

Part III – Administrative, Procedural, and Miscellaneous

Transition Relief Regarding the Application of Section 409A(b) to Nonqualified Deferred Compensation Plans

Notice 2006-33

I. PURPOSE

This notice provides transition relief with respect to the application of section 409A(b) of the Internal Revenue Code to nonqualified deferred compensation plans. Pursuant to section 403(hh)(3)(B) of the Gulf Opportunity Zone Act of 2005, P.L. 109-135 (GOZA), this transition relief includes a limited period for certain nonqualified deferred compensation plans that are in violation of the requirements of section 409A(b) to come into compliance with such requirements.

Section 409A(b) generally applies to the use of offshore trusts in connection with amounts payable under a nonqualified deferred compensation plan, and also the use of restrictions on assets to protect the payment of benefits under a nonqualified deferred compensation plan in connection with a change in the service recipient's financial health. The use of such offshore trusts or restrictions on assets in connection with a change in the financial health of the service recipient generally triggers the income inclusion and additional tax provisions of section 409A. This notice addresses the application of certain technical corrections made to these provisions in GOZA, (which was enacted on December 21, 2005), including the requirement that sponsors of certain plans be given a limited period during which the arrangements may be made compliant with section 409A(b).

II. BACKGROUND

A. Section 885 of the American Jobs Creation Act of 2004

1. General Provisions Regarding Nonqualified Deferred Compensation Plans

Section 409A was added to the Code by section 885 of the American Jobs Creation Act of 2004, Public Law 108-357 (118 Stat. 1418). Section 409A(a) generally provides that unless certain requirements are met, amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Section 409A(a) also provides rules under which deferrals of compensation will not result in such immediate and additional tax liability, including rules about the timing of initial elections to defer compensation, payments of deferred compensation, and changes to the time or form of a scheduled payment of previously deferred amounts.

2. Income Inclusion Required if an Offshore Trust is used in Connection with a Nonqualified Deferred Compensation Plan

Section 409A(b)(1) provides that in the case of assets set aside (directly or indirectly) in a trust (or other arrangement determined by the Secretary) for purposes of paying deferred compensation under a nonqualified deferred compensation plan, for purposes of section 83 such assets shall be treated as property transferred in connection with the performance of services whether or not such assets are available to satisfy claims of general creditors – (A) at the time set aside if such assets (or such trust or other arrangement) are located outside of the United States, or (B) at the time transferred if such assets (or such trust or other arrangement) are subsequently transferred outside of the United States. Section 409A(b)(1) provides further that these provisions do not apply to assets located in a foreign jurisdiction if substantially all of the services to which the nonqualified deferred compensation relates are performed in such jurisdiction.

3. Income Inclusion Required if Assets Become Restricted Upon a Change in the Employer's Financial Health

Section 409A(b)(2) provides that in the case of compensation deferred under a nonqualified deferred compensation plan, there is a transfer of property within the meaning of section 83 with respect to such compensation as of the earlier of – (A) the date on which the plan first provides that assets will become restricted to the provision of benefits under the plan in connection with a change in the employer's financial health, or (B) the date on which assets are so restricted, whether or not such assets are available to satisfy claims of general creditors.

4. Additional Tax Imposed on Amounts Includible under Sections 409A(b)(1) and 409A(b)(2)

Section 409A(b)(4) provides that in the event amounts are required to be included in income under section 409A(b)(1) (due to use of an offshore trust or similar arrangement) or section 409A(b)(2) (due to a restriction on assets in connection with a change in the financial health of the service recipient), the tax imposed on such inclusion is increased by the sum of the amount equal to 20% of the amount required to be included in income, plus an interest charge based on the underpayment interest rate plus 1% determined on the underpayments of tax that would have occurred if the affected deferred amounts had been includible in income for the taxable year when first deferred.

5. Effective Date of Section 409A

Section 885(d) of the American Jobs Creation Act of 2004 (AJCA) provides that section 409A of the Code generally applies to amounts deferred after December 31, 2004. Section 885(d) further provides that section 409A applies to earnings on deferred compensation only to the extent that section 409A would apply to the deferred compensation. Section 885(d) also provides, however, that amounts deferred in taxable years beginning before January 1, 2005 are treated as amounts deferred in a taxable year beginning on or after such date if the plan under which the deferral is made is materially modified after October 3, 2004, except as permitted under transition guidance.

Many taxpayers interpreted the provisions of section 885(d) of the AJCA, in combination with section 409A(b) of the Code, to mean that the restrictions of section 409A(b) applied only with respect to deferred compensation subject to section 409A(a), and that the section 409A(b) restrictions did not apply with respect to amounts of deferred compensation that were not subject to section 409A(a).

B. Section 403(hh) of the Gulf Opportunity Zone Act of 2005 – Clarification of the Effective Date of Section 409A(b)

Section 403(hh)(3)(A) of the Gulf Opportunity Zone Act of 2005 (GOZA) provides that notwithstanding section 885(d)(1) of the AJCA, section 409A(b) shall take effect on January 1, 2005. As stated in the legislative history, this provision is intended to clarify that the effective date of the provisions relating to offshore trusts and financial health triggers is January 1, 2005, including amounts set aside or restricted with respect to deferrals of compensation that were earned and vested on or before December 31, 2004. Thus, for example, amounts set aside in an offshore trust before January 1, 2005 for the purpose of paying deferred compensation and plans providing, before January 1, 2005, for the restriction of assets in connection with a change in the employer's financial health are subject to section 409A(b) on and after January 1, 2005. See Staff of the Joint Committee on Taxation, 109th Cong., Technical Explanations of the

Revenue Provisions of H.R. 4440, The "Gulf Opportunity Zone Act of 2005" as Passed by the House of Representatives and the Senate (Dec. 16, 2005), at 89.

Section 403(hh)(3)(B) of GOZA provides that not later than 90 days after the date of the enactment of GOZA, the Secretary of the Treasury shall issue guidance under which a nonqualified deferred compensation plan which is in violation of the requirements of section 409A(b) shall be treated as not having violated such requirements if such plan comes into conformance with such requirements during such limited period as the Secretary may specify in such guidance. This notice is intended to provide such guidance.

III. APPLICATION OF SECTION 409A(b)

A. Transition Relief; Limited Period to Come Into Compliance

The Treasury Department and the IRS intend to issue further guidance regarding the application of section 409A(b). Until further guidance is issued, taxpayers may rely upon a reasonable, good faith interpretation of section 409A(b) to determine whether the use of a trust or other arrangement causes an amount to be included in income under section 409A(b). Notwithstanding the foregoing, with respect to assets set aside, transferred or restricted on or before March 21, 2006 so as to be subject to inclusion under sections 409A(b)(1) or 409A(b)(2) (hereinafter "grace period assets"), taxpayers shall be treated as not having triggered the inclusion or additional tax provisions of section 409A(b) if the nonqualified deferred compensation plan comes into conformity on or before December 31, 2007, with the requirements of section 409A(b) and any guidance issued before such date.

For this purpose, grace period assets include actual earnings on such assets (or trust or other arrangement), including actual earnings credited on such assets after March 21, 2006. However, grace period assets do not include assets located outside of the United States as of March 21, 2006 that have not been set aside, transferred or restricted as of March 21, 2006. Accordingly, any subsequent setting aside, transfer or restriction of such assets is not eligible for the transition relief. In addition, grace period assets located in the United States on or after March 21, 2006 that are subsequently transferred outside of the United States, and grace period assets that are subjected, after March 21, 2006 to a new restriction triggered in connection with a change in the financial health of the service recipient, will no longer be treated as grace period assets effective as of the date of the transfer or the addition of such restriction, as applicable. For example, grace period assets that were located outside of the United States as of December 31, 2004, and that were subsequently transferred to the United States and were within the United States as of March 21, 2006, will no longer be considered grace period assets if the assets are subsequently transferred outside of the United States.

For purposes of the transitional relief, with respect to grace period assets used to make any payment of nonqualified deferred compensation on or before December 31, 2007, including the payment of such compensation upon the termination of a nonqualified deferred compensation plan, such that any payment is included in income on or before December 31, 2007, a plan will be treated as having complied with section 409A(b) during periods before the payment. For this purpose, if an amount is paid from a trust or other arrangement, where some of the assets of the trust or other arrangement are grace period assets described above and some are not, the payment shall be treated as made first from grace period assets.

In addition, if as of a date on or before December 31, 2007, grace period assets are no longer associated with the payment of nonqualified deferred compensation, either under the terms of the plan or through the dissolution of a trust or desegregation of assets, the plan will be treated as having complied with section 409A(b) with respect to those assets through the date such action is taken.

B. Definition of a Nonqualified Deferred Compensation Plan Subject to Section 409A(b)

The same definitions of a nonqualified deferred compensation plan and of deferred compensation are applicable for purposes of applying section 409A(a) and section 409A(b), except that the effective date provisions in section 885(d) of the AJCA that operate to grandfather certain nonqualified deferred compensation arrangements for purposes of section 409A(a) are not applicable for purposes of section 409A(b). Accordingly, until further guidance is issued defining a nonqualified deferred compensation plan, the definition of a nonqualified deferred compensation plan provided in Notice 2005-1, Q&A-3 is applicable for purposes of the application of section 409A(b). In addition, until further guidance is issued defining a nonqualified deferred compensation plan, taxpayers may rely upon the definition of a nonqualified deferred compensation plan provided in the proposed regulations § 1.409A-1(a). See 49 FR 57930 (Oct. 4, 2005).

IV. APPLICATION OF OTHER CODE PROVISIONS AND TAX DOCTRINES

This notice is intended solely to address the requirements under section 409A(b), and nothing in this notice should be construed to affect the requirements of, or any potential liability under, section 409A(a).

In addition, section 409A(c) provides that nothing in section 409A shall be construed to prevent the inclusion of amounts in gross income under any other provisions of this chapter or any other rule of law earlier than the time provided in section 409A. Accordingly, a participant in a nonqualified deferred compensation plan may be required to include amounts in income due to the application to the plan (or to any trust or assets associated with the plan) of section 83, section

451, the economic benefit doctrine, or other applicable law even though the plan (and any associated trust or assets) complies with this notice or section 409A(b).

V. REQUEST FOR COMMENTS

The Treasury Department and the IRS request comments as to the application of this notice, as well as all aspects of the application of section 409A(b). Because section 409A(b) only applies to the use of a trust, restriction or other arrangement determined by the Secretary in connection with a deferred compensation plan as defined for purposes of section 409A, commentators should consider the impact of any guidance with respect to the definition of a deferred compensation plan for purposes of section 409A, including Notice 2005-1 (2005-2 I.R.B. 274), and any proposed or final regulations issued under section 409A.

Comments may be submitted through June 21, 2006 to Internal Revenue Service, CC:PA:LPD:RU (Notice 2006-33), 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 2006-33), Room 5203. Submissions may also be sent electronically via the internet to the following email address: Notice.comments@irs.counsel.treas.gov. Include the notice number (Notice 2006-33) in the subject line.

VI. 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). However, other personnel from the Treasury Department and the IRS participated in its development. For further information regarding this notice, contact Stephen Tackney at (202) 927-9639 (not a toll-free call), or for further information regarding the submission of comments, contact Richard Hurst at Richard.A.Hurst@irs.counsel.treas.gov.