

ANNOUNCEMENT  
Clarification of Certain Transition Rules in Notice 2005-1

Notice 2005-1 provides guidance on the executive compensation provisions of new section 409A of the Internal Revenue Code, which was added by the American Jobs Creation Act of 2004. An advance version of the notice was released to the public on December 20, 2004. Two small but helpful clarifications are being added to the transition rules in the notice. Notice 2005-1, revised to incorporate these two clarifications, will be included as scheduled in Internal Revenue Bulletin 2005-2, to be published on January 10, 2005.

Specifically, the revisions are being made to paragraph (c) of Q&A 19 and to the first sentence of Q&A 20. Paragraph (c) of Q&A 19 in the December 20 version of the notice provides transition relief under which certain amendments and elections will not be treated as a change in the form or timing of a payment under section 409A(a)(4). The revisions to the paragraph make it clear that those amendments and elections also will not be treated as an acceleration of the payment under section 409A(a)(3). The first sentence of Q&A 20 provides transition relief with respect to certain terminations of participation in a plan and certain cancellations of deferrals by participants. The revisions to that sentence make it clear that the relief in that sentence also applies to deferrals prior to 2005 that are subject to section 409A (and that otherwise meet the conditions for the transition relief).

Q&A 19, paragraph (c) now reads as follows: Payment elections. With respect to amounts subject to § 409A, the plan may be amended to provide for new payment elections with respect to amounts deferred prior to the election and the election will not be treated as a change in the form and timing of a payment under § 409A(a)(4) or an acceleration of a payment under § 409A(a)(3), provided that the plan is so amended and the participant makes the election on or before December 31, 2005. Similarly, an outstanding stock option or stock appreciation right that provides for a deferral of compensation subject to § 409A may be amended to provide for fixed payment terms consistent with § 409A, or to permit holders of such rights to elect fixed payment terms consistent with § 409A, and such amendment or election will not be treated as a change in the form and timing of a payment under § 409A(a)(4) or an acceleration of a payment under § 409A(a)(3), provided that the option or right is so amended and any elections are made, on or before December 31, 2005.

The first sentence of Q&A 20, paragraph (a) now reads as follows: A plan adopted before December 31, 2005 may be amended to allow a participant during all or part of the calendar year 2005 to terminate participation in the plan or cancel a deferral election, without causing the plan to fail to conform to the provisions of § 409A(a)(2), (3) or (4), provided that (i) the amendment is enacted and effective on or before December 31, 2005, and (ii) the amounts subject to the termination or cancellation are includible in income of the participant in the

calendar year 2005, or if later, the taxable year in which the amounts are earned and vested (as defined in Q&A 16).

Accordingly, the revised Notice 2005-1 reads as follows:

## Part IV – Items of General Interest

### Guidance Under § 409A of the Internal Revenue Code

Notice 2005-1

#### **I. Purpose and Overview**

Section 885 of the recently enacted American Jobs Creation Act of 2004, Pub. Law No. 108-357, 118 Stat. 1418 (the Act), added § 409A to the Internal Revenue Code (Code). Section 409A provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are met. Section 409A also includes rules applicable to certain trusts or similar arrangements associated with nonqualified deferred compensation, where such arrangements are located outside of the United States or are restricted to the provision of benefits in connection with a decline in the financial health of the sponsor.

As explained more fully below, this notice provides the first part of what is expected to be a series of guidance with respect to the application of § 409A. The Treasury Department and the Internal Revenue Service (Service) intend to incorporate the principles of this notice into additional, more comprehensive guidance in 2005.

Taxpayers should note that although the statute makes a number of fundamental changes, § 409A does not alter or affect the application of any other provision of the Code or common law tax doctrine. Accordingly, deferred compensation not required to be included in income under § 409A may nevertheless be required to be included in income under § 451, the constructive receipt doctrine, the cash equivalency doctrine, § 83, the economic benefit doctrine, the assignment of income doctrine or any other applicable provision of the Code or common law tax doctrine.

## **A. Definitions and Coverage**

This notice generally outlines the scope of coverage of § 409A. The notice first provides definitions of a nonqualified deferred compensation plan, a plan and the deferral of compensation. Guidance is provided on the application of § 409A to welfare plans, plans covered by § 457, stock appreciation rights, and arrangements between partners and partnerships. This notice provides a definition of a substantial risk of forfeiture.

The definition of nonqualified deferred compensation contains an exception for amounts actually or constructively received by the service provider within a short period following the lapse of a substantial risk of forfeiture. The exception is intended to address multi-year compensation arrangements, where the right to the compensation is or may be earned over multiple years but is payable at the end of the earning period. For example, a three-year bonus program requiring the performance of services over three years and entitling the service provider to a payment within a short specified period following the end of the third year generally would not constitute a deferral of compensation. The Treasury Department and the Service are, however, concerned about arrangements purported to involve a substantial risk of forfeiture and fixed payment date where the parties do not intend for the substantial risk of forfeiture or fixed payment date to be enforced. Accordingly, the Treasury Department and the Service are considering a more restrictive rule under which arrangements involving payments in later taxable years structured to coincide with a lapse in a substantial risk of forfeiture would constitute deferrals of compensation subject to § 409A. However, even under a more restrictive rule, the Treasury Department and the Service anticipate that a payment within a short period following a scheduled vesting date and, in specified circumstances, within a short period following an accelerated vesting date, would be permitted under the statutory authority provided to permit accelerated payments that are not inconsistent with the purposes of the statute. Comments are requested with respect to these issues and the extent to which additional guidance is required to prevent arrangements designed to evade application of § 409A.

This notice does not provide generally applicable methods for calculating the amount of deferrals for a given year. However, a rule is provided for calculation of the amount of deferrals before January 1, 2005 for purposes of applying the effective date provisions. The Treasury Department and the Service anticipate issuing guidance in 2005 providing methods for calculating the amount of deferrals for purposes of all deferrals to which § 409A applies, including deferrals preceding the issuance of the guidance. Until such guidance is issued, certain transition relief is provided to address information reporting and withholding requirements. However, nothing in this guidance should be interpreted to exempt amounts actually distributed to the taxpayer in 2005 from inclusion in income or from applicable reporting or withholding requirements.

## **B. Nonstatutory Stock Options and Stock Appreciation Rights**

The definition of nonqualified deferred compensation contains an exception that generally excludes certain nonstatutory stock options from coverage under § 409A. This exception is consistent with the further exception covering transfers of restricted property, as the taxation of transfers of nonstatutory stock options and transfers of restricted property generally both are governed by § 83. Commentators have pointed out that under certain conditions, stock appreciation rights yield economically equivalent results to nonstatutory stock options exercised in a cashless transaction, and have requested that stock appreciation rights be treated similarly. However, the Treasury Department and the Service are concerned that a general exception for stock appreciation rights may be exploited as a method to avoid application of § 409A, particularly in regard to valuation of the underlying stock where the value is not established by and in an established securities market. In many respects, stock appreciation rights are similar to other forms of nonqualified deferred compensation, particularly where the recipient of a stock appreciation right may receive cash. In such cases, the taxation of stock appreciation rights generally is governed by § 451 and the constructive receipt doctrine. See Rev. Rul. 80-300, 1982-2 C.B. 165.

Accordingly, this notice provides limited exceptions from coverage under § 409A for certain stock appreciation rights which do not present potential for abuse or intentional circumvention of the purposes of § 409A. Under this exception, a stock appreciation right will not constitute a deferral of compensation if (1) the value of the stock the excess over which the right provides for payment upon exercise (the SAR exercise price) may never be less than the fair market value of the underlying stock on the date the right is granted, (2) the stock of the service recipient subject to the right is traded on an established securities market, (3) only such traded stock of the service recipient may be delivered in settlement of the right upon exercise, and (4) the right does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the right. In addition, until further guidance is issued, a payment of stock or cash pursuant to the exercise of a stock appreciation right (or economically equivalent right), or the cancellation of such a right for consideration, where such right is granted pursuant to a program in effect on or before October 3, 2004 will not be treated as a payment of a deferral of compensation subject to the requirements of § 409A if: (1) the SAR exercise price may never be less than the fair market value of the underlying stock on the date the right is granted, and (2) the right does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the right. The Treasury Department and the Service request comments on the extent to which stock appreciation rights should be excepted from coverage under § 409A, in light of the statutory purpose.

The Treasury Department and the Service also are concerned about the potential for taxpayers to avoid application of § 409A by combining an exception from

coverage under § 409A for nonstatutory stock options or stock appreciation rights with a requirement or right that the stock acquired by the service provider be repurchased by the service recipient. Accordingly, the Treasury Department and the Service are considering a restriction on the exception from coverage under § 409A for nonstatutory stock options or stock appreciation rights, to options or rights that are not accompanied by an arrangement or agreement under which the service recipient has an obligation or right to repurchase the acquired shares (including repurchases for an amount other than fair market value). In this context, the Treasury Department and the Service also request comments on appropriate techniques for valuation of stock subject to options or stock appreciation rights where the value of such stock is not established by and in an established securities market, in order to ensure that such valuation reflects the actual fair market value of the stock.

To the extent the additional guidance adopts a position on an issue addressed in this notice with respect to stock options or stock appreciation rights that is less favorable to taxpayers than provided in this notice, the Treasury Department and the Service anticipate that such a position will be applied only on a prospective basis with adequate transition relief to allow modification of plans to comply on a prospective basis.

### **C. Change in Control Events**

This notice next addresses what constitutes a change in ownership or effective control of a corporation, or in the ownership of a substantial portion of the assets of a corporation (Change in Control Event) for purposes of § 409A. Section 885(e) of the Act requires that within 90 days of the enactment of the legislation, the Treasury Department and the Service issue guidance on what constitutes a Change in Control Event. Section 409A provides that, to the extent provided by the Treasury Department and the Service in guidance, a nonqualified deferred compensation plan may permit amounts deferred under the plan to be distributed upon a Change in Control Event.

### **D. Acceleration of Payments**

Except under circumstances specified by the Treasury Department and the Service in guidance, a nonqualified deferred compensation plan may not permit the acceleration of payments under the plan. This notice provides circumstances under which payments under the plan may be accelerated, such as to meet the requirements of a domestic relations order or conflict of interest divestiture requirements. Comments are requested as to other circumstances under which a plan should be allowed to accelerate payments under the plan.

## **E. Effective Dates and Transition Relief**

The notice provides guidance on the effective date provisions and transition relief. Section 409A generally is effective with respect to amounts deferred after December 31, 2004. Section 409A also is effective with respect to amounts deferred in taxable years beginning before January 1, 2005 if the plan under which the deferral is made is materially modified after October 3, 2004. This notice addresses what amounts will be considered deferred after December 31, 2004, generally providing that an amount will be treated as deferred on or before December 31, 2004 only if the service recipient has a binding legal obligation to pay an amount in a future taxable year and the service provider's right to the amount is earned and vested as of December 31, 2004. Methods of calculating amounts treated as deferred on or before December 31, 2004 are provided. This notice also addresses when a plan under which a deferral is made will be considered materially modified after October 3, 2004.

This notice addresses the requirements of § 885(f) of the Act, which provides that within 60 days of the enactment of the legislation, the Treasury Department and the Service must issue guidance providing that for a limited period and under certain conditions, a nonqualified deferred compensation plan may be amended without violating certain provisions of § 409A to (i) allow a participant to terminate participation in the plan, or cancel an outstanding deferral election with respect to amounts deferred after December 31, 2004, or (ii) conform the plan to the provisions of § 409A with respect to amounts deferred after December 31, 2004. This notice provides certain relief addressing the application of the initial deferral election requirements to compensation attributable, in whole or in part, to the performance of services in the years 2004 or 2005. This includes, for example, provisions addressing the deferral of bonuses, including bonuses for services performed in 2004.

## **F. Application of Information Reporting and Wage Withholding Requirements**

This notice next addresses certain information reporting and wage withholding requirements imposed by § 885(b) of the Act with respect to deferred amounts. For information reporting purposes, the Act amends §§ 6041 and 6051 to require that all deferrals for the year under a nonqualified deferred compensation plan be separately reported on a Form 1099 (Miscellaneous Income) or a Form W-2 (Wage and Tax Statement). For wage withholding purposes, the Act amends § 3401(a) to provide that the term "wages" includes any amount includible in gross income of an employee under § 409A. Finally, for purposes of reporting nonemployee compensation, the Act further amends § 6041 to require that amounts includible in gross income under § 409A that are not treated as wages under § 3401(a) must be reported as gross income. This notice does not provide methods for calculating the amount of deferrals for the year or the amounts includible in gross income under § 409A and in wages under § 3401(a).

Consequently, interim guidance is provided with respect to an employer's withholding and reporting obligations where the employer furnishes an expedited Form W-2 prior to the issuance of additional guidance providing such methods.

## **II. Reliance on Transition Guidance; Good Faith, Reasonable Interpretation**

This notice provides rules governing the application of § 409A. The Treasury Department and the Service anticipate issuing additional guidance that incorporates this notice. To the extent the additional guidance adopts a position on an issue addressed in this notice that is less favorable to taxpayers than provided in this notice, the Treasury Department and the Service anticipate that such a position will be applied only on a prospective basis with adequate transition relief to allow modification of plans to comply on a prospective basis.

This notice does not provide comprehensive guidance with respect to the application of § 409A. Until additional guidance is issued, to comply with the requirements of § 409A with respect to issues not addressed in this notice, taxpayers should base their positions upon a good faith, reasonable interpretation of the statute and its purpose, which includes consideration of the legislative history. Whether a taxpayer position constitutes a good faith, reasonable interpretation of the statutory language generally will be determined based upon all of the relevant facts and circumstances, including whether the taxpayer has applied the position consistently and the extent to which the taxpayer has resolved unclear issues in the taxpayer's favor. In addition, certain provisions of § 409A provide definitive rules, but allow the Treasury Department and the Service to issue guidance providing exceptions to such rules. For example, § 409A(a)(3) provides that the Treasury Department and the Service may issue guidance providing an exception to the general prohibition against the acceleration of the time or schedule of any payment under a nonqualified deferred compensation plan. A taxpayer position based on an expected exception that the taxpayer speculates that the Treasury Department and the Service will adopt in future guidance is not a good faith, reasonable interpretation of the statutory language. In addition, as discussed above, the Treasury Department and the Service intend to issue guidance in 2005 providing methods for calculating the amount of deferrals for a year for purposes of all amounts of deferrals to which § 409A applies, including deferrals predating the issuance of the anticipated guidance. Accordingly, taxpayers will not be able to rely upon methods of calculation that differ from the methods provided in the 2005 guidance.

## **III. Request for Comments on Anticipated Guidance**

### **A. Request for Comments**

The Treasury Department and the Service request comments on all aspects of the application of § 409A, including but not limited to the topics addressed in this



notice. The Treasury Department and the Service specifically request comments with respect to the following:

- (1) The application of § 409A to severance plans, including whether to exclude any specific types of severance plans or arrangements (see Q&A 19).
- (2) Funding arrangements for nonqualified deferred compensation that involve foreign trusts or similar arrangements, and identification of arrangements that will not result in an improper deferral of United States tax and will not result in assets being effectively beyond the reach of creditors for purposes of the potential exemption from the provisions of § 409A(b) that the Treasury Department and the Service are authorized to provide under § 409A(e)(3).
- (3) The application of § 409A to arrangements involving partners and partnerships. Comments are specifically requested with respect to the applicability of § 409A to arrangements subject to § 736, and whether there should be a distinction between payments subject to § 736(a) and (b) and the coordination of the timing rules of § 1.736-1(b)(5) with the rules of § 409A for nonqualified deferred compensation plans. Comments are also specifically requested on whether there should be special rules in applying § 409A in the case of a putative allocation and distribution which is recast, under § 707(a)(2)(A), as a payment to a nonpartner under § 707(a)(1).
- (4) Potential additional exclusions from coverage under § 409A with respect to contractual arrangements between businesses (see Q&A 8).
- (5) Situations where the acceleration of benefits should be permitted under § 409A(a)(3) (see Q&A 15), particularly in light of the legislative history regarding accelerated payments required for reasons beyond the control of the participant.

All materials submitted will be available for public inspection and copying.

## **B. Submission of Comments**

Comments may be submitted to Internal Revenue Service, CC:PA:LPD:RU (Notice 2005-1), Room 5203, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may also be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to the Courier's Desk at 1111 Constitution Avenue, NW, Washington DC 20224, Attn: CC:PA:LPD:RU (Notice 2005-1), Room 5203. Submissions may also be sent electronically via the internet to the following email address: [Notice.comments@irs.counsel.treas.gov](mailto:Notice.comments@irs.counsel.treas.gov). Include the notice number (Notice 2005-1) in the subject line.

## **IV. Guidance**

### **A. Definitions and Coverage**

#### **Q-1 What does § 409A provide, in general?**

A-1 Section 409A provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are satisfied. Section 409A also includes rules applicable to certain trusts or similar arrangements associated with nonqualified deferred compensation, where such arrangements are located outside of the United States or are restricted to the provision of benefits in connection with a decline in the financial health of the sponsor.

#### **Q-2 What are the federal income tax consequences of a failure to satisfy the requirements of § 409A?**

A-2 Generally, if at any time during a taxable year a nonqualified deferred compensation plan fails to meet the requirements of § 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, by any participant with respect to whom the failure relates, are includible in gross income for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. If a deferred amount is required to be included in income under § 409A, the amount also is subject to interest and an additional income tax. The interest imposed is equal to the interest at the underpayment rate plus one percentage point, imposed on the underpayments that would have occurred had the compensation been includible in income for the taxable year when first deferred, or if later, when not subject to a substantial risk of forfeiture. The additional income tax is equal to 20 percent of the compensation required to be included in gross income.

#### **Q-3 What is a nonqualified deferred compensation plan?**

A-3 (a) In general. Except as otherwise provided in this A-3, the term nonqualified deferred compensation plan means any plan (within the meaning of Q&A 9) that provides for the deferral of compensation (within the meaning of Q&A 4). The application of § 409A is not limited to arrangements between an employer and an employee. For example, § 409A may apply to arrangements between a service recipient and an independent contractor, or arrangements between a partner and a partnership (see Q&A 7 and Q&A 8).

(b) Qualified employer plans. The term nonqualified deferred compensation plan does not include (i) any plan, contract, pension, account, or trust described in

subparagraph (A) or (B) of § 219(g)(5) (without regard to subparagraph (A)(iii)), (ii) any eligible deferred compensation plan (within the meaning of § 457(b)), and (iii) any plan described in § 415(m). Accordingly, the term nonqualified deferred compensation plan does not include a qualified retirement plan, tax-deferred annuity, simplified employee pension, SIMPLE or § 501(c)(18) trust.

(c) Certain welfare benefits. The term nonqualified deferred compensation plan does not include any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. For these purposes, the term disability pay has the same meaning as provided in § 31.3121(v)(2)-1(b)(4)(iv)(C) of the Employment Tax Regulations, and the term death benefit plan refers to a plan providing death benefits as defined in § 31.3121(v)(2)-1(b)(4)(iv)(C). The term nonqualified deferred compensation plan also does not include any Archer Medical Savings Account as described in § 220, any Health Savings Account as described in § 223, or any other medical reimbursement arrangement, including a health reimbursement arrangement, that satisfies the requirements of § 105 and § 106.

#### **Q-4 What constitutes a deferral of compensation?**

A-4 (a) Deferral of compensation defined. A plan provides for the deferral of compensation only if, under the terms of the plan and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in gross income, and that, pursuant to the terms of the plan, is payable to (or on behalf of) the service provider in a later year. A service provider does not have a legally binding right to compensation if that compensation may be unilaterally reduced or eliminated by the service recipient or other person after the services creating the right to the compensation have been performed. However, if the facts and circumstances indicate that the discretion to reduce or eliminate the compensation is available or exercisable only upon a condition that is unlikely to occur, or the discretion to reduce or eliminate the compensation is unlikely to be exercised, a service provider will be considered to have a legally binding right to the compensation. For this purpose, compensation is not considered subject to unilateral reduction or elimination merely because it may be reduced or eliminated by operation of the objective terms of the plan, such as the application of an objective provision creating a substantial risk of forfeiture (within the meaning of Q&A 10). Similarly, a service provider does not fail to have a legally binding right to compensation merely because the amount of compensation is determined under a formula that provides for benefits to be offset by benefits provided under a plan that is qualified under § 401(a), or because benefits are reduced due to actual or notional investment losses, or in a final average pay plan, subsequent decreases in compensation.

(b) 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 § 3401(b), or with respect to a non-employee service provider, a period not longer than the payroll period described in § 3401(b).

(c) Short-term deferrals. Until additional guidance is issued, a deferral of compensation does not occur if, absent an election to otherwise defer the payment to a later period, at all times the terms of the plan require payment by, and an amount is actually or constructively received by the service provider by, the later of (i) the date that is 2 ½ months from the end of the service provider's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture (as defined in Q&A 10) or (ii) the date that is 2 ½ months from the end of the service recipient's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture (as defined in Q&A 10). For these purposes, an amount that is never subject to a substantial risk of forfeiture is considered to be no longer subject to a substantial risk of forfeiture on the date the service provider has a legally binding right to the amount. For example, an employer with a calendar year taxable year who on November 1, 2006 awards a bonus so that the employee is considered to have a legally binding right to the payment as of November 1, 2006, will not be considered to have provided for a deferral of compensation if, in accordance with the terms of the bonus plan, the amount is paid or made available to the employee on or before March 15, 2007. An employer with a September 1 to August 31 taxable year who on November 1, 2006 awards a bonus so that the employee is considered to have a legally binding right to the payment as of November 1, 2006, will not be considered to have provided for a deferral of compensation if, in accordance with the terms of the bonus plan, the amount is paid or made available to the employee on or before November 15, 2007. Notwithstanding the foregoing, if an election is provided to the service provider with respect to the taxable year in which payment of the compensation will occur, and the service provider elects a taxable year later than the taxable year in which he or she obtained a legally binding right to the payment, the arrangement constitutes a deferral of compensation subject to § 409A, including the deferral election timing rules of § 409A(a)(4). In addition, the arrangement continues to be subject to applicable U.S. Federal tax principles which may require immediate income inclusion.

(d) Stock options, stock appreciation rights, and other equity-based compensation. (i) Except as provided in paragraphs (ii), (iii) and (iv), the grant of a stock option, stock appreciation right or other equity-based compensation provides for a deferral of compensation subject to § 409A. Stock appreciation rights generally will be covered by § 409A; however, stock appreciation rights may be structured to comply with the provisions of § 409A. For example, the terms of a stock appreciation right with a fixed payment date generally will comply with the provisions of § 409A.

(ii) Nonstatutory stock options. An option to purchase stock of the service recipient, other than an incentive stock option described in § 422 or an option granted under an employee stock purchase plan described in § 423, does not provide for a deferral of compensation if: (1) the amount required to purchase stock under the option (the exercise price) may never be less than the fair market value of the underlying stock on the date the option is granted, (2) the receipt, transfer or exercise of the option is subject to taxation under § 83, and (3) the option does not include any feature for the deferral of compensation other than the deferral of recognition of income until the later of exercise or disposition of the option under § 1.83-7. For purposes of the preceding sentence, the right to receive substantially nonvested stock (as defined in § 1.83-3(b)) upon the exercise of a stock option does not constitute a feature for the deferral of compensation. If under the terms of the option, the amount required to purchase the stock is or could become less than the fair market value of the stock on the date of grant, the grant of the stock option may provide for the deferral of compensation within the meaning of this A-4. For purposes of determining the fair market value of the stock at the date of grant, any reasonable valuation method may be used. Such methods include, for example, the valuation method described in § 20.2031-2 of the Estate Tax Regulations. To the extent an arrangement grants the recipient a right other than to purchase stock at a defined price and such additional rights allow for the deferral of compensation (for example, tandem arrangements involving options and stock appreciation rights), the entire arrangement provides for the deferral of compensation. If the requirements of § 1.424-1 would be met if the nonstatutory option were a statutory option, the substitution of a new option pursuant to a corporate transaction for an outstanding option or the assumption of an outstanding option will not be treated as the grant of a new option or a change in the form of payment for purposes of § 409A. For purposes of the preceding sentence, the requirement of § 1.424-1(a)(5)(iii) will be deemed to be satisfied if the ratio of the option price to the fair market value of the shares subject to the option immediately after the substitution or assumption is not greater than the ratio of the option price to the fair market value of the shares subject to the option immediately before the substitution or assumption.

(iii) Statutory stock options. The grant of an incentive stock option as described in § 422, or the grant of an option under an employee stock purchase plan described in § 423 (including the grant of an option with an exercise price discounted in accordance with § 423(b)(6) and the accompanying regulations), does not constitute a deferral of compensation.

(iv) Certain stock appreciation rights. A stock appreciation right with respect to stock of the service recipient does not provide for a deferral of compensation if: (1) the value of the stock the excess over which the right provides for payment upon exercise (the SAR exercise price) may never be less than the fair market value of the underlying stock on the date the right is granted, (2) the stock of the service recipient subject to the right is traded on an established securities

market, (3) only such traded stock of the service recipient may be delivered in settlement of the right upon exercise, and (4) the right does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the right. For purposes of the preceding sentence, the right to receive substantially nonvested stock (as defined in § 1.83-3(b)) upon the exercise of a stock appreciation right does not constitute a feature for the deferral of compensation. If, under the terms of the stock appreciation right, the SAR exercise price is or could become less than the fair market value of the underlying stock on the date of grant, the right may be settled upon exercise in a medium other than the traded stock of the service recipient, or there is an agreement or arrangement under which the service recipient will purchase the stock delivered in settlement of the right upon exercise, then the grant of the stock appreciation right may provide for the deferral of compensation within the meaning of this A-4. In addition, until further guidance is issued, a payment of stock or cash pursuant to the exercise of a stock appreciation right (or economically equivalent right), or the cancellation of such right for consideration, where such right is granted pursuant to a program in effect on or before October 3, 2004 will not be treated as a payment of a deferral of compensation subject to the requirements of § 409A if: (1) the SAR exercise price may never be less than the fair market value of the underlying stock on the date the right is granted, and (2) the right does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the right.

(e) Restricted property. If a service provider receives property from, or pursuant to, a plan maintained by a service recipient, there is no deferral of compensation merely because the value of the property is not includible in income (under § 83) in the year of receipt by reason of the property being nontransferable and subject to a substantial risk of forfeiture, or is includible in income (under § 83) solely due to a valid election under § 83(b). However, a plan under which a service provider obtains a legally binding right to receive property (whether or not the property is restricted property) in a future year may provide for the deferral of compensation and, accordingly, may constitute a nonqualified deferred compensation plan. For purposes of this paragraph, a transfer of property includes the transfer of a beneficial interest in a trust or annuity plan, or a transfer to or from a trust or under an annuity plan, to the extent such a transfer is subject to § 83, § 402(b) or § 403(c).

(f) Earnings. References to the deferral of compensation include references to income (whether actual or notional) attributable to such compensation or such income.

#### **Q-5 Who is the service recipient?**

A-5 For purposes of § 409A, the service recipient refers to the person for whom the services are performed, and all persons with whom such person would be considered a single employer under § 414(b) (employees of controlled group of

corporations), and all persons with whom such person would be considered a single employer under § 414(c) (employees of partnerships, proprietorships, etc., which are under common control).

#### **Q-6 How Does § 409A Apply to Arrangements Covered by § 457?**

A-6 The rules of § 409A apply to nonqualified deferred compensation plans under § 457(f) in addition to any requirements already applicable to such plans under § 457(f). Eligible plans under § 457(b) are not subject to the requirements of § 409A. However, nonelective deferred compensation of nonemployees described in § 457(e)(12) and grandfathered plans under prior § 457 transition rules generally are subject to § 409A. Pending additional guidance, length of service awards to bona fide volunteers under § 457(e)(11)(A)(ii) are not subject to § 409A. Further, pending additional guidance, State and local government and tax exempt entities may rely on the definitions of bona fide vacation leave, sick leave, compensatory time, disability pay, and death benefit plans for purposes of § 457(f) as applicable for purposes of applying § 409A to nonqualified deferred compensation plans under § 457(f). However, State and local government and tax exempt entities may not rely upon the definition of a deferral of compensation for purposes of § 409A as applicable for purposes of the § 457(f) definition of a deferral of compensation. For example, for purposes of § 457(f), a deferral of compensation includes stock options (whether nonstatutory or under § 422 or § 423) and arrangements in which an employee or independent contractor of a State or local government or tax-exempt entity earns the right to future payments for services, even if those amounts are paid immediately upon vesting.

#### **Q-7 How Does § 409A Apply to Arrangements Between a Partnership and a Partner of the Partnership?**

A-7 The application of § 409A is not limited to arrangements between an employer and employee. Accordingly, § 409A may apply to arrangements between a partner and a partnership which provides for the deferral of compensation under a nonqualified deferred compensation plan. However, until additional guidance is issued, for purposes of § 409A taxpayers may treat the issuance of a partnership interest (including a profits interest), or an option to purchase a partnership interest, granted in connection with the performance of services under the same principles that govern the issuance of stock (see Q&A 4). Specifically, until additional guidance is issued, for purposes of § 409A, taxpayers may treat an issuance of a profits interest in connection with the performance of services that is properly treated under applicable guidance as not resulting in inclusion of income by the service provider at the time of issuance, as also not resulting in the deferral of compensation. Similarly, until additional guidance is issued, for purposes of § 409A, taxpayers may treat an issuance of a capital interest in connection with the performance of services in the same manner as an issuance of stock. The § 409A rules governing other stock-based

compensation may be applied by analogy to grants of equity-based compensation where the compensation is determined by reference to partnership equity. In addition, until further guidance is issued, taxpayers may treat arrangements providing for payments subject to § 736 as not being subject to § 409A, except that an arrangement providing for payments which qualify as payments to a partner under § 1402(a)(10) are subject to § 409A. Finally, § 409A may apply to payments covered by § 707(a)(1) (partner not acting in capacity as partner), if such payments otherwise would constitute a deferral of compensation under a nonqualified deferred compensation plan.

#### **Q-8 To Which Service Providers Does § 409A Apply?**

A-8 Until additional guidance is issued, a service provider for purposes of § 409A includes (i) an individual, (ii) a personal service corporation (as defined in § 269A(b)(1)), or a noncorporate entity that would be a personal service corporation if it were a corporation, or (iii) a qualified personal service corporation (as defined in § 448(d)(2)), or a noncorporate entity that would be a qualified personal service corporation if it were a corporation. Section 409A does not apply to arrangements between taxpayers all of whom use the accrual method of accounting. Section 409A also does not apply to arrangements between a service provider and a service recipient if (a) the service provider is actively engaged in the trade or business of providing substantial services, other than (I) as an employee or (II) as a director of a corporation; and (b) the service provider provides such services to two or more service recipients to which the service provider is not related and that are not related to one another. For purposes of the preceding sentence, a person is related to another person if (i) the persons bear a relationship to each other that is specified in § 267(b) or 707(b)(1), subject to the modifications that the language “20 percent” is used instead of “50 percent” each place it appears in §§ 267(b) and 707(b)(1), and § 267(c)(4) is applied as if the family of an individual includes the spouse of any member of the family; or (ii) the persons are engaged in trades or businesses under common control (within the meaning of § 52(a) and (b)). The Treasury Department and the Service intend to issue additional guidance addressing types of service providers not subject to § 409A.

#### **Q-9 What constitutes a plan?**

A-9 A plan includes any agreement, method or arrangement, including an agreement, method or arrangement that applies to one person or individual. A plan may be adopted unilaterally by the service recipient or may be negotiated among or agreed to by the service recipient and one or more service providers or service provider representatives. An agreement, method or arrangement may constitute a plan regardless of whether it is an employee benefit plan under § 3(3) of the Employee Retirement Income Security Act of 1974 (ERISA), as amended (29 U.S.C. 1002(3)). Unless otherwise specified in this notice, the requirements of § 409A are applied as if (a) a separate plan or plans is



maintained for each service provider, and (b) all compensation deferred with respect to a particular service provider under an account balance plan (as defined in § 31.3121(v)(2)-1(c)(1)(ii)(A)) is treated as deferred under a single plan, all compensation deferred under a nonaccount balance plan (as defined in § 31.3121(v)(2)-1(c)(2)(i)) is treated as deferred under a separate single plan, and all compensation deferred under a plan that is neither an account balance plan nor a nonaccount balance plan (for example, discounted stock options, stock appreciation rights or other equity-based compensation described in § 31.3121(v)(2)-1(b)(4)(ii)) is treated as deferred under a separate single plan. For these purposes a severance plan is either an account balance plan or a nonaccount balance plan, determined in accordance with the rules of this A-9.

**Q-10 When is an amount subject to a substantial risk of forfeiture?**

A-10 (a) Definition. Compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial. For purposes of this A-10, a condition related to a purpose of the compensation must relate to the service provider's performance for the service recipient or the service recipient's business activities or organizational goals (for example, the attainment of a prescribed level of earnings, equity value or a liquidity event). Any addition of a substantial risk of forfeiture after the beginning of the service period to which the compensation relates, or any extension of a period during which compensation is subject to a substantial risk of forfeiture, in either case whether elected by the service provider, service recipient or other person (or by agreement of two or more of such persons), is disregarded for purposes of determining whether such compensation is subject to a substantial risk of forfeiture. An amount is not subject to a substantial risk of forfeiture merely because the right to the amount is conditioned, directly or indirectly, upon the refraining from performance of services. For purposes of § 409A, an amount will not be considered subject to a substantial risk of forfeiture beyond the date or time at which the recipient otherwise could have elected to receive the amount of compensation, unless the amount subject to a substantial risk of forfeiture (ignoring earnings) is materially greater than the amount the recipient otherwise could have elected to receive. For example, a salary deferral generally may not be made subject to a substantial risk of forfeiture. However, where an election is granted to receive a materially greater bonus amount in a future year rather than a materially lesser bonus amount in an earlier year, the materially greater bonus may be made subject to a substantial risk of forfeiture.

(b) Enforcement of forfeiture condition. In determining whether the possibility of forfeiture is substantial in the case of rights to compensation granted to a service provider by the service recipient corporation, where the service provider owns a significant amount of the total combined voting power or value of all classes of stock of the service recipient corporation or of its parent corporation, there will be

taken into account (i) the service provider's relationship to other stockholders and the extent of their control, potential control and possible loss of control of the corporation, (ii) the position of the service provider in the corporation and the extent to which the service provider is subordinate to other service providers, (iii) the service provider's relationship to the officers and directors of the corporation, (iv) the person or persons who must approve the service provider's discharge, and (v) past actions of the service recipient in enforcing the restrictions. For example, if a service provider would be considered as having deferred compensation subject to a substantial risk of forfeiture, but for the fact that the service provider owns 20 percent of the single class of stock in the transferor corporation, and if the remaining 80 percent of the class of stock is owned by an unrelated individual (or members of such an individual's family) so that the possibility of the corporation enforcing a restriction on such rights is substantial, then such rights are subject to a substantial risk of forfeiture. On the other hand, if 4 percent of the voting power of all the stock of a corporation is owned by the president of such corporation and the remaining stock is so diversely held by the public that the president, in effect, controls the corporation, then the possibility of the corporation enforcing a restriction on the right to deferred compensation of the president is not substantial, and such rights are not subject to a substantial risk of forfeiture.

## **B. Change in Control Events**

### **Q-11 Under what circumstances will payments be permitted upon a change in the ownership or effective control of a corporation, or a change in the ownership of a substantial portion of the assets of a corporation?**

A-11 (a) In general. Pursuant to § 409A(a)(2)(A)(v), a plan may permit a payment upon the occurrence of a change in the ownership of the corporation (as defined in Q&A 12), a change in effective control of the corporation (as defined in Q&A 13), or a change in the ownership of a substantial portion of the assets of the corporation (as defined in Q&A 14) (collectively referred to as a Change in Control Event). To qualify as a Change in Control Event, the occurrence of the event must be objectively determinable and any requirement that any other person, such as a plan administrator or board of directors compensation committee, certify the occurrence of a Change in Control Event must be strictly ministerial and not involve any discretionary authority. For purposes of this paragraph (a), a payment also will be treated as occurring upon a Change in Control Event if the right to the payment arises due to the corporation's exercise of discretion under the terms of the plan to terminate the plan and distribute the compensation deferred thereunder within 12 months of the Change in Control Event. The plan may provide for a payment on any Change in Control Event, and need not provide for a payment on all such events, provided that each event upon which a payment is provided qualifies as a Change in Control Event.

(b) Identification of relevant corporation(s). To constitute a Change in Control Event as to the plan participant, the Change in Control Event must relate to (i) the corporation for whom the participant is performing services at the time of the Change in Control Event, (ii) the corporation that is liable for the payment of the deferred compensation (or all corporations liable for the payment if more than one corporation is liable), or (iii) a corporation that is a majority shareholder of a corporation identified in (i) or (ii), or any corporation in a chain of corporations in which each corporation is a majority shareholder of another corporation in the chain, ending in a corporation identified in (i) or (ii). For example, assume Corporation A is a majority shareholder of Corporation B, which is a majority shareholder of Corporation C. A change in ownership of Corporation B will constitute a Change in Control Event to plan participants performing services for Corporation B or Corporation C, and to plan participants for which Corporation B or Corporation C is solely liable for payments under the plan (for example, former employees), but will not constitute a Change in Control Event as to Corporation A or any other corporation of which Corporation A is a majority shareholder. Notwithstanding the foregoing, a sale of Corporation B may constitute an independent Change in Control Event for Corporation A, Corporation B and Corporation C if the sale constitutes a change in the ownership of a substantial portion of Corporation A's assets (see Q&A 14). For purposes of this paragraph, a majority shareholder is a shareholder owning more than 50% of the total fair market value and total voting power of such corporation.

(c) Attribution of stock ownership. For purposes of this A-11, Q&A 12, Q&A 13 and Q&A 14, § 318(a) applies to determine stock ownership. Stock underlying a vested option is considered owned by the individual who holds the vested option (and the stock underlying an unvested option is not considered owned by the individual who holds the unvested option). For purposes of the preceding sentence, however, if a vested option is exercisable for stock that is not substantially vested (as defined by §§ 1.83-3(b) and (j)), the stock underlying the option is not treated as owned by the individual who holds the option. In addition, mutual and cooperative corporations are treated as having stock for purposes of this paragraph (c).

#### **Q-12 What is a change in the ownership of a corporation?**

A-12 (a) Change in the ownership of a corporation. For purposes of § 409A, a change in the ownership of a corporation occurs on the date that any one person, or more than one person acting as a group (as defined in paragraph (b)), acquires ownership of stock of the corporation that, together with stock held by such person or group, constitutes more than 50 percent of the total fair market value or total voting power of the stock of such corporation. However, if any one person or more than one person acting as a group, is considered to own more than 50 percent of the total fair market value or total voting power of the stock of a corporation, the acquisition of additional stock by the same person or persons is not considered to cause a change in the ownership of the corporation (or to

cause a change in the effective control of the corporation (within the meaning of Q&A 13)). An increase in the percentage of stock owned by any one person, or persons acting as a group, as a result of a transaction in which the corporation acquires its stock in exchange for property will be treated as an acquisition of stock for purposes of this section. This A-12 applies only when there is a transfer of stock of a corporation (or issuance of stock of a corporation) and stock in such corporation remains outstanding after the transaction (see Q&A 14 for rules regarding the transfer of assets of a corporation).

(b) Persons acting as a group. For purposes of paragraph (a), persons will not be considered to be acting as a group solely because they purchase or own stock of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. If a person, including an entity, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation. See § 1.280G-1, Q&A 27(d), Example 4.

(c) Stock ownership. For purposes of determining stock ownership, see Q&A 11.

### **Q-13 What is a change in the effective control of a corporation?**

A-13 (a) Change in the effective control of the corporation. For purposes of § 409A, notwithstanding that a corporation has not undergone a change in ownership under Q&A 12, a change in the effective control of a corporation occurs on the date that either –

(i) Any one person, or more than one person acting as a group (as determined under paragraph (iv)), acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) ownership of stock of the corporation possessing 35 percent or more of the total voting power of the stock of such corporation; or

(ii) a majority of members of the corporation's board of directors is replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the members of the corporation's board of directors prior to the date of the appointment or election, provided that for purposes of this paragraph (ii) the term corporation refers solely to the relevant corporation identified in Q&A 11, paragraph (b) for which no other corporation is a majority shareholder for purposes of that paragraph (for example, if Corporation A is a publicly held corporation with no majority shareholder, and Corporation A is the

majority shareholder of Corporation B, which is the majority shareholder of Corporation C, the term corporation for purposes of this paragraph (ii) would refer solely to Corporation A).

In the absence of an event described in paragraph (i) or (ii), a change in the effective control of a corporation will not have occurred.

(b) Multiple Change in Control Events. A change in effective control also may occur in any transaction in which either of the two corporations involved in the transaction has a Change in Control Event under A-12 or A-14. Thus, for example, assume Corporation P transfers more than 40 percent of the total gross fair market value of its assets to Corporation O in exchange for 35 percent of O's stock. P has undergone a change in ownership of a substantial portion of its assets under A-14 and O has a change in effective control under this A-13.

(c) Acquisition of additional control. If any one person, or more than one person acting as a group, is considered to effectively control a corporation (within the meaning of this A-13), the acquisition of additional control of the corporation by the same person or persons is not considered to cause a change in the effective control of the corporation (or to cause a change in the ownership of the corporation within the meaning of Q&A 12).

(d) Persons acting as a group. Persons will not be considered to be acting as a group solely because they purchase or own stock of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. If a person, including an entity, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only with respect to the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation.

(e) Stock ownership. For purposes of determining stock ownership, see Q&A 11.

#### **Q-14 What is a change in the ownership of a substantial portion of a corporation's assets?**

A-14 (a) Change in the ownership of a substantial portion of a corporation's assets. For purposes of § 409A, a change in the ownership of a substantial portion of a corporation's assets occurs on the date that any one person, or more than one person acting as a group (as determined in paragraph (c)), acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) assets from the corporation that have a

total gross fair market value equal to or more than 40 percent of the total gross fair market value of all of the assets of the corporation immediately prior to such acquisition or acquisitions. For this purpose, gross fair market value means the value of the assets of the corporation, or the value of the assets being disposed of, determined without regard to any liabilities associated with such assets.

(b) Transfers to a related person. There is no Change in Control Event under this A-14 when there is a transfer to an entity that is controlled by the shareholders of the transferring corporation immediately after the transfer, as provided in this paragraph (b). A transfer of assets by a corporation is not treated as a change in the ownership of such assets if the assets are transferred to –

(i) A shareholder of the corporation (immediately before the asset transfer) in exchange for or with respect to its stock;

(ii) An entity, 50 percent or more of the total value or voting power of which is owned, directly or indirectly, by the corporation;

(iii) A person, or more than one person acting as a group, that owns, directly or indirectly, 50 percent or more of the total value or voting power of all the outstanding stock of the corporation; or

(iv) An entity, at least 50 percent of the total value or voting power of which is owned, directly or indirectly, by a person described in paragraph (iii).

For purposes of this paragraph (b) and except as otherwise provided, a person's status is determined immediately after the transfer of the assets. For example, a transfer to a corporation in which the transferor corporation has no ownership interest before the transaction, but which is a majority-owned subsidiary of the transferor corporation after the transaction is not treated as a change in the ownership of the assets of the transferor corporation.

(c) Persons acting as a group. Persons will not be considered to be acting as a group solely because they purchase assets of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of assets, or similar business transaction with the corporation. If a person, including an entity shareholder, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only to the extent of the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation.

(d) Stock ownership. For purposes of determining stock ownership, see Q&A 11.

### **C. Acceleration of Payments**

#### **Q-15 Under what conditions may a plan permit the acceleration of the time or schedule of any payment under the plan?**

A-15 (a) In general. Except as provided in paragraphs (b) through (f) below, a plan may not permit the acceleration of the time or schedule of any payment under the plan. 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 § 409A 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 § 409A if the service recipient reduces the vesting requirement to 5 years of service, even if a service provider becomes vested as a result and qualifies for a payment in connection with a separation from service.

(b) Domestic relations order. A plan may permit such acceleration of the time or schedule of a payment under the plan to an individual other than the plan participant as may be necessary to fulfill a domestic relations order (as defined in § 414(p)(1)(B)).

(c) Conflicts of interest. A plan may permit such acceleration of the time or schedule of a payment under the plan as may be necessary to comply with a certificate of divestiture (as defined in § 1043(b)(2)).

(d) Section 457 plans. A plan subject to § 457(f) may permit an acceleration of the time or schedule of a payment to a participant to pay income taxes due upon a vesting event, provided that the amount of such payment is not more than an amount equal to the income tax withholding that would have been remitted by the employer if there had been a payment of wages equal to the income includible by the participant under § 457(f) at the time of the vesting.

(e) De minimis and specified amounts. A plan that does not otherwise provide for de minimis cashout payments may be amended to permit the acceleration of the time or schedule of a payment to a participant under the plan, provided that (i) the payment accompanies the termination of the entirety of the participant's interest in the plan; (ii) the payment is made on or before the later of (A) December 31 of the calendar year in which occurs the participant's separation from service from the service recipient or (B) the date 2 ½ months after the participant's separation from service from the service recipient; and (iii) the

payment is not greater than \$10,000. Such an amendment may be made with respect to previously deferred amounts under the plan as well as amounts to be deferred in the future. In addition, a nonqualified deferred compensation plan that otherwise complies with § 409A may be amended with regard to future deferrals to provide that, if a participant's interest under the plan has a value below an amount specified by the plan at the time that amounts are payable under the plan, then the participant's entire interest under the plan shall be distributed as a lump sum payment.

(f) Payment of employment taxes. A plan may permit the acceleration of the time or schedule of a payment to pay the Federal Insurance Contributions Act (FICA) tax imposed under § 3101 and § 3121(v)(2) on compensation deferred under the plan (the FICA Amount). Additionally, a plan may permit the acceleration of the time or schedule of a payment to pay the income tax at source on wages imposed under § 3401 on the FICA Amount, and to pay the additional income tax at source on wages attributable to the pyramiding § 3401 wages and taxes. However, the total payment under this acceleration provision must not exceed the aggregate of the FICA Amount, and the income tax withholding related to such FICA amount.

(g) Definition of plan. For purposes of this A-15, the term plan has the meaning provided in Q&A 9, except that the provisions treating all account balance plans under which compensation is deferred as a single plan, all nonaccount balance plans under which compensation is deferred as a separate single plan, and all other nonqualified deferred compensation plans as a separate single plan, does not apply.

#### **D. Effective Dates and Transition Guidance**

##### **Q-16 When does section 409A become effective?**

A-16 (a) In general. Except as provided in Q&As 19 through 23, § 409A is effective with respect to (i) amounts deferred in taxable years beginning after December 31, 2004; and (ii) amounts deferred in taxable years beginning before January 1, 2005 if the plan under which the deferral is made is materially modified after October 3, 2004. Section 409A is effective with respect to earnings on amounts deferred only to the extent that § 409A is effective with respect to the amounts deferred. Accordingly, § 409A is not effective with respect to earnings on amounts deferred before January 1, 2005 unless § 409A is effective with respect to the amounts deferred.

(b) Date of deferral for effective date purposes. For purposes of determining whether § 409A is effective with respect to an amount, the amount is considered deferred before January 1, 2005 if (i) the service provider has a legally binding right to be paid the amount and (ii) the right to the amount is earned and vested. For purposes of this A-16, a right to an amount is earned and vested only if the



amount is not subject to either a substantial risk of forfeiture (as defined in § 1.83-3(c)) or a requirement to perform further services. Accordingly, amounts to which the service provider does not have a legally binding right before January 1, 2005 (for example because the service recipient retains discretion to reduce the amount), will not be considered deferred before January 1, 2005. In addition, amounts to which the service provider has a legally binding right before January 1, 2005, but the right to which is subject to a substantial risk of forfeiture or a requirement to perform further services after December 31, 2004 are not considered deferred before January 1, 2005 for purposes of the effective date. Notwithstanding the foregoing, an amount to which the service provider has a legally binding right before January 1, 2005, but for which the service provider must continue performing services to retain the right only through the completion of the payroll period (as defined in Q&A 4) which includes December 31, 2004, shall not be treated as subject to a requirement to perform further services (or a substantial risk of forfeiture) for purposes of the effective date.

**Q-17 For purposes of the effective date, how is the amount of compensation deferred under a nonqualified deferred compensation plan before January 1, 2005 determined?**

A-17 (a) Nonaccount balance plans. The amount of compensation deferred before January 1, 2005 under a nonqualified deferred compensation plan that is a nonaccount balance plan (as defined in § 31.3121(v)(2)-1(c)(2)(i)) equals the present value as of December 31, 2004 of the amount to which the participant would be entitled under the plan if the participant voluntarily terminated services without cause on December 31 of that taxable year, and received a full payment of benefits from the plan on the earliest possible date allowed under the plan following the termination of services, to the extent the right to the benefit is earned and vested (as defined in Q&A 16) as of December 31, 2004. For purposes of determining the present value of the benefit, the actuarial assumptions contained within the plan are used provided such assumptions are reasonable; otherwise, reasonable actuarial assumptions must be used. Amounts to which the participant would not be entitled upon termination, such as early retirement subsidies for which the participant would not have attained sufficient service if he or she terminated services on December 31, 2004, are not includible as compensation deferred under the plan as of December 31, 2004.

(b) Account balance plans. The amount of compensation deferred before January 1, 2005 under a nonqualified deferred compensation plan that is an account balance plan (as defined in § 31.3121(v)(2)-1(c)(1)(ii)) equals the portion of the participant's account balance as of December 31, 2004 the right to which is earned and vested (as defined in Q&A 16) as of December 31, 2004.

(c) Equity-based compensation plans. For purposes of determining the amounts deferred before January 1, 2005 under an equity-based compensation plan, the rules of paragraph (b) governing account balance plans are applied except that

the account balance is deemed to be the amount of the payment available to the participant on December 31, 2004 (or that would be available to the participant if the right were immediately exercisable) the right to which is earned and vested (as defined in Q&A 16) as of December 31, 2004. For this purpose, the payment available to the participant excludes any exercise price or other amount which must be paid by the participant.

(d) Earnings. Earnings on amounts deferred under a plan before January 1, 2005 include only income (whether actual or notional) attributable to the amounts deferred under a plan as of December 31, 2004 or such income. For example, notional interest earned under the plan on amounts deferred in an account balance plan as of December 31, 2004 generally will be treated as earnings on amounts deferred under the plan before January 1, 2005. Similarly, an increase in the amount of payment available under a stock option, stock appreciation right or other equity-based compensation above the amount of payment available as of December 31, 2004, due to appreciation in the underlying stock after December 31, 2004, is treated as earnings on the amount deferred. In the case of a nonaccount balance plan, earnings include the increase, due solely to the passage of time, in the present value of the future payments to which the service provider has obtained a legally binding right, the present value of which constituted the amounts deferred under the plan before January 1, 2005. Thus, for each year, there will be an increase (determined using the same interest rate used to determine the amounts deferred under the plan before January 1, 2005) resulting from the shortening of the discount period before the future payments are made, plus, if applicable, an increase in the present value resulting from the service provider's survivorship during the year. However, an increase in the potential benefits under a nonaccount balance plan due to, for example, an application of an increase in compensation after December 31, 2004 to a final average pay plan or subsequent eligibility for an early retirement subsidy, does not constitute earnings on the amounts deferred under the plan before January 1, 2005.

(e) Definition of plan. For purposes of this A-17, the term plan has the same meaning provided in Q&A 9, except that the provisions treating all nonaccount balance plans under which compensation is deferred as a single plan does not apply for purposes of the actuarial assumptions used in paragraph (b). Accordingly, different reasonable actuarial assumptions may be used to calculate the amounts deferred by a participant in two different arrangements each of which constitutes a nonaccount balance plan.

### **Q-18 When is a plan materially modified?**

A-18 (a) In general. Except as otherwise provided in this A-18 and Q&A 19, a modification of a plan is a material modification if a benefit or right existing as of October 3, 2004 is enhanced or a new benefit or right is added. Such benefit enhancement or addition is a material modification whether it occurs pursuant to

an amendment or the service recipient's exercise of discretion under the terms of the plan. For example, an amendment to a plan to add a provision that payments may be allowed upon request if participants are required to forfeit 10 percent of the amount of the payment (a "haircut") would be a material modification to the plan. Similarly, a material modification would occur if a service recipient exercised discretion to accelerate vesting of a benefit under the plan to a date on or before December 31, 2004. However, it is not a material modification for a service recipient to exercise discretion over the time and manner of payment of a benefit to the extent such discretion is provided under the terms of the plan as of October 3, 2004. Also, it is not a material modification to change a notional investment measure to, or to add, an investment measure that qualifies as a predetermined actual investment within the meaning of § 31.3121(v)(2)-1(d)(2). It is not a material modification for a participant to exercise a right permitted under the plan as in effect on October 3, 2004. The amendment of a plan to bring the plan into compliance with the provisions of § 409A will not be treated as a material modification. However, a plan amendment or the exercise of discretion under the terms of the plan that enhances an existing benefit or right or adds a new benefit or right will be considered a material modification even if the enhanced or added benefit would be permitted under § 409A. For example, the addition of a right to a payment upon an unforeseeable emergency would be considered a material modification. The reduction of an existing benefit is not a material modification. For example, the removal of a "haircut" provision generally would not constitute a material modification.

(b) Adoption of new arrangement. It is presumed that the adoption of a new arrangement or the grant of an additional benefit under an existing arrangement after October 3, 2004 will constitute a material modification of a plan. However, the presumption may be rebutted by demonstrating that the adoption of the arrangement or grant of the additional benefit is consistent with the service recipient's historical compensation practices. For example, the presumption that the grant of a stock appreciation right on November 1, 2004 is a material modification of a plan may be rebutted by demonstrating that the grant was consistent with the historic practice of granting substantially similar stock appreciation rights (both as to terms and amounts) each November for a significant number of years. Notwithstanding paragraph (a) and this paragraph (b), the grant of an additional benefit under an existing arrangement that consists solely of a deferral of additional compensation not otherwise provided under the plan as of October 3, 2004 will be treated as a material modification of the plan only as to the additional deferral of compensation, if the plan explicitly identifies the additional deferral of compensation and provides that the additional deferral of compensation is subject to § 409A. A plan may be amended to comply with the provisions of the preceding sentence in accordance with the rules of Q&A 19.

(c) Suspension or termination of a plan. Amending an arrangement to stop future deferrals thereunder is not a material modification of the arrangement or

the plan. Amending an arrangement on or before December 31, 2005 to terminate the arrangement and distribute the amounts of deferred compensation thereunder will not be treated as a material modification, provided that all amounts deferred under the plan are included in income in the taxable year in which the termination occurs.

(d) Equity-based compensation. Provided that the cancellation and reissuance occurs on or before December 31, 2005, it will not be a material modification to replace a stock option or stock appreciation right otherwise providing for a deferral of compensation under Q&A 4 with a stock option or stock appreciation right that would not have constituted a deferral of compensation under § 409A if it had been granted upon the original date of grant of the replaced stock option or stock appreciation right. The preceding sentence only applies if (i) the number of shares which form the basis of the new stock option or new stock appreciation right corresponds directly to the number of shares subject to the original stock option or stock appreciation right; and (ii) the new stock option or new stock appreciation right does not provide any additional benefit to the service recipient (other than the benefit directly due to a change in form of the award to a form not treated as a deferral of compensation). A replacement stock option or replacement stock appreciation right will be treated as meeting the requirements of clause (i) of the preceding sentence if the new grant is made in accordance with the principles of § 1.424-1(a)(5) except to the extent necessary to ensure that the new grant does not violate § 409A. For example, a stock option originally issued with an exercise price discounted below the value of the shares subject to the option on the date of grant could be amended, without causing a material modification of the option, to be excluded from the definition of deferral of compensation by eliminating the discount on the exercise price below the value of the shares subject to the option on the original date of grant. Similarly, a stock appreciation right could be converted to a stock option or stock appreciation right that, based on its terms, would be excluded from the definition of deferral of compensation.

(e) Definition of plan. For purposes of this A-18, the term plan has the same meaning provided in Q&A 9, except that the provision treating all account balance plans under which compensation is deferred as a single plan, all nonaccount balance plans under which compensation is deferred as a separate single plan, and all other nonqualified deferred compensation plans as a separate single plan, does not apply.

**Q-19 Under what conditions may a plan adopted before December 31, 2005 be operated and amended without violating the requirements of section 409A(a)(2), (3) and (4)?**

A-19 (a) In general. A plan adopted before December 31, 2005 will not be treated as violating § 409A(a)(2), (3) or (4) only if (i) the plan is operated in good faith compliance with the provisions of § 409A and this notice during the calendar

year 2005, and (ii) the plan is amended on or before December 31, 2005 to conform to the provisions of § 409A with respect to amounts subject to § 409A.

(b) Good faith compliance. A plan will be treated as operated in good faith compliance during the calendar year 2005 if it is operated in accordance with the terms of this notice and, to the extent an issue is not addressed in this notice, a good faith, reasonable interpretation of § 409A, and, to the extent not inconsistent therewith, the plan's terms, provided that the plan sponsor does not exercise discretion under the terms of the plan, or that a participant does not exercise discretion with respect to that participant's benefits, in a manner that causes the plan to fail to meet the requirements of § 409A. For example, if an employer retains the discretion under the terms of the plan to delay or extend payments under the plan and exercises such discretion, the plan will not be considered to be operated in good faith compliance with § 409A with regard to any plan participant. However, an exercise of a right under the terms of the plan by a plan participant solely with respect to that participant's benefits under the plan, in a manner that causes the plan to fail to meet the requirements of § 409A, will not be considered to result in the plan failing to be operated in good faith compliance with respect to other participants. For example, the request for and receipt of an immediate payment permitted under the terms of the plan if the participant forfeits 10% of the participant's benefits (a "haircut") will be considered a failure of the plan to meet the requirements of § 409A with respect to that participant, but not with respect to all participants under the plan.

(c) Payment elections. With respect to amounts subject to § 409A, the plan may be amended to provide for new payment elections with respect to amounts deferred prior to the election and the election will not be treated as a change in the form and timing of a payment under § 409A(a)(4) or an acceleration of a payment under § 409A(a)(3), provided that the plan is so amended and the participant makes the election on or before December 31, 2005. Similarly, an outstanding stock option or stock appreciation right that provides for a deferral of compensation subject to § 409A may be amended to provide for fixed payment terms consistent with § 409A, or to permit holders of such rights to elect fixed payment terms consistent with § 409A, and such amendment or election will not be treated as a change in the form and timing of a payment under § 409A(a)(4) or an acceleration of a payment under § 409A(a)(3), provided that the option or right is so amended and any elections are made, on or before December 31, 2005.

(d) Severance plans. Provided that the plans are otherwise amended in compliance with paragraph (a), a plan that provides severance pay benefits, and that is either (i) a collectively bargained plan or (ii) covers no service providers who are key employees (as defined in § 416(i) and the regulations thereunder), is not required to meet the requirements of § 409A during the calendar year 2005 with respect to such severance pay benefits. Benefits that are provided under a severance pay arrangement (within the meaning of § 3(2)(B)(i) of ERISA (29

U.S.C. § 1002(2)(B)(i)) that satisfies the conditions in 29 CFR § 2510.3-2(b)(1)(i) through (iii) are considered severance pay for purposes of this paragraph (d). Benefits provided under a severance pay arrangement (within the meaning of § 3(2)(B)(i) of ERISA) are in all cases severance pay within the meaning of this paragraph (d) if the benefits payable under the plan upon an employee's termination of employment are payable only if that termination is involuntary.

**Q-20 Under what conditions may a plan adopted before December 31, 2005 provide a participant a right to terminate participation in the plan, or cancel an outstanding deferral election with regard to amounts subject to § 409A, and receive a payment of amounts subject to the termination or cancellation, without violating the requirements of § 409A(a)(2), (3) and (4)?**

A-20 (a) Plan amendment. A plan adopted before December 31, 2005 may be amended to allow a participant during all or part of the calendar year 2005 to terminate participation in the plan or cancel a deferral election, without causing the plan to fail to conform to the provisions of § 409A(a)(2), (3) or (4), provided that (i) the amendment is enacted and effective on or before December 31, 2005, and (ii) the amounts subject to the termination or cancellation are includible in income of the participant in the calendar year 2005 or, if later, in the taxable year in which the amounts are earned and vested (as defined in Q&A 16). Solely for purposes of effecting the relief provided in this A-20, neither the availability of the election to the participant nor the making of the election by the participant will be treated as resulting in a violation of the requirements of § 409A(a)(2), (3) or (4) or causing amounts the participant continues to defer to be includible in income under § 451 or the doctrine of constructive receipt (although these provisions may still apply for other reasons). There is no requirement that the opportunity to terminate participation in a plan or to cancel a deferral election be granted, or that if granted, be granted to all plan participants. A termination or cancellation may be made with respect to elective or nonelective deferred compensation and may be undertaken by the service recipient or at the election of the participant. A termination or cancellation under this paragraph may apply in whole or in part to one or more plans in which a participant participates and to one or more outstanding deferral elections the participant has made with regard to amounts subject to § 409A.

(b) Payments. Provided that the plan amendment is adopted in accordance with paragraph (a), a provision permitting a payment to a participant during calendar year 2005 or, if later, the taxable year in which the amount is earned and vested (as defined in Q&A 16), upon a termination of participation in the plan or the cancellation of a deferral election with regard to amounts subject to § 409A, will not be treated as causing a plan to violate the provisions of § 409A(a)(2), (3) or (4), and a payment from a plan pursuant to such an amendment will not be treated as a violation of the provision of § 409A(a)(2), (3) or (4), provided that the full amount of the distribution is included in the participant's income in calendar

year 2005 or, if later, the participant's taxable year in which the amount is earned and vested (as defined in Q&A 16).

(c) Partial terminations and cancellations. For purposes of this Q&A 20, the termination of participation in the plan or the cancellation of an outstanding deferral election with regard to amounts subject to § 409A includes a termination or cancellation that results in a lower amount of deferrals for the period, without a complete elimination of the deferrals.

(d) Definition of plan. For purposes of this A-20, the definition of plan under Q&A 9 applies, except that the rule requiring the aggregation of all account balance plans, all nonaccount balance plans, and all other plans does not apply.

**Q-21 Under what conditions will deferral elections under a plan in existence on or before December 31, 2004, made with respect to deferrals relating all or in part to services performed on or before December 31, 2005, be exempt from the requirements of § 409A(a)(4)(B) relating to the timing of elections?**

A-21 With respect to deferrals subject to § 409A that relate all or in part to services performed on or before December 31, 2005, the requirements of § 409A(a)(4)(B) relating to the timing of elections will not be applicable to any elections made on or before March 15, 2005, provided that (a) the amounts to which the deferral election relate have not been paid or become payable at the time of election, (b) the plan under which the deferral election is or was made was in existence on or before December 31, 2004, (c) the elections to defer compensation are made in accordance with the terms of the plan in effect on or before December 31, 2005 (other than a requirement to make a deferral election after March 15, 2005), (d) the plan is otherwise operated in accordance with § 409A with respect to deferrals subject to § 409A and (e) the plan is amended to comply with the requirements of § 409A in accordance with Q&A 19. For purposes of this A-21, a nonqualified deferred compensation plan will be treated as in existence before December 31, 2004 only if a written plan document (a) identifies a specific amount or type of compensation that is subject to the plan and not otherwise payable at the time of the deferral election, and (b) provides that a participant in the plan may elect to defer the compensation beyond the taxable year in which the amount otherwise would have been payable. Solely for purposes of effecting the relief provided in this A-21, neither the availability of the election to the participant nor the making of the election by the participant will be treated as causing amounts the participant defers to be includible in income under § 451 or the doctrine of constructive receipt.

**Q-22 Until additional guidance is issued, under what conditions may deferral elections be made with respect to bonus compensation?**

A-22 Section 409A(a)(4)(B)(iii) provides that in the case of any performance-based compensation based on services performed over a period of at least 12 months, an election to defer such compensation may be made no later than 6 months before the end of the period. The Treasury Department and the Service anticipate issuing guidance that sets forth the requirements for compensation to qualify as performance-based compensation. The Treasury Department and the Service anticipate that those requirements will be more restrictive than the requirements outlined in this A-22. Until additional guidance is issued, a deferral election with respect to bonus compensation based on services performed over a period of at least 12 months will be treated as meeting the requirements of § 409A(a)(4) if the election is made at least 6 months before the end of the service period. For purposes of this transition relief, the term bonus compensation refers to compensation where (i) the payment of the compensation or the amount of the compensation is contingent on the satisfaction of organizational or individual performance criteria, and (ii) the performance criteria are not substantially certain to be met at the time a deferral election is permitted. Bonus compensation may include payments based upon subjective performance criteria, but (i) any subjective performance criteria must relate to the performance of the participant service provider, a group of service providers that includes the participant service provider, or a business unit for which the participant service provider provides services (which may include the entire organization); and (ii) the determination that any subjective performance criteria have been met must not be made by the participant service provider or a family member of the participant service provider (as defined in § 267(c)(4) applied as if the family of an individual includes the spouse of any member of the family). Bonus compensation may also include payments based on performance criteria that are not approved by a compensation committee of the board of directors (or similar entity in the case of a non-corporate service recipient) or by the stockholders or members of the service recipient. Notwithstanding the foregoing, bonus compensation does not include any amount or portion of any amount that will be paid either regardless of performance, or based upon a level of performance that is substantially certain to be met at the time the criteria is established, or that is based solely on the value of, or appreciation in value of, the service recipient or the stock of the service recipient.

**Q-23 Under what circumstances will payments be permitted based upon elections under a qualified plan for periods ending on or before December 31, 2005.**

A-23 For periods ending on or before December 31, 2005, an election as to the timing and form of a payment under a nonqualified deferred compensation plan that is controlled by a payment election made by the participant under a qualified plan will not violate § 409A, provided that the determination of the timing and form of the payment is made in accordance with the terms of the nonqualified deferred compensation plan as of October 3, 2004 that govern payments. For purposes of this paragraph, a qualified plan means a retirement plan qualified



under § 401(a). For example, where a nonqualified deferred compensation plan provides as of October 3, 2004 that the time and form of payment to a participant will be the same time and form of payment elected by the participant under a related qualified plan, it will not be a violation of § 409A for the plan administrator to make or commence payments under the nonqualified deferred compensation plan on or after January 1, 2005 and on or before December 31, 2005 pursuant to the payment election under the related qualified plan. Notwithstanding the foregoing, other provisions of the Code and common law tax doctrines continue to apply to any election as to the timing and form of a payment under a nonqualified deferred compensation plan.

## **E. Information Reporting Requirements for Deferred Amounts**

### **Q-24 What information reporting requirements are imposed by § 885(b) of the Act?**

A-24 The Act adds §§ 6041(g)(1) and 6051(a)(13), which require that all deferrals for the year under a nonqualified deferred compensation plan be separately reported on a Form 1099 (Miscellaneous Income) or a Form W-2 (Wage and Tax Statement), respectively. The Act requires annual reporting of all compensation deferred under the plan for the year regardless of whether such compensation is includible in gross income pursuant to § 409A(a)(1)(A). However, neither § 6041(g)(1) nor § 6051(a)(13) requires the reporting of deferrals under a nonqualified deferred compensation plan that benefit a person with respect to whom a Form 1099-MISC or a Form W-2 is not required to be filed.

### **Q-25 What constitutes deferrals for the year under a nonqualified deferred compensation plan for purposes of §§ 6041(g)(1) and 6051(a)(13)?**

A-25 Deferrals for the year under a nonqualified deferred compensation plan for purposes of §§ 6041(g)(1) and 6051(a)(13) generally include all deferrals of compensation within the meaning of § 409A that occur during the year and that are made under a nonqualified deferred compensation plan within the meaning of § 409A(d). See Q&A 4 (definition of a deferral of compensation) and Q&A 3 (definition of a nonqualified deferred compensation plan). The Treasury Department and the Service anticipate issuing additional guidance that will provide a method for calculating the amount of deferrals for the year.

### **Q-26 Do the information reporting requirements imposed by §§ 6041(g)(1) and 6051(a)(13) apply with respect to amounts deferred under a nonqualified deferred compensation plan that is a nonaccount balance plan?**

A-26 Yes. The information reporting requirements imposed by §§ 6041(g)(1) and 6051(a)(13) generally apply with respect to amounts deferred under a

nonqualified deferred compensation plan that is a nonaccount balance plan (as defined in § 31.3121(v)(2)-1(c)(2)). However, amounts deferred that are not reasonably ascertainable (as defined in § 31.3121(v)(2)-1(e)(4)) are not required to be reported until such deferrals become reasonably ascertainable (regardless of whether the service provider is an employee). The Treasury Department and the Service anticipate issuing additional guidance that will provide a method for calculating the amount of deferrals for the year under a nonqualified deferred compensation plan.

**Q-27 Is there a minimum amount of aggregate deferrals for the year with respect to an individual employee below which the information reporting requirement imposed by § 6051(a)(13) does not apply?**

A-27 Yes. The Act authorizes the Secretary of the Treasury, through regulations, to establish a minimum amount of deferrals below which the information reporting requirement imposed by § 6051(a)(13) does not apply. The Treasury Department and the Service anticipate providing the authorized guidance in future regulations. Until such guidance is provided, however, employers may rely on this notice to exclude from the information reporting requirement imposed by § 6051(a)(13) all deferrals for the year with respect to an individual employee under one or more nonqualified deferred compensation plans if the aggregate amount of such deferrals does not exceed \$600.

**Q-28 What is the effective date for the information reporting requirements imposed by §§ 6041(g)(1) and 6051(a)(13)?**

A-28 The information reporting requirements imposed by §§ 6041(g)(1) and 6051(a)(13) are effective for amounts actually deferred in calendar years beginning after December 31, 2004. Additionally, such information reporting requirements apply to income (whether actual or notional) attributable to amounts actually deferred in calendar years beginning after December 31, 2004. For purposes of §§ 6041(g)(1) and 6051(a)(13), amounts are considered actually deferred at the time the service provider has a legally binding right to the compensation as described in Q&A 4. Thus, the information reporting requirements are not effective for amounts actually deferred in calendar years beginning before January 1, 2005, (or for income attributable to such amounts) notwithstanding that § 885(d) of the Act may treat such amounts as having been deferred in a calendar year beginning on or after such date under the general effective date provisions.

**Q-29 How should an employer report to an employee the total amount of deferrals for the year under a nonqualified deferred compensation plan as required by § 6051(a)(13)?**

A-29 An employer should report to an employee the total amount of deferrals for the year under a nonqualified deferred compensation plan in box 12 of Form W-2

using code Y. The instructions for Form W-2 provide additional information relating to this reporting requirement. However, see Q&A 38 for interim guidance with respect to an employer's reporting requirements where the employer furnishes an expedited Form W-2 prior to the issuance of additional guidance that will provide a method for calculating the amount of deferrals for the year. Neither § 6051(a)(13) nor this notice affect the rules for reporting deferred compensation in Box 11 of Form W-2.

**Q-30 How should a payer report to a nonemployee the total amount of deferrals for the year under a nonqualified deferred compensation plan as required by § 6041(g)(1)?**

A-30 A payer should report to a nonemployee the total amount of deferrals for the year under a nonqualified deferred compensation plan in box 15a of Form 1099-MISC. The instructions for Form 1099-MISC provide additional information relating to this reporting requirement. However, the information reporting requirement imposed by § 6041(g)(1) does not apply to deferrals that are required to be reported under § 6051(a)(13) (without regard to any de minimis exception). Additionally, § 6041(g)(1) does not require the reporting of deferrals under a nonqualified deferred compensation plan that benefit a person with respect to whom a Form 1099-MISC is not required to be filed.

**F. Wage Withholding for Employees**

**Q-31 What wage withholding requirements are imposed by § 885(b) of the Act?**

A-31 The Act amends § 3401(a) (defining wages for income tax withholding purposes) to provide that the term "wages" includes any amount includible in gross income of an employee under § 409A. The amount is treated as a payment of wages in the taxable year in which the amount is includible in the employee's gross income. The Treasury Department and the Service anticipate issuing additional guidance that will provide a method for computing the amount includible in gross income of an employee under § 409A.

**Q-32 When are amounts that are includible in gross income under § 409A treated as a payment of wages for income tax withholding purposes?**

A-32 For the calendar year 2005, amounts includible in gross income under § 409A but neither actually nor constructively received by an employee may be treated as having been paid by an employer for income tax withholding purposes on any date on or before December 31, 2005. However, nothing in § 409A prevents the inclusion of amounts in gross income and in wages for income tax withholding purposes under any other provision or rule of law on a date earlier than December 31, 2005. Thus, amounts includible in gross income under § 409A and either actually or constructively received by an employee during the

calendar year 2005 are considered a payment of wages when received by the employee for purposes of withholding, depositing, and reporting the income tax at source on wages.

**Q-33 How should an employer report to an employee amounts includible in gross income under § 409A and in wages under § 3401(a) as required by § 6051(a)(3)?**

A-33 An employer should report amounts includible in gross income under § 409A and in wages under § 3401(a) in box 1 of Form W-2 as part of the total wages, tips, and other compensation paid to the employee during the year. Additionally, an employer should report such amounts in box 12 of Form W-2 using code Z. The amount reported in box 12 using code Z should include all amounts deferred under the plan for the taxable year and all preceding taxable years that are currently includible in gross income under § 409A and in wages under § 3401(a). The instructions for Form W-2 provide additional information relating to this reporting requirement. However, see Q&A 38 for interim guidance with respect to an employer's reporting requirements relating to an employee or business that is terminated prior to the issuance of additional guidance that will provide a method for calculating the amounts includible in gross income under § 409A and in wages under § 3401(a).

**G. Reporting Nonemployee Compensation**

**Q-34 What reporting requirements relating to nonemployee compensation are imposed by § 885(b) of the Act?**

A-34 The Act adds § 6041(g)(2), which requires a payer to report to a nonemployee any amount includible in gross income under § 409A that is not treated as wages under § 3401(a). However, § 6041(g)(2) does not require the reporting of amounts includible in gross income under § 409A that are treated as having been paid to a person with respect to whom a Form 1099-MISC is not required to be filed.

**Q-35 How should a payer report to a nonemployee amounts includible in gross income under § 409A and not treated as wages under § 3401(a) as required by § 6041(g)(2)?**

A-35 A payer should report the amounts includible in gross income under § 409A and not treated as wages under § 3401(a) in box 7 (nonemployee compensation) of Form 1099-MISC. Additionally, a payer should report such amounts in box 15b of Form 1099-MISC. The amount reported in box 15b should include only the amounts includible in gross income under § 409A and not included in wages under § 3401(a). The instructions for Form 1099-MISC provide additional information relating to this reporting requirement.

**Q-36 What are the SECA tax consequences of a failure to satisfy the requirements of § 409A?**

A-36 Gross income of a self-employed individual (for example, a nonemployee director, partner, or independent contractor) derived by the individual from any trade or business is generally subject to tax in accordance with the Self-Employment Contributions Act (SECA) when includible in gross income. See §§ 1401, 1402(a). Accordingly, an amount derived from an individual's trade or business that is includible in the self-employed individual's gross income under § 409A is generally subject to the application of SECA taxes at the time such amount is includible in gross income.

**Q-37 Does § 885 of the Act affect the imposition of the employee tax and the employer tax under the Federal Insurance Contributions Act (FICA) with respect to wages paid and received for employment under a nonqualified deferred compensation plan within the meaning of § 409A(d)?**

A-37 No. Section 885 of the Act does not affect the imposition of the employee tax and the employer tax under FICA with respect to wages paid and received for employment under a nonqualified deferred compensation plan within the meaning of § 409A(d). Thus, remuneration for employment constituting wages within the meaning of § 3121(a) is taken into account for FICA tax purposes in accordance with the rules for wage inclusion under §§ 3121(a) and 3121(v)(2).

**H. Interim Reporting for Expedited Form W-2**

**Q-38 What are an employer's withholding and reporting obligations where an employee is terminated or a business files a final Form 941 prior to the issuance of further guidance providing methods for calculating the amount of deferrals for the year and the amounts includible in gross income under § 409A and in wages under § 3401(a)?**

A-38 An employer is generally required to issue a Form W-2 reporting compensation paid during a calendar year no later than January 31 of the succeeding calendar year. However, if an employee's employment is terminated before the close of the calendar year, an employer must furnish an expedited Form W-2 if requested to do so by the employee. Additionally, an employer may, at its option, furnish a Form W-2 to such an employee at any time after the termination but no later than January 31 of the succeeding calendar year. See § 31.6051-1(d)(i). In addition, if an employer makes a final return on Form 941, the employer must furnish expedited Form W-2s to employees and file expedited Form W-2s with the Social Security Administration. See §§ 31.6051-1(d)(ii), 31.6071(a)-1. If an employer furnishes an expedited Form W-2 before the issuance of additional guidance providing methods for determining the amount of deferrals for the year or the amounts includible in gross income under § 409A and in wages under § 3401(a), the employer need not report an amount

described in Q&A-25 (deferrals for the year) or in Q&A-31 (amounts includible in gross income and wages) on the Form W-2. However, if an employer furnishes an expedited Form W-2 prior to the issuance of additional guidance that requires the employer to report a deferral for the year or an amount includible in gross income and wages, then the employer must subsequently furnish a corrected Form W-2. See § 31.6051(c).

#### **IV. Drafting Information**

The principal author of this notice is Stephen Tackney of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) and, regarding the employment tax and information reporting requirements, Neil D. Shepherd of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the Treasury Department and the Service participated in its development. For further information regarding this notice, contact Stephen Tackney (202) 927-9639; or for further information regarding the employment tax and information reporting requirements, Neil D. Shepherd (202) 622-6040; or regarding the submission of comments, contact Lanita Van Dyke (202) 622-7180 (not toll-free calls).