the principal amount credited to the account and any earnings or losses attributable to the principal amount that have been credited to the account, as of that date.

(B) *Unreasonable rates of return*. This paragraph (c)(1)(iv)(B) applies to an account balance plan under which the income credited is based on neither a predetermined actual investment, within the meaning of § 31.3121(v)(2)–1(d)(2)(i)(B) of this chapter, nor a rate of interest that is reasonable, within the meaning of § 31.3121(v)(2)–1(d)(2)(i)(C) of this chapter, as determined by the Commissioner. The present value of compensation deferred under that type of plan as of an applicable date is equal to the amount credited to the participant's account as of that date, plus the present value of the excess (if any) of the earnings to be credited under the plan over the earnings that would be credited through the projected payment date using a reasonable rate of interest. If the present value of compensation deferred under the plan is not determined and is not taken into account by the taxpayer in this manner, the present value of the compensation deferred under the plan will be treated as equal to the amount credited to the participant's account as of the applicable date, plus the present value of the excess (if any) of the earnings to be credited under the plan through the projected payment date over the earnings that would be credited using the AFR.

(C) *Combinations of predetermined actual investments or interest rates*. If the amount of earnings or losses credited under an account balance plan is based on the greater of two or more rates of return (each of which would be a predetermined actual investment or a reasonable interest rate if the earnings or losses credited were based on only one of those rates of return), then the amount included in income on the applicable date is the sum of the amount credited to the participant's account as of the applicable date and the present value (determined under paragraph (c)(1)(i) of this section) of the right to future earnings.

(D) *Examples.* The following examples illustrate the provisions of paragraphs (c)(1)(i) through (iv) of this section. For purposes of these examples, assume that the arrangements are either not subject to section 409A or 457A or otherwise comply with the requirements of those provisions, and that the parties are not under examination for any of the tax years in question.

Example 1. (i) *Facts.* On October 1, 2017, an eligible employer agrees to pay \$100,000 to a participant on January 1, 2024, if the participant is alive on that date. The employer determines that the October 1, 2017 present value of that payment is \$75,000 based on the second segment rate used for purposes of section 417(e)(3)(C) on October 1, 2017, and using the mortality table applicable under section 417(e)(3)(B) on October 1, 2017.

(ii) *Conclusion.* The present value has been determined in accordance with paragraph (c)(1)(i) of this section.

Example 2. (i) *Facts.* On October 1, 2018, an eligible employer agrees to pay \$100,000 to a participant at severance from employment. The assumptions that the employer uses to determine the present value are that the participant will have a severance from employment on October 1, 2023 (the fifth anniversary of the date the participant obtains the right to the payment in accordance with paragraph (c)(1)(ii)(C)(2) of this section) and that the present value will be determined using a rate of 4.5% compounded monthly.

(ii) *Conclusion.* Assuming, solely for purposes of this example, that the employer's severance from employment date and interest rate assumptions are reasonable, the value included in income on the applicable date (October 1, 2018) is \$79,885.

Example 3. (i) *Facts.* On October 1, 2017, an eligible employer agrees to pay \$100,000 to a participant at severance from employment, but no payment will be made if the severance from employment occurs on or after October 1, 2021.

(ii) *Conclusion.* Although paragraph (c)(1)(ii)(C)(2) of this section provides that for purposes of determining when a payment will be made, severance may be treated as if it occurred on the fifth anniversary of the applicable date, that assumption would be unreasonable under these facts and circumstances and would not be permitted under paragraph (c)(1)(ii)(C)(2) of this section. Accordingly, for purposes of determining the present value, an assumption that severance from employment would occur after September 30, 2021 would be unreasonable.

Example 4. (i) *Facts.* An eligible employer maintains a supplemental executive retirement plan that provides a subsidized early retirement benefit payable to participants between age 60 and 65. A 60 year old participant becomes vested in the right to the subsidized early retirement benefit on December 31, 2017.

(ii) *Conclusion.* The assumption under paragraph (c)(1)(ii)(C)(2) of this section would not be permitted for purposes of determining the amount to be included in income because the nature of the subsidized early retirement benefit causes it to decline in

value until it becomes worthless upon attainment of age 65. In other words, the value of the subsidized early retirement benefit using the assumption permitted in paragraph (c)(1)(ii)(C)(2) of this section would result in a value of \$0 and would be unreasonable under the facts and circumstances.

Example 5. (i) *Facts.* On October 1, 2017, an eligible employer agrees to provide compensation to an employee for prior services in an amount equal to \$100,000, plus interest at a reasonable rate, with payment to be made at the time of the employee's severance from employment. The participant's right to the compensation is not subject to a substantial risk of forfeiture at any time.

(ii) *Conclusion.* Because the agreement provides for a reasonable rate of interest, the amount included in income on the applicable date (October 1, 2017) is \$100,000.

Example 6. (i) *Facts.* The facts are the same as in *Example 5* of this paragraph (c)(1)(iv)(D), except that the right is subject to a requirement that the participant continue to provide substantial services for three additional years (which constitutes a substantial risk of forfeiture as described in paragraph (e) of this section). On October 1, 2020, when the substantial risk of forfeiture lapses, the account balance is \$116,147.

(ii) *Conclusion.* The amount included in income on the applicable date (October 1, 2020) is \$116,147.

Example 7. (i) *Facts.* The facts are the same as in *Example 5* of this paragraph (c)(1)(iv)(D), except that the rate of interest credited on the account is 5% above a reasonable rate of interest. On October 1, 2017, the sum of the \$100,000 account balance, plus the present value of the right to receive the difference between a reasonable rate of return and the rate of return being credited on the account (from October 1, 2017 until October 1, 2022) is \$128,336. The participant has a severance from employment on October 16, 2020, and is paid \$135,379 on that date.

(ii) *Conclusion.* The amount included in income on the applicable date (October 1, 2017) is \$128,336. Pursuant to paragraph (a)(5) of this section, the \$128,336 is treated as investment in the contract for purposes of section 72 and, pursuant to paragraph (a)(4) of this section, the participant recognizes an additional \$7,043 (\$135,379, minus the \$128,336 that was previously included in gross income for 2017) in income attributable to the payment on October 16, 2020.

Example 8. (i) *Facts.* The facts are the same as in *Example 5* of this paragraph (c)(1)(iv)(D), except that the employer also agrees to pay the participant an amount that is estimated to be equal to the federal, state, and local income taxes due (based on a fixed percentage that is pre-specified in the agreement) attributable to the amount included in income on the applicable date (October 1, 2017). In exchange for that tax payment, the amount payable upon severance from employment is to be reduced by an amount equal to the federal, state, and local income taxes for the taxable year of payment that the employer estimates would otherwise have been due but for the income inclusion in 2017. In satisfaction of this obligation to make the tax payment, the employer pays the participant \$66,667 on April 15, 2018.

(ii) *Conclusion.* The present value on the applicable date (October 1, 2017) is \$100,000, plus the present value of the \$66,667 payment to be made on April 15, 2018, minus the present value of the reduction that will be applied at the time of payment (which, if reasonable, may be assumed to be October 1, 2022 in accordance with paragraph (c)(1)(ii)(C)(2) of this section).

Example 9. (i) *Facts.* An eligible employer credits \$100,000 on December 31, 2017, to the account of a participant under an ineligible plan, subject to the condition that the amount will be forfeited if the participant voluntarily terminates employment before December 31, 2019. The account balance will be credited with notional annual earnings based on the greater of the return of a designated S&P 500 index fund or a specified rate of interest and will be paid on December 31, 2025.

(ii) *Conclusion.* Under paragraph (c)(1)(iv)(C) of this section, the sum of the amount credited to the participant's account as of the applicable date (December 31, 2019) and the present value (determined under paragraph (c)(1)(i) of this section) of the right to future earnings based on the greater of the return of the designated S&P 500 index fund or the specified rate of interest must be included in the participant's gross income on the applicable date.

(v) *Application of the general calculation rules to formula amounts.* With respect to a right to receive a formula amount, the amount or amounts of future payments under the plan, for purposes of determining the present value as of an applicable date, is determined based on all of the facts and circumstances existing as of that date. This determination must reflect reasonable, good faith assumptions with respect to any contingencies as to the amount of the payment, both with respect to each contingency and with respect to all contingencies in the aggregate. An assumption based on the facts and circumstances as of the applicable date may be reasonable even if the facts and circumstances change in the future so that when the amount payable is determined in a subsequent year, the amount payable is a greater (or lesser) amount. In such a case, the increase (or decrease) due to the change in the facts and circumstances is treated as earnings (or losses). For purposes of this paragraph (c)(1)(v), an amount payable is a formula amount to the extent that the amount payable in a future taxable year is dependent upon factors that, after applying the assumptions and other rules set forth in this section, are not determinable as of the applicable date, such that the amount payable may not be readily determined as of that date under the other provisions of this section. If some portion of an amount payable is not

a formula amount, the amount payable with respect to such portion is determined under the rules applicable to amounts that are not formula amounts, and only the balance of the amount payable is determined under the rules applicable to formula amounts.

(vi) *Treatment of payment restrictions.* The rules in § 1.409A-4(b)(2)(v) apply for purposes of determining the treatment of payment restrictions.

(vii) *Treatment of alternative times and forms of a future payment.* The rules in § 1.409A-4(b)(2)(vi) apply for purposes of determining the treatment of alternative times and forms of a future payment.

(viii) *Reimbursement and in-kind benefit arrangements.* The rules in § 1.409A-4(b)(4) apply for purposes of determining the present value of reimbursement and in-kind benefit arrangements.

(ix) *Split-dollar life insurance arrangements.* The rules in § 1.409A-4(b)(5) apply for purposes of determining the present value of benefits provided under a split-dollar life insurance arrangement.

(2) *Forfeiture or other permanent loss of right to compensation previously included in income—(i) In general.* If a participant has included compensation under a plan in income pursuant to paragraph (a)(2) or (4) of this section, but all or a portion of that compensation is never paid under the plan, the participant is entitled to a deduction for the taxable year in which the entire remaining right to the payment of the compensation is permanently forfeited under the plan's terms or otherwise permanently lost. The deduction to which the participant is entitled equals the excess of the amounts included in income under paragraphs (a)(2) and (4) of this section with respect to the compensation over the total amount of the compensation actually received that constitutes investment in the contract under paragraph (a)(5) of this section.

(ii) *Forfeiture or permanent loss of right.* For purposes of this paragraph (c)(2), a mere diminution in the amount payable under the plan due to a deemed investment loss, an actuarial reduction, or any other decrease in the amount deferred under the plan is not treated as a forfeiture or permanent loss of the right if the participant retains the right to any payment

under the plan (whether or not such right is subject to a substantial risk of forfeiture as described in paragraph (e) of this section). In addition, an amount payable under a plan is not treated as forfeited or otherwise permanently lost if another amount or an obligation to make a payment in a future year is substituted for the original amount. However, an amount payable under a plan is treated as permanently lost if the participant's right to receive payment of the amount becomes wholly worthless during the taxable year. Whether the right to receive payment has become wholly worthless is determined based on the relevant facts and circumstances existing as of the last day of the relevant taxable year.

(iii) *Examples.* The provisions of this paragraph (c)(2) are illustrated in the following examples:

Example 1. (i) Facts. On October 1, 2017, an eligible employer establishes an ineligible plan for a participant under which the employer agrees to pay the amount credited to the participant's account when the participant has a severance from employment. The obligation to make the payment is not subject to a substantial risk of forfeiture. The account balance on October 1, 2017 is \$125,000, and the participant includes \$125,000 in income in 2017. The plan subsequently experiences notional investment losses, and the participant receives \$75,000 from the plan in a lump-sum distribution in 2024, when the participant has a severance from employment. The \$75,000 lump-sum distribution represents all amounts due to the participant under the plan.

(ii) *Conclusion.* For 2024, the participant is entitled to deduct \$50,000 (the excess of the amount included in income under paragraph (a)(2) of this section (\$125,000) over the amount actually received that constitutes investment in the contract under paragraph (a)(5) of this section (\$75,000)).

Example 2. (i) Facts. The facts are the same facts as in *Example 1* of this paragraph (c)(2)(iii), except that the plan provides that the participant will receive the deferred compensation in three installments (1/3 of the account balance in 2024, 1/2 of the then remaining account balance in 2025, and the remaining balance in 2026), and that the sum of all three installments is \$75,000.

(ii) *Conclusion.* The participant is entitled to deduct \$50,000 in the taxable year of the last installment payment (2026) (\$125,000, reduced by the sum of the amounts received in 2024, 2025, and 2026 (\$75,000)).

(d) *Definition of deferral of compensation—(1) In general—(i) Legally binding right.* A plan provides for the deferral of compensation with respect to a participant for purposes of section 457(f) and this section if, under the terms of the plan and the relevant facts and circumstances, the participant has a legally binding right dur-

ing a calendar year to compensation that, pursuant to the terms of the plan, is or may be payable to (or on behalf of) the participant in a later calendar year. Whether a plan provides for the deferral of compensation for purposes of section 457(f) and this section is determined based on the relevant facts and circumstances at the time that the participant obtains a legally binding right to the compensation, or, if later, when a plan is amended to convert a right that does not provide for a deferral of compensation into a right that does provide for a deferral of compensation. For example, if a plan providing for retiree health care does not initially provide for a deferral of compensation but is later amended to provide the ability to receive future cash payments instead of health benefits, it may become a plan that provides for the deferral of compensation at the time of the amendment. An amount of compensation deferred under a plan that provides for the deferral of compensation within the meaning of section 457(f) and this section does not cease to be an amount subject to section 457(f) and this section by reason of any change to the plan that would otherwise recharacterize the right to the amount as a right that does not provide for the deferral of compensation with respect to such amount. In addition, any change under the plan that results in an exchange of an amount deferred under the plan for some other right or benefit that would otherwise be excluded from the participant's gross income does not affect the characterization of the plan as one that provides for a deferral of compensation.

(ii) *Discretion to reduce or eliminate compensation.* A participant does not have a legally binding right to compensation to the extent that the compensation may be reduced or eliminated unilaterally by the employer or another 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 participant is considered to have a legally binding right to the compensation. Whether the discretion to reduce or eliminate compensation

lacks substantive significance depends on all the relevant facts and circumstances. However, if the participant 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) but also including 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 is not treated as having substantive significance. 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 a nondiscretionary, objective provision creating a substantial risk of forfeiture or the application of a formula that provides for benefits to be offset by benefits provided under another plan (such as a plan that is qualified under section 401(a)).

(2) *Short-term deferrals.* For purposes of section 457(f) and this section, a deferral of compensation does not occur under a plan with respect to any payment for which a deferral of compensation does not occur under section 409A pursuant to § 1.409A-1(b)(4) (short-term deferrals), except that, for purposes of this paragraph, in applying the rules provided in § 1.409A-1(b)(4) the meaning of *substantial risk of forfeiture* under § 1.457-12(e) applies in each place that term is used (and not the meaning of *substantial risk of forfeiture* provided under § 1.409A-1(d)).

(3) *Recurring part-year compensation.* For purposes of section 457(f) and this section and notwithstanding paragraph (d)(2) of this section, a deferral of compensation does not occur under a plan with respect to an amount that is recurring part-year compensation (as defined in § 1.409A-2(a)(14)), if the plan does not defer payment of any of the recurring part-year compensation to a date beyond the last day of the 13th month following the first day of the service period for which the recurring part-year compensation is paid, and the amount of the recurring part-year compensation does not ex-

ceed the annual compensation limit under section 401(a)(17) for the calendar year in which the service period commences.

(4) *Certain other exceptions.* For purposes of section 457(f) and this section, a deferral of compensation does not occur to the extent that a plan provides for:

(i) The payment of expense reimbursements, medical benefits, or in-kind benefits, as described in § 1.409A-1(b)(9)(v)(A), (B), or (C);

(ii) Certain indemnification rights, liability insurance, or legal settlements, as described in § 1.409A-1(b)(10), or (11); or

(iii) Taxable educational benefits for an employee (which, for this purpose, means solely benefits consisting of educational assistance, as defined in section 127(c)(1) and the regulations thereunder, attributable to the education of an employee, and does not include any benefits provided for the education of any other person, including any spouse, child, or other family member of the employee).

(5) *Interaction with section 409A—(i) In general.* The rules of section 457(f) apply to an ineligible plan separately and in addition to any requirements applicable to the plan under section 409A.

(ii) *Acceleration of the time or schedule of a payment.* Although section 457(f) and this section do not preclude the acceleration of payments, see § 1.409A-3(a) for the general rules and exceptions relating to the acceleration of payments that are subject to section 409A.

(iii) *Example.* The provisions of this paragraph (d)(5) are illustrated in the following example:

Example. (i) *Facts.* On December 1, 2017, an eligible employer establishes an account balance plan for an employee that is subject to section 457(f), under which an initial amount is credited to the account and is increased periodically by earnings based on a reasonable specified rate of interest. The entire account balance is subject to a substantial risk of forfeiture until December 1, 2021. Under the terms of the plan, the account balance will be paid in three annual installments on each January 15, beginning in 2024 (one third of the balance for the first installment, one half of the then remaining balance for the second installment, and the remaining balance for the third installment). However, in 2022, the plan is amended to provide for payments to begin in 2023, such that the plan fails to comply with the requirements of section 409A during 2022. The account balance is: \$100,000 on December 1, 2021; \$118,000 on December 31, 2022; \$120,000 on January 15, 2023 (so that the payment made that day is

\$40,000 (\$120,000/3)); \$88,000 on January 15, 2024 (so that the payment made that day is \$44,000 (\$88,000/2)); and \$50,000 on January 15, 2025 (so that the payment made that day is \$50,000).

(ii) *Conclusion: Federal income tax treatment in 2021.* The plan provides for a deferral of compensation to which section 457(f) applies. Under section 457(f) and paragraph (a)(2) of this section, the \$100,000 amount of the account balance on December 1, 2021, when the benefits cease to be subject to a substantial risk of forfeiture, is included in the employee's gross income on that date.

(iii) *Conclusion: Federal income tax treatment after 2021—(1) Treatment in 2022 under section 409A.* Because the arrangement fails to meet the requirements of section 409A in 2022, the employee has gross income under section 409A equal to the account balance on December 31, 2022, reduced by the amount previously included in income. Accordingly, the amount included in gross income under section 409A is equal to \$18,000 (the \$118,000 account balance on December 31, 2022, reduced by the \$100,000 previously included in income under section 457(f) for 2021). The amount included in gross income under section 409A is subject to an additional 20 percent tax under section 409A(a)(1)(B)(i)(II) and a premium interest tax under section 409A(a)(1)(B)(i)(I).

(2) *Federal income tax treatment of first installment payment in 2023—(i) Earnings previously included under section 409A.* The first \$18,000 of the \$40,000 payment in 2023 is excluded from gross income under section 409A as a result of the earlier inclusion of that amount in income in 2022 due to the section 409A violation. See § 1.409A-4(f).

(ii) *Deferral of compensation under section 457(f).* The amount of the investment in the contract (described in paragraph (a)(5) of this section) allocated to the remaining \$22,000 of the installment paid in 2023 is \$33,333 (\$100,000/3), so no amount is included in gross income for 2023.

(3) *Federal income tax treatment of second installment payment in 2024.* The employee has unused investment in the contract from 2023 in the amount of \$11,333 (\$33,333 - \$22,000). Assuming that the employee elects to redetermine the amount recognized for the current and subsequent years in 2024 pursuant to § 1.72-4(d)(3)(ii), the amount included in gross income for 2024 is \$5,000 (the payment of \$44,000, reduced by the portion of the remaining investment in the contract that is allocable to the installment, which is \$39,000 (((\$100,000 - \$22,000)/2)).

(4) *Federal income tax treatment of third installment payment in 2025.* The

amount included in gross income for 2025 is \$11,000 (the payment of \$50,000, reduced by the remaining investment in the contract of \$39,000).

(e) *Rules relating to substantial risk of forfeiture*—(1) *Substantial risk of forfeiture*—(i) *In general*. An amount of compensation is subject to a substantial risk of forfeiture only if entitlement to the amount is conditioned on the future performance of substantial services, or upon the occurrence of a condition that is related to a purpose of the compensation if the possibility of forfeiture is substantial. An amount is not subject to a substantial risk of forfeiture if the facts and circumstances demonstrate that the forfeiture condition is unlikely to be enforced (see paragraph (e)(1)(v) of this section). If a plan provides that entitlement to an amount is conditioned on involuntary severance from employment without cause (which includes, for this purpose, a voluntary severance from employment that is treated as involuntary under § 1.457-11(d)(2)(ii)), the right is subject to a substantial risk of forfeiture if the possibility of forfeiture is substantial.

(ii) *Substantial future services*. For purposes of paragraph (e)(1)(i) of this section, the determination of whether an amount of compensation is conditioned on the future performance of substantial services is based on the relevant facts and circumstances, such as whether the hours required to be performed during the relevant period are substantial in relation to the amount of compensation.

(iii) *Condition related to a purpose of the compensation*. For purposes of paragraph (e)(1)(i) of this section, a condition related to a purpose of the compensation must relate to the participant's performance of services for the employer or to the employer's governmental or tax-exempt activities (as applicable) or organizational goals.

(iv) *Noncompetition conditions*. For purposes of paragraph (e)(1)(i) of this section, an amount of compensation will not be treated as subject to a substantial risk of forfeiture merely because the right to payment of the amount is conditioned, directly or indirectly, upon the employee refraining from the future performance of certain services, unless each of the following conditions is satisfied:

(A) The right to payment of the amount is expressly conditioned upon the employee refraining from the future performance of services pursuant to an enforceable written agreement.

(B) The employer makes reasonable ongoing efforts to verify compliance with noncompetition agreements (including the noncompetition agreement applicable to the employee).

(C) At the time that the enforceable written agreement becomes binding, the facts and circumstances demonstrate that the employer has a substantial and bona fide interest in preventing the employee from performing the prohibited services and that the employee has bona fide interest in, and ability to, engage in the prohibited competition. Factors taken into account for this purpose include the employer's ability to show significant adverse economic consequences that would likely result from the prohibited services; the marketability of the employee based on specialized skills, reputation, or other factors; and the employee's interest, financial need, and ability to engage in the prohibited services.

(v) *Enforcement of forfeiture condition*. To constitute a substantial risk of forfeiture, the possibility of actual forfeiture in the event that the forfeiture condition occurs must be substantial based on the relevant facts and circumstances. Factors to be considered for this purpose include, but are not limited to, the extent to which the employer has enforced forfeiture conditions in the past, the level of control or influence of the employee with respect to the organization and the individual(s) who would be responsible for enforcing the forfeiture condition, and the likelihood that such provisions would be enforceable under applicable law.

(2) *Addition or extension of risk of forfeiture*—(i) *General rule*. The initial addition or extension of any risk of forfeiture after a legally binding right to compensation arises, including the application of a risk of forfeiture to a plan providing for deferrals of current compensation (an additional or extended risk of forfeiture), will be disregarded unless the plan meets the requirements of paragraphs (e)(2)(ii) through (v) of this section.

(ii) *Benefit must be materially greater*. A deferred amount will not be subject to a

substantial risk of forfeiture for purposes of section 457 and this section after the date on which an employee could have received the amount, unless the present value of the amount made subject to the additional or extended substantial risk of forfeiture (disregarding the risk of forfeiture in determining the present value of the amount) is materially greater than the present value of the amount the employee otherwise would have received absent the initial or extended risk of forfeiture. For purposes of this paragraph (e)(2)(ii), present value is determined in accordance with the rules described in paragraph (c) of this section as of the applicable date for the amount the employee otherwise would have received absent the initial or extended risk of forfeiture. In addition, an amount is materially greater for purposes of this paragraph (e)(2)(ii) only if the present value of the amount subject to the additional or extended substantial risk of forfeiture is more than 125 percent of the present value of the amount that the employee would have received absent the additional or extended risk of forfeiture. For this purpose, compensation that the participant would receive for continuing to perform services, regardless of whether the deferred amount is subjected to an additional or extended substantial risk of forfeiture, is not taken into account.

(iii) *Minimum two years of substantial future services*. The employee must be required to perform substantial services in the future, or refrain from competing pursuant to an agreement that meets the requirements of paragraph (e)(1)(iv) of this section, for a minimum of two years after the date that the employee could have received the compensation in the absence of the additional or extended substantial risk of forfeiture. For example, if an employee elects to defer a fixed percentage from each semi-monthly payroll, the two year minimum applies to each semi-monthly payroll amount that would otherwise have been paid. Notwithstanding the two year minimum, a plan may provide that that the substantial future service condition will lapse upon death, disability, or involuntary severance from employment without cause.

(iv) *Timing*. The parties must agree in writing to any addition or extension of a substantial risk of forfeiture under this

paragraph (e)(2). In the case of an initial addition of a substantial risk of forfeiture if none previously existed (for example, in the case of a deferral of current compensation), this written agreement must be entered into before the beginning of the calendar year in which any services that give rise to the compensation are performed, and, in the case of an extension of a substantial risk of forfeiture, the written agreement must be entered into at least 90 days before an existing substantial risk of forfeiture would have lapsed. If an employee with respect to whom compensation is made subject to an initial or extended substantial risk of forfeiture was not providing services to the employer at least 90 days before the addition or extension, the addition or extension may be agreed to in writing within 30 days after commencement of employment but only with respect to amounts attributable to services rendered after the addition or extension is agreed to in writing.

(v) *Substitutions.* For purposes of paragraph (e)(2) of this section, if an amount is forfeited or relinquished and replaced, in whole or part, with a right to another amount (or benefit) that is a substitute for the amount that was forfeited or relinquished and that is subject to a risk of forfeiture, the risk of forfeiture will be disregarded unless the requirements of paragraphs (e)(2)(ii) through (iv) of this section are satisfied.

(3) *Examples.* The provisions of this paragraph (e) are illustrated in the following examples:

Example 1. (i) *Facts.* On January 15, 2017, an employee has a severance from employment with an eligible employer and enters into an agreement with the eligible employer under which the eligible employer agrees to pay the employee \$250,000 on January 15, 2018, if the employee provides consulting services to the employer until that date. The consulting services required are insubstantial in relation to the payment. The employee provides the required consulting services for the employer through January 15, 2018.

(ii) *Conclusion.* The consulting services provided by the former employee do not constitute substantial services because they are insubstantial in relation to the payment. Accordingly, the present value of \$250,000 payable on January 15, 2018 is includible in the employee's gross income on January 15, 2017.

Example 2. (i) *Facts.* On January 27, 2020, an eligible employer agrees to pay an employee an amount equal to \$120,000 on January 1, 2023, provided that the employee continues to provide substantial services to the employer through that date. In 2021, the parties enter into a written agreement to

extend the date through which substantial services must be performed to January 1, 2025, in which event, the employer will pay an amount that has a present value of \$145,000 on January 1, 2023.

(ii) *Conclusion.* As of the date the initial risk of forfeiture would have lapsed, the present value of the compensation subject to the extended substantial risk of forfeiture is not materially greater than the present value of the amount previously deferred under the plan (\$145,000 is not more than 125% of \$120,000) and, therefore, the intended extension of the substantial risk of forfeiture is disregarded under the provisions of paragraph (e)(2) of this section. Accordingly, the employee will recognize income, on the applicable date (January 1, 2023) in an amount equal to \$120,000 (the amount that is not subject to a substantial risk of forfeiture on that date, disregarding the intended extension). With respect to the amount that is ultimately paid under the plan on January 1, 2025, the employee is treated as having investment in the contract of \$120,000 (pursuant to paragraph (a)(5) of this section).

Example 3. (i) *Facts.* On December 31, 2017, a participant enters into an agreement to defer \$15,000 of the participant's current compensation that would otherwise be paid during 2018, with payment of the deferred amounts to be made on December 31, 2024, but only if the participant continues to provide substantial services until December 31, 2024. Under the terms of the agreement, the participant's periodic payments of current compensation are reduced, and a corresponding amount is credited (with a 30% employer match) to an account earning a reasonable rate of interest. The present value of the amount payable on December 31, 2024 is 130% of the present value of the amount deferred.

(ii) *Conclusion.* The amounts deferred are subject to a substantial risk of forfeiture because the plan satisfies the requirements of paragraphs (e)(2)(ii) through (v) of this section.

Example 4. (i) *Facts.* Employee A is a well-known college sports coach with a long history of success in a sports program at University X. University X reasonably expects that the loss of Employee A would be substantially detrimental to its sports program and would result in significant financial losses. Employee A has bona fide interest in continuing to work as a college sports coach and is highly marketable. On June 1, 2020, Employee A and University X enter into a written agreement under which Employee A agrees to provide substantial services to University X until June 1, 2023. The parties further agree that University X will pay \$500,000 to Employee A on June 1, 2025 if Employee A has not performed services as a sports coach before that date for any other college or university with a sports program similar to that of University X. The agreement is enforceable under applicable law and University X would be reasonably expected to enforce it.

(ii) *Conclusion.* The \$500,000 payable under the agreement is subject to a substantial risk of forfeiture until June 1, 2025, and includible in Employee A's gross income on that date.

Par. 12. Newly-designated § 1.457-13 is revised to read as follows:

§ 1.457-13 Applicability dates.

(a) *General applicability date.* Except as otherwise provided in paragraph (b) of this section, §§ 1.457-1 through 1.457-12 apply to compensation deferred under a plan for calendar years beginning after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**, including deferred amounts to which the legally binding right arose during prior calendar years that were not previously included in income during one or more prior calendar years.

(b) *Special applicability dates—(1) Plans maintained pursuant to collective bargaining agreements.* In the case of a plan maintained pursuant to one or more collective bargaining agreements that have been ratified and are in effect on the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**, these regulations will not apply with respect to compensation deferred under the plan before the earlier of:

(i) The date on which the last of the collective bargaining agreements terminates (determined without regard to any extension thereof after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**); or

(ii) The first day of the third calendar year beginning after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

(2) *Governmental plans.* If legislation is required to amend a governmental plan, these regulations will not apply to compensation deferred under that plan in taxable years ending before the day following the end of the second legislative session of the legislative body with the authority to amend the plan that begins after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

John Dalrymple,
Deputy Commissioner
for Services and Enforcement.

(Filed by the Office of the Federal Register on June 21, 2016, 8:45 a.m., and published in the issue of the Federal Register for June 22, 2016, 81 F.R. 40548)

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 sub-

stance 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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¹A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2016–01 through 2016–26 is in Internal Revenue Bulletin 2016–26, dated June 27, 2016.

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¹A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2016–01 through 2016–26 is in Internal Revenue Bulletin 2016–26, dated June 27, 2016.

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