



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

January 23, 2006

OFFICE OF
CHIEF COUNSEL

Number: **INFO 2006-0004**
Release Date: 3/31/06
CONEX-100247-06/CC:TEGE:EB:EC
Index Number: 409A.00-00

Dear _____ :

This letter is in response to your inquiry, dated December 16, 2005, about section 409A of the Internal Revenue Code (the Code) and the regulations we recently proposed under section 409A of the Code about the taxation of amounts deferred under a nonqualified deferred compensation plan. In particular, your constituent mentioned health insurance and malpractice insurance benefits provided to retirees and how section 409A may affect them.

The Enactment of Section 409A of the Code

The Congress added section 409A to the Code as section 885 of the American Jobs Creation Act of 2004, Pub. Law No. 108-357, 118 Stat. 1418. Section 409A provides a framework for the taxation of nonqualified deferred compensation, an area where little statutory or regulatory guidance had existed. Specifically, section 409A provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are includible in gross income to the extent they are not subject to a substantial risk of forfeiture and were not previously included in gross income, unless the taxpayer meets certain requirements. Those requirements include explicit rules explaining the following:

- How taxpayers can defer compensation without incurring an immediate and additional tax liability,
- The timing and manner of initial elections to defer compensation,
- The timing and manner of payments of deferred compensation, and
- How to change the time or form of a scheduled payment before receiving the payment.

Notice 2005-1 – Initial Taxpayer Guidance Under Section 409A

On December 20, 2004, we issued Notice 2005-1 [2005-2 I.R.B. 274 (published as modified on January 6, 2005)], as the initial taxpayer guidance on section 409A. Because the law does not clearly define nonqualified deferred compensation, Notice 2005-1 defined the term, so that taxpayers could know which types of arrangements section 409A covered. In addition, Notice 2005-1 provided certain transition relief, some that the statute directed us to provide and some that we believed was necessary to provide taxpayers time and flexibility to adapt to the new Code provision. As part of Notice 2005-1, we requested comments on the rules provided in the notice, and on all other aspects of the application of section 409A.

Recently Issued Proposed Regulations

We received over 100 comments in response to Notice 2005-1, all of which we considered in writing the recently issued proposed regulations under section 409A. See 70 Fed. Reg. 57930 (Oct. 4, 2005). These regulations address three main topics. First, the regulations propose more expansive guidance on the types of arrangements covered by section 409A, and the types of arrangements not covered by section 409A. Second, the regulations propose operational rules, applying the provisions of section 409A to specific types of arrangements. As part of these operational rules, the regulations also contain provisions intended to make the application of section 409A less burdensome. Finally, the regulations provide additional details and extend the transitional relief in Notice 2005-1, generally through December 31, 2006.

The Definition of Deferred Compensation in the Proposed Regulations

Consistent with Notice 2005-1, the proposed regulations generally provide that deferred compensation exists when a service provider obtains a legally binding right in one taxable year to a compensation payment in a subsequent taxable year. Under this general rule, we would treat the right to a taxable health insurance or taxable malpractice insurance benefit in a year after the service provider has separated from service could be treated as providing for the deferral of compensation. This is because the service provider will have a current right to a taxable payment of compensation in the future. The regulations propose to allow us to exclude taxable health insurance from coverage under section 409A if provided for only a limited time following a separation from service (generally two to three years).

Delayed Effective Date of Final Regulations

Due to the complexity and variety of topics we need to address regarding the application of section 409A, we proposed that the final regulations would not be effective until January 1, 2007. Although taxpayers can now rely on the rules in the proposed regulations, they are not required to do so. Taxpayers must only comply with the more limited guidance provided in Notice 2005-1, and for the many areas not addressed by Notice 2005-1 or any other guidance, to demonstrate that they operated their arrangements consistent with a reasonable, good faith interpretation of the statute.

Consideration of Comments

We have received approximately 70 comments to the proposed regulations, several of which address the issues raised by your constituent. In addition, we will conduct a public hearing with respect to the proposed regulations on January 25, 2006. We are currently considering all the comments submitted, including the suggestions made on the provision of post-retirement health insurance and malpractice insurance benefits. When we complete that process, we will issue final regulations addressing the application of section 409A to nonqualified deferred compensation plans.

I hope this information is helpful. If you have further questions, please call me or
(ID#) of my staff at .

Sincerely,

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Senior Technician Reviewer
Executive Compensation Branch
Associate Chief Counsel/Division Counsel
(Tax Exempt & Government Entities)