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The Honorable Henry A. Waxman
Member, U.S. House of Representatives
8436 West Third Street, Suite 600
Los Angeles, CA 90048

Attention:

Dear Congressman Waxman:

This letter is in response to your inquiry, dated _____, on behalf of your constituent, _____. He contacted you about the effect of section 409A of the Internal Revenue Code (the Code) on his participation in a nonqualified deferred compensation plan that his employer sponsors.

The Congress added section 409A to the Code as part of the American Jobs Creation Act of 2004, Public Law 108-357 (118 Stat. 1418), which generally was effective on January 1, 2005. Under this legislation, unless a nonqualified deferred compensation plan meets certain requirements, participants in the plan must include all amounts deferred under the plan in income immediately, to the extent such amounts are not subject to a substantial risk of forfeiture. In addition, these amounts are subject to certain additional taxes, including an additional 20% tax and a tax based on the interest on the tax underpayment that would have occurred had the amount been includible in income when first deferred or, if later, when not subject to a substantial risk of forfeiture.

Section 409A applies to amounts deferred on or after January 1, 2005, or to amounts deferred before January 1, 2005, if that plan is materially modified after October 3, 2004. The law treats an amount as deferred before January 1, 2005 if the employee's right to the amount was earned and vested before January 1, 2005. An employee's right to an amount is earned and vested before January 1, 2005, if as of December 31, 2004, the right to the amount was not subject to a condition requiring that the employee perform further services, or any other condition that would constitute a

substantial risk of forfeiture. These amounts often are referred to as grandfathered amounts.

One of the requirements of section 409A is that an amount of deferred compensation must be payable only upon one or more of the following events:

- A specific date or a fixed schedule
- A separation from service
- Death
- Disability
- A change in control transaction
- An unforeseeable emergency.

The plan may provide for payments at the earlier or later of a combination of these events, for example the earlier of death, disability, a fixed date (such as January 1, 2008) or a separation from service. _____ wrote that he will not be able to receive a distribution upon a separation from service if he elects early retirement but continues to provide services on a per-diem basis.

On December 20, 2004, we issued Notice 2005-1, 2005-2 CB 274, which provided initial guidance on the application of section 409A. Q&As-16 and 17 of the Notice provide guidance on the identification of the grandfathered amounts discussed above, to which section 409A would not apply. As to these amounts, the plan generally may continue to operate under the terms in effect before 2005.

Q&A-19 of Notice 2005-1 provided certain transition relief to help taxpayers comply with the requirements of section 409A for deferred amounts subject to section 409A. Specifically, in areas where we had not yet issued guidance, taxpayers during 2005 could operate such plans in reasonable, good faith compliance with the terms of the statute. We generally extended this reasonable, good faith compliance standard through 2007. (Notice 2006-79, 2006-43 IRB 763).

Q&A-19(c) of Notice 2005-1 provided that during 2005 taxpayers could make new elections on when they would be paid amounts deferred under a nonqualified deferred compensation plan, without complying with the section 409A rules governing these changes. For example, a participant whose payment was scheduled to occur at separation from service could make a new election for payment on a specific date, or under a fixed schedule. We also extended this relief through 2007, subject to certain limitations. (Preamble to the proposed regulations section XI, 70 Fed. Reg. 57930 (Oct. 4, 2005); Notice 2006-79, 2006-43 IRB 763).

On September 29, 2005, we issued proposed regulations under section 409A that taxpayers may rely upon until final regulations become effective. Among the many topics addressed by the proposed regulations is the definition of a separation from service for purposes of section 409A. The proposed regulations generally provide that an employee separates from service when the employer and employee reasonably anticipate that the employee will no longer provide significant services.

We have received comments on the potential effects of this proposed definition on retirement programs where the employee continues to perform services after retirement, such as on a part-time or per-diem basis. We appreciate _____ comments and will consider them as we write the final regulations.

Again, transition relief may be available if _____ and his employer wish to take advantage of such relief. For example, _____ and his employer may wish to consider whether changing _____ payment schedule from a payment upon a separation from service to a fixed schedule of payments beginning on the earlier of separation from service or a fixed date after December 31, 2007, may effectively address _____ concerns (See Notice 2006-79). In addition, the requirements of section 409A generally would not affect any grandfathered amounts of deferred compensation under the plan, unless the plan is materially modified.

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

Sincerely,

Donald L. Korb
Chief Counsel